AGL Energy Sales & Marketing Limited Submission

To

Independent Pricing and Regulatory Tribunal of NSW

Issues Paper

Review of Electricity Regulated Retail Tariffs

PREAMBLE

The Independent Pricing and Regulatory Tribunal of NSW (The Tribunal) notes a number of objectives for establishing the form of regulation for gas and electricity regulated retail prices in its Issues Paper (the Paper) which are summarised below:

- Transitional regulation to ensure vulnerable customers are not disadvantaged;
- Consider effectiveness or otherwise of competition;
- Regulatory arrangements to be as simple as possible (Government direction);
- Move all tariffs to cost reflective levels without exposing customers on under recovering tariffs to unacceptable price shocks;
- Consider impact of price changes on regulated businesses;
- Consider appropriate degree of consistency between gas and electricity.

The Terms of Reference issued by the NSW Minister for Energy and Utilities for the review of electricity regulated prices notes that the difference between regulated tariffs and market based prices is the key determinant of how many eligible customers remain on regulated tariffs. It further notes that the government's policy aim is to reduce customers' reliance on regulated prices.

The Minister has extended the availability of regulated tariffs and charges to 2007 and requires an assurance that customers can return to regulated tariffs while testing the market. The Tribunal is expected to take the following into account in its consideration of regulated electricity prices:

- Effect of its determination on competition in the retail electricity market;
- Ensure regulated tariffs cover costs;
- Recognise customers' ability to adjust to prices;
- Consider tariff options to encourage demand management;
- Ensure regulated tariffs are at cost reflective levels by 2007;
- Smooth transition for customers;
- Consider alternative options for the transition.

This paper provides comments on the most effective option for meeting the objectives of promoting competition and ensuring that customers are not subject to unacceptable price shocks. The paper also provides our comments on the basis for establishing costs and margin benchmarks where there is a likelihood of unacceptable price shocks to customers, that is where average price increases exceed a predetermined benchmark (eg CPI).

We note from submissions by the standard electricity retailers in NSW that the electricity industry will require a one-off adjustment to prices for a CPI threshold to work or alternatively the threshold for the electricity market in NSW will have to set at CPI+X.

EXECUTIVE SUMMARY

AGL Energy Sales & Marketing (AGL ES&M) is a second tier retailer in the NSW electricity market committed to providing its customers electricity at reasonable prices. AGL ES&M has always endeavoured to ensure its prices reflect the costs and risks incurred in supplying gas and electricity.

The unique characteristics of the NSW electricity market mean that the new entrants and incumbent suppliers do not compete on the same terms. The costs and risk profiles of the new entrants and incumbents are significantly different. AGL ES&M is of a firm view that if a competitive electricity market is to be encouraged in NSW then these differences need to be addressed as a matter of urgency.

Current benchmarks used for setting regulated electricity tariffs stifle competition and do not reflect the costs of a second tier retailer operating in this market. Specifically:

- the wholesale electricity cost benchmark is set artificially low as new entrants do not have access to the wholesale electricity prices or the risk profile available under the Electricity Tariff Equalisation Fund (ETEF);
- operating cost benchmarks used for the electricity industry are low by national standards; and
- retail margins do not reflect the risks for a non-incumbent business. Working capital, interest and tax payments, and an appropriate recovery of customer acquisition costs come out of the retail margin before any return to shareholders.

In addition, the NSW electricity market is characterised by:

- existing tariffs that are not cost-reflective. Standard retailers have highlighted that the inter play of the numerous constraints set on price movements have precluded the achievement of this objective;
- significant increases in network charges being sought by electricity distributors relating to previously under-recovered costs and new investments.

Unless these matters are addressed as a matter of urgency there is likelihood that the NSW electricity market will require a substantial price adjustment in future (with potential price shocks to customers) or that competition in the electricity market will be severely restricted.

In our submission on the review of regulated gas prices, we forwarded our views on the form of regulation and the approach to establishing benchmarks for assessing price proposals by retailers.

Consistent with the form of regulation proposed by us for gas, AGL ES&M proposes that the Tribunal adopt an average price approach ("CPI approach") to default electricity pricing. AGL ES&M considers this to be the most appropriate form of price regulation to meet the government's broader policy objectives of:

- Promoting competition in the energy market and ensuring the public receives the benefit of a competitive market;
- Taking proper account of and protecting the interests of small retail customers (that is, ensure that small retail customers are not exposed to unacceptable price shocks); and
- Taking proper account of the business interests of persons supplying energy to small retail customers.

AGL ES&M acknowledges that for electricity "CPI Plus" proposals will be required to achieve cost reflective tariffs by 2007. The situation is compounded by the impact of future network charges with the NSW electricity distributors seeking distribution price increases that will have retail price impacts in excess of CPI. The options for the Tribunal to ensure tariffs become cost reflective are:

- A one-off adjustment to average retail prices to accommodate the cost increases, followed by a CPI average price path; or
- A CPI + X average price path for the next regulatory period.

AGL ES&M proposes that subject to the acceptability of an initial increase in prices (avoiding undesirable price shocks) that the first option is more appropriate. This will provide appropriate opportunities to second-tier retailers and permit a more mature competitive market to be in place by the end of the regulatory period.

1. INTRODUCTION

The Tribunal has advised that it is government policy that the regulation of gas and electricity prices continues to June 2007. The relevant legislation provides the Tribunal with the flexibility to determine the form of regulation used.

AGL ES&M supports the view held by many regulators in Australia and overseas that competition is preferred over price regulation. For example, the United Kingdom (UK) regulator, where competition has been robust, suggests that price controls may inhibit competition and could also remove competitive pressures on prices for those customers who choose to remain with their traditional supplier. In the UK price controls for gas and electricity were removed in April 2002 and replaced with reserve powers existing under UK competition law.

The Victorian Energy Minister (in the special reference for the review of gas and electricity tariffs, November 2002) directs the Essential Services Commission, to have regard to the overarching principle that "effective competition is to be preferred over regulation". The Commission is also required to consider that where regulation is needed (in place of effective competition) it should lead to outcomes consistent with outcomes that would be expected under effective competition.

Whilst the principle to replicate outcomes consistent with a competitive market is commendable, there are a number of issues for regulators in the practical implementation of this principle. Measures of the outcomes under effective competition are difficult to establish and significant risks exist that benchmarks established by regulators may stifle competition. Ultimately, it is the market that will determine the efficient outcomes for the energy industry. If replicating efficient market outcomes was readily determined then full retail contestability would not have needed to be implemented.

The requirement on regulators to replicate competitive market outcomes and the regulators' familiarity with mechanics of monopoly price regulation ("cost plus") with all its inherent flaws, has diverted emphasis away from more effective alternatives to achieving key objectives of transitional price regulation.

AGL ES&M believes that the "cost plus" approach is relevant but only in circumstances where customers are likely to see undesirable price shocks. A "cost plus" approach provides *a guide* to moving prices to cost reflectivity whilst managing price impacts on customers.

AGL ES&M believes that the CPI Approach meets the objectives of promoting competition and ensuring that customers are not subject to unacceptable price shocks.

Our proposed approach to default price regulation reflects the transition in other jurisdictions. For example, in Victoria a similar approach is currently used for the review of retailers' default price proposals by the regulator. It is our view that by the end of the next regulatory period price controls should be removed similar to arrangements in the United

Kingdom (UK) where price controls were removed after 3-4 years of full retail contestability.

2. KEY CHALLENGES

AGL ES&M notes that standard electricity retailers have indicated that their tariffs are not cost reflective at present nor that they achieve an appropriate margin under the current benchmarks. This would mean that standard retailers will require CPI plus proposals over the next regulatory period.

We are concerned that current price regulation arrangements have impeded the achievement of cost reflective tariffs in the current regulatory period (2.5 years of full retail contestability) and have acted as a barrier to entry to the market. Further, AGL ESM is concerned that the current benchmarks have not been appropriately determined to reflect the true costs of non-government owned retailers (second tier retailers).

The current review of regulated retail prices for small customers by the Tribunal has important consequences for the development of competition and the welfare of consumers.

The review is particularly important to AGL ES&M.

Although AGL ES&M is not a standard retailer we will be directly affected by the Tribunal's recommendations. The level of regulated tariffs determines whether non-standard retailers such as AGL ES&M can profitably enter the electricity market in the NSW. Regulated tariffs effectively set a cap on the prices that any retailer can charge for customers using less than 160 MWh of electricity per annum. If prices are set too low relative to the costs of purchasing and supplying electricity, retailers such as AGL ES&M will be limited in our ability to effectively compete in the market in the NSW. The Government's stated policy goals of reducing customers' reliance on regulated tariffs and encouraging competition will not be achieved.

AGL ES&M recognises the important role that regulated tariffs play in protecting customers who do not elect to participate in the competitive market but this needs to be balanced with the goal of encouraging active competition in the NSW electricity retail market.

The terms of reference for the review require the Tribunal to set tariffs at cost-reflective levels and to encourage new entry into the retail sector. In relation to costs, many elements of retail costs, particularly energy costs and retail margins cannot be known with certainty, and therefore a range of reasonable estimates should be made. To reconcile the need to ensure that tariffs both reflect costs and facilitate new entry, the logical requirement for regulated tariffs is that they be set at the upper end of these estimates. If they are set at the mid-point or the low end of the range of reasonable cost estimates it likely that the benchmarks will not reflect the actual costs of new entrant retailers which will limit their ability to compete.

AGL ES&M believes that the Tribunal needs to address the following issues if the stated objectives of promoting competition, ensuring customer protection and business viability are to be achieved:

- A LRMC approach to estimating the cost of wholesale energy costs does not adequately address the market risks which arise from operating in a complex and volatile market. Such estimates understate energy costs and risks for new entrants like AGL ES&M;
- Operating costs benchmarks used by the Tribunal in its previous decisions and "apparently" accepted by the standard retailers is low and significantly below operating cost benchmarks accepted by other regulators; and
- Retail margins allowed for electricity are not reflective of the risks faced by the non-incumbent retailers and do not allow sufficient "headroom" to amortise costs associated with customer acquisition.

The failure to deal with these issues will risk the electricity market in NSW being exposed to a significant price adjustment in future years and seriously impede the development of a competitive energy market in NSW.

3. CURRENT ELECTRICITY PRICE REGULATION – THE ISSUES

The current arrangements for electricity price regulation were established with the objectives of achieving cost reflective tariffs under a target tariff approach and of promoting competition. The Tribunal sought to ensure that tariffs were "neutral", that is reflect competitive market outcomes.

This approach assumed that the benchmarks established by the Tribunal were reflective of costs in a competitive market and ignored costs to new entrants both for supply and acquisition.

Current Tariffs Not Cost Reflective

Current tariffs are governed by a number of constraints established on the price movements. Standard retailers have stated that these constraints have significantly impacted on their ability to move tariffs to cost reflective levels because they:

- constrain average price increases;
- limit individual tariff movements;
- preclude tariff increases where tariffs are above or at target levels; and
- constrain increases to individual customer bills.

The combined effect of these constraints has been that standard retailers have had limited scope to restructure tariffs to achieve cost reflectivity. The learning from this approach is that multiple constraints have a compounding effect. A single price constraint may avoid similar issues occurring in the future.

4. MOVING TARIFFS TO COST-REFLECTIVE LEVELS

The terms of reference for the retail price review clearly identify the Government's policy position that a reliance on regulated tariffs is to be reduced, and that competition is to be encouraged. The terms of reference also state that as far as practicable, regulated retail tariffs should be at cost reflective levels for all small retail customers by 30 June 2007, having regard to the need for a smooth transition for customers.

The single most important barrier to entry into the NSW retail market is the widespread presence of under-recovering tariffs. Under recovering tariffs renders it virtually impossible for any other retailer to profitably compete for customers on such tariffs. Therefore, under-recovering tariffs will result in these segments of the customer base not being provided with the opportunity to participate in the competitive market.

The effect of under-recovering tariffs on the competitiveness of the retail market is not limited to the customers on under-recovering tariffs. Economies of scale are important in the retailing business. To the extent that under-recovering tariffs reduce the potential size of a new entrant's customer base, new entrants may experience higher costs than otherwise, and have difficulty in attracting even customers on fully recovering tariffs.

The consequences of moving under-recovering tariffs upwards to become fully cost-reflective would not be unambiguously bad from an equity perspective. Firstly, under-recovering tariffs impose costs on other retail customers (who pay higher tariffs than otherwise), and/or reduce dividends payable to the Government shareholder (given Government ownership of standard retailers), which affects its ability to provide services to the people of NSW, or its ability to reduce taxes. Both of these consequences have undesirable efficiency and equity effects.

Secondly, it should not be assumed that all customers paying under-recovering tariffs would face financial hardship if tariffs were increased. Under-recovering tariffs represent an extremely blunt and untargeted instrument of social welfare. The Government's arrangements in relation to energy bill concessions represent a much more targeted and transparent approach to assisting those who are in need.

The terms of reference also require the Tribunal to consider options for restructuring tariffs to promote demand management. At a minimum, tariffs to promote the efficient use of electricity should be cost-reflective.

Putting price shocks into perspective

The terms of reference for the retail price review require IPART to take into account the need to protect consumers from price shocks.

Clearly, this reflects an equity rather than an efficiency objective. The price constraints included in the mid-term review are unreasonably tight, and should not be adopted in the

current determination. Over-recovering and recovering tariffs were not permitted to rise in nominal terms. In addition, average prices across all small retail customers were not permitted to increase by more than the percentage change in CPI. These latter constraints ensured that it was difficult for a standard retailer to increase prices for those on under-recovering tariffs to the full extent allowed under the individual tariff constraints.

The Terms of Reference clearly identify a need to protect consumers from price shocks. What constitutes an unacceptable price shock is a subjective matter. The types of possible price increases that could be faced by electricity customers could be placed into perspective by looking at cost increases for other commonly purchased items.

A minority of customers, however, would be expected to experience some degree of financial hardship related to increases in electricity prices. Other mechanisms to deal with these problems (such as State Government's assistance programs for low-income households) represent a more targeted and transparent mechanism to addressing the issue than under-recovering tariffs. Although concessions represent a direct budgetary cost, to the extent that under-recovering tariffs reduce the dividends payable by State-owned retail businesses, this also represents a budgetary cost. Since the latter is not targeted, it is entirely possible for it to be a greater budgetary cost than an increase in concession payments.

5. APPROPRIATE LEVELS OF COSTS TO BE RECOVERED

Establishing benchmarks for supply costs and margins requires a regulator to form a view on the levels that will promote competition. This is a difficult task and has the inherent risk that competition may be stifled. The objectives of competition reforms infer that the market is best placed to deliver efficient outcomes.

Governments and regulators have stated that competition is preferred over regulation. There is a need to move away from an approach that attempts to "second guess" efficient market outcomes (which if too low, would inhibit competition), to allowing the markets to work whilst ensuring that customers do not see unacceptable price increases (price shocks).

AGL ES&M reiterates its view that a CPI approach to price regulation best achieves this objective over the next period. The CPI approach is based on a single average price threshold (CPI) on all tariff categories. If retailers propose average price variations that are less than or equal to the CPI threshold then these should be allowed. If retailers propose average price variations that exceed CPI, then a price justification will be required. The benefits of a CPI Approach are as follows:

- Meets the government's policy objectives;
- Ensures a stable price path in transition to market based default prices, that is, no increase in real terms on average without formal justification;
- Allows year to year variations to costs to be managed more effectively (smoothes price to customers);

- Whilst such an approach sets a threshold to average price variations without a detailed justification being undertaken it may in fact lead to prices being lower than CPI as retailers respond to an increasingly competitive market;
- Achieves a sound business platform for enhancing competition in the market;
- Promotes competition by allowing a more flexible approach to pricing which can be more reflective of market conditions and result in more efficient market outcomes. Reduces regulator's risk of getting benchmarks wrong, thus distorting market or creating a barrier to entry (costs or margins too low); and
- Generally reduces the need for regulatory intervention in the market as reviews will only be required for "CPI plus" proposals.

However, we also recognise that the constraints placed on electricity prices in the current period means that a one-off adjustment in the first year is necessary. This should then enable business viability to be achieved by removing the threat of under recovery of costs and allowing an appropriate allowance for risks associated with supplying electricity to small customers.

In establishing appropriate benchmarks consideration needs to be given to four key costs drivers which are:

- wholesale electricity costs;
- network charges;
- retail operating costs; and
- retail net margins.

The amalgamation of each of these components together with an allowance for the risks faced by retailers could provide sufficient encouragement for competition to be further developed in the electricity market. AGL ES&M provides specific comments on the benchmarks for these cost components.

Wholesale Electricity Costs

The Tribunal currently incorporates wholesale electricity costs into retail electricity prices based on the long run marginal costs (LRMC) of electricity generation. The Tribunal notes that the level of LRMC depends on factors such as:

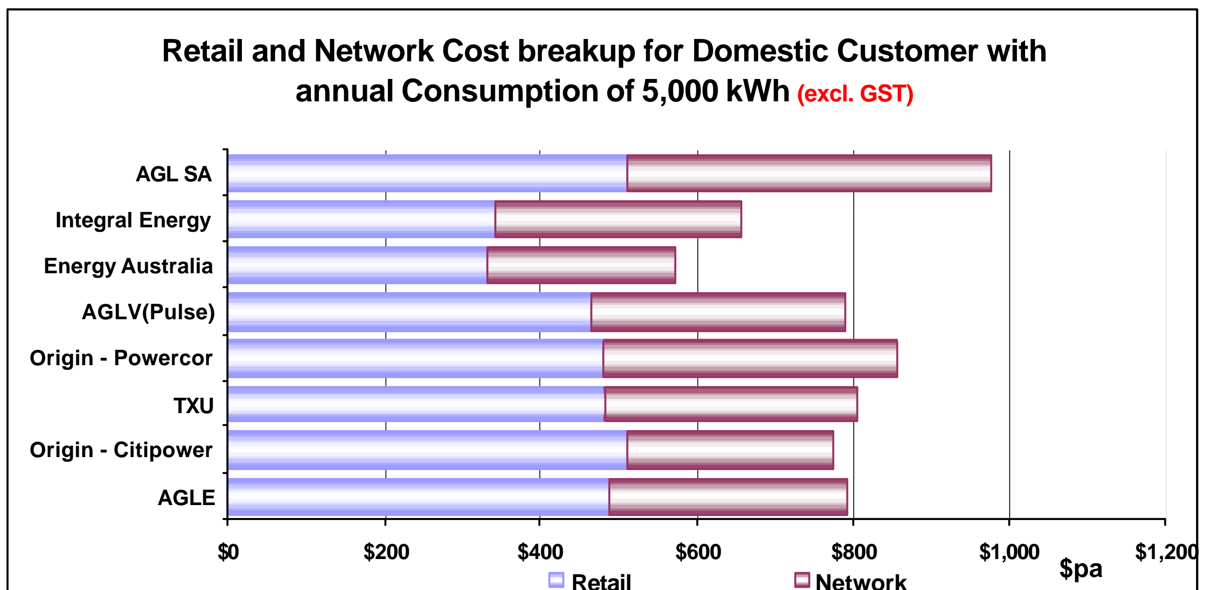
- The cost of potential fuels for generation (for example, coal, gas);
- Taxes, charges and subsidies;
- Environmental standards;
- The size and utilisation of electricity and gas transmission networks (for example, the extent of interconnection between different states).

AGL ES&M is of the view that sufficient consideration is not being given to the load profiles supplied by the standard retailers or to the risks faced by the non- standard retailers. If wholesale electricity costs do not reflect second-tier retailers' costs in entering the market then the Tribunal's pricing decisions will have a detrimental effect on competition in the retail electricity market.

Current Wholesale Electricity Cost Benchmark

As mentioned earlier the current wholesale electricity cost benchmark used by the Tribunal does not reflect the costs to second tier retailers. These benchmarks have also not been varied to reflect the change in load profiles supplied by the standard retailers.

The electricity purchase cost benchmarks used by the Tribunal are in the range of $39 to $59/MWh and are significantly lower than those assessed in other states. Whilst the NSW benchmarks may reflect the actual costs of standard retailers under the Electricity Tariff Equalisation Fund (ETEF), they are not reflective of the costs to second tier retailers. The graph below illustrates the difference between the NSW retail component and those in other jurisdictions. The retail component comprises wholesale electricity costs, retail operating costs and net margins. The retail cost for a second tier retailer are not significantly different between the regions, however, this is not reflected in the retail tariffs in NSW.



Long Run Marginal Cost of Electricity versus Contract Estimates

The estimate of long run marginal cost included in the Tribunal's determination for regulated retail tariffs has asymmetric implications for standard and non-standard retailers. These asymmetries have important implications for the continued development of a competitive retail market in NSW.

For standard retailers, the presence of the ETEF arrangements means that their risk exposure to wholesale energy prices is extremely limited – in fact, non-existent. In a sense, so long as the ETEF arrangement exists, the energy cost estimates embodied in them is largely irrelevant. In particular, if the estimate of LRMC is set too low, and this is reflected in the

ETEF arrangements, standard retailers experience no material commercial harm. If anything, they would benefit from slightly higher sales volumes, induced by lower retail prices.

Non-standard retailers are in a completely different position, however. They are not included in the ETEF arrangements. In order compete with incumbent retailers, a non-standard retailer must organise it's own wholesale hedging arrangements at costs at or below those available to the standard retailers.

Analysis prepared for AGL ES&M on the LRMC highlights the difficulties in using this as an absolute measure of future energy purchase costs.

The estimated LRMC based on these results for the optimal mix and dispatch of plant to meet the ETEF load is in the upper end of the range published by IPART (2002). This should be viewed as an **absolute minimum** to be included in any assessment of energy purchase costs faced by retailers. Establishing a contract portfolio in the market frequently results in costs higher than the predicted LRMC. Inherent difficulties with using LRMC of generation as the sole estimate for energy purchase costs include:

- The NEM – like all real-world markets – is not perfectly efficient, all participants do not have perfect knowledge about the most appropriate timing and location of generation assets, and there is uncertainty about future demand and price levels.
- The LRMC model assumes perfectly efficient investment and operation of the generation system including perfect knowledge.

Both a LRMC approach and a contract portfolio approach require allowance for

- costs associated with any statutory greenhouse gas reduction obligations;
- hedge mismatch risks faced by second tier retailers;
- other risks relating to counterparty risks, force majuere and customer churn;
- pass through costs such as NEM market fees, ancillary services etc are also to be included; and
- the impact of transmission and distribution system losses.

The above items impact the wholesale electricity cost benchmark as follows:

- All retailers are required to surrender NSW Greenhouse Abatement Certificates (NGACs) each year to comply with their individual benchmarks, or else face a penalty of $10.50 per tonne of excess emissions. The cost of Renewable Energy Certificates (MRET) is also required to be included in the green compliance allowance.

  An estimated allowance for green compliance costs of between $1.60 and $1.90 is expected for 2004 and this allowance is expected to increase over the period to 2007. The cost of green compliance should be a passthrough cost to customers
- Purchasing hedge contracts to meet volatile customers' demand is difficult. Retailers will utilise a range of different hedge contracts to match customers demand, however,

retailers will continually experience differences between predicted demand and actual demand at any given time. This gives rise to retailers being over and under contracted and an appropriate allowance should be made for this hedge mismatch. Regulators in other jurisdictions have incorporated such an allowance in their wholesale cost benchmarks. In South Australia an allowance of 6.5% was provided for this risk.

- Retailers are required to pay a range of market fees relating to NEMMCO operating the market and for the provision of ancillary services to allow the physical generation market to operate. Market fees are a passthrough cost.
- An appropriate allowance for other risks experienced by retailers including counterparty default, force majuere events and customer churn. An allowance of 5% has been accepted as appropriate in other jurisdictions.
- Energy losses are experienced in the delivery of electrical energy to the customers' premises. Accordingly wholesale energy purchases need to be scaled to reflect higher quantum of energy that retailers are required to purchase to meet customers' demand. Losses vary by distribution area and range from 5.4 % to 20 %

When these additional items are included together with estimates of the base energy cost we would expect the wholesale energy cost (at the meter) to be in the range of $70-$73 per MWh for metropolitan electricity customers.

Network Charges (including Transmission Charges)

The Tribunal advises that benchmarks for network charges will need to reflect regulatory outcomes on the various network operators' access reviews.

AGL ES&M strongly supports the full passthrough of network charges.

The Tribunal's previous determination based retail prices on the formula N + R, where N reflected network tariffs (transmission and distribution), and R reflected the retail component (energy costs, retail costs, retail margins). Price constraints applied to the combined total of N + R. This meant that where network charges increased, the scope for total retail prices to increase was diminished.

If competition is to be encouraged, network costs should be treated as a straight pass-through item. It is vital that the Tribunal does not seek to 'undo' the effects of any decisions made on price increases in the distribution pricing review through constraints on regulated retail tariffs.

Increases in regulated distribution charges are likely to be a potential source of price shocks to electricity customers. All NSW electricity distributors have requested significant increases in their charges, relating variously to previously under-recovered costs and new investments. It is expected that the Tribunal would rigorously assess such claims for price increases, and ensure that distributors could only recover the costs of genuinely efficient investments.

For some customers to suddenly face the true cost of their distribution charges could entail substantial price increases. For example, Australian Inland Energy has submitted that passing on the true cost of distribution standing charges to some of its domestic customers could raise their bills by around $75, and for some irrigation customers, by around $1,400 a year.[1] Price increases of such magnitude may well be considered by the Tribunal to be beyond consumers' powers of adjustment.

Assuming that the Tribunal did not want consumers to be faced with such a large price increase, it has two regulatory options to achieve this:

- it could allow the distributor to charge this full amount, but require the retailer to pass on a lesser amount to the customer; or
- it could not allow the distributor to charge this full amount. The retailer could then pass through whatever (smaller) amount has been deemed to be a reasonable distribution charge for that customer.

Transition paths from under-recovery to full cost recovery are merely sub-options within these two broad approaches. These two options achieve the same equity goal, but have very different consequences for the development of competition in the retail market.

The effects of the first option are as follows:

- the distribution company would be made 'whole', and would not need to charge other customers higher distribution charges to make up any losses. The dividends it could pay to Government would not be reduced;
- the standard retailer would incur a loss. This loss would either need to be recouped from other customers (distorting their electricity consumption decisions, and raising its own equity concerns), or else it would result in reduced dividends paid to Government, also raising equity concerns;
- *no other retailer would be able to compete with the standard retailer for that customer,* at least not profitably. Competition would not be encouraged, and the customer's reliance on regulated tariffs would not be reduced;
- the consumer would face no incentive to reduce its electricity consumption. Depending on the pattern of this consumption, this could require additional expenditure on network infrastructure in the future.

The consequences of the second option would be that:

- the distributor would incur a loss for that customer, which would either need to be made up from other customers (distorting their consumption of electricity and raising equity concerns), or else dividends to Government would be reduced;
- the retailer would not incur a loss, and would not need to recover this loss from other customers, or to reduce its dividend payments;

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1 Australian Inland 2003, *Submission to the Independent Pricing and Regulatory Tribunal – Review of Regulated Retail Tariffs,* 1 December, p. 6.

- *other retailers would be able to compete with the standard retailer to supply that customer, since they would all be passing through the same distribution cost;* and
- again, the customer would face no incentive to reduce its consumption of electricity, which could potentially require additional network expenditure if reliability requirements are to be maintained. However, the customer's reliance on regulated retail tariffs would be reduced.

Both options entail poor outcomes in terms of potential cross-subsidies and/or reduced dividends (it makes little difference whether these occur strictly at the distribution or the retail level – the effect is the same). Neither option promotes the efficient consumption of energy. However, they both meet the same equity objective. The crucial difference lies in the incentives and ability for other retailers to compete with the standard retailer in serving that customer. Only the second approach manages to achieve this objective. Given the similarities in effects on other fronts, this option should be preferred.

In summary, managing prices that relate to distribution costs should be undertaken in the Tribunal's decisions in the distribution price review, not the retail price review. Any price constraints applying to retail prices should relate to the retail component of prices alone.

Retail Operating Costs

The Tribunal intends to consider the following issues in its assessment of operating cost benchmarks:

- Whether costs vary across different customers (such as geographical area or customer size);
- Whether costs vary across gas and electricity retailer;
- Whether in a competitive market, it is appropriate to make allowance for the search and marketing costs incurred by other retailers in the process of attracting customers on regulated tariffs to negotiated tariffs.

Operating costs can vary across different jurisdictions and fuels however, our view is that the primary cost driver is the level of service required by customers. Segmenting the market on geographical, fuel or service levels is complex and costly and is generally not maintained or available. Instead of segmenting the market AGL ES&M believes that if costs associated with the different services to customers are recovered in a cost reflective manner, then costs for the standard services should be reasonably similar.

AGL ES&M believes that there should be recognition of marketing costs incurred by retailers in attracting customers on regulated tariffs to market contracts if the objective of promoting competition is to be achieved.

The benchmarks for retail operating costs (including FRC costs) should reflect the following:

- The increased costs in providing an efficient and effective level of service to customers. Customers are expecting and requesting increased services. Retailers as

with every other business have incurred increased salary and wages costs, contract costs to third parties and general business outgoings;

- With the introduction of FRC, customer interactions are more complex and additional services have been introduced such as energy usage advice and AGL's *"Staying Connected"* programs to assist customers experiencing financial hardship; and
- CRA in undertaking their review for 2003 gas prices in Victoria acknowledged that retailers' estimates of operating costs were significantly higher than costs previously allowed by regulators.

AGL ES&M has serious concerns with the operating cost benchmarks adopted for the NSW electricity (and gas) markets which are significantly lower than operating costs assessed by other regulators.

	Operating cost benchmarks ($/customer)
IPART (2002) - Electricity	45 - 75
ESC – Vic (2001)	50 - 80
CRA – Vic (2002)	90
ESCOSA – SA (2002)	80
ICRC – ACT (2003)	85
ESC – Vic (2003)	53 - 85

Retailers have consistently advised regulators that operating costs are at or exceed the upper end of these benchmark ranges. We are concerned with the wide range ($30 per customer) used by the Tribunal in NSW, which on a $600 bill amounts to a variance of 5%. We believe that such a wide range provides unreasonable discretion to the regulator when approving price variations. AGL ES&M supports the approach adopted by South Australia and Victoria of setting an upper limit only on operating costs and that the upper limit should be in the range of $90-95.

AGL ES&M considers that the low operating cost benchmark for NSW electricity retailers is not consistent with the experiences of retailers operating in Victoria and SA. In these states the retail and distribution businesses are separate entities and in many cases have different owners.

Retail Margin

AGL ES&M considers that retail margins of at least 5% are more appropriate for the NSW electricity market and the current range of 1.5-2.5% is not adequate.

There have been a number of studies on appropriate levels of regulatory margins but the best indicator is the level set by a competitive market. AGL ES&M proposal for default price regulation will allow a gradual "opening up" of margins and allow it to settle on market based levels.

AGL ES&M considers that 1.5% to 2.5% allowance for net margin for electricity is insufficient to achieve the long-term objective of maintaining a financially viable electricity industry with an appropriate incentive for retailers to commit to arrangements which allow for long-term investment.

Retail margins are the earnings achieved before retailers pay their interest and tax liabilities. The benefits that flow to shareholders are significantly less than the headline retail margins. An appropriate net margin for supply to small customers must ensure that retailers are adequately compensated for their risks and customer acquisition costs.

These risks include:

- Potential of losing customers to competitors and the associated take or pay and other supply cost commitments;
- Credits risks associated with payment defaults;
- Allowance for interest and tax; and
- Other competitive market related risks.

Standard electricity retailers in NSW have made the following submissions in relation to net retail margins:

- Integral Energy has argued that a retail margin of 3 to 5 per cent represents a return on capital employed and the risks associated with the business;[2]
- Australian Inland stated that 'much work has been done on an appropriate retail margin, with the current range of 1.5% to 2.5% probably as good as any other figure;'[3]
- Energy Australia has argued that it has adopted a quarterly (approximately every 90 days) billing cycle for the large majority of its regulated customers, which means that at any moment in time it carries a large amount of working capital necessary to cover the time lag between receiving payment from its customers and actually paying for the energy and network costs resultants from their consumption. Energy Australia also argued that retail net margins used by regulators in other jurisdictions also suggest that the current range used by IPART is low for a regulated retail business providing a default service;[4] and

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2 Integral Energy, 2004 Review of Gas and Electricity Regulated Retail Tariffs Submission to the Independent Pricing and Regulatory Tribunal, 1 December 2003.

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

4 Energy Australia, Submission to IPART's Review of Electricity Regulated Retail Tariffs, 1 December 2003, p. 11.

- Country Energy recommends that an allowance be added to the retail margin to cover the risks associated with the smearing of loss factors. It also states that 'the current electricity framework provides an allowance for 1.5 per cent to 2.5 per cent for retail margin. Compared to international experience this is probably an appropriate minimum benchmark. Given the risk associated with losses as discussed above, Country Energy believes it should be set at the upper end of this range, with a margin allowance of 2 to 2.5 per cent.

The retail margin allowed by IPART in its previous determination of 1.5 to 2.5 per cent is low by comparison with allowances included in regulated tariffs in other jurisdictions.

Net retail margins in other jurisdictions (defined as retail price minus energy purchase costs, distribution charges, transmission charges and market fees, and operating costs, divided by total revenue) have been determined as follows:

- the ESC allowed for retail margins in the range of between 2.5 to 5 per cent;
- the Office of the Tasmanian Energy Regulator allowed a 3 per cent net retail margin;[5]
- the Essential Services Commission of South Australia (ESCOSA) allowed a 5 per cent margin (the upper end of the Victorian range, reflecting the risks associated with peakier South Australian demand);[6]
- the Independent Pricing and Regulatory Commission (ACT) allowed a 3 per cent retail margin.[7]
- CRA reported that a retail margin up to 8% maybe appropriate for electricity retailers in Victoria (2002).

The Tribunal's mid-term review noted that:

For the December 2000 Determination, the Tribunal examined benchmarks for the net profit margin established in the previous Determination and also the experience in the United Kingdom. Since then, the ESC in Victoria conducted a review of regulated retail prices in its jurisdiction and specifically identified benchmarks for net profit margins based on similar sources as the Tribunal's December 2000 Determination.

The consultants that undertook the benchmark review for ESC recommended a range of 2.5 to 5 per cent for the net profit margin in Victoria. In its submission, Energy Australia argued that this finding supported its call for an increased profit margin in New South Wales regulated retail tariffs.

The Tribunal believes that this is not an appropriate range for New South Wales. The primary reason is that retail suppliers in Victoria do not have access to a scheme similar to ETEF that eliminates energy purchase price risk. The consultants took explicit account

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5 Office of the Tasmanian Energy Regulator 2003, Investigation of Prices for Electricity Distribution and Retail Tariffs on Mainland Tasmania, Final Report and Proposed Maximum Prices, September.

6 ESCOSA 2002, Inquiry into Electricity Standing Contract Prices, Final Report and Determination, October.

7 IPRC 2003, Investigation into Retail Prices for Non-Contestable Electricity Customers in the ACT, Final Determination.

of energy purchase price risk in recommending a higher range for Victoria than is in place in New South Wales.[8]

In relation to the Victorian decision, consultants to the ESC argued for a higher range to be used in Victoria than in NSW because:

- the NSW retailers enjoy substantially more protection (through the ETEF) from energy trading risks than do Victorian retailers, and
- the NSW retailers are government-owned entities and as such will almost certainly have lower cost of capital than the private owners of the Victorian host electricity retailers.[9]

In relation to the latter point, it should be noted that the opportunity cost of capital is independent of ownership, and so it would be incorrect for the Tribunal to assume a lower cost of capital in NSW compared with other jurisdictions on this basis.

In relation to the former point, it is true that the ETEF eliminates wholesale price risk for the standard retailers. However, it is important that the regulated tariff be set in a way that encourages the operation of the competitive retail market. If the tariff reflects the costs of an arrangement that second tier retailers cannot access, this will adversely affect the operation of a competitive market. At the same time it is appreciated that unnecessarily rewarding the standard retailers with a (higher) market based retail margin could also damage the operation of the competitive market. Standard retailers could use the 'rent' provided by a higher retail margin to subsidise their offers to contestable customers, making it even more difficult for second tier retailers to compete with the standard retailers.

It is possible, *without any modification to the current arrangements*, to have the regulated tariff reflect a realistic retail margin while at the same time not unnecessarily rewarding the standard retailers for hedging risks they did not incur because of the operation of the ETEF.

The way the ETEF currently works, Treasury set for each standard retailer a separate Regulated Energy Charge (REC) such that each standard retailer gets, more or less, the retail margin determined by IPART. The ETEF then 'settles' financial flows with the retailer on the basis of the REC determined by Treasurer.

Given this arrangement, it would be easy to have the regulated tariff reflect a market based retail margin and then for Treasury to set the REC so that the standard retailers only earn the retail margin that IPART believes is justified.

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8 IPART 2004, Mid-term Review of Regulated Retail Prices for Electricity to 2004, Report and Determination to the Minister for Energy, June, p. 25.

9 Charles River Associates 2001, Inputs to the Development of Benchmarks for Retail Electricity Operating Costs and Net Margins for Domestic and Small Business Customers, 15 November, p. 15.

Under this arrangement standard retailers would not be earning any economic rent which they could use against competitors, and regulated customers would be paying a price that reflected the opportunity cost of supplying them. This would reduce at least one of the barriers facing second tier retailers operating in NSW. Finally, this would not require any amendment to the operation of the ETEF, IPART would only need to notify Treasury of the appropriate retail margin target in setting the RECs for the standard retailers.

These benefits flowing from the NSW ETEF may be more appropriately used by the government to support customer hardship programs without distorting the operation of a competitive market.

Further, AGL ES&M estimates that it costs a second tier retailer in excess of $100 per customer to acquire and transfer a customer. This is consistent with the costs incurred per customer in the UK. The *"headroom"* required will of the order of 7% to 10% to recover these acquisition and transfer costs over the period of a typical negotiated contract of 2 to 3 years.

AGL ES&M considers that retail margins in the upper range of 5-10% are more appropriate for the NSW electricity market.

International experience may also be used as guides to the appropriate levels of margins in a competitive market. For example, at the time when price controls were removed in the UK, the UK regulator noted that *headroom* for gas was in the range of 5-6% and that for electricity averaged 8%. This allowed for the continued development of the competitive market.

6. APPROPRIATE STRUCTURE FOR REGULATED TARIFFS

The Tribunal has sought comment on issues regarding the structure of regulated retail tariffs, including whether an inclining block structure is a proxy for cost reflectivity and the implications of allowing more complex price structures for the objective of rationalising the number of regulated tariffs.

The majority of a retailer's costs of supplying small retail customers are passed onto retailers by the generators, transmission system operators, and distributors. Operating costs incurred by retailers is generally on a per customer basis. Retailers pass on these costs to customers through tariffs and charges on a cost reflective basis, that is in the manner in which the costs are incurred.

AGL ES&M believes that it is not appropriate for the Tribunal to determine the tariff structures as this may result in retailers not being able to recover costs. Regulating tariff structures may also compromise the objective of ensuring that tariffs are cost reflective.

7. REGULATION OF NON-TARIFF CHARGES

The Tribunal has sought comments on the regulation of non-tariff charges including where possible the incidence and cost of different types of charges.

There are three categories of non-tariff charges that may apply to customers:

- Pass through of cost incurred by retailers for services provided to customers by third parties, such as meter tests and special meter reads paid to the network operators. AGL ES&M believes that retailers should be able to add an administration fee (on a cost reflective basis) associated with the procurement of services from third parties;
- Administration of service levels and incentive payments associated with services provided by third parties such as the network operators for which retailers should be able to recover administration costs; and
- Retailers' own costs for specific services required by customers, such as high bill field visits (where no fault is found) and disconnection fee (for debt), which should be recovered on a cost reflective basis.

Non-tariff charges should be determined on a cost reflective basis and be applied to customers who incur the costs. AGL ES&M proposes that the Tribunal adopt a light-handed approach to the regulation of non-tariff charges based on a set of principles similar to South Australia:

- non-tariff charges are to be cost reflective, and
- passed onto customers on a fair and reasonable basis.

This would be consistent with the proposed approach for default prices. The Tribunal may require retailers to justify non-tariff charges if they are seen to be not compliant with these principles.