Country Energy's Response to the Draft Report and Draft Determination

Regulated electricity retail tariffs and charges for small customers 2007 to 2010

FOR PUBLIC RELEASE

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1 OVERVIEW

Country Energy is pleased to provide this response to the Independent Pricing and Regulatory Tribunal's publication, *Promoting retail competition and investment in the NSW electricity industry – Regulated electricity retail tariffs and charges for small customers 2007 to 2010* (hereafter the 'Draft Report', 'Draft Determination' or 'draft decisions').

Our submission, as well as providing specific comments on the Draft Report and Draft Determination, reinforces earlier proposals made by Country Energy throughout this review to assist the Tribunal in formulating the Final Determination. Country Energy is of the view that the Draft Determination has largely met the objectives of the terms of reference.

Country Energy commends the Tribunal on its decision to employ a form of regulation which is light-handed. We believe the proposed form of regulation, in particular the Weighted Average Price Cap approach to regulating prices, will greatly assist Country Energy in achieving cost reflective prices and further assist rationalisation of these prices. Country Energy strongly supports this approach to regulating retail prices.

There are, however, several important matters Country Energy believes require further consideration by the Tribunal.

First, Country Energy notes that 2009/10 energy purchase cost allowance represents a substantial decrease from the allowance for 2008/09. In our view, a decrease of the magnitude suggested in the Tribunals draft decisions will not eventuate. This is particularly relevant in the context of the revenue smoothing approach employed by the Tribunal. This approach has effectively eroded the energy purchase cost allowance in 2007/08 and 2008/09. We believe the appropriate allowance for 2009/10 should be consistent with the upper end of the range determined by Frontier Economics in line with 2007/08 and 2008/09.

Second, although Frontier Economics' modelling and results were based on accurate forecasts at the time the modelling was being conducted, the current market forecasts now predict a result which would be substantially higher. It is Country Energy's view that these market forecasts may not be sustained, but we cannot predict when this may occur or to what degree. Country Energy understands the predicament faced by the Tribunal, particularly in light of recent market movements and the fast approaching implementation date for the relevant decisions. For this reason, Country Energy proposes a mechanism designed to address concern about the energy purchase cost allowance, by allowing a review of the energy purchase cost allowance during the relevant regulatory period.

Finally, Country Energy believes that vulnerable customers are best protected through the currently available customer assistance measures, including our own *Country Support* hardship program. However we believe further enhancements are required to *Country Support* though targeted temporary subsidy arrangements aimed at reducing the impact of drought.

To assist the Tribunal in its deliberations, our positions on certain aspects of the Draft Report and Draft Determination are summarised below:

Section	Country Energy's position
2. Policy context for this review	o Country Energy supports the transition to removal of retail price regulation and believes that the light handed approach to regulation employed by the Tribunal will greatly assist the attainment of this objective. o Vulnerable customers are best protected through currently available customer assistance measures and the standard retailers' own hardship programs.
3. Current level of retail competition	o We believe that the Tribunal's Draft Determination will increase competition in Country Energy's area over the term of the Determination. o Country Energy has made significant progress in reducing the numbers of customers on 'obsolete' prices, and we believe the form of regulation proposed will further assist this objective.
4. How tariffs will be regulated	o Country Energy believes the Weighted Average Price Cap approach adopted by the Tribunal will greatly assist in achieving the requirement of the terms of reference. o Introduction of a *Country Support* temporary subsidy arrangement should be allowed. o A mechanism is required that will allow retailers to ensure regulated retail prices can achieve cost reflectivity in the event of material movements in energy purchase costs.
5. Allowance for energy costs	o The energy purchase cost allowance for 2009/10 should be consistent with the upper end of the range in Frontier Economics final report. o The revenue smoothing approach adopted effectively erodes the energy purchase cost allowance in 2007/08 and 2008/09. o The recent material movements in the wholesale market highlight the need for a form of pass through or review mechanism.
6. Allowances for retail costs and margins	o The allowances for retail costs and margin adopted by the Tribunal provide an appropriate transition to cost reflective prices and COAG's agreement to phase out retail price regulation.
7. Non-tariff charges	o Country Energy supports the Tribunal's draft decisions relating to non-tariff charges.

2 POLICY CONTEXT FOR THE REVIEW

2.1 COAG endorsement to phase out retail price regulation

Country Energy supports the form of regulation and price constraints described in the Draft Determination. We believe they will provide a mechanism to phase out retail price regulation. As stated in Country Energy's original submission to the Review, cost reflective regulated tariffs are a precursor to a buoyant competitive market for electricity in NSW. Whilst we agree with the need to phase out price regulation as soon as is practical to ensure that the energy market in NSW matures, we do not believe this is possible until general cost reflectivity of existing prices is attained.

Country Energy believes the Tribunal's selection of a light-handed approach to regulation facilitates the transition towards the Government's aim to phase out energy price regulation. The current form of regulation has been successful in allowing a pass through of the majority of network increases and the removal of certain inequities in Country Energy's regulated retail prices. During the current Determination, cost reflectivity has also improved, however the various layers of price limits have impeded our ability to achieve 'target tariffs'.

Country Energy believes that the Draft Determination will further improve cost reflectivity to a level where the majority of price inequities are removed. It will also enable significant rationalisation of Country Energy's current regulated retail prices. In Country Energy's opinion the increased cost reflectivity and ability to rationalise are a direct result of:

- the establishment of the requirement to transition to total target revenue rather than individual target levels,
- the ability for retailers to set prices without strict controls on movement, which in the past has impeded Country Energy's ability to rationalise tariffs, and
- the removal of individual customer limits on price movements.

Country Energy supports a form of regulation which aims to phase our retail price regulation. We believe that Draft Determination's form of regulation provides a mechanism to achieve the aims of the Terms of Reference.

2.2 COAG agreement to roll out of time of use meters

Country Energy believes that the Draft Determination will allow retailers to more readily adapt to the establishment of Time of Use tariffs resulting from COAG's agreement to roll out time of use meters. This adaptation is enabled through the light-handed approach to regulation taken by the Tribunal, allowing retailers to respond to price signals through restructuring regulated retail prices.

2.3 Decision to phase out the ETEF arrangement

The NSW Government's decision to phase out the Electricity Tariff Equalisation Fund (ETEF) arrangement is perhaps the most significant consideration in the context of the Tribunal's review. The impact of removing ETEF – which is in affect a 'whole of meter hedge' – exposes the standard retailers to the market. The cost of wholesale electricity purchases provides a significant proportion of a retailer's total cost and, with the phasing out ETEF, will become increasingly risky.

The phasing out of the ETEF provides significant challenges for the management of regulated retail prices. It is difficult to predict the changes that may occur, however consideration should be given to the liquidity of financial instruments to hedge the post ETEF consumption, risk management and transaction cost requirements.

The phasing out of ETEF will create considerable uncertainty for retailers in the NSW market. ETEF currently protects Country Energy from risks of movement in wholesale energy prices as well as risks associated with variability in load. The current market position is significantly different to the market position in September 2006, having risen substantially mainly due to the impact of water scarcity on generation capacity. The current market position demonstrates the risk and uncertainty relating to wholesale energy purchases and the need for a mechanism which can provide for greater certainty. The current market position and options to address this uncertainty are discussed later in the submission.

2.4 New policies relating to renewable energy

From 15 January 2007, retailers in NSW were required to offer a minimum of 10 percent accredited 'Green Power' to all 'new' and 'moving' customers. Country Energy proposed in its initial submission to this review, that the current Ddetermination does not regulate Green Power and that this principle should remain for the next regulatory period. Green Power products are currently subject to customer choice and should not be subject to regulation. Country Energy welcomes the Tribunal's decision to continue this approach.

2.5 Customer assistance measures

The Tribunal provided in its Draft Decision details of government assistance measures, obligations of retail supplier licence holders and the standard retailers own programs aimed at addressing the needs of customers in financial hardship.

Country Energy's hardship program is known as *Country Support*. We believe the needs of customers suffering from financial hardship, often referred to as vulnerable customers, are best protected through programs such as *Country Support* in conjunction with the measures identified by the Tribunal.

Country Support is an innovative financial assistance program specifically targeted to assist customers experiencing financial hardship. The program was first launched in 2002 when the current drought was beginning to have an impact on customers.

Country Support provides dedicated and discreet case managers to help customers, whatever their circumstances – including unemployment, family change and drought.

Country Support has –

- helped over 7,000 customers since 2002, including 2,500 customers in 2005/06 alone

- helped to halve disconnections for non-payment of accounts – from some 9,000 in 2001 to around 4,000 in 2005.

Country Energy also operates an Easypay program, generally available to residential, small business and rural customers. Easypay allows customers to pay a flat amount weekly, fortnightly or monthly, based on forecast consumption plus any outstanding balance, over a 12 to 36 month period.

Recent figures published by the Tribunal show that among NSW-owned energy retailers, Country Energy has the highest percentage of customers on payment plans (7.0 per cent), and the lowest percentage of disconnections for non payment (0.7 per cent).

Other features of *Country Support* include:

- support services to small business owners and farming families through our *Busiplan* and *Farmplan* payment options, which work to align account payments options with business income cycles.

- being the only program of its type accredited by the NSW Department of Energy Utilities and Sustainability to distribute 'Energy Accounts Payment Assistance' vouchers directly to customers.

- partnerships with community welfare organisations, including St Vincent de Paul, Salvation Army and Creditline, to assist with the referral of customers between agencies and to give them access to support, concessions and energy efficiency advice.

Country Support's success is based on flexible solutions that allow customers to manage financial pressures with dignity and anonymity, while maintaining access to essential energy services. Country Energy is promoting awareness of the program with customers and community support groups to allow early intervention.

3 CURRENT LEVEL OF RETAIL COMPETITION

3.1 Levels of competition

Although the Tribunal's findings indicate there is currently not sufficient competition, we believe that the Tribunal's Draft Determination will increase competition in Country Energy's area over the term of the Determination. The draft decisions increase incentives to the competitive market and, as a result, competition will inevitably increase – we are in fact starting to see increasing levels of competition in the Country Energy supply district.

The Tribunal notes the relative remoteness and low population density of Country Energy's customers which may limit the extent of competition within the supply district. Although some customers are remote and may not be approached by door-knockers, customers will increasingly self-select competitive options through other forms of marketing – including telemarketing, direct mail and general advertising.

3.2 Barriers to Entry

The Tribunal notes in its Draft Report that the significant number of Country Energy's regulated retail prices, of which a number are under-recovering, may present a barrier to entry for competing Retailers.

It is important to note, that Country Energy has made significant improvements in relation to the proportion of customers on Country Energy's current regulated retail prices and the cost reflectivity of these prices. Country Energy implemented a single Country Energy price list in 2002, where all new connections and 'move-ins' are required to connect to the standard price list. This initiative has resulted in more than 50 percent of the regulated retail customer base being connected on the basis of the standard Country Energy price list.

Further, where possible, prices have been rationalised further reducing the number of regulated retail prices. However, full rationalisation of prices was not possible due to the limits on price movements imposed by previous Determinations.

Under the current Determination increases to customers' bills could not exceed the greatest of CPI plus 5 per cent or $35 per annum. This was established in order to protect customers from unacceptable price shocks while still providing standard retailers with some ability to undertake tariff reform. Country Energy accepts that such measures were necessary and have been largely effective.

However a key concern with that approach is the limits it placed on Country Energy's ability to rationalise tariffs in a cost reflective manner. This has perpetuated a level of complexity in billing and administration, and may have impacted the transparency and simplicity of the competitive market.

The constraint on individual customers' bills has further limited price rationalisation. A small number of customers with peculiar consumption patterns can prevent such rationalisation even though the discrepancy between the allowed increase and the increase to achieve cost-reflective levels are small.

Looking forward, Country Energy believes that form of regulation proposed in the Draft Determination provides a relaxation of limits on price movements that will achieve both cost reflective pricing and rationalisation of Country Energy's regulated retail prices in the vast majority of cases. Country Energy's indicative modelling has demonstrated that the average movement in price that customers would see in achieving these twin goals would not be significantly greater than the constrained amounts currently allowed for the majority of tariff adjustments. This is also an important transitional step towards phasing out retail price regulation.

While there will be a need to manage the very few customers who are far below cost reflectivity, there is little need for such a protective constraint to be carried forward across the entire tariff base.

4 HOW TARIFFS WILL BE REGULATED

4.1 Draft decision on how tariffs will be regulated

Country Energy welcomes the introduction of a Weighted Average Price Cap (WAPC) approach to regulation and agrees this form of regulation will provide an opportunity to significantly rationalise prices and allow the ability to transition to cost reflectivity.

The WAPC will allow Country Energy to address most of our under recovering regulated retail prices during the period of the Determination, particularly in the absence of complex constraints and conditions. However, a small number of regulated retail customers will more than likely remain on under recovering prices primarily due to the significant increases required to bring these prices to cost reflective levels. Country Energy estimates that a very small proportion of customers – approximately 3 percent – will be under recovering at the end of the next regulatory period.

It is also important to note, that although a small number of regulated retail prices will remain under-recovered, this is not a reflection of the Draft Determination, but rather Country Energy's view on the ongoing need to manage impacts for customers whose prices have persistently and significantly under recovered. That said, Country Energy notes that customers on significantly under recovering prices are not necessarily 'vulnerable' customers. In fact, Country Energy believes there is no relationship between under recovery and vulnerability other than the general trend that exists throughout the regulated retail tariff base.

Overall, Country Energy believes that the WAPC provides the framework that will assist in achieving the requirements of the terms of reference for this review, namely:

- regulated retail prices to be at cost reflective levels by 2010, and
- the WAPC approach to price constraints will allow further rationalisation of prices over the period of the determination.

4.2 Introduction of regulated retail prices

The Tribunal's Draft Determination excludes the establishment of new regulated retail prices, unless there are exceptional circumstances. Country Energy had previously proposed to the Tribunal the introduction of a pricing arrangement from 1 July 2007 aimed at enhancing our existing *Country Support* program. Introducing this pricing arrangement from 1 July 2007 is excluded under the Draft Determination.

The *Country Support* pricing arrangement is designed to assist those customers within the Country Energy area that are experiencing severe financial hardship, principally as a result of the current drought. These pricing arrangements are intended to be targeted at customers identified as having a temporary ‘incapacity to pay’ despite the assistance currently available under the *Country Support* program.

To mitigate the impact of the move to more fully cost reflective pricing, Country Energy proposed to extend the *Country Support* program to include those people identified by both government and non-government agencies as suffering significant hardship. We proposed to create partnerships to enable the early identification of genuine customers in need, and the provision of a special temporary subsidy to provide relief. Country Energy believes it will be important that the assistance offered is reviewed regularly to ensure that normal pricing arrangements resume when the identified hardship circumstances are alleviated. Our intention is to enhance existing social policy measures, rather than create new assistance criteria.

We propose that customers would be identified through relief agencies in conjunction with our normal business processes. These customers may formally apply for their account to be transferred to the *Country Support* temporary subsidy arrangements. At this point they would be made aware of the detail of our offering and agreement would take place for the timing of return to normal charges. Country Energy would rely on the agency to help in these discussions and to liaise with the customer if difficult circumstances arise.

Where a customer has no agency support, they will be able to formally apply in a similar manner to those applying through an agency, though it is unlikely that their circumstances will warrant *Country Support* temporary subsidy arrangements if they are not currently receiving external agency support. While Country Energy envisages that this relief will apply only to those on standard contracts through the 2007-2010 period, we recognise the need to develop this package for use in the competitive market if price regulation ceases.

Country Energy proposes these special *Country Support* arrangements to be effective from 1 July 2007 which would mirror the current standard regulated price; however the fixed charge would be removed or rebated. This would allow customers, such as farmers, to carefully manage their accounts in a way which gives them more control over their expenditure in difficult times.

Country Energy believes the introduction of the proposed special arrangements can be managed under the form of regulation proposed in the Tribunal’s Draft Determination. Country Energy would propose that any under recoveries be addressed through overall revenue allowances and price settings, to maintain the integrity of the transition to total target revenue. We believe that such an arrangement, within the WAPC, minimises any distortionary impacts.

4.3 The form of regulation

Country Energy supports the Tribunal's draft decisions that would see regulated retail tariffs governed under a WAPC approach based on a Network (N) plus Retail (R) component framework.

Country Energy is currently managing a large number of regulated retail prices, a proportion of which will be below target levels at the end of the current regulatory period. This is the result of Country Energy's predecessors maintaining a complex and varied suites of tariffs. As discussed above, amalgamating these prices into a consolidated regulated retail price framework has been a key focus of Country Energy since its formation. In July 2006 Country Energy also began an initiative to further reduce the complexity and variability of prices by removing a relatively arbitrary differentiation between rural and urban customers, providing further opportunities to reduce tariff complexity and remove many obsolete tariffs.

During the course of the current determination Country Energy has been successful in unwinding significant cross subsidies between customer classes. In addition we have taken a number of steps to standardise regulated retail pricing options which has also removed some inequities.

The current regulatory framework has allowed Country Energy to provide the foundations of a standardised suite of regulated retail prices. However Country Energy recognises that further rationalisation and increased cost reflectivity of prices is required. Country Energy believes this can be achieved through the Tribunal's draft decision on the form of regulation.

In Country Energy's view, the outcomes achievable under a WAPC enable considerable flexibility in the setting of individual tariffs and would deliver positive outcomes in relation to the key objectives of the review. The WAPC will substantially build on the progress already made under previous determinations.

4.4 Additional regulatory mechanisms

4.4.1 The threshold price increase test for Country Energy

The Tribunal notes that the proposed 'threshold test' is designed to ensure there are no significant unjustified price increases for regulated retail prices, which may not otherwise be corrected by the competitive market.

We believe that the threshold test for Country Energy may not be necessary as regulated retail prices increased above cost reflective levels would be corrected by the market, given recent increases in levels of competitor activity within the Country Energy supply district. However, we do accept the Tribunal's draft decision and understand the reasons behind the decision.

4.4.2 Cost pass-through mechanism

Country Energy is pleased that the Tribunal has considered a cost pass through mechanism in its draft determination. However, Country Energy remains concerned at the limited scope in which a cost pass though event is triggered. The cost pass through mechanism proposed in the draft determination is triggered by:

- Regulatory events, including:
  - meeting additional obligations related to green energy schemes (existing and future)
  - a Retailer of Last Resort (ROLR) event
  - meeting additional obligations related to Government-imposed energy hardship policies
  - one-off NEMMCO charges (such as reserve trader or direction events)
- Certain new taxation events.

Country Energy believes that consideration of a mechanism which allows regulated retail prices to take into account significant movements (positive and negative) in wholesale energy purchase costs is necessary. The absence of an ability to pass through significant negative or positive movements in the purchase cost of electricity leaves Country Energy with a fixed regulated retail revenue base, without a mechanism to allow major movements in the cost of purchasing electricity.

Recent events in the wholesale electrcity market, in our opinion, clearly demonstrate the need for some form of mechanism which recognises significant wholesale purchase cost movements. Retailers operating in the National Electricity Market can be exposed to significant levels of risk, and for the NSW standard retailers the phasing out of ETEF increases these risks. Energy purchases can be extremely volatile, and for this reason, Country Energy believes that material movements in wholesale electricity purchase costs should be brought into the scope of the pass through mechanism.

The early part of 2007 has seen a material increase in the average pool price of electricity from the National Electricity Market that has resulted in a significant upward movement in the forward contract rates. These increases have resulted in the forecast wholesale energy purchase costs rising well above the electricity purchase cost allowances incorporated into the draft decision. Although there is uncertainty of how long these high prices will remain, it provides a clear example of the need for cost pass through mechanisms. It is important to note, that in general terms a movement of 10 percent in energy purchase costs will erode the retail margin completely.

Country Energy considers there are a number of options which the Tribunal could employ to mitigate the risk of significant market movements impeding cost reflectivity of regulated prices. Country Energy provides the following options which the Tribunal may consider.

- **Cost pass through mechanism**

  The cost pass though mechanism could be expanded to include material changes in forward wholesale energy purchase costs. The mechanism could be triggered by a positive change event or a negative change event. In Country Energy's view the level at which a trigger would occur, would be driven by a movement in wholesale energy purchases being greater than a proportion of the Retailer's net margin.

- **Cost pass through mechanism with annual adjustments**

  An alternative option to the expansion of the cost pass through discussed above would be to incorporate a further mechanism which would limit the frequency of a trigger of the cost pass through mechanism. Country Energy suggests that after a variation of 10 percent between the forward wholesale energy purchase cost and the energy purchase cost allowance included in the Draft Determination, an automatic trigger of the pass through mechanism would occur. Variations below 10 percent should be incorporated into retailer's annual pricing proposals and any pass though amount would be subject to Tribunal approval.

- **Mid-term review**

  The cost pass through mechanism enhancements discussed above provide standard retailers with the ability to maintain a certain degree of cost reflectivity in retail prices. However, the next regulatory period only covers a period of three years, and such mechanisms may create undue complexity in determining prices. A final option is an approach which is similar to previous mid-term reviews conducted by the Tribunal on regulated retail pricing determinations. Mid-way through the next regulatory period, a review of the appropriateness of each standard retailer's energy purchase cost allowances could be undertaken. A mid-term review of the wholesale energy purchase cost allowance is Country Energy's preferred option as it will provide an opportunity to restate the allowance if a material shift in the market has occurred. It will also be completed within the context of the standard retail suppliers already having some of the regulated load exposed to the market, providing valuable experience not currently available.

Country Energy believes that the inclusion of a mechanism which accounts for major movements in wholesale energy costs must be carefully considered by the Tribunal. The terms of reference for this review require cost reflectivity of regulated retail prices by 2010. Given the volatility and uncertainty of wholesale energy purchases, to ensure the cost reflectivity of regulated retail prices by 2010, a mechanism is required to ensure unanticipated major movements in these costs is captured.

4.5 No additional price limits will apply

The primary reason for regulated retail tariffs remaining under target levels has been the inability to transition customers to appropriate cost reflective regulated prices. The Tribunal's draft decision to minimise price limits will allow Country Energy to largely address cost reflectivity of prices and significantly reduce the number of regulated retail prices.

Country Energy has modelled a number of scenarios to demonstrate the effect of price constraints on the total revenue and under recovery through to the end of the next regulatory period. The scenario modelling and analysis demonstrate the impacts on customers of varying price constraints and the transition of tariffs to a more cost reflective level. Country Energy encourages the Tribunal to revisit this analysis provided as part of our December 2006 Commercial in Confidence submission when considering its Final Determination.

In Country Energy's view, to achieve the objectives of the terms of reference, the form of regulation outlined in the Draft Determination is necessary. Complex limits on price movements at the individual price and customer level will inhibit the attainment of fully cost reflective and rationalised prices. Country Energy acknowledges that there will be a need to manage the very few customers who are far below cost reflectivity; however we believe we are well placed to manage this transition.

There is also little need for complex price constraints to be carried forward across the regulated retail customer base in order to protect a small group of vulnerable customers. The use of complex constraints to protect vulnerable customers can create serious issues regarding attainment of cost reflectivity and rationalisation of prices and provide very little benefit in addressing the key needs of these customers. Targeted hardship programs such as *Country Support* are much more effective in assisting customers in need of assistance.

Targeted programs have demonstrated their success in identifying customers in hardship. Identifying these customers is often the most difficult part of the process as we have found in our experience, there are no hard and fast rules that can be applied to categorise and identify these customers. Country Energy has provided a profile of our *Country Support* customers in Attachment 1 (on a commercial-in-confidence basis).

Country Energy's *Country Support* program provides customers with additional options to assist those facing short or long term periods of hardship. As discussed above, Country Energy has proposed the extension of the *Country Support* program by providing a temporary subsidy arrangement. This arrangement is the most appropriate mechanism to deal with vulnerable customers, rather than imposing price limits on the entire regulated retail customer base. The imposition of constraints will severely impede Country Energy's ability to achieve fully cost reflective prices and rationalisation of our regulated retail prices.

Country Energy's *Country Support* program provides customers with additional options to assist those facing short or long term periods of hardship. As indicated above, Country Energy proposes to extend the *Country Support* program to include those people identified by relevant agencies as suffering significant hardship by providing a temporary subsidy arrangement to suit their circumstances. This is clearly evident in the successes of *Country Support* discussed above.

5 ALLOWANCE FOR ENERGY COSTS

As discussed above, the early part of 2007 has seen a material increase in the average pool price of electricity from the National Electricity Market that has resulted in a significant upward movement in the forward contract rates. Country Energy is concerned that the energy purchase cost allowance may not be sufficient to viably operate a retail business, particularly in the absence of a mechanism which will allow regulated retail prices to maintain cost reflectivity during the period of the Final Determination.

5.1 Electricity purchase cost allowance

The regulated energy cost is currently based on the Long Run Marginal Cost (LRMC). Historically the LRMC has been used in retail pricing determinations in the absence of competition within the wholesale electricity market. Country Energy believes a robust and active wholesale electricity market exists, thus diminishing the need for such a measure within the next Determination. A key objective of this review is to promote retail competition and investment in NSW. Regulated retail prices based on market-based purchase costs will best deliver this outcome. For these reasons, Country Energy strongly supports the Tribunal's Draft Decision that the electricity purchase cost allowance is based on the market-based cost subject to the inclusion of mechanisms to cover material market price movements.

The upper-end of the conservative marked-based electricity purchase cost represents a more appropriate point on the efficient frontier for setting energy purchase cost allowances. In our view, underestimated energy pricing will deter competition and may threaten standard retailers' sustainability. Country Energy notes that 2009/10 energy purchase cost allowance represents a substantial decrease from 2008/09 – approximately ten percent. Our modelling indicates that a decrease of this magnitude will not eventuate; in fact the 2009/10 allowance should be slightly above 2008/09.

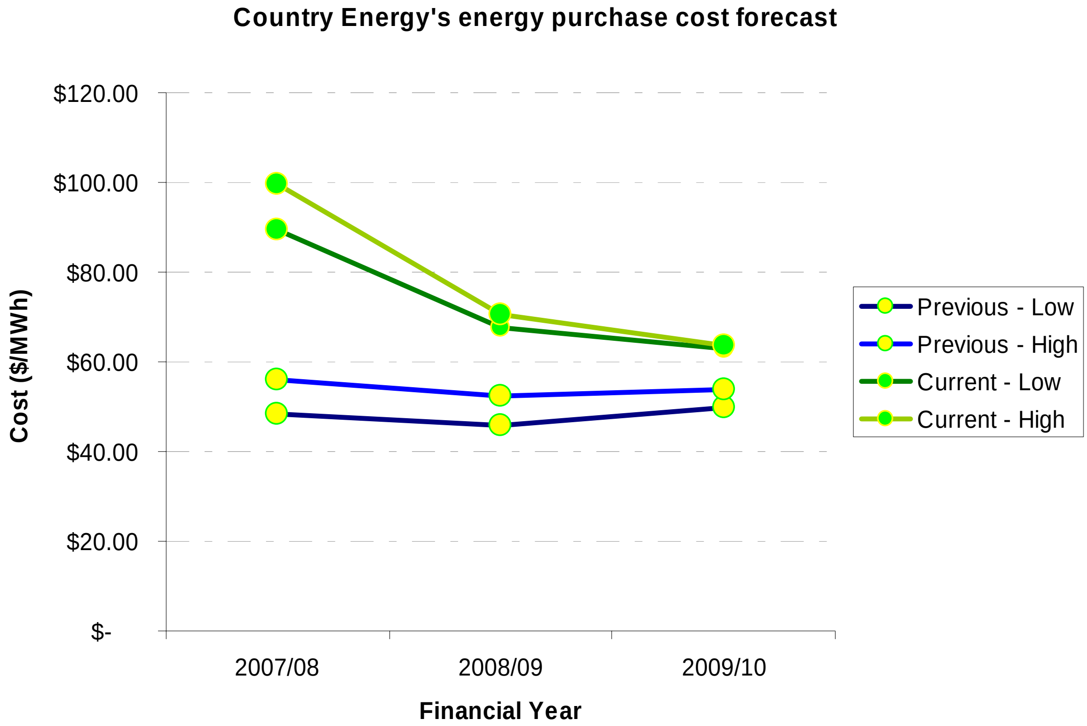
Frontier Economics' final report on energy costs prepared for the Tribunal indicated the following range for Country Energy's Market Price (Conservative):

Market-based conservative	**2007/08**	**2008/09**	**2009/10**
Lower	$48.07	$45.89	$44.00
Upper	$49.09	$48.75	$49.09
Frontier Economics' Assessment	$49.10	$48.00	$44.00

Country Energy believes that based on the ranges determined in Frontier Economics' final report, the energy purchase cost allowance for 2009/10 should be based on the upper end of the range at $49.10 in line with 2007/08 and 2008/09. This point is particularly relevant in the context of the revenue smoothing approach undertaken by the Tribunal. This smoothing approach has effectively eroded the energy purchase cost allowances for 2007/08 and 2008/09 due to the reduced allowance in 2009/10.

However, given the recent increases in the forward energy hedge market, the conservative point may understate the forward market cost. If the analysis was to be completed based on current values a substantial increase in the energy purchase cost allowance range would be seen. Furthermore, a mass market new entrant will be unlikely to enter the New South Wales market if the current wholesale market forecasts are sustained.

This significant movement is demonstrated below. The analysis compares the energy purchase costs based on current market forecasts to those costs based on market conditions prevalent during the early part of 2007.



	2007/08	2008/09	2009/10
Previous – Low	$ 48.37	$ 45.73	$ 50.00
Previous – High	$ 56.10	$ 52.53	$ 53.80
Current – Low	$ 89.35	$ 67.69	$ 62.80
Current – High	$ 99.65	$ 70.40	$ 63.57

As shown there is a significant increase for all three years of the next regulatory period. In our view, the recent increases may not be sustained, but we can not predict when these recent increase may reduce or to what degree.

The increases in the forward hedge market prices have been primarily driven by water shortages which have impacted generation capacity in Queensland, Victoria, Tasmania and New South Wales. The Frontier Economics modelling assumes a certain level of caps in the market – at the moment there is a shortage of available cap cover due to water shortages faced by Snowy Hydro. Snowy Hydro is the principal provider of caps in NSW, which means the Frontier Economics modelling could produce inaccurate results based on illiquid instruments leaving retailers to cover their load with a higher level of swaps – at a higher price.

We will be soon approaching the period where Country Energy is required to hedge the ETEF load. If Country Energy was to go into the market today and attempt to hedge this load we would be locking in a substantial loss due to the inability to reflect the increased cost of electricity in our regulated prices.

ETEF would normally protect the regulated retail load from these scenarios, and the phasing out of ETEF is happening during what is considered to be an extraordinary event related to water shortages for generation in the market.

Due to the upward pressure on current forward contract prices, Country Energy can either hold off on purchasing cover for our load or lock in a substantial loss. Nonetheless, if the market does soften to appropriate levels, retailers may rush to the market at the same time putting further upward pressure on contract prices. Timing for undertaking forward hedge contracts is a critical factor, the affects of which is not evident under ETEF, and may not have been adequately factored in to Frontier Economics' analysis.

Country Energy agrees with the Tribunal's approach for addressing volatility through an allowance for working capital. However in our view, the working capital allowance addresses profile risk only – not significant market movements or other hedging factors, such as those we are currently observing in the wholesale electricity market.

The issue is now one of timing – will the forward hedge market prices fall sufficiently to meet the energy purchase cost allowance in the draft determination and the commencement of the phasing out of ETEF? Coupled with this timing risk is the risk management faced by retailers. Recent upward movements in the forward contract curve may result in retailers adopting more risk to avoid 'locking in' hedge contracts above the energy purchase cost allowance determined by the Tribunal. This direction will significantly increase the risk capital requirements for retailers.

As previously discussed, Country Energy believes that consideration of a mechanism which allows regulated retail prices to take into account significant movements (upward or downward) in wholesale energy purchase costs is necessary. Recent events in the wholesale electricity market, in our opinion, clearly demonstrate the need for some form of mechanism which recognises significant wholesale purchase cost movements.

5.2 Greenhouse and renewable energy cost allowance

Country Energy agrees with the Tribunal that the most appropriate method for determining a purchase allowance for compliance with renewable energy schemes is the Long Run Marginal Cost (LRMC). However, Country Energy notes that the LRMC for the Federal Government's Mandatory Renewable Energy Target (MRET) and the NSW Mandatory Renewable Energy Target (NRET) have decreased when comparing Frontier Economics' draft report to the final report. The following table displays the movement in the renewable energy cost allowance for NRET and MRET.

LRMC of greenhouse schemes	**2007/08**	**2008/09**	**2009/10**
MRET – draft	$1.10	$1.40	$1.70
MRET – final	$0.90	$1.20	$1.50
Change in MRET	***-18%***	***-14%***	***-12%***
NRET – draft	$0.40	$0.60	$0.90
NRET – final	$0.20	$0.40	$0.60
Change in NRET	***-50%***	***-33%***	***-33%***

Country Energy previously reported that the green energy costs of greenhouse gas schemes based on LRMC proposed by Frontier Economics in their draft report appeared to be adequate for MRET and NRET. Due to the downward shift in the estimates of LRMC for MRET and NRET, all three schemes now deliver an allowance below Country Energy's predicted costs for the next regulatory period.

Although the LRMC estimates for the NSW Greenhouse Gas Abatement Scheme (GGAS) have increased when compared to Frontier Economics draft report, the allowance is still below our current costs of compliance and forecasts for each year of the next regulatory period.

With regard to the MRET allowance, the water scarcity issues discussed above are also having a significant impact on the hydro schemes' ability to generate Renewable Energy Certificates (REC's) above their base. This has resulted in the supply of REC's from these old hydro schemes significantly reducing. The likely result of these events is an upward movement on the future REC market price.

6 ALLOWANCES FOR RETAIL COSTS AND RETAIL MARGIN

6.1 Retail operating costs

Country Energy generally supports the Tribunal's draft decision regarding retail operating costs for a Mass Market New Entrant (MMNE). Country Energy in previous submissions and presentations to the Tribunal queried the extent to which reliance has been placed on New South Wales standard retail operating costs as the basis for a mass market new entrant. We believe there are certain synergies in New South Wales standard retail businesses because of the way they operate as integrated retail and distribution businesses which may not have been fully acknowledged.

As a standard retailer supplier, Country Energy believes the retail operating cost allowance provides a reasonable estimate of our current retail operating costs. However, it is worth noting that Country Energy traditionally has had a low cost base in comparison to other retailers due to historical factors. In addition Country Energy is an established and diversified business with the ability to share costs. For these reasons, it is extremely unlikely that a MMNE would be able to achieve the same level of costs currently enjoyed by Country Energy.

The Tribunal's Terms of Reference indicate that the –

> …*setting of tariffs for small retail customers to apply from 1 July 2007 to 30 June 2010 include…. mass market new entrant retail costs*.

Country Energy's specific circumstances in relation to retail operating costs would be quite different to that of a MMNE. At the very least, the cost of a standard retailer would provide the absolute minimum level, however it must be acknowledged that a MMNE's retail operating costs would be higher.

6.2 Retail margin

The Tribunal's draft decision of 5 per cent is considered an appropriate allowance for current retailers, provided that the risks involved with purchasing energy in the absence of the ETEF are adequately captured in energy costs. If energy costs are inadequate, the recommended level of retail margin is unlikely to provide sufficient incentive for a MMNE to enter the market. In fact, given the current wholesale market conditions, a MMNE would be unlikely to enter the New South Wales market.

As discussed earlier, the upper-end of conservative marked-based electricity purchase cost represents a more appropriate point on the efficient frontier for setting energy purchase cost allowance. Country Energy notes that the 2009/10 energy purchase cost allowance, represents a substantial decrease from 2008/09. This decrease is approximately 10 per cent – which in general terms is equivalent to a 5 per cent net margin.

7 NON TARIFF CHARGES

Country Energy welcomes the Tribunal's draft decision regarding non-tariff charges. In particular, we support the Tribunal's intention to request the expansion of dishonour cheque fees to also encompass direct debit dishonour. The use of cheques for payment is in relative decline while payment via direct debit has increased significantly. Country Energy feels that it is only appropriate that similar charges are allowed to be levied for direct debit dishonours.

Country Energy understands that the current miscellaneous charges which standard retail suppliers can charge regulated customers is restricted by the definitions of these charges within the *Electricity Supply Act*. Accordingly, Country Energy supports the commencement of the process to amend the current definitions within the Electricity Supply Act to expand the definition of cheque dishonour fees to simply dishonour fees.