RETAIL COSTS AND MARGINS

Cover note for the report on retail costs and margins prepared by NERA '***New South Wales Energy Retail Costs: A report for the Independent Pricing and Regulatory Tribunal***'

Prepared by members of the IPART Secretariat

Background on the NERA paper

The Tribunal intends to use the NERA paper to inform its decision on the appropriate retail costs and margins for standard retailers of electricity and gas in NSW and to invite discussion amongst roundtable participants on the topic.

The Tribunal has previously incorporated retail costs into regulated tariffs based on benchmark costs for both electricity and gas retailers, including an allowance for costs associated with retail contestability. The Tribunal aims to ensure that retail operating cost benchmarks represent efficient retail operating costs to provide appropriate incentives for retailers to operate efficiently.

The Tribunal believes that the approach of determining a benchmark range determined with reference to the retailers' actual costs over the period will allow the Tribunal to include an appropriate retail cost and margin associated with serving electricity and gas customers on regulated retail prices.

Issues for discussion at roundtable – 4 March 2004

Is the methodology used by NERA appropriate for determining benchmark retail operating costs and margins? If not, is there a more suitable way of obtaining a benchmark range?

Has the methodology been applied appropriately? If not, what specific problems with NERA's approach can be identified?

Is the range recommended in the NERA report reasonable?

NEW SOUTH WALES ENERGY RETAIL COSTS

A Report for the Independent Pricing and Regulatory Tribunal

Prepared by NERA

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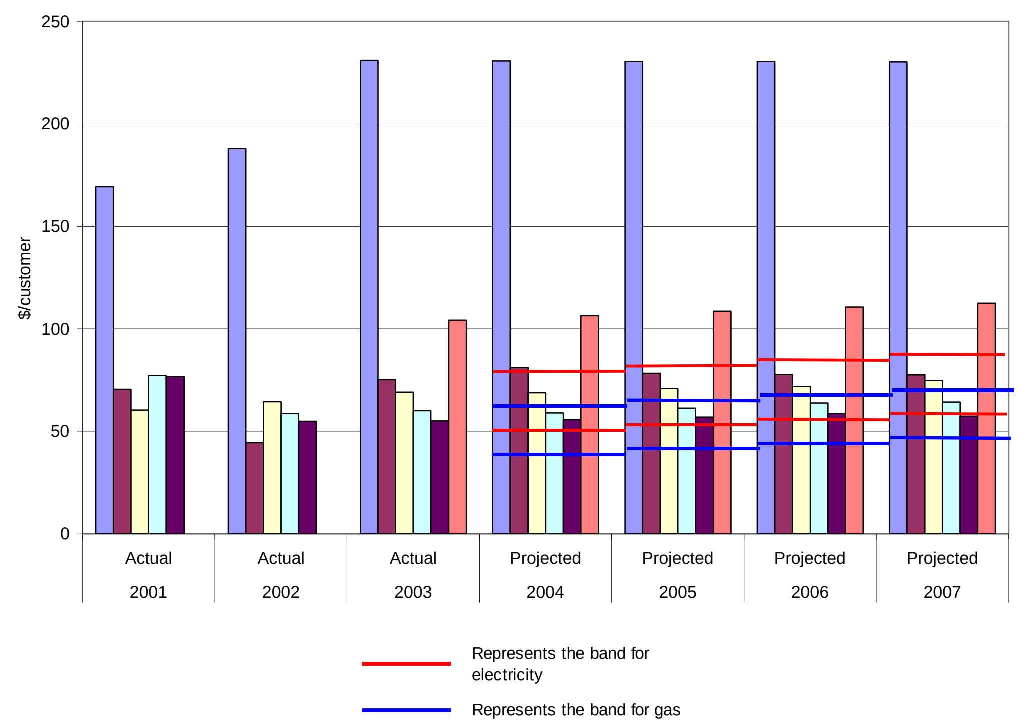
EXECUTIVE SUMMARY

The Independent Pricing and Regulatory Tribunal of New South Wales (the Tribunal) has commissioned NERA to provide advice on the appropriate allowance for retail costs and net profit margins to be included in gas and electricity retail tariffs for the regulatory period July 2004 to June 2007.

This report recommends that:

- the per-annum, per-customer retail operating cost allowance for electricity retailers have a lower bound of $50 and an upper bound of $80 – these figures are in June 2004 dollars and would compare with the previous (inflation adjusted) range of $47 to $79;
- the per-annum, per-customer retail operating cost allowance for gas retailers have a lower bound of $45 and an upper bound of $65 – these figures are in June 2004 dollars and would compare with the previous (inflation adjusted range of $43 to $65; and
- the margin for electricity retailers remains at 1.5 to 2.5 per cent and that for gas retailers remains at 2 to 3 per cent, reflecting the fact that risks have changed very little since the time of the Tribunal's last review of appropriate margins.

Chart 1:
Comparison of Recommended Band and Reported Costs Per-customer (nominal)



These recommendations are based on a review of the information provided by the retailers, decisions by regulators in other jurisdictions and an assessment of the environment within which retailers operate. The recommended range will allow most retailers to fully recover reported retail costs associated with serving customers on default tariffs and are in line with decisions made by regulators in other jurisdictions.

We have not audited the information provided by retailers and cannot comment on the accuracy or appropriateness of retailers' submissions. In addition to the information contained in the information requests it would have been useful to have further information from retailers regarding:

- the methodology by which the companies allocate costs between retail and other components of their businesses;
- the methodology by which the companies allocate costs between default and competitive customers; and
- the rationale for the significant fluctuations in projected costs between years and since the 2002 midterm review.

1. INTRODUCTION

All gas and electricity customers in NSW now have the option of negotiating the arrangements for their energy supply. Small customers (consuming less than 160 MWh of electricity or 1 TJ of gas per-annum) who choose not to enter negotiated contracts are supplied by designated retailers under "default" tariffs. These default tariffs are regulated by the Tribunal. The designated retailers are EnergyAustralia, Integral Energy, Country Energy and Australian Inland for electricity, and AGL Retail (AGLRE), Country Energy, Origin Energy and ActewAGL for gas.

The current default tariffs are due to expire on 30 June 2004. The Minister for Energy and Utilities has indicated that the default tariffs will continue to be regulated and has asked the Tribunal to determine a new set of tariffs to apply from 1 July 2004 to 30 June 2007.

The default tariffs are to include an appropriate allowance for retail costs as well as a net profit margin. The retail cost component of the default tariff is intended to compensate retailers for:

- customer service costs such as call centre operation and customer relations;
- billing and revenue collection costs;
- finance costs, such as credit card fees, EFTPOS fees, bank charges and costs associated with bad debts;
- marketing and advertising costs;
- IT systems;
- costs associated with full retail competition;
- depreciation; and
- regulatory compliance.

The net profit margin is intended to compensate retailers for capital investments and the risks they assume in order to provide retail services.

The Tribunal has commissioned NERA to provide advice on the appropriate retail costs and net retail margins for the July 2004 to June 2007 period. This report discusses our analysis and summarises our conclusions. We have based our advice on:

- actual and forecast retail costs as submitted by the gas and electricity companies, as discussed in section 2;
- retail cost allowances in other (comparable) jurisdictions, also discussed in section 2; and

- consideration of the appropriate net retail margin that will compensate for risks and investment, discussed in section 3.

2. OPERATING COSTS

2.1. Retailers' Operating Cost Projections

2.1.1. Submitted information

All retailers were requested to submit cost information to the Tribunal to provide an indication of the current level of operating costs and projections of expected costs up to the end of the regulatory period. Retailers were sent information requests in early November and asked to respond by 1 December 2003. Each retailer was asked to provide actual and forecast figures for 2001 to 2007 regarding:

- the number of customers on regulated retail tariffs;
- churn rates;
- energy sales by tariff and customer category;
- operating and depreciation expenses;
- estimates of the fixed and variable proportions of operating and maintenance expenses; and
- sales revenue arising from regulated retail customers.

The requested information was received from Australian Inland Energy, Integral Energy,[1] EnergyAustralia, Country Energy and Origin Energy. AGLRE and ActewAGL did not provide this information, although they did submit responses to the Issues Paper.[2] AGLRE currently supplies the majority of small customers in NSW and without its cost information we have necessarily had to rely on the information provided by electricity retailers and decisions in other jurisdictions as benchmarks for an appropriate retail allowance for NSW gas retailers. The implications of this are discussed further in section 2.1.6.

We have not audited the information provided by the retailers, as this would be beyond the scope of this project, and the nature of the information allows only limited investigation into the reasonableness of the projected costs. That said, in arriving at our recommended range, the information provided by retailers has been benchmarked against decisions in other jurisdictions and the Tribunal's earlier decisions, providing some comfort that this range would not unreasonably over or under compensate retailers.

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1 Integral provided 3 scenarios: CPI, CPI + 2% and CPI + 5%. We have used the CPI scenario in our calculations.

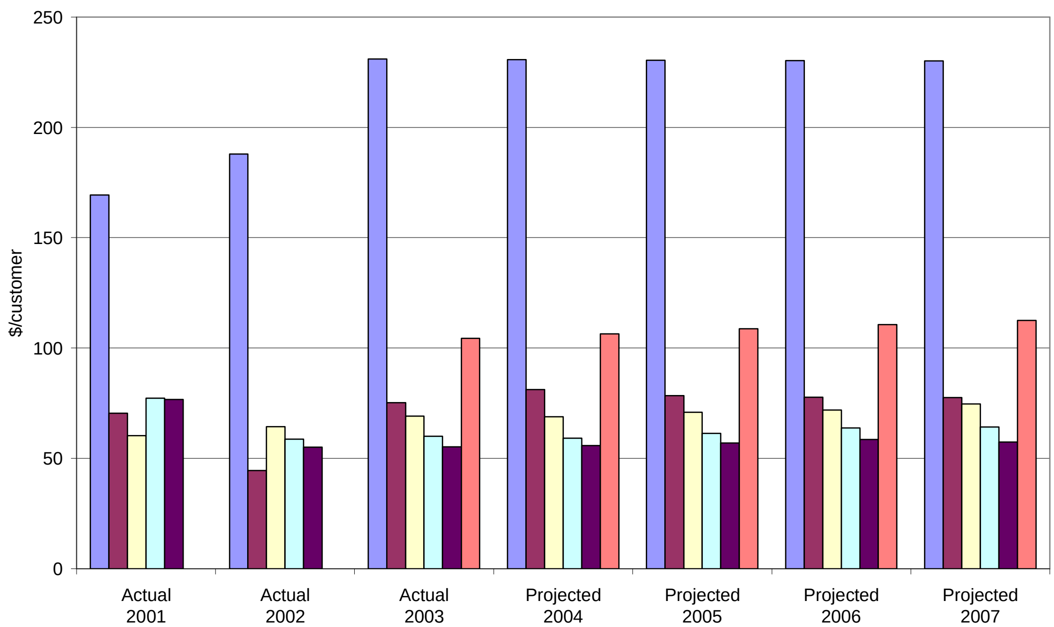
2 IPART, ***Review of Gas and Electricity Regulated Retail Tariffs: Issues Paper***, October 2003

2.1.2. Analysis of Reported Costs

2.1.2.1. Averages and Relativities Between Retailers

The information provided by the participating retailers suggests an average per-annum per-customer cost of $100 in 2004, increasing to $103 by 2007 and an average cost over the period of $102. However, for the reasons set out below, we do not believe this average would be an appropriate basis for the cost allowance.

Chart 2:
Reported Retail Costs per-Customer (years ended 30 June)



As this graph demonstrates, although the costs per customer for most retailers are very similar, there are some significant outliers. Although the average cost per-customer per-annum for all retailers over the 2004 to 2007 period is $102, the average excluding the costs of the two outlying companies is $67. Because of the large difference in costs, and the reasons discussed below, rather than setting a band that would allow all retailers to recover all projected costs, we have suggested a band that would allow most retailers in most years to cover their costs, with a midpoint approximately given by the average of costs excluding the outlying retailers.

2.1.2.2. Movement in Costs Over Time

As the above chart demonstrates, the retailers have reported significant fluctuations in experienced operating costs between years. There is insufficient explanation contained within the information requests to understand why costs have fluctuated to this extent and what the implications may be for costs moving forward. We note that the forecast costs for 2004 to 2007 for most retailers are anticipated to be relatively stable and appear to be broadly based on expected costs for 2003. However, if 2003 was an "abnormal" year, such a forecasting basis may have resulted in unnecessarily high cost predictions.

There is also a risk that the past fluctuations may be due to changes in accounting practices, such as the cost allocation methodologies that are used. To the extent that an element of arbitrariness is introduced by the cost allocation methodologies, there is a risk that retailers' projections may be towards the higher end of a reasonable range. Retailers will naturally have an incentive to recover as high a proportion of their costs as possible via default tariffs. This may be reflected through the cost allocation methodology for allocating costs between either the retailing and other parts of the business or between default and competitive customers.

To confirm that the cost allocation methodologies are reasonable, it would be useful to compare total retail costs to the companies' total NSW electricity related costs over time to determine whether there are substantial changes in this ratio that cannot be explained by business conditions. We have been unable to find suitable information for such a comparison because, for most of the companies, the NSW retail business is a very small component of the total operations reported in their annual financial statements.

It would also have been useful to compare the costs per default customer with the costs per-customer on competitive contracts. At this point, we have not been able to source a consistent set of customer numbers to allow us to undertake such analysis. However, if such information became available, significant discrepancies between the two cost allocations, which could not be explained as a result of different consumption patterns, may indicate that retailers have been allocating more costs to default customers than would be considered reasonable.

It may also be beneficial to assess retailers' allocation methodologies directly. Retailers provided the following explanations in their submissions:[3]

> ***Costs have been allocated to regulated retail using an activity based costing methodology with customer numbers being the main cost driver.***
>
> ***Retail costs have been allocated to regulated customers based primarily on two cost drivers, revenue and customer numbers.***

However, it would be useful to obtain further information about these methodologies. Significant discrepancies between cost allocation methods, or methods that resulted in a disproportionately high ratio of costs being allocated to default customers, would raise immediate concerns.

3 Comments provided by retailers accompanying responses to the data request

2.1.2.3. Comparison with Costs Reported in 2002

For electricity retailers, the projected costs during the mid-term review for 2004 averaged $50.55 million (excluding one retailer, which did not provide projected costs). In comparison, the projected costs for 2004 given by retailers during the current review average $41.28 million, a reduction of 18 per cent.

However, one retailer has reported substantial increases in its revised estimates, including updated previous "actual" numbers. A possible explanation for this is a change in accounting practices or allocation methodology. In contrast, two retailers are anticipating a reduction in costs compared to previously anticipated levels. It would be useful to better understand why these revisions have occurred and whether they should indicate an industry-wide trend of declining costs.

Taken as a whole, the information provided does not argue for a significant increase in the retail band compared with that provided under current arrangements.

2.1.2.4. Breakdown of Costs into Categories

In considering whether the cost estimates submitted by retailers are reasonable, it would have been useful to compare the proportion of costs each company spent within each major cost category. If a retailer incurs significantly higher costs in a particular category compared to its counterparts, this may indicate an opportunity for efficiency gains.

Unfortunately, we have not been able to undertake such analysis in a meaningful way, as retailers do not appear to have used consistent allocation methodologies. For instance, while one retailer has included salaries and wages in a separate, "other" category. Other retailers have presumably included these costs in other categories, such as "call centre operations".

It is unlikely there would be much to gain from asking retailers to revise these breakdowns using consistent methodologies. It may even be the case that their underlying accounting systems would prevent such reconsideration, at least within a reasonable period of time. However, it would be useful to gain a better understanding of the allocation methodologies used by retailers to better assess:

- the rationale and reasonableness of the ratio of costs within each category allocated to default customers;
- why the breakdown of costs provided by the retailers during the current review bear little resemblance to those provided during the mid-term review in some cases; and
- why there appear to be no consistent trends regarding the cost breakdowns over the coming regulatory period. For instance, while some retailers are anticipating significant increases in finance costs compared to earlier years, other retailers are expecting these to remain constant. Similarly, call centre operations and customer

communications/relations costs are expected to increase for two electricity retailers but decline for the remaining two.

Comparison of the cost categories provided by the gas retailers show similar discrepancies between the proportions of costs made up by the various categories.

2.1.3. Incorporating Company-Specific Information

In their submissions, retailers raised two main types of company-specific distinctions that may affect per-customer costs. These relate to scale economies and differences in the nature of the customer base in terms of its dispersion and consumption levels. In short, we do not believe there is sufficient evidence to suggest that these factors should be taken into account in setting the band. This is discussed in further detail below.

2.1.3.1. Economies of scale

Australian Inland suggested that the level of operating costs incurred by a retailer is dependent on the operating environment, and argued that it has "limited ability to improve retail business efficiency because of the characteristics of its operating environment".[4] Specifically, Australia Inland argued that its small customer base spread over a large area of western NSW necessitates higher operating costs per-customer compared to other retailers. We note that the Tribunal has previously been disinclined to include an allowance for economies of scale, arguing that costs should be recovered with reference to an industry rate for all standard suppliers. In its initial determination for electricity the Tribunal argued that in an efficient market costs would converge to an 'efficient' level. The Tribunal also pointed out that the information supplied by electricity retailers indicated a similar cost per-customer was incurred by each retailer (other than Australian Inland) suggesting there was no need to differentiate between retailers on the basis of economies of scale. The Tribunal reaffirmed this position in the mid-term review, stating that costs remained similar on a per-customer basis for all but Australian Inland and therefore it would not make an allowance for economies of scale.

In a competitive market environment, small retailers would be unlikely to be able to charge contestable customers a premium on the basis of a lack of scale unless such lack of scale is unavoidable for all companies serving the market. Companies with costs substantially in excess of their competitors would subsequently earn lower, or potentially negative, profits. This may eventually result in them exiting the market or being absorbed by other retailing companies.

4 Australian Inland, ***Submission to the Independent Pricing and Regulatory Tribunal – Review of Regulated Retail Tariffs***, 1 December 2003, p.16

2.1.3.2. The nature of the customer base

We could find no strong evidence that the nature of the customer base impacts retailing costs. For example, although Australian Inland has argued that the rural nature of its customer base increases its costs due to “the costs associated with serving a small number of customers across a large portion of the state”[5], we note that Country Energy also supports a dispersed customer base but is predicting lower retail costs per-customer than its urban counterparts.

We also note that EnergyAustralia claims that its costs differ “substantially” between different types of customers, namely business versus residential. However, Australian Inland, Integral Energy and AGLRE suggest that the retail cost to serve a customer is generally the same across categories and consumption levels.

The large proportion of fixed costs associated with providing retail services and the type of services provided suggest costs are likely to be comparable between different customer groups. Processing bills and providing customer services, for example, are likely to be the same, or very similar, regardless of the size or location of the customer.

2.1.4. Full Retail Competition Costs

No retailer expressed concern at the level of recoverable FRC costs and Country Energy noted, “Based on the Tribunal’s determination on prudent FRC costs, this amount is an appropriate level and should continue”.[6] FRC costs will continue to be included in the recoverable retail costs to the extent they were reflected in the cost estimates provided by retailers. These costs may be reflected, for example, in the computer and billing categories or within the depreciation expenses. Two retailers specified them separately.

2.1.5. Costs Changes as a Result of Competition

Retailers have also expressed concern that per-customer costs may rise as full retail competition develops. Although they note that retail operating costs are generally related to the number of customers and the size of load served by the retailer, they have argued that there are a significant proportion of costs that would be unchanged as a result of changes in customer numbers. This has raised concerns that the level of operating costs per-customer will necessarily increase as customers are drawn to competitive contracts, leaving the same level of costs to be spread over fewer customers.

This will only be relevant if customers move to competitive contracts with retailers other than their default retailer. Country Energy stated in their annual report that they have had a

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[5] Australian Inland, ***Submission to the Independent Pricing and Regulatory Tribunal – Review of Regulated Retail Tariffs***, 1 December 2003, p.16

[6] Country Energy, ***Submission to IPART: Review of Gas and Electricity Regulated Retail Tariffs***, 1 December 2003, p.22

"win to loss ratio of nearly four to one for residential and small business customers",[7] suggesting that this argument may not hold for them. In any case, such cost increases should be reflected in retailers' cost projections and our recommended band allows most retailers to recover such costs.

2.1.6. Are Electricity Retail Costs a Reasonable Proxy for Gas Retail Costs?

We have necessarily had to focus our analysis on electricity costs due to a lack of information provided by gas retailers. There is no question that there are difficulties associated with applying estimated electricity retail costs to the gas sector. For example, in its review of AGLRE's tariffs, the Tribunal noted:[8]

- competition is developing from two different historical bases and therefore the two industries face varying risks from competition;
- regulatory powers differ in the two industries; and
- the operating environments are not identical, although they are converging.

These factors relate to the risks associated with providing retail services in the two industries, which is dealt with in the profit margin. The similarities in the activities undertaken suggest that the actual costs of providing retail services in the gas and electricity sector are likely to be consistent. Given the limited amount of information from the gas retailers, we have therefore used the cost of electricity retailing as a proxy for the cost of gas retailing to some extent. However, we have also been cognisant of the fact that reported costs for one of the gas retailers have fallen considerably since 2001.

We also compared the data provided by Country Energy for its gas and retailing businesses, which indicated gas retailing costs were, if anything, lower than those for electricity retailing.

2.2. Benchmarks

2.2.1. The Value of Benchmarking

Retailers expressed concerns regarding the use of benchmarking. EnergyAustralia and Origin Energy were concerned that their costs were likely to be higher than benchmark

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7 Country Energy Annual Report 2002-2003, p.8

8 IPART, ***Review of the Delivered Price of Natural Gas to Tariff Customers Served from the AGL Gas Network in NSW***, February 2001, p.10

levels.[9] Integral Energy also argued that benchmarking would yield cost estimates that were unreasonably low:[10]

> ***…this approach is inconsistent with the Government's TOR in that it risks focussing on a precise and theoretical ideal cost level that has the potential to suppress competition by setting regulated tariffs that are too low to encourage entry by efficient retailers.***

Origin Energy expressed concern regarding the circuitous nature of benchmarking:[11]

> ***[W]e continue to be concerned with the trend for regulators to assess retail cost benchmarks largely based, it would appear, on cross-referencing with other state regulators rather than recognising a retailer's actual retail costs or referencing to independent studies on retail costs. This circular referencing between regulators becomes a self-perpetuating "answer" to the benchmarking problem.***

While we acknowledge the concerns raised by the retailers, we remain of the view that benchmarking can be useful for assessing whether the allowance in the NSW default tariffs is "reasonable". We accept that benchmark comparisons must be undertaken with caution; the unique characteristics of the NSW retail businesses, their regulatory environment and customer base as well as the types of costs included in the retail margin can all make direct comparisons problematic. However, benchmarking can provide a broad check that the costs reported by retailers are in line with industry norms. If it were the case that the allowed costs in NSW were significantly different from those in other jurisdictions, explanations as to the cause of this would be required. Furthermore, while we recognise that there is a trend in Australia for regulators to base "appropriate" retail ***margins*** on benchmark decisions, retail ***cost*** allowances have generally been based largely on an assessment of the actual costs provided by retailers. Benchmarking is only used as a "reference check" to provide an indication of where NSW retail costs sit in relation to those costs in other jurisdictions.

Benchmarking is particularly useful in this instance, where there may be some questions regarding the information provided by certain retailers and the major gas retailer has not provided information on its costs. Under these circumstances, benchmarking increases the degree of confidence we have that the recommended range is reasonable.

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9 EnergyAustralia, ***Submission to IPART Review of Regulated Retail Tariffs***, 1 December 2003, p.11; Origin Energy, ***Response to Independent Pricing and Regulatory Tribunal Review of Gas Regulated Retail Tariffs Issues Paper***, December 2003, p.12

10 EnergyAustralia, ***Review of Gas and Electricity regulated Retail Tariffs Submission***, 1 December 2003, p.22

11 Origin Energy, ***Response to Independent Pricing and Regulatory Tribunal Review of Gas Regulated Retail Tariffs Issues Paper***, December 2003, p.12

2.2.2. Operating Costs in Other Jurisdictions

The tables on the following pages set out the reported retail costs applicable to energy retailing businesses in a range of jurisdictions and note any key distinctions between the benchmarks.

Table 2: Benchmarking of Electricity Retail Costs ($/Customer)

Jurisdiction	Range Nominal	Range 2004 dollars	Comments
NSW (IPART) 2000[1]	$40 - $60	$45.96 - $68.95	• Includes FRC allowance of $5
NSW (IPART) 2002[2]	$45 - $75	$47.25 - $78.75	• Reflects increased costs for computer processing, billing and revenue collection, updated benchmarks and includes a range of allowances for FRC.
Victoria (ORG[3]) 2001[4]	$50 - $80	$54.06 - $86.50	• Benchmarked on IPART's 2000 decision, with slightly higher costs justified due to Victorian retailers being less likely to benefit from economies of scale • Includes a FRC allowance of $5 - $10
South Australia (SAIIR[5]) 2002[6]	$80	$84	• Retailers' information suggested they were at the upper end of the ORG's range • AGL SA submitted that it was a 'stand-alone' retail business unlike the majority of retailers in NSW and Victoria, resulting in higher costs
South Australia (ESCOSA)[7] 2003	$82	$83.72	• Previous decision was determined to be 'reasonable' and increased by CPI
Tasmania (OTTER) 2003[8]	$76.67	$78.27	• Excludes FRC costs which are to be agreed by the regulator / passed through
ACT (ICRC) 2003[9]	$85	$86.78	• Higher cost recognises diseconomies of scale in the ACT compared to NSW and Vic
UK (Ofgem) 1999[10]	$69.34 - $85.04[11]	$79.68 - $97.71[11]	• Includes metering costs (which were not separately specified)

1. IPART, ***Regulated Retail Prices for Electricity to 2004***, December 2000; ***2.*** IPART, ***Mid-term review of regulated retail prices for electricity to 2004***, June 2002; ***3.*** Office of the Regulator General, now the Essential Services Commission; ***4.*** Office of the Regulator General, ***Special Investigation: Electricity retailers' proposed price increases***, December 2001; ***5.*** South Australian Independent Industry Regulator, now the Essential Services Commission of South Australia; ***6.*** SAIIR, ***Electricity Retail Price Justification: Final Report***, September 2002; ***7.*** ESCOSA, ***2004 Electricity Standing Contract Price: Final Report***, December 2003; ***8.*** OTTER, ***Investigation of Prices for Electricity Distribution Services and Retail Tariffs on Mainland Tasmania: Final Report and Proposed Maximum Prices***, September 2003; ***9.*** ICRC ***Final Determination: Investigation into Retail Prices for Non-Contestable Electricity Customers in the ACT***, May 2003; ***10.*** Ofgem, ***Reviews of Public Electricity Suppliers 1998 to 2000: Supply Price Control Review, Final Proposals***, December 1999; ***11.*** £34.41 - £42.20 Converted to Australian dollars using the PPI index for 1999, obtained from the OECD website.

Table 3: Benchmarking of Gas Retail Operating Costs (s/customer)

Jurisdiction	Range Nominal	Range 2004 dollars	Comments
NSW (IPART) 2001[1] for AGLRE	$40 - $60	$43.25 - $64.88	• Noted difficulty in obtaining estimates of the cost of retailing gas • Substantially drew from electricity retailing cost benchmarks • Includes a $5 FRC allowance
NSW (IPART) 2001[2] for Country Energy	$40 - $60	$43.25 - $64.88	• Based substantially on the review of AGLRE's costs and tariffs
VIC (ESC) 2003[3]	$53 - $85	$54.11 - $86.78	• Costs scaled up by CPI from 2001 previous decision
ACT (ICRC) 2001[4]	$40 - $60	$43.25 - $64.88	• A smaller customer base suggests that operating costs in the ACT are at the higher end of the range determined for NSW
UK (Ofgem) 2000[5]	$41.60, $86.13 or $92.56[6,7]	$47.80, $98.97. or $106.36[6,7]	• Includes metering costs which were not separately costed and cannot be removed

1. IPART, ***Final Report: Review of the Delivered Price of Natural Gas to Tariff Customers served from the AGL Gas Network in NSW***, February 2001; ***2.*** IPART, ***Final Report***: ***Review of the Delivered Price of Natural Gas to Low-Usage Customers Served by Country Energy***, December 2001; ***3.*** ESC, ***Final Report: Special Investigation: Proposed Retail Tariff Amendments***, December 2003; ***4.*** ICRC, ***Final Determination: Review of natural gas prices***, May 2001; ***5.*** Ofgem, ***Review of British Gas Trading's Price Regulation: Final Proposals***, February 2000; ***6.*** Operating cost depends on the type of tariff, ie, PromptPay, Standard or PrePayment respectively; ***7.*** £20.12, £41.66 or £44.77 converted to Australian dollars using the PPI for 2000, obtained from the OECD website

These benchmark costs for electricity retailing also appear broadly in line with retail costs in the telecommunications industry. In its latest ***Determination*** on the price terms and conditions for telecommunications services, the ACCC outlined the lower bound of Telstra's average costs for 2003-2003 in terms of the cost of a local call, the cost of line rental per-annum and the cost of line rental per local call.[12] From this we were able to derive the retail cost per-customer per-annum of $71.[13]

2.3. Conclusions Regarding the Cost of Retail

The information provided by retailers suggests an average per-annum per-customer cost of $100 in 2004, increasing to $103 by 2007. However, the average excluding the costs of 'outlier' retailers with substantively higher costs is $67. Because of the large difference in costs, rather than bands that would allow all retailers to recover all projected costs we have suggested bands that would allow most retailers in most years to cover their costs, with a midpoint approximately given by the average in costs excluding the outlying retailers.

Furthermore, two of the four electricity retailers have revised their projections downwards since the Tribunal's midterm review, and one has retained them around previous levels. This argues against increasing the retail cost allowance.

This leads us to suggest a range of allowable retail costs of $50 to $80 for electricity retailers and $45 to $65 for gas retailers, which would allow most companies to recover their projected costs, but does not fully reflect the high costs incurred by the two outlying companies. This represents a slight increase (in inflation adjusted terms) from the existing upper-band for electricity retailers, and remains the same for gas retailers. Given that two of the four retailers have reduced their cost projections compared to those submitted at the time of the midterm review, we do not believe there are strong arguments for a significant increase in the upper bound.

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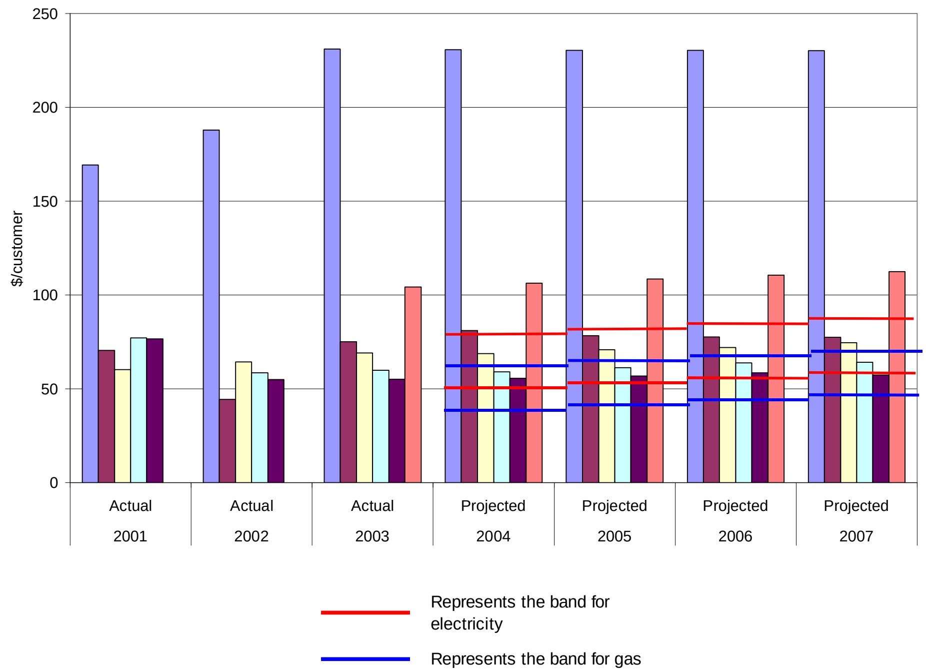
12 Australian Competition and Consumer Commission, ***Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services***, October 2003, p.101

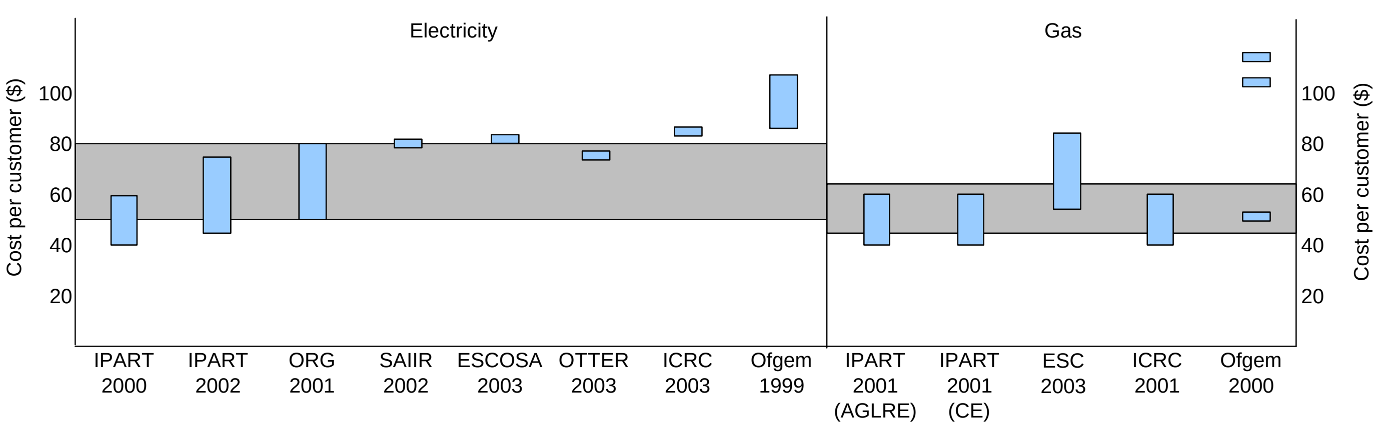
13 From the line rental cost per call we can infer that on average, 1076 local calls are made per-customer each year. Multiplying this by the cost of a local call and adding the cost of line rental gives the annual retail cost per customer.

Chart 4:
Comparison of Recommended Band and Reported Costs Per-customer (nominal)



The following graph depicts this range against quoted benchmarks provided above. This provides further support for the recommended range, as the benchmarking suggests allowances for electricity retailers should increase slightly. Although the recommended upper bound is slightly less than those in Victoria and South Australia (in inflation adjusted terms), this is partly justified by the fact that the Victorian regulator has chosen to allow for economies of scale. The recommended range is at the lower end of the range for gas, although it is consistent with the decision in the ACT.

Chart 5:
Comparison of Recommended Band With Benchmarks



Our analysis has also raised a number of issues regarding the credibility and comparability of the information submitted by retailers, which we have not been able to verify:

- the methodologies used to allocate costs between retail and other parts of retailers' businesses;
- the methodologies retailers use to allocate costs between default and competitive small customers;
- the methodologies used to allocate costs between cost categories;
- the discrepancies between the estimates and forecasts provided at the time of the midterm review and those provided for the purposes of this review; and
- the fluctuations in costs experienced from year to year.

3. THE NET RETAIL MARGIN

3.1. Overview

The net retail margin compensates retailers for capital investments and the risks they assume, such as those associated with power trading, competition from substitutes and customer default.

Arriving at an appropriate margin allowance is not an exact science. There are no rules of thumb for determining the implications of various risk factors or the "right" margin. Indeed the appropriate margin will depend as much on the regulator's view of an appropriate return, including whether it should incorporate "headroom", as it will on the types of risks the retailers face. Reflecting the inexact nature of margin setting, regulators in various jurisdictions have largely tended to rely on the decisions from other jurisdictions, adjusting for the factors unique to the companies they regulate.

We have taken a similar approach in this report, using the Tribunal's previous decisions as a starting point, then considering the evolution of the market and the outcomes from other jurisdictions to determine whether there are arguments for adjusting this margin. In sum, we do not believe there have been substantial changes in the risks assumed by NSW retailers and therefore do not believe there are strong arguments for altering these margins at this point.

3.2. Current Margins

3.2.1. Electricity

In its first determination on regulated retail tariffs in December 2000,[14] the Tribunal concluded that a net profit margin of 1.5 to 2.5 per cent of sales would be appropriate for electricity retailers. This assessment was based on information on net profit margins in other jurisdictions, which was compiled during the 1999 determination on franchise businesses,[15] and an analysis of the level of risk faced by standard retail suppliers. Notably, the Tribunal decided not to incorporate 'headroom' into the profit margin for electricity retailers, arguing that it was inappropriate in terms of equity and efficiency to attempt to encourage competition by artificially inflating regulated tariffs.

At the time of the mid-term review,[16] the Tribunal acknowledged the higher allowances for retail margins provided in other jurisdictions but decided not to increase the retail margin

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[14] IPART, ***Regulated Retail Prices for Electricity to 2004***, December 2000

[15] Franchise businesses were those retailers that were compelled to offer regulated retail tariffs to customers that were not eligible to enter the competitive market.

[16] IPART, ***Mid-term review of regulated retail prices for electricity to 2004***, June 2002

applying to NSW retailers. The Tribunal argued that the ETEF continued to lower the risk faced by NSW retailers and that the low churn rates experienced to date suggested the risks associated with a changing customer base due to competition had remained low. The Tribunal therefore chose to maintain a net profit margin of 1.5 to 2.5 per cent of sales.

3.2.2. The Current Gas Retail Margin

The Tribunal completed a review of the price of natural gas delivered by AGLRE in February 2001.[17] The Tribunal argued that although electricity and gas retailers should earn comparable profit margins, it should not be assumed that they are the same. Specifically, the Tribunal noted that while neither electricity nor gas retailers faced significant energy risks, gas retailers have less revenue per-customer but similar retail costs per-customer. Therefore it was deemed appropriate for AGLRE to earn a slightly higher profit margin of 2 to 3 per cent.

A similar review was completed to determine default tariffs for Country Energy in December 2001. The analysis relied heavily on AGLRE's review. Consequently a similar outcome was reached, with a profit margin of 2 to 3 per cent of sales.

3.3. The Risks Assumed by Retailers

3.3.1. Energy Purchase Risks

Electricity

Electricity retailing is generally considered a low risk activity with the exception of the uncertainty of power trading. In NSW, this risk is reduced through the ETEF scheme, which requires retailers to pay into (or draw out of) the fund any deviation between pool prices and the estimated long run marginal cost (LRMC) included in the target tariff.

Integral Energy stated that, in its view, the ETEF scheme does not lower the risk sufficiently to justify a lower retail margin than in other jurisdictions.[18] Specifically Integral Energy argued that there is a 'misconception' that incumbent NSW retailers face reduced risks resulting from the ETEF scheme. Integral Energy noted that it still faces the risk associated with varying consumption profiles and that hedging costs are specifically acknowledged as a cost in other jurisdictions. On these grounds the retailer suggested that the ETEF scheme does not provide any justification for NSW retailers to face a lower net retail margin than provided in other jurisdictions.

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[17] IPART, ***Review of the Delivered Price of Natural Gas to Tariff Customers Served from the AGL Gas Network in NSW***, February 2001

[18] Integral Energy, ***2004 Review of Gas and Electricity Regulated Retail Tariffs Submission to the Independent Pricing and Regulatory Tribunal***, 1 December 2003

We accept that the ETEF scheme does not completely negate all of retailers' energy purchasing risks. The ETEF payments are based on the previous year's consumption profiles for each retailer. Should the consumption pattern of a retailer's customer pool change substantially between years the ETEF payment receipts may not entirely remove any divergence between the LRMC price included in retail tariffs and actual energy purchasing costs. However, we do not believe this residual risk is sufficient to argue that the ETEF scheme does not lower NSW retailers' risks relative to the risks assumed by retailers in other jurisdictions.

We also accept that an allowance for hedging costs is included in the energy costs for retailers in some other jurisdictions. However, it is not our understanding that this allowance would be sufficient for the relevant retailers to offset their risks to the extent implied by the ETEF. For example, in Victoria retailers are allowed the costs associated with a "prudent" hedging strategy, which is likely to involve retaining more risk than retailers face under the ETEF scheme. The ETEF scheme is equivalent to (almost) fully hedging electricity costs, which retailers in other states are unlikely to do because of the high costs involved.

We note that no other retailer has argued that the profit margin should be increased on the basis of risks associated with the purchase of energy. The ESC, in its final decision on an appropriate net retail margin for Victorian electricity retailers, did not argue that the Tribunal's margin of 1.5 to 2.5 per cent was too low, but rather suggested that Victorian retailers would require a higher margin to allow for higher risks that they faced in the absence of an ETEF scheme. This suggests that the ESC considered such issues as the residual risk assumed by NSW retailers and the fact that Victorian retailers are able to hedge.

Gas

Gas retailers typically enter into long-term contracts for the supply of gas. As we understand it, these contracts specify a pre-determined price for the length of the contract, subject to revisions, which provides some stability of energy purchasing costs. In contrast to electricity retailers, whose main risks are associated with variability in the spot market price, the major uncertainties associated with the purchase of gas under such contracts are linked with security of supply, as demonstrated by the recent explosion at the Moomba gas plant.

Currently retailers are unable to pass through any cost increases that may result from such events to customers on regulated retail tariffs. In general, however, the probability of such a disruption is extremely low. Furthermore, similar risks exist for gas retailers in other locations and, as the following section indicates, the margin provided for in NSW is consistent with that in other jurisdictions.

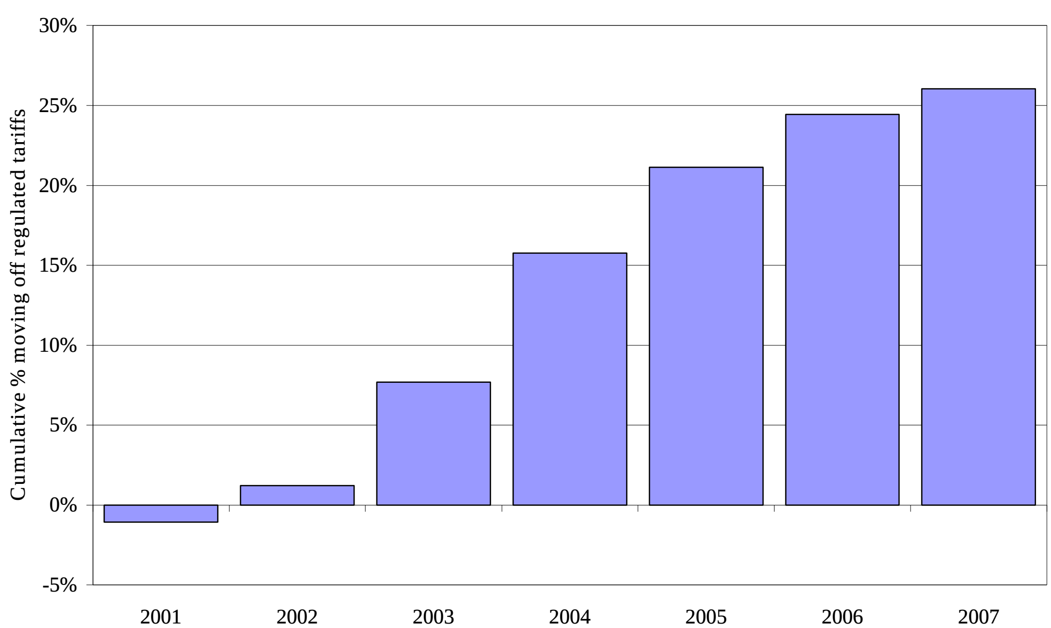
3.3.2. Full Retail Competition Risks

The development of full retail competition may increase the riskiness of the pool of default customers. In general, competitive offers would be expected to initially target more attractive customers, such as those who are more likely to pay their bills on time. Standard retailers therefore risk being left with a smaller regulated customer base comprising of more risky customers.

At the time of the mid-term review, the Tribunal believed it to be too early to judge the impact of FRC on business risk. The Tribunal believed that the current range provided sufficient compensation to retail suppliers for the increased risk they are likely to face as FRC impacts on their customer base in the form of movements towards competitive contracts.

To date there has been relatively low churn rates and the majority of residential and small business consumers have chosen to remain on standard supply contracts. Electricity retailers have indicated that they expect churn rates to increase as competition continues to develop, the ratio of customers on competitive contracts is expected to increase to slightly over 25 per cent by June 2007 (a 10 percentage point increase from current levels). The following graph shows the total, cumulative, net churn rates as a percentage of customer base as reported by electricity retailers. The graph demonstrates that just over a quarter existing electricity default tariff customers are expected to move to competitive contracts by 2007.

Chart 6:
Customer Churn for Electricity



If this increase in churn resulted in an increased risk associated with remaining customers, it may be appropriate to reflect this in a higher margin. However, retailers have not provided any evidence to suggest this might be the case. Given that a number of tariffs are currently over-recovering revenues, this is likely to be a greater determinant of the type of customer switching to competitive contracts than the relative riskiness of those customers.

3.4. Submissions on the Net Retail Margin

Australian Inland stated that the current retail margin of 1.5 to 2.5 per cent is "probably as good as any other figure".[19] Both Integral Energy and EnergyAustralia[20] argue for the inclusion of working capital in the retail margin, however working capital requirements have not changed since the Tribunal's last determination and we see no reason to presume that this issue was not previously accounted for in establishing the margin. Country Energy notes that the current range is at the lower end of the range, and suggests altering it to 2 to 2.5 per cent.[21]

In contrast, Origin Energy and AGLRE argue that the 2 to 3 per cent benchmark for gas retail businesses is insufficient, and a reasonable retail margin would be 5 to 10 per cent[22]. Origin's justification for claiming such an increased margin is that in needs to provide a reasonable return to its shareholders, arguing that the low returns resulting from a 2 to 3 per cent margin would discourage investment in the industry. Origin further claims that a higher margin is required to insure against uncontrollable events such as the weather, which cannot be hedged against at an affordable price in Australia. AGLRE's justification is based on the UK, where at the time of the removal of price controls gas retailers had headroom of between 5 and 6 per cent and headroom for electricity averaged 8 per cent.

Consistent with the Tribunal's previous practice, we have not included an allowance for headroom. If the Tribunal takes the view that headroom is required in order to encourage competition in the retail market, the net retail margin should be increased appropriately.

However, one reason for allowing a higher margin in gas compared to electricity may be to compensate for the lower average revenue per-customer received by gas companies compared to electricity companies. In NSW, the average electricity customer spent $816[23]

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19 Australian Inland, ***Submission to the Independent Pricing and Regulatory Tribunal – Review of Regulated Retail Tariffs***, 1 December 2003, p.15

20 Integral Energy, ***2004 Review of Gas and Electricity Regulated Retail Tariffs Submission to the Independent Pricing and Regulatory Tribunal,*** 1 December 2004, p.32; EnergyAustralia, ***Review of Gas and Electricity regulated Tariffs Submission, 1 December 2003***, p.11

21 Country Energy, ***Submission to IPART: Review of Gas and Electricity Regulated Retail Tariffs***, 1 December 2003, p.20

22 Origin Energy, ***Response to Independent Pricing and Regulatory Tribunal Review of Gas Regulated Retail Tariffs Issues Paper,*** December 2003, p.13; AGL Retail Energy Limited, ***Submission to Independent Pricing and Regulatory Tribunal of NSW Issues Paper: Review of Gas Regulated Retail Tariffs***, 1 December 2003, p.11

23 OTTER, ***Annual Report 2002-2003***, November 2003

whereas the average gas customer spent $487.[24] In comparison, in Victoria the amount spent by gas and electricity customers was much more similar, with $665[25] for gas and $756[26] for electricity. A revenue-based margin therefore provides a lower return to gas retailers than to electricity retailers. The Tribunal explicitly took this into account when it set the margin for gas slightly above that for electricity. We therefore suggest the slightly higher margin for gas retailers be retained.

On balance we do not believe there are strong grounds for increasing the margins for either gas or electricity retailers. We note that two of the four electricity retailers have expressed satisfaction with the current margin. Although gas retailers have not expressed a similar sentiment, we see no strong case for increasing the margin for gas retailers above existing levels, unless the Tribunal wishes to introduce headroom into this margin. Furthermore, as we discuss in the next section, a benchmark of 2 to 3 per cent for gas retailers is in line with margins in other jurisdictions.

3.5. Net Profit Margins in Other Jurisdictions

As discussed in section 3, benchmarking does have its weaknesses but it can provide an indication of how the proposed margins compare with those in other jurisdictions.

The following tables outline the net profit margins established in regulatory decisions in other jurisdictions for electricity and gas retailers respectively, and comment on major differences in the assumed risks:

[24] IPART, ***AGLRE Mid-term Review Final Report***, June 2003

[25] ESC, ***Gas Industry Comparative Performance Report 2002***, July 2003

[26] OTTER, ***Annual Report 2002-2003***, November 2003

Table 4: Benchmarking of Electricity Retail Margins

Jurisdiction	Range (% of sales)	Comments
NSW (IPART) 2000[1]	1.5 – 2.5%	• Used the UK profit margin as a starting point • Noted that the UK and NSW are not directly comparable because retailers operate in different environments with varying levels of risk and varying degrees of competitive pressures
NSW (IPART) 2002[2]	1.5 – 2.5%	• IPART believed no change was warranted from the previous determination
Victoria (ORG) 2001[3]	2.5 – 5%	• A higher margin than NSW is reasonable because of reduced risks from energy trading as a result of ETEF
South Australia (SAIIR) 2002[4]	5%	• Inherent 'riskiness' of the market more similar to Victoria than NSW • The higher end of the range reflects the 'peakiness' of the SA energy market
South Australia (ESCOSA)[5] 2003	5%	• ESCOSA was provided with no reason to alter its position from the previous decision
Tasmania (OTTER) 2003[6]	3%	• The major retailer faces little contestability risk in the next regulatory period; • Some risk associated with inter-fuel competition is justified
ACT (ICRC) 2003[7]	3%	• Not as risky as the SA market, therefore 5% proposed margin was not justified
UK (Ofgem) 1999[8]	1.5%	• Low margin reflects relatively few competitive pressures

1. IPART, ***Regulated Retail Prices for Electricity to 2004***, December 2000; ***2.*** IPART, ***Mid-term review of regulated retail prices for electricity to 2004***, June 2002; ***3.*** Office of the Regulator General, ***Special Investigation: Electricity retailers' proposed price increases***, December 2001; ***4.*** SAIIR, ***Electricity Retail Price Justification: Final Report***, September 2002; ***5.*** ESCOSA, ***2004 Electricity Standing Contract Price: Final Report***, December 2003; ***6.*** OTTER, ***Investigation of Prices for Electricity Distribution Services and Retail Tariffs on Mainland Tasmania: Final Report and Proposed Maximum Prices***, September 2003; ***7.*** ICRC, ***Final Determination: Investigation into Retail Prices for Non-Contestable Electricity Customers in the ACT***, May 2003; ***10.*** Ofgem, ***Reviews of Public Electricity Suppliers 1998 to 2000: Supply Price Control Review, Final Proposals***, December 1999

Table 5: Benchmarking of Gas Retail Margins

Jurisdiction	Range	Comments
NSW (IPART) 2001[1] for AGLRE	2 - 3%	• IPART commented in its draft report (May 2000) that 'sufficient headroom on the retail margin is important if potential competitors are to be encouraged' p.21
NSW (IPART) 2001[2] for Country Energy	2 - 3%	• Based on the decision for AGLRE
Victoria (ESC) 2003[3]	2 – 3%	• The ESC noted the lower risk faced by gas retailers than electricity retailers in Vic due to long-term contracts for the supply of gas • This range is consistent with the ESC's previous decisions and IPART's decision
ACT (ICRC) 2001[4]	3%	• Sufficient headroom is important to encourage competition (p.9)
UK (Ofgem) 2000[5]	1.5%	

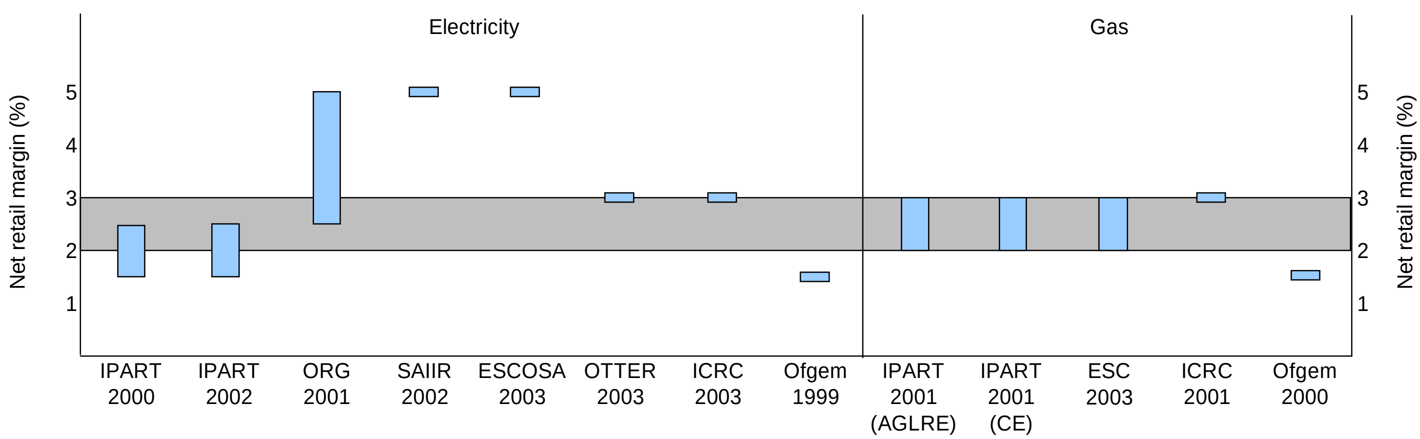
1. IPART, ***Final Report: Review of the Delivered Price of Natural Gas to Tariff Customers Served from the AGL Gas Network in NSW***, February 2001; ***2.*** IPART, ***Final Report***: ***Review of the Delivered Price of Natural Gas to Low-Usage Customers Served by Country Energy***, December 2001; ***3.*** ESC ***Final Report: Special Investigation: Proposed Retail Tariff Amendments***, December 2003; 4**.** ICRC, ***Final Determination: Review of natural gas prices***, May 2001; ***5.*** Ofgem, ***Review of British Gas Trading's Price Regulation: Final Proposals***, February 2000

We note that our recommended range for the retail margin of 1.5 to 2.5 per cent is at the lower end of the range for electricity, with a range of 2.5 to 5 per cent in Victoria and a margin of 5 per cent in South Australia. We believe a lower margin is justified for the NSW retailers because of the impact of the ETEF scheme, as discussed above.

Although there is a lack of available comparisons for gas retailing in Australia, the information that is available suggests the current margin of 2 to 3 per cent for gas is reasonable. In its recent decision for gas retailers in Victoria, the ESC also concluded a range of 2 to 3 per cent was sufficient. There is no reason to suggest that the risks faced by NSW gas retailers are substantially higher than those faced in Victoria. We recognise Origin and AGLRE's arguments for raising the margin to 5 to 10 per cent, however the justifications provided are not strong enough to convince us of the need to increase the margin to this level.

The following diagram illustrates how our recommended range for a net retail margin compares with that in other jurisdictions:

Chart 7:
Benchmarking Comparison



3.6. Should Margins be a Percentage or Fixed Dollar Amount?

In the other jurisdictions we have considered, margins have been provided as a percentage of total revenues. This has been the consistent approach by gas and electricity regulators in Australia, the UK and the US. The Tribunal has asked us to consider whether the margin should be provided as a fixed dollar amount instead, particularly in light of the fact that the bills for gas customers are generally lower than those for electricity customers.

Should a fixed dollar margin be provided, in comparison with the current system, this would imply that households with smaller bills would pay a higher proportion towards retailers' profits. Furthermore, households with both electricity and gas would pay two margins, rather than 3 per cent of their total bill. In addition, any increase in the fixed component of household's bill and offsetting reduction in the variable components would weaken the price signals for demand management.

That said the retail margin is intended to compensate retailers for their risks and any investment that may be required. Ideally, the margin should be structured in accordance with retailers' risks, some of which are likely to vary with the size of revenue while others are likely to vary with respect to the level of total costs. It may therefore be sensible to structure the margin in the form of a mix of a fixed amount and a percentage amount. The existing structure of retail tariffs already does this to a certain extent. The fixed charge effectively provides retailers with a fixed amount of margin. If existing tariffs are structured in a way that is risk (as well as cost) reflective, then the margin allowance is effectively already in an appropriate fixed and variable structure. However, determining the extent to which the existing structure is risk-reflective is unlikely to be a trivial exercise.

4. CONCLUSION

We have undertaken an assessment of the appropriate level of retail costs, including a profit margin, to be included in the default tariffs. In doing so, we have considered:

- the realised and projected retail costs incurred by retailers in serving customers on default tariffs;
- the information contained in retailers' submissions and presentations to the Tribunal; and
- the retail cost allowances that are included in similar tariffs in other jurisdictions.

On the basis of this information, we have suggested:

- the per-annum, per-customer retail operating cost allowance for electricity retailers have a lower bound of $50 and an upper bound of $80 – these figures are in June 2004 dollars and would compare with the previous (inflation adjusted) range of $47 to $79 ;
- the per-annum, per-customer retail operating cost allowance for electricity retailers have a lower bound of $45 and an upper bound of $65 – these figures are in June 2004 dollars and represent no increase from the previous (inflation adjusted) range of $43 to $65; and
- the margin for electricity retailers remains at 1.5 to 2.5 per cent and that for gas retailers remains at 2 to 3 per cent, reflecting the fact that risks have changed very little since the time of the Tribunal's last review of appropriate margins.

However, our analysis of the information submitted by retailers has raised a number of issues regarding its credibility and it would have been useful to have additional information regarding:

- the methodologies used to allocate costs between retail and other parts of retailers' businesses;
- the methodologies used to allocate costs between cost categories;
- the methodologies retailers use to allocate costs between default and competitive small customers;
- the discrepancies between the estimates and forecasts provided at the time of the midterm review and those provided for the purposes of this review; and
- the fluctuations in costs experienced from year to year.