Discussion notes for Retail Review Roundtable on the Form of Regulation

(prepared by IPART Secretariat)

The Minister for Energy and Utilities has requested that the Tribunal review the regulated retail tariffs to apply from July 2004 to June 2007, taking into account the following:

1. regulated retail tariffs and charges should be set at cost-reflective levels for all small customers by 30 June 2007;
2. the setting of any ‘price constraint’ should allow the further rationalisation of regulated retail tariffs and movement to full cost recovery over the determination period with regard to the need for a smooth transition for customers; and
3. alternative ways to facilitate transition to full cost recovery by 2007, or by an appropriate later date, such as the setting of regulated retail tariffs at cost reflective levels for all new connections and new customers.

The form of regulation is a key issue in the regulatory framework for default tariffs in the electricity and gas sectors. The legislative requirements for regulating electricity and gas default tariffs for small retail customers allow the Tribunal some flexibility in the form of regulation that it uses.

The Tribunal considers that the primary objective in setting the form of regulation for both sectors should be to move all regulated tariffs towards cost-reflective levels without exposing customers on under-recovering tariffs to unacceptable price shocks. Whether prices are increasing or decreasing, the Tribunal also needs to consider the impact of these price changes on the regulated businesses.

This view is in line with the Terms of Reference for the electricity determination. It is also in line with the current form of regulation for both electricity and gas, which use target tariffs and price paths respectively to move towards cost reflectivity, and price constraints to prevent price shocks.

Current Arrangements

For electricity, the Tribunal’s current determination establishes a ‘target level’ for tariffs and a transitional process to move them to that level over time. The target tariffs were set using the ‘N+R’ formula. The ‘N’ component represents the network element of the tariffs (the amount retailers are charged by the local distribution network service provider) and ‘R’ represents the retail component, which is derived from the cost of supply and set by the Tribunal. As well as the N+R target the current form of regulation comprises:

- An overall CPI constraint
- Limits on movements in individual tariffs
- Limits on movements in individual bills.

At the roundtable, the Tribunal would like to hear stakeholders’ views on whether, if the current approach is retained, all four constraints are really needed or whether some could be dispensed with.

For gas, the current Voluntary Pricing Principles (VPPs) set price paths for final retail prices. These price paths are often expressed in terms of the movement of individual tariffs in relation to the CPI over time, rather than as a particular dollar amount for each period.

Although not explicit in the Tribunal's regulatory approach for gas, in agreeing to the final retail prices in each of the VPPs, the Tribunal has considered the costs of providing the service under each tariff (including field price of gas, network charges and retail costs).

As discussed above, for both electricity and gas, the Tribunal has set a path (or process for transition) to move individual tariffs towards cost reflective levels over time. To reduce price shocks to customers, the Tribunal has set price constraints that limit the tariff increases that regulated retailers can impose on customers supplied under standard form contracts.

Why change from the current form?

In considering whether it is desirable to change the form of regulation of retail tariffs, a starting point is to determine whether the current form of regulation is inappropriate or does not strike an appropriate balance of the various regulatory objectives.

At the roundtable the Tribunal would like to hear stakeholders' views on why they consider that the current form of regulation is inappropriate.

The Tribunal has identified the following objectives for considering the form of regulation:

- to ensure that, should competition not be sufficiently effective, standard retailers do not extract monopoly profits from retail customers;
- to prevent excessive price shocks to retail customers;
- to allow retailers to cover their (efficient) costs;
- to promote efficient and effective competition by establishing default tariffs that at least recover the (efficient) costs associated with serving customers both collectively and individually; and
- to minimise compliance and administrative costs.

Alternative forms of regulation

Various approaches to the form of regulation were put forward for the Tribunal's consideration by the various stakeholders in their submissions to the review. The submissions contain proposals ranging from variations of the existing N+R approach to setting prices at cost reflective levels in 2004/05 followed by a path of CPI-X increases for the remainder of the regulatory period.

There were common themes among many of the proposals, for example a number of the proposals involve removing the current price limits on individual tariffs and/or the overall constraint on the average selling price.

The proposals put forward by stakeholders can be expressed as a set of options for the Tribunal's consideration. These options are summarised below. Within each option there are a number of sub-options. In the discussion below various sub-options have been discussed (eg no limits on individual tariffs), in most cases the alternative sub-option could be used.

Option 1

Retain the N+R approach in its current form

Advantages

- prevents excessive price shocks for all customers
- provides a transparent benchmark for determining tariffs

Disadvantages

- retailers do not recover efficient costs for all tariffs
- under recovering tariffs limit scope for competition
- may prevent tariffs from achieving cost reflectivity by 2007
- depending on price limits, network increases may reduce the extent that retail costs are recovered
- multiple levels of constraints

Option 2

Retain N+R approach
Remove constraint on average selling price
Apply a single price constraint either to residential customers' bills or to individual tariffs (or tariff components)

Advantages

- prevents excessive price shocks for all customers
- provides a transparent benchmark for determining tariffs
- reduces the number of constraints in the form of regulation
- removing limit on average prices would assist in tariffs achieving cost reflectivity by 2007

Disadvantages

- retailers do not recover efficient costs for all tariffs
- under recovering tariffs limit scope for competition
- depending on price limits, network increases may reduce the extent that retail costs are recovered.

Option 3

Retain N+R
Incorporate a pass-through of network costs
Apply price limits on the R component only

Advantages

- provides a transparent benchmark for determining tariffs
- removing limit on average prices would assist in tariffs achieving cost reflectivity by 2007
- passing through network increases would allow retail costs to be recovered.

Disadvantages

- no control of overall level of price increases
- depending on the level of the limit on price movements, under recovering tariffs limit scope for competition

Option 4

Weighted average price cap approach
No limits on individual tariffs

Incorporate a pass-through of specified external costs (this is one option, could have the alternative)

Advantages

- ensures that on average price increases are not excessive
- passing through external costs would allow retail costs to be recovered.
- retailers would recover efficient costs for all tariffs

Disadvantages

- no control of level of price increases for individual bills
- may not be appropriate where (1) tariffs significantly under recovering, and (2) there are many tariffs

Option 5

Weighted average price cap approach
Limits on individual tariffs
Incorporate a pass-through of specified external costs (this is one option, could have the alternative)

Advantage

- ensures that on average price increases are not excessive
- passing through external costs would allow retail costs to be recovered
- retailers should recover efficient costs for all tariffs by 2007

Disadvantages

- may not be appropriate where (1) tariffs significantly under recovering, and (2) there are many tariffs

Option 6

Set 2004/05 tariffs at cost reflective levels, then specify a CPI-X price path to 2007
No additional limits on individual tariffs

Advantage

- relatively straight forward form of regulation
- enables retailers to recover efficient costs from 2004/05
- provides scope for competition

Disadvantages

- price shocks for customers

Option 7

CPI based threshold approach.
Adjustments of CPI each year without review
Where proposed price increases exceed CPI the retailer is to seek review by the Tribunal
No limits on individual tariffs (this is one option, could have the alternative)

Advantage

- prevents excessive price shocks on average for customers
- relatively straight forward form of regulation unless there are large increases in input costs

- removing limit on individual tariffs would assist in tariffs achieving cost reflectivity by 2007

Disadvantages

- no control of individual tariff increases
- over recovering tariffs would be able to increase (ie allows retailer to increase over recovering tariffs)
- could have large administrative costs if input costs increase (ie there is a need for a review of the tariffs)

At the roundtable the Tribunal would like to hear stakeholders' views on how well each of the options above achieves the regulatory objectives.

Implementing the options

One of the fundamental considerations of the Tribunal in selecting an appropriate form of regulation is how each theoretical option can be practically and consistently applied.

Some of the relevant considerations are:

- How transparent is the proposed approach?
- Is the approach easy for stakeholders to understand?
- Can the approach be consistently applied to all of the standard retailers? Are the options still appropriate where there are significantly under and over-recovering tariffs?
- What are the relevant information requirements? Do all retailers currently maintain the requisite information in an acceptable format?
- How would retailers demonstrate that the relevant constraints are being complied with? What information would retailers provide (and how often) to demonstrate that customers are not significantly affected by tariff rebalancing?
- How would direct pass through of external costs work in practice (for example, how would retailers show that only actual costs are being passed through and that costs are being shared appropriately among different customers / tariffs)? Would reductions in external costs also be directly passed through?
- Where a weighted average price cap is advocated, how would the Tribunal deal with retailers with large numbers of regulated tariffs? Should the form of weighted average price cap be different to that for the network tariffs? How would growth be incorporated into the calculation?
- Where a threshold approach is used, what criteria would the Tribunal use to assess increases greater than CPI (particularly where it may have been some time since costs were last reviewed)? What incentive does this approach provide for efficiency gains in the retail component?

At the roundtable the Tribunal would like to hear stakeholders' views on how the options described above could be implemented and the practical issues associated with them.