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Review of Regulated Retail Tariffs and Charges for
Electricity 2007 – 2010
Independent Pricing and Regulatory Tribunal
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Review of Regulated Retail Tariffs and Charges for Electricity 2007-2010

AGL welcomes the opportunity to provide comments to the Independent Pricing and Regulatory Tribunal (Tribunal) on the 'Review of Regulated Retail Tariffs and Charges for Electricity 2007 – 2010 Issues Paper' (Issues Paper).

AGL notes that the clear intent in the Terms of Reference issued by the Minister is to address fundamental characteristics in the NSW electricity market that preclude standard and new entrant retailers from competing on the same terms. The Tribunal has the opportunity to address these fundamental differences by establishing electricity prices that enable a successful transition to a fully competitive electricity market. This should also allow achievement of the objectives of cost reflective prices, continued quality and reliability of supply and enable future investment in generation capacity;

The Tribunal is to have due regard to the Government's stated policy goals of reducing customers' reliance on regulated tariffs and encouraging competition.

AGL looks forward to assisting in the Tribunal in the development of regulated retail tariffs that deliver a cost reflective electricity service to customers in NSW. Our detailed comments on the matters raised by the Tribunal in the Issues Paper are attached.

Please contact me on 08 8299 5441 if you wish to discuss any aspect of this submission or require any additional information.

Yours Sincerely,

Sean Kelly
General Manager Energy Regulation

AGL Response

IPART Issues Paper

on

**Review of Regulated Retail Tariffs
and Charges for Electricity 2007 to
2010**

October 2006



PREAMBLE

In June 2006 the Minister for Energy (Minister) issued a Terms of Reference (TOR) to the Independent Pricing and Regulatory Tribunal (Tribunal) requiring the Tribunal to investigate and report on the regulated electricity retail tariffs and charges that will apply from 1 July 2007. The Tribunal is to also consider and report on the basis for regulating miscellaneous charges, including security deposits.

The Tribunal is required to consider the NSW Government's policy aim of reducing customers' reliance on regulated prices, and the likely effect of its determination on competition in the retail electricity market.

The TOR require the Tribunal's determination to ensure that:

- Regulated retail tariffs and charges for all small retail customers are at cost reflective levels by 30 June 2010; and
- Any 'price constraints' allow for the further rationalisation of regulated retail tariffs and movement to full cost recovery over the determination period.

This paper provides comments on the most effective option for meeting the objectives of promoting competition and ensuring that tariffs are at cost reflective levels by 2010.

AGL Sales Pty Ltd (AGL) looks forward to working with the Tribunal and its consultants throughout the review process.

EXECUTIVE SUMMARY

AGL is a new entrant retailer in the NSW electricity market committed to providing its customers with electricity at reasonable prices and has always endeavoured to ensure prices reflect the costs and risks incurred in supplying electricity. Accordingly, AGL welcomes the opportunity to comment on the Issues Paper. Specifically that:

- The current characteristics and market arrangements of the NSW electricity market result in new entrant and incumbent retailers not competing on the same terms. Under these arrangements the costs and risk profiles of the new entrants and incumbents are significantly different;
- AGL notes that the clear intent in the Terms of Reference is to address these differences and to establish electricity prices that enable transition to a fully competitive electricity market. This should also allow achievement of the objectives of cost reflective prices, continued quality and reliability of supply and enabling future investment in generation capacity;
- The Tribunal has noted a number of Government policy changes relating to the removal of the Electricity Tariff Equalisation Fund (ETEF), a commitment under the National Energy Reforms to phase out price regulation in competitive markets and the agreement to consider smart meters as a means of demand management. AGL encourages the Tribunal to take account of the impacts of these reforms on the costs to retailers during the price review period.
- A weighted average price cap on the retail component with full pass through of network charges be adopted as the form of regulation for the next 3 years. This approach will provide retailers with appropriate flexibility in transitioning to cost reflective tariffs. Any side constraints (if needed) should relate to the retail component only and be sufficiently broad to allow for the rational transition to cost reflective tariffs, the progressive removal of cross subsidies and provide for the flexibility to establish appropriate pricing arrangements linked to interval meters and demand management initiatives.
- Determining future Wholesale Electricity Costs (WEC) is a complex, dynamic task. WEC comprise energy purchased at pool prices, the costs of hedge transactions which seek to manage demand and price volatility, a range of market fees and charges and the costs of renewable energy requirements. These costs are then translated to costs at the customer's meter by applying line losses.

AGL notes that the TOR require the Tribunal to consider both the Long Run Marginal Cost (LRMC) approach and to allow for the hedging, risk management and transaction costs when determining a WEC benchmark. The LRMC is an economic analysis of lowest cost operation of future plant not yet built and is not considered a true measure of the WEC for the period under review. The WEC costs for the period to 30 June 2010 will in effect reflect the capital and operating costs of existing generation plant, together with the retailers costs of risk management and other applicable market charges.

AGL notes that ETEF will be progressively removed during the price review period and would support WEC being determined without consideration of the impacts of ETEF on the standard retailers' costs. This approach would further assist the standard retailers to effectively transition to market based hedging arrangements as the ETEF is removed. Also importantly this will ensure competitive neutrality within the NSW electricity market.

- An allowance for operating costs be set at a level that includes all costs in attaining, retaining and servicing customers. Benchmarks for operating costs used in other jurisdictions allow for a range of retailers to compete in those markets, we would expect a similar approach to be adopted in NSW. Consideration also needs to be given to costs that retailers will incur in the future which are not currently being incurred. For example, costs associated with the roll out of interval meters.

Further, the accurate average consumption per customer is paramount to ensuring appropriate conversion of operating cost per customer to operating cost per MWh;

- Low retail margins are a significant impediment to developing competition and to the future investment in generation capacity. AGL notes that the standard retailers have proposed possible retail margins in the range of 8% to 13%. These margins are considered reasonable for the risk profile of retailing energy and are not inconsistent with retail margins considered in other jurisdictions. Achievement of the benchmark margin will be dependent on realistic benchmarks being established for wholesale and operating costs;
- AGL considers that miscellaneous charges should be set on a fair and reasonable basis. AGL notes that current miscellaneous charges are restricted to security deposits, late payment fees and dishonoured bank cheque fees. At an appropriate time the range of fees and charges that can be applied should be reviewed to determine whether additional fees and charges are warranted.

1 POLICY CHANGES THAT AFFECT THE REVIEW

The Tribunal notes that there are a number of changes in government policy that will need to be taken into account when determining retail tariffs for the period to 30 June 2010. These include:

- the progressive phase out the Electricity Tariff Equalisation Fund (ETEF) between September 2008 and June 2010;
- Council of Australian Governments (COAG) endorsement of the Ministerial Council on Energy (MCE) reform agenda, particularly the phase out of the regulation of retail prices where effective competition can be demonstrated; and
- COAG agreement to the progressive national roll out of 'smart' electricity meters from 2007 to allow the introduction of time-of-day pricing.

AGL supports the requirement to consider policy changes that may have a bearing on the supply of electricity to residential customers in NSW.

In order to ensure cost reflective levels by 30 June 2010 as required under the TOR for the review, it is important that the final determination and regulated tariffs and charges are sufficiently flexible to enable the incorporation of new policy changes that may arise during the regulatory period.

Other changes to existing policy and legislative framework will include the transition of retail regulation (except retail pricing) to a National Regulatory Framework from 1 January 2008. There are consultations in progress to determine the appropriate regulatory framework and legislation to underpin a national energy market. Any changes / amendments that result from streamlined regulations and processes should be reflected in the NSW electricity market to enable an efficient and national energy market.

AGL encourages the Tribunal to enable sufficient flexibility in its determination to enable the effective transfer functions to the Australian Energy Markets Commission (AEMC) and to achieve national harmonisation of rules and processes.

NSW Government's decision to phase out the ETEF

The Tribunal seeks comment on:

- Whether, for the purposes of establishing cost reflective tariff levels, it should consider the phasing out of the ETEF over a period of time or assume that the ETEF immediately ceases.*
- How the phasing out of the ETEF will affect retailers' hedging, risk management and transactions costs over the course of the determination and whether these costs are different between a standard retailer and a mass market new entrant retailer.*
- How it should recognise the forecasting risks that retailers will face in the absence of the ETEF and whether these risks are different between a standard retailer and a mass market new entrant retailer.*

AGL notes that the Government has established a timetable for the progressive removal of the ETEF. AGL supports such action as it removes a market distortion between standard retailers and new entrant retailers. Mass market new entrants do not have access to the wholesale electricity prices or the risk profile available under the ETEF arrangement.

AGL considers that two alternatives exist to removing the market distortion arising from ETEF during the phase out period:

- Firstly, the Tribunal could develop a view of an appropriate benchmark for Wholesale Electricity costs (WEC) without regard to the ETEF arrangement. This would require the Tribunal (and its consultants) forming a view on the WEC on the basis that the standard retailers were required to hedge their load using over the counter available hedges.
- Secondly, the Tribunal could establish a market-based value for a hedge that has the characteristics of the ETEF and recommend a strike price under ETEF that reflects a market-based cost of a hedge with the same characteristics as the ETEF.

Either of these options would ensure that the WEC incorporated into the regulated tariff are reflective of the hedging, risk management and transactions costs associated with providing electricity to customers and would promote competition by removing a market distortion between standard and new entrant retailers.

COAG endorsement of Ministerial Council on Energy's agenda to phase out retail price regulation

The Tribunal seeks comment on:

- *The extent of competition in the NSW retail electricity market*
- *The appropriate form of regulation given Governments' aim to phase out energy retail price regulation.*

AGL supports a light-handed approach to energy retail price regulation. Many governments and regulators have stated that competition is preferred over regulation and that there is a need to move away from an approach that attempts to "second guess" market outcomes.

By June 2007 the NSW electricity market will have been open to competition for a period of 5 years. The NSW electricity market currently exhibits a number of the market characteristics of a competitive market whilst not experiencing the same high level of market activity as has occurred in Victoria and South Australia. Specifically:

- The IPART household survey (2003¹) identified that there is a large percentage (74%) of customers who are aware that they can choose their gas or electricity supplier;
- Customers have choice in that there are around 19 licensed retailers currently operating in NSW;
- The NSW market is an 'active market' with around 22% of customers in NSW having chosen to take up a market contract with another retailer; and
- there exists a broad range of market offers available in NSW with the potential for further innovation in products and services offered, such as the introduction of pre-payment meters and advanced metering infrastructure (AMI).

AGL considers that the removal of the ETEF and the establishment of tariffs using market based benchmarks for WEC, operating costs and margin will lead to further enhancement of competition.

¹ Residential energy use in Sydney, the Blue Mountains and Illawarra, Results from the 2003 household survey. Independent Pricing and Regulatory Tribunal of New South Wales, Research Paper, December 2004, p. 27

The Minister's TOR requires the establishment of a price determination for a period of three years. However, it would be consistent with the intent of the COAG agreement for the Tribunal's determination to have provisions that would allow for the price regulation to lapse prior to 30 June 2010. This would be on the basis that the AEMC competition effectiveness review recommended the removal of price regulation and the Minister was satisfied with the implementation of such recommendations. Where price regulation is removed the Australian Energy Markets Agreement allows for price monitoring and reserve powers to be maintained by the jurisdictions.

Market based retail energy pricing will promote product innovation and is the best mechanism for producing efficient prices, providing the correct price signals for new investment and giving incentives for the most efficient use of energy.

AGL strongly believes that a light-handed approach should be adopted to facilitate the transition to market based prices and further comments are provided in the section covering the form of regulation.

COAG's agreement to roll out time-of-use meters

The Tribunal seeks views on:

- *What problems have arisen during the current determination as a result of network roll out of time-of-use meters*
- *How the new determination could be used to facilitate the transition to time-of-use tariffs*
- *How the Tribunal should consider the impact of its determination on demand management*

AGL supports the use of interval meters and acknowledges that the market can derive benefits from the increased use of interval meters, such as improved demand management and removal of cross subsidies through improvement of net system load profile calculations.

A number of trials are currently under way in NSW and in other states to assess the benefits of interval meters and the likely impacts on the energy consumption patterns of residential and small business customers. It is noted that in Victoria a government sponsored trial will be undertaken to look at advanced metering infrastructure over the summer. A specific area of focus in more recent considerations on interval metering is to assess whether the real time provision of information to customers is more likely to influence customer behaviour.

The net benefits to be gained through the use of manually read type five interval meters are largely untested for residential customers. As such, AGL considers a comprehensive

quantitative analysis of the costs and benefits of interval meters, including the benefits of remote communication functions, prior to consideration of a mandated interval meter rollout or facilitating regulated tariff structures to suit a mandated interval meter rollout. This was recommended to the states in the final recommendation of the Joint Jurisdiction Review of Metrology Procedures.

The Tribunal, in making the tariff determination, will need to take account of the current progressive rollout of meters by the NSW network businesses, incorporating into the operating cost benchmarks an allowance for the significant costs borne by retailers that include:

IT expenses relating to:

- meter data management systems;
- billing systems changes to handle significant increases in data volumes and alternate billing arrangements;
- central communication systems (where Automated Metering Infrastructure is introduced);
- Marketing and customer communication costs; and
- Management overheads to respond to a changing metrology environment.

The Tribunal will need to assess the quantum of such costs in determining the appropriate operating cost benchmark. The Tribunal should note that operating cost benchmarks utilised in other jurisdictions have not included any costs related to interval metering as such costs were not expected at the time of the relevant price determinations.

Additionally, the form of regulation must be sufficiently flexible for the appropriate price signals associated with time of use metering to be reflected in the electricity bills of customers. If the form of regulation precludes an effective price signal to customers then the demand management benefits of interval meters would be at risk.

2 FORM OF REGULATION AND PRICE CONSTRAINTS

Broad options for the form of regulation

The Tribunal seeks comment from stakeholders on the regulatory approach that best meets the objectives for the review, the pros and cons of the options, and whether there are additional broad options or variations within the options that the Tribunal should consider.

The form of regulation and the tariff structure can directly impact the level of competition in the market place. New entrant retailers currently find it difficult to compete in the NSW electricity market as there numerous regulated tariffs, many of which are obsolete, complex or are under-recovering.

AGL strongly encourages the Tribunal to adopt a form of regulation that will enable tariffs to be cost reflective, which promotes a simplification of existing tariff structures and provides the flexibility to support an active competitive market.

AGL considers that a weighted average price cap on the retail component with full pass through of network charges should be adopted as the form of regulation for the next 3 years. This approach will provide retailers with appropriate flexibility in transitioning to cost reflective tariffs. Any side constraints (if needed) should relate to the retail component only and be sufficiently broad to allow for the rational transition to cost reflective tariffs, the progressive removal of cross subsidies and provide for the flexibility to establish appropriate pricing arrangements linked to interval meters and demand management initiatives.

With respect to the alternate forms of regulation outlined in the Issues Paper AGL provides the following comments:

- The current N+R approach of setting individual target tariffs is too restrictive and continuation of this approach will be detrimental to competition. With over 300 regulated retail tariffs this approach is too complex and contrary to moving to market based prices.
- A retail component (R) based on a weighted average price cap approach would provide retailers with greater flexibility in setting tariffs whilst ensuring a smooth transition to cost reflective prices over the price path period.

- A full pass through of network charges (N) should be allowed. Network charges are already separately regulated under the electricity distribution pricing determination covering the period 1 July 2004 to 30 June 2009².
 - AGL's experience indicates that in markets at a similar stage of competitive development to NSW a weighted average price cap approach (on the retail component) with full pass through of network charges provides standard retailers with the flexibility to:
 - appropriately rebalance tariffs,
 - unwind cross subsidies that are not sustainable in a competitive market; and
 - ensure that any network price signals (with respect to demand management) flow through to customers.
 - The option of an opt-in tariff, whilst appealing, would require significant consideration whether such tariffs would incorporate a premium and the associated regulatory framework impacts that may arise, for example, at what rate would a default customer be charged. The Tribunal would need to consider whether a new entrant retailer would also be required to have an opt-in tariff. Requiring customers to actively choose to be on a regulated tariff would be a significant divergence from the approach in other jurisdictions.
 - Under a weighted average price cap approach AGL does not consider there is a demonstrated need to impose any side constraints on the increases in customer bills. Should the Tribunal nevertheless consider side constraints are warranted then these should relate only to the retail component and should be sufficiently broad (greater of CPI+X% or a dollar amount) to allow for the transition to cost reflective tariffs. The current arrangement that allow \$5 for retail tariff restructuring is too restrictive.
 - AGL does not support limitations being placed on individual tariffs.
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3 COSTS TO BE RECOVERED

The Tribunal seeks views on the appropriate level for each of the relevant costs and on how the Tribunal should directly or indirectly consider that cost in determining regulated tariffs.

The costs incurred by retailers in providing electricity to their customers fall within the four broad categories:

- Wholesale Electricity Costs (WEC) comprising pool purchases, hedging, risk management and transaction costs, market fees and charges and costs for renewable energy requirements. These costs are then converted to energy costs at the customer meter by applying the transmission and network line losses;
- Network charges being the transmission and distribution charges incurred in supplying the energy to the customers' premises;
- Retail operating costs (ROC); and
- Retail margin, being the return of investment etc.

Establishing a sustainable market based cost benchmark for each of these cost categories is imperative if regulated tariffs are to be reflective of the costs and risks of providing electricity to customers. Experience has shown that where benchmarks are set below market costs then tariffs will act as an impediment to competition, may adversely impact the quality and reliability of supply and not support future investment in generation capacity.

The following provides general comments on these cost benchmarks. AGL will provide further comment upon release of the draft reports on retail costs, retail margin and wholesale costs by the Tribunal's consultants.

Wholesale Electricity Costs (WEC)

Determining future Wholesale Electricity Costs (WEC) is a complex, dynamic task. WEC comprise energy purchased at pool prices, the costs of hedge transactions which seek to manage demand and price volatility, a range of market fees and charges and the costs of renewable energy requirements. These costs are then translated to costs at the customer's meter by applying line losses.

Long Run Marginal Costs

AGL notes that the terms of reference require the Tribunal to consider both the Long Run Marginal Cost (LRMC) approach and to allow for the hedging, risk management and transaction costs when determining a WEC benchmark.

The LRMC is an economic analysis of lowest cost operation of future plant not yet built and is not considered a true measure of the WEC for the period under review. The WEC costs for the period to 30 June 2010 will in effect reflect the capital and operating costs of existing generation plant, together with the retailers costs of risk management and other applicable market charges.

A LRMC approach to estimating the cost of wholesale energy does not adequately address the market risks that arise from operating in a complex and volatile market. Experience has shown that a LRMC estimation methodology understates energy costs and risks for new entrant retailers. Analysis prepared in the past for AGL on the LRMC highlights the difficulties in using this as an absolute measure of future energy purchase costs. AGL recommends that, at a minimum, the following be taken into consideration in attempting to model the LRMC:

- The individual load profiles of the incumbent retailers must be incorporated into a separate LRMC for each profile;
- The peakiness of those profiles needs to be taken into consideration, including the impacts from changing climate, air conditioner penetration levels and any smart meter rollout (whether mandated or not);
- The increasing capital costs and operating costs need to be incorporated, as well as the varying assumptions on mix of expected generation capacity; and
- The losses that occur between the generation plant and the regional reference node where energy is priced.

The Tribunal's current retail electricity price determination allows for LRMC of \$50 per MWh including green costs to be incorporated into the recoverable costs. This amount, in AGL's view, is too low and does not appropriately cover the minimum considerations outlined above.

Extensive work was undertaken in South Australia by the Electricity Supply Planning Council to estimate an appropriate LRMC of supplying electricity. AGL suggests that the modelling undertaken in South Australia be reviewed and analysed by the Tribunal and its consultants to assist in the understanding of the modelling required in NSW.

Hedging, Risk Management and Transaction Costs

Good corporate governance demands that prudent retailers manage the purchase of electricity within the parameters of a Board-approved Risk Management Policy and Framework. Best practice risk management approaches require significant attention be given to the nature and characteristics of the customer demand and load profile, the utilisation of market hedge instruments to reduce exposure to volatile pool prices (which can be as high as \$10,000 per MWh) and quantified assessment of the revenue and profit at risk should unexpected events occur.

New entrant retailers in the NSW electricity market face a range of key risks including:

- Volatility of the electricity price – the NSW pool and contract price has been the most volatile in the National Electricity Market (NEM) for the past few years;
- Customer load is unpredictable - AGL considers load forecasting to be one of the greatest challenges of retailers:
 - the mass market load is highly weather sensitive and pool costs on peak summer days can be extreme;
 - consumption patterns of customers are changing due to increased air conditioning and other electrical appliance penetration;
 - increasing levels of customer churn / switching make customer number expectations unpredictable; and
 - variability in Net System Load Profile (NSLP) caused by, amongst other things, the 'cherry picking' of customers;
- Liquidity Risk – the volatility in the NSW price can result in a lack of liquidity for retailers in certain periods;
- Credit Risk – some counter-parties expose retailers to risk of default;
- Vertically integrated retailers may be exposed to generator outage, transmission risk, fuel costs etc; and
- Contract risk, eg carbon uplift, is also a factor for retailers.

While there are hedging products available to mitigate risk, AGL is of the view that even with very conservative hedging practices, the wholesale electricity risk to retailers can be extreme.

AGL notes that ETEF will be progressively removed during the price review period and would support WEC being determined without consideration of the impacts of ETEF on the standard retailer's costs. This approach would further assist the standard retailers to effectively transition to market based hedging arrangements as ETEF is removed. Also importantly this will ensure competitive neutrality within the NSW electricity market.

The Tribunal should also consider the effect that phasing out the ETEF will have on wholesale energy load, hedging and risk management costs over the determination period. With the increased wholesale energy load purchases subject to the pool price as opposed to the ETEF arrangements there is likely to be a substantial effect on the generation activities and electricity wholesale pricing arrangements.

AGL considers that the Tribunal should consider hedging, risk management and transaction costs over and above the LRMC, which does not incorporate these aspects of retailing electricity to customers.

For standard retailers, the ETEF arrangements mitigate their risk exposure to wholesale energy prices. It is understood that the estimate of the LRMC is used in setting the strike price under the ETEF arrangements. Accordingly, standard retailers are not exposed to the same level of market risks faced by new entrant retailers and are able to purchase a significant volume of energy at prices below that available to new entrant retailers.

Market Fees and Charges, Renewable Energy Costs and Green Energy Option

AGL is of the view that in the upcoming regulatory period the NEM retailer fees are not likely to increase significantly from their current levels. However, AGL suggests that sufficient consideration should be given by the Tribunal to allowing a pass through mechanism for any material increases that may arise if there are any significant structural changes in the NEM.

The full costs of securing Renewable Energy Certificates (RECS) to effectively comply with Mandatory Renewable Energy Targets (MRET) and the NSW Greenhouse Gas Abatement Scheme (NGAC) are costs to be incorporated into the WEC.

AGL will provide on a confidential basis a forecast of costs of compliance with green energy obligations MRET and NGAC for the consideration of the Tribunal. The forecast will be based on:

- Existing MRET and NGAC liabilities which, under legislation, increase each calendar year;
- The average purchase price of the underlying instruments required for a retailer to meet their MRET and NGAC liabilities and comply under each green energy scheme; and
- An allowance for administration costs associated with meeting the compliance requirements, which includes items such as auditing, certificate surrender, statement preparation, etc.



AGL supports the development of policy initiatives that increase customer awareness of, and demand for, renewable energy. AGL notes that the requirement for retailers to offer the 10% Green Power component will be governed through NSW electricity retailers' licence conditions.

While the actual requirement to offer a 10% Green Power component to all new (or moving) residential customers will be a licence condition, it is AGL's view that the product itself should not be regulated. The minimum 10% green offer should be offered through competitive market contracts determined by each retailer. This will ensure that any remaining regulated tariffs will not cross subsidise the 10% Green Power offer, and will allow regulated retail tariffs to effectively transition to cost reflective tariffs.

Energy losses

Due to the nature of energy flows through networks some energy is lost during transmission and distribution. Energy purchase costs need to be adjusted for these losses as retailers record energy consumption at the customer's meter but are billed for the energy purchased at the reference node.

The system loss factors are calculated by multiplying transmission and distribution losses. The transmission losses included in the calculation are those approved by the National Electricity Market Management Company (NEMMCO), and the distribution losses are those approved by the Tribunal each year.

AGL notes that the distributors in NSW are moving towards a process of determining their distribution loss factors in a given year by taking into account their 'under / over' losses based on actual versus forecast calculation as well as expected forecast losses. This adds a further level of complexity than that experienced in other jurisdictions. Accordingly, as these are costs beyond the control of the retailers it may be appropriate for the Tribunal to allow a pass through arrangement for variances from the line losses used in making the price determination.

Network Charges

In view of the current state of development of the NSW competitive market and planned investment in network infrastructure AGL supports a full passthrough of network charges. Without allowing for such a mechanism, any increases in network charges will erode the

standard retailer's margin and may act to partially diminish competition in the NSW electricity market.

The currently approved network charges were subject to vigorous regulatory review by the Tribunal and reflected those costs which the Tribunal considered appropriate at the time to be incurred by network operators to deliver electricity to customers. The Tribunal has determined that network charges should increase in real terms by between 1.5% and 2.5% per annum. It is noted that network operators have requested and obtained approval for additional expenditure to support further investment in reliability of network. In this context, and given the potential for other network developments (eg interval meters,) a full pass through of network charges is warranted.

Retail Operating Costs and Margin

AGL considers that:

- An allowance for operating costs should be set at a level that includes all costs in attaining, retaining and servicing customers. Benchmarks for operating costs used in other jurisdictions allow for a range of retailers to compete in those markets, we would expect a similar approach to be adopted in NSW. Consideration also needs to be given to costs that retailers will incur in the future which are not currently being incurred. For example, costs associated with the roll out of interval meters;
- The accurate average consumption per customer is paramount to ensure appropriate conversion of operating cost per customer to operating cost per MWh;
- Low retail margins are a significant impediment to developing competition and to the future investment in generation capacity. AGL notes that the standard retailers have proposed possible retail margins in the range of 8% to 13%. These margins are considered reasonable for the risk profile of retailing energy and are not inconsistent with retail margins considered in other jurisdictions. Achievement of the benchmark margin will be dependent on realistic benchmarks being established for wholesale and operating costs.

Specific comments on retail operating costs and margin follow.

Mass Market New Entrant Retail Operating Costs

The allowance for retail operating costs is intended to cover a retailer's costs associated with activities such as:

- Billing and revenue collection;

- Operating a telephone call centre;
- Providing advice and assistance to consumers;
- IT system costs and business to business (B2B) costs associated with handling metering data and other transactions with the distributors.
- Regulatory compliance; and
- Corporate overheads (including licence fees and ombudsman charges).

In addition to these, mass market new entrant retailers incur customer acquisition costs and customer establishment costs.

New entrant retailers can also experience higher operating costs than retailers stapled to a distributor. Currently, AGL finds it difficult to compete in the NSW electricity market due to the cost of IT system modifications required for the type 5 meter roll-out being undertaken by Energy Australia.

AGL's experience nationally is that there is an increase in the demands by, and expectations from, customers, customer groups, governments and regulators. Retailers face increased costs from:

- Increasing customer expectations;
- Introducing new systems and processes for handling transactions with the distributors on behalf of customers;
- Establishing new programs to help customers manage their energy consumption and lower their energy bills;
- Implementing assistance programs for customers in financial hardship; and
- The licence requirement to offer a 10% Green Power product. The cost to contract a customer will increase as a result of the additional time spent with each customer to explain the new requirement - many customers will not be familiar with 'green products'.

AGL's notes that the current benchmark retail operating cost in NSW of \$70 per customer is well below the benchmarks used in Victoria and South Australia. Further, these interstate benchmarks do not include any allowance for customer acquisition costs nor costs associated with new initiatives such as interval metering. The Victorian Government has announced recently that an allowance of \$4 per customer per annum has been made to provide funding for additional hardship initiatives by retailers.

Mass Market New Entrant Retail Margin

Retail margins needs to be sufficient to cover business risks, interest payments, tax liabilities, etc as well as ensuring a reasonable return to shareholders.

A number of alternative approaches can be adopted to establish an appropriate level of retail margin. AGL strongly supports a retail margin based on a percentage of total sales. This approach is commercially accepted across a range of industries and is generally consistent with that adopted in other jurisdictions. Alternatives considered have included a return of and return on investment approach. Irrespective of the approach, the level of margins must be sufficient to attract new entrant retailers and to encourage retailers to support future investment in generation capacity. The current retail margin benchmark of 2% of sales is insufficient.

The margins proposed by the standard retailers are in the range of 8-13%. Margins of this order would not be inconsistent with the margins that considered in other jurisdictions and are consistent with the level of risk in supplying electricity to small customers in the NSW market.

Further, it is relevant that the Tribunal notes the asymmetric risk in setting benchmark costs and margin levels. That is, if the benchmark costs and margins are set below realistic levels for the NSW market then competition and investment are likely to be stifled. Whereas if costs and margins are set marginally above realistic levels then any benefit is likely to be competed away as retailers seek to attract customers.

Pass-Through Mechanisms

AGL's view of the most appropriate mechanism to capture costs of new schemes is that of a 'pass-through' mechanism. This mechanism should also be available for changes in legislation such as new requirements as a result of the move to a national regulatory framework. Each 'pass-through' event request should be submitted to the Tribunal for approval prior to adjustment of retail tariffs.

AGL considers that a request for a pass-through should be a commercial decision of the individual retailer, who is best placed to determine if the pass-through amount warrants recovering via tariff adjustment.

4 MISCELLANEOUS CHARGES

The Electricity Supply Act 1995 (ESA) defines regulated retail charges as a security deposit, late payment fee or dishonoured bank cheque fee of an amount specified in a determination that is in force.

AGL notes that the Tribunal has determined that it is restricted to considering only these three charges and that no additional charges can be introduced.

AGL suggest that the Tribunal adopts a light-handed approach to the regulation of miscellaneous charges based on a set of principles similar to that applying in South Australia:

- fees and charges are to be cost reflective; and
- are set on a fair and reasonable basis.

The Tribunal would be able to require retailers to justify miscellaneous charges if they are considered not to be compliant with these principles.

Specific comments on the allowable miscellaneous charges are:

- Current arrangements for retailers to collect security deposits from residential customers are appropriate and are in line with other jurisdictions. AGL considers that the collection or otherwise of security deposits for business customers should be left to the retailer to determine. The energy accounts of business customers range considerably, potentially placing retailers in substantial commercial risk in the event that a business customer defaults on their energy account. Where a product is consumed prior to payment, as is the case with gas and electricity, AGL considers it reasonable to request an up-front payment to mitigate commercial risk exposure to the retailer.
- Late payment fees should be applied on a cost reflective basis and should be applied to those customers who have, through their own actions, caused additional costs to be incurred by the retailer. Late payments are designed to encourage customers to meet their obligation to pay their accounts by the due date.

Currently, AGL charges approximately \$12 for those customers on market contracts that make a late payment. This amount is cost reflective and calculated and charged to the customer on a fair and reasonable basis.

The late payment fee applicable to residential customers should be applied to the energy account following late payment of the initial invoice. This practice is consistent with other jurisdictions, as well as with other consumer goods, such as telecommunications.

Late payment fees should be applied to business customers from the due date of the account, particularly given the value of the energy accounts for small business.

- The level of 'bank cheques' used by customers to pay their energy account has somewhat diminished in recent years with the availability of alternative methods of payment, such as credit card and savings account direct debits, being preferred payment methods. AGL believes that amendments to the Electricity Supply Act should be considered to allow dishonoured fees to be placed on payment options (other than bank cheques) as is currently the case in other jurisdictions (VIC and SA).

The dishonoured payment process generally requires manual intervention by the retailers and thus can result in considerable administration costs being incurred by the retailer. Therefore, the retailer should be able to recover these costs where payments are dishonoured by financial institutions.

While AGL recognises the current limitations on the Tribunal in considering miscellaneous charges it may be appropriate for the Tribunal to provide the capability to consider changes to the type and quantum of charges should the ESA or regulations in the future permit.

In addition to miscellaneous charges, AGL is of the view that retailers should be able to recover an 'administration charge' for those services that it coordinates between the network operator and the customer. This would include the administration of service level and incentive payments, connection requests, special meter reads, etc.