

*Ref: TB:JC:A1697*

1 December 2003

Dr Thomas Parry  
Chairman  
Independent Pricing and Regulatory Tribunal  
PO Box Q290  
**QVB Post Office NSW 1230**

Dear Dr Parry

**Review of Gas and Electricity Regulated Retail Tariffs**

Country Energy is pleased to provide the attached submission to the Independent Pricing and Regulatory Tribunal of New South Wales' Review of Gas and Electricity Regulated Tariffs.

This review provides an opportunity to review the framework under which regulated retail prices are managed, to ensure equitable price outcomes can be delivered to all customers. Country Energy is seeking the ability to restructure tariffs and transition prices to reflect underlying costs and to ensure consistent price outcomes to customers, to address equity in both the regulated and competitive market contexts.

If you have any questions in relation to this submission please contact Terri Benson on (02) 6338 3424 or Natalie Banicevic on (02) 6589 8419.

Yours sincerely

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Att. 1

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# Country Energy's

submission to the  
Independent Pricing and  
Regulatory Tribunal



It's your country.

**Review of gas and electricity regulated retail tariffs**

1 December 2003

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# 1 Introduction

Country Energy is pleased to provide this response to the Independent Pricing and Regulatory Tribunal of New South Wales's Review of Gas and Electricity Regulated Tariffs.

This review provides an opportunity to review the framework under which regulated retail prices are managed, to ensure equitable price outcomes can be delivered to all customers.

Country Energy has in excess of 300 regulated retail electricity tariffs, accumulated over the years before Country Energy's formation in July 2001. While Country Energy has had limited success in reducing the number of applicable regulated retail tariffs in the past two years, regulatory constraints have compromised Country Energy's ability to deliver consistent prices to all customers.

Structural tariff reform is a priority for Country Energy. Without significant changes to current tariff structures, widely divergent price impacts on customers will persist. In contrast, greater latitude to improve the consistency of tariff structures will allow Country Energy to deliver greater equity for all customers.

Beyond the structure of tariffs, Country Energy's price levels remain around five per cent below 'target' levels – meaning that current prices are often failing to recoup costs. Again, this situation creates inequities between customers, in several ways.

First, some customers are contributing more fully to costs than are others. While Country Energy accepts that some degree of cross subsidy is inevitable, greater cost reflectivity is necessary to ensure sustainable overall cost recovery, and address unsustainable inequities.

Second, some customers have an opportunity to meaningfully access the benefit of price and service alternatives provided by the competitive retail market, while others do not. Of concern is the fact that those customers that have taken advantage of competitive alternatives can have their pricing gains eroded, relative to what they may have experienced had they remained on a regulated retail tariff, because they become more fully exposed to network costs as a consequence of moving away from regulated retail tariffs.

Country Energy believes that it is necessary to resolve these inequities. Country Energy also believes that the complexity of the current retail price regulatory framework is contributing to these inequities, and is creating inefficiencies that add to unrecovered costs.

Country Energy's intent is not to undermine the current retail price regulatory framework. In fact Country Energy believes that the 'target tariff' framework has been successful in demonstrating the inequities described above.

However the current framework has been less successful in allowing those inequities to be addressed, because the multiple layers of price control that often conflict with one another, and overly constrain the transition of prices to more equitable levels. Currently, there are price controls at the individual tariff level, customer level and on the overall average price.

Country Energy believes it is possible to retain, but significantly simplify, the target tariff framework.

Country Energy is seeking the ability to restructure tariffs and transition prices to reflect underlying costs and to ensure consistent price outcomes to customers, to address equity in both the regulated and competitive market contexts.

This submission details Country Energy's position on a range of issues as outlined in the terms of reference. A summary of the recommendations contained within the paper are provided below.

Section	Key Recommendations
<b>2. Form of Regulation</b>	<ul style="list-style-type: none"> <li>➤ CPI cap on average selling price should be removed.</li> <li>➤ Pass through of network charges to the customer.</li> <li>➤ Individual tariff constraints should be removed.</li> <li>➤ Flexibility in the side constraint to enable tariff rationalisation and recovery of unexpected increases in underlying costs.</li> </ul>
<b>3. Appropriate Cost Recovery</b>	<ul style="list-style-type: none"> <li>➤ FRC costs associated with the gas business have only been partially recovered, therefore the voluntary pricing principle must allow for recovery of the remaining costs.</li> <li>➤ FRC costs associated with the electricity business have not been recovered; therefore the current allowance for FRC costs should be maintained.</li> </ul>
<b>4. Appropriate Structures for Regulated Tariffs</b>	<ul style="list-style-type: none"> <li>➤ A further target tariff be introduced, being a 'peak' target which should be reflective of supplying energy in times other than off peak. The proposed target levels would be as follows:               <ul style="list-style-type: none"> <li>➤ Standard;</li> <li>➤ <b>Peak;</b></li> <li>➤ Off Peak;</li> <li>➤ Extended Off Peak.</li> </ul> </li> </ul>
<b>5. Regulation of Non Tariff Charges</b>	<ul style="list-style-type: none"> <li>➤ Dishonour fees to be expanded to include dishonoured direct debits.</li> <li>➤ Ability to pass through of credit card transaction costs.</li> </ul>

## 2 Form of Regulation

*The Tribunal seeks comment on what form of regulation will best assist the Tribunal in meeting its objectives of moving all regulated tariffs towards cost-reflective levels without exposing customers on under-recovering tariffs to unacceptable price shocks.*

The transitioning of energy prices to cost reflective levels is a key issue to be addressed in this review. Since its formation, Country Energy has been reviewing existing tariffs to ensure that efficient and equitable prices are delivered to customers. With the number of tariffs we currently manage, Country Energy knows first hand how complex this process is.

Country Energy currently has in excess of 300 regulated retail electricity tariffs, of which more than half are below the target level. This has occurred due to historical factors coupled with the operation of pricing constraints that have limited the ability of Country Energy to transition these tariffs to cost reflective levels. Customers who are on a price which is below the target level are effectively receiving their energy for less than cost, delivering inequitable outcomes. For many of the customers who are supplied energy on an under recovering tariff, there is no price incentive to sign a negotiated contract in the competitive market.

The current form of regulation has multiple layers of price control. Firstly target levels are established against which each existing tariff is compared, with price changes then allowed for any tariff below the target level. Side constraints existing at the customer level ensure that the annual increases seen by any individual customer are limited. Finally there is an overall CPI cap on the increase in average prices. This is extremely complicated and difficult to implement. While we believe that the existing target tariff approach is appropriate in measuring the cost reflectivity of prices, and important in setting overall price paths, we believe the multiple layers of price control are overly complex and could be simplified, by reducing the layers of price control.

To ensure that the Tribunal's key objective of moving all regulated tariffs to cost reflective levels without exposing customers on under recovering tariffs to unacceptable price shocks, Country Energy believes that the current form of regulation should be continued with a number of key changes:-

- CPI cap on average selling price should be removed;
- Direct pass through of network charges to the customer;
- Individual tariff constraints should be removed; and
- Flexibility in the side constraint to enable tariff rationalisation and recovery of unexpected increases in underlying costs.

Country Energy believes that the above changes to the current framework will ensure that the majority of tariffs will reach cost reflective levels, without exposing customers to unacceptable price shocks.

For the 2004 financial year Country Energy's regulated retail electricity tariffs, on average, are five percent below target levels.

It is important to ensure tariffs are at cost reflective levels, and retailers must have the ability to recover the costs of efficient electricity supply. Therefore, the form of regulation must include accurate representation of efficient costs and more importantly the ability to recover these costs. Movements in costs over which retailers have no control, such as network charges, should be allowed to be passed through to customers without limitations imposed by retail side constraints.

Country Energy believes the principles embodied in the electricity form of regulation would apply equally to gas. There are a number of similarities between the structures of gas and electricity prices, and as such, Country Energy believes the proposed amended target tariff approach can be equally applied to voluntary pricing principles agreed between Country Energy and IPART.

Retailers currently must comply with varying rules and regulations depending on the source of energy and the jurisdiction of operation. Country Energy strongly recommends that where possible, the form of regulation for electricity and gas are aligned as closely as possible.

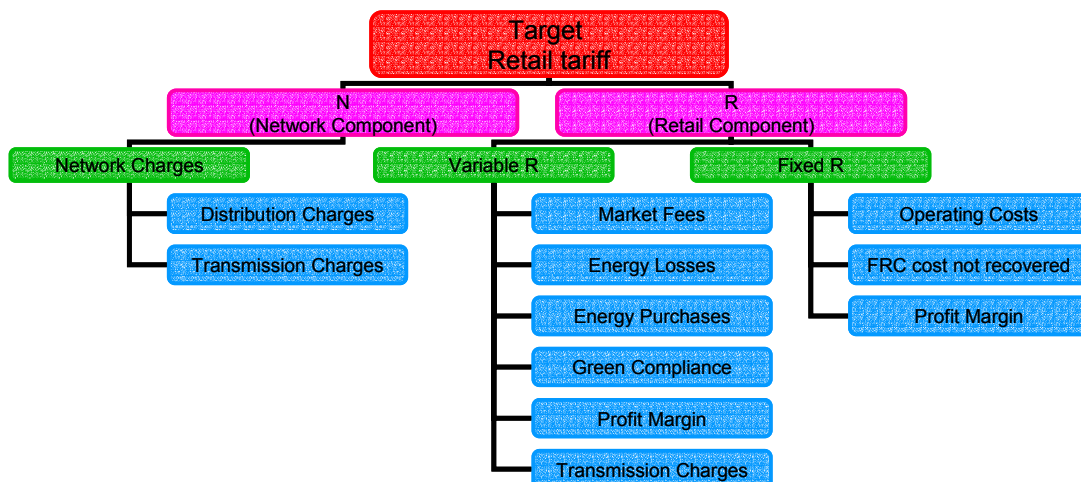
## 2.1 Target Tariff approach

Target tariffs provide a very transparent measure of individual tariff cost reflectivity and therefore provide valuable information when determining future price paths, however we believe the current focus on tariff by tariff movements is not required.

The objectives of ensuring tariffs are at cost reflective levels will be partly met by utilising a target tariff approach as the form of regulation. The objective will be completely met if retailers are able to transition tariffs to the target cost reflective level.

There are a number important variables that need to be included in determining the target levels of the fixed and variable components to ensure all relevant costs are covered. Figure 1 depicts a target tariff structure and the key cost components which can be generally applied to both electricity and gas price regulation. Each of these components is addressed in more detail under section 3 – Appropriate Cost Recovery.

**Figure 1 Target Tariff Structure**





The current differentiation between the urban and rural electricity retail components is important and should be maintained as the difference in cost components, largely driven by energy losses, can vary dramatically. This will ensure that the significant variances in costs between urban and rural are not smeared, and the target levels for these groups are cost reflective. This is an important distinction in delivering efficient and equitable pricing.

The above diagram of the target tariff structure also highlights the layers of regulation and price setting that is applied to the various components of the regulated retail tariff. For example the network component is regulated by the Tribunal; however a significant part of the network component is made up of Transmission use of System charges (TUoS) which is regulated by the Australian Competition and Consumer Commission (ACCC). Losses and market fees are also regulated or determined by external parties. The regulated retail price is in many ways the accumulation of a number of already regulated prices. The current form of regulation basically involves regulation of the individual cost components followed by regulation of the total end price.

It is important to consider options that allow tariffs to reach and or maintain cost reflectivity. This could be achieved through allowing pass through of uncontrollable costs, such as network tariffs, directly to the customer. The target tariff effectively allows pass through, however, if for example a network increase outweighs the total allowed retail increase, the gap between target levels and regulated retail tariffs will continue to grow. There is an inherent risk that the target approach will be seriously undermined if price constraints do not reflect firstly, the current under recovery of tariffs and secondly, any anticipated increases in costs.

## ***2.2 Direct pass through of network increases***

Network prices are subject to side constraints at each price change implemented by the distribution business. These price changes at times can not be entirely passed through to the customers due to the retail side constraints operating on the entire bill.

If a standard retail supplier can not pass through network charge increases directly to the customer, the retail price will not reflect the underlying costs of supply and result in inefficient end use prices to customers. Over time it may erode any incentive to enter the competitive market. In addition, customers who have entered the competitive market may be encouraged to return to regulated retail tariffs, as increases in competitive prices may be a disincentive for the customer to remain in the competitive market.

Additionally, network increases which can not be recovered within the retail side constraints have the effect of eroding the standard retail suppliers margin. Country Energy currently does not recover the allowable gross margin, and any further increase in the underlying costs will further reduce the actual gross margin.

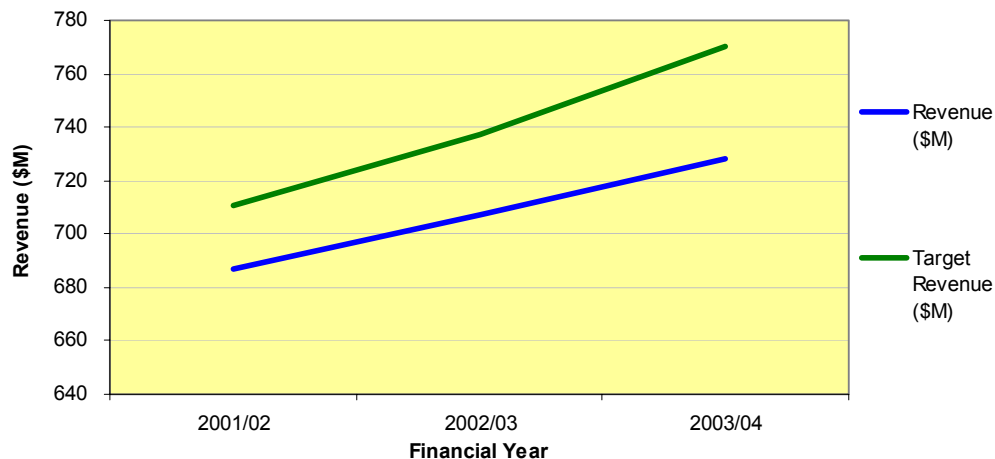
Greater than CPI increases in the network component and a CPI increase in the average retail price has been a common occurrence for Country Energy since the mid-term review. This partially accounts for the fact that on average Country Energy prices are 5% below the current targets or cost reflective levels.

The table and chart below demonstrates the effect of the current price constraints with CPI average increases in the retail component based on the last two years price



changes implemented by Country Energy. During this period greater than CPI increases in network charges, driven by increasing transmission costs, were implemented by the distribution business.

**Figure 2 Comparison of regulated retail revenue to target revenue**



As shown, there is a widening gap between actual tariffs and cost reflective levels. This effectively means that increases in transmission and distribution charges were not passed through to regulated retail customers.

In the 2002 financial year, Country Energy was under recovered by approximately 20 million dollars. This under recovery has increased to in excess of 40 million dollars for the 2004 financial year.

At this stage, the level of network price increases which will be seen during the retail determination period of 1 July 2004 to 30 June 2007 are unknown, namely:

- electricity network price increases to be allowed in the network determination currently being reviewed by the Tribunal,
- gas network price increases to be allowed in the Wagga Wagga Access Arrangement are also currently being reviewed,.

Standard retail suppliers must have the ability to pass these increases directly through to the customer, to ensure cost reflectivity in tariffs and pricing equity applies to all customers.

Country Energy believes that a direct pass through of network charges to customers can be achieved without “unbundling” the current retail tariff. This could be achieved by a transparent application of certain rules at price change time each year, discussed below in Section 2.3 – Limits on Price Movements.

## 2.3 Limits on Price Movements

As outlined earlier, the current framework has multiple layers of price control, with effectively three limits on price movements;

- Individual tariff constraints;
- Average selling price constraint; and
- Customer side constraints

Country Energy believes this could be significantly simplified and also adapted to allow for the pass through of uncontrollable costs. This would be achieved by removing the individual tariff constraint, and the overall CPI limit on average price movements.

A mechanism that would allow for the pass through of network charges is also proposed by Country Energy by weighting the network price change into the price limit formulae. This is discussed in more detail in section 2.3.2 – Average selling price constraint.

Our overall aim is to reduce the number of existing retail prices from in excess of 300 down to a few major Country Energy wide retail price structures. This will enhance simplicity, ensure equal treatment of all customers and encourage demand management.

If Country Energy's revenue structures are not closely aligned with underlying costs, Country Energy will be exposed to risks associated with changes in profitability as volume changes or customers churn. The ability for Country Energy to minimise this risk will, in practice, be significantly impaired by the existence of excessive constraints on price movements. Country Energy otherwise consider that the expected cost of this risk should be recognised explicitly in the target tariffs.

The primary reason for Country Energy's regulated retail tariffs remaining under the target retail tariff is essentially the inability to transition these tariffs due to the existing price constraints in place. The current determination does not allow in some cases, an increase in the regulated retail tariff equivalent to the increases seen in the underlying costs of supply.

The best way to foster competition in the electricity market is to minimise artificial restraints on demand, supply and prices, restrain monopolistic pressures and foster complete knowledge of the market. While "perfect competition" can seldom be achieved in practice, the allocation of resources will be improved if restraints on the market system result in minimal distortions to the free market.

The aim should thus be to establish a regime of default tariffs that encourages customers to enter the market and discourages retailers from misallocating resources. The current determination, in theory, would meet these objectives and thus promote competition. However, the pricing constraints limit the effective transitioning of the regulated retail tariff to the target retail tariff resulting in the objectives not being met.

Additionally, perpetuating historical structures at artificially low levels inhibits demand management initiatives such as cost reflective time of use pricing.

### **2.3.1 Individual tariff constraints**

The current determination effectively imposes a control on all regulated retail tariffs, in that, the regulated retail revenue is compared to the target revenue for each individual tariff. Regulated retail tariffs above the target tariff must not increase in nominal terms and those that are below must be increased subject to price constraints.

The current target tariff N+R should be set to reflect the underlying costs and be used to determine a price path, but individual tariff changes should be determined by the retailer. The current approach effectively limits the level of tariff rationalisation that can be achieved, due to some inability of changing tariffs that are above target levels.

Country Energy gives preference to a form of regulation which provides scope to address tariff rationalisation and cost reflectivity issues. It should be at a retailer's discretion on how increases to regulated retail tariffs are applied. It is in the retailers best interest to reduce the number and level of under recovering tariffs, and to also address issues with over recovering tariffs.

Country Energy has a significant range of tariffs, with sixty five percent of tariffs being below target levels. Almost twenty percent of Country Energy's tariffs are more than twenty percent below the target, and at the other extreme eleven percent of tariffs are twenty percent above cost reflective levels. This means that customers throughout rural New South Wales are paying vastly different amounts for essentially the same service. This is far from an equitable pricing outcome. This is obviously a source of frustration for both Country Energy and its customers. Under the current framework it is extremely difficult to address this anomaly, and we are therefore proposing significant changes to all limits on price movements.

We believe that the removal of individual tariff constraints will assist the tribunal in addressing the key objectives of this review without delivering unacceptable price shocks to consumers, as a degree of price controls will still be in place.

### **2.3.2 Average selling price constraint**

The Tribunals "Mid-term review of regulated retail prices for electricity to 2004" introduced a new price constraint where regulated retail tariffs, on average, cannot increase by more than CPI.

As highlighted in the issues paper, the Tribunal must strike a balance between transitioning prices to cost reflective levels and limiting price shocks to customers. Unfortunately these objectives are often conflicting, but it is important that there is a balanced outcome, and does not favor either the retailer or the customer. While priority must be given to protecting customers, prices must also deliver the correct price signal, and reflect the underlying cost of supply. We believe there are a number of ways to do this and a single side constraint may not be the answer.

Country Energy believes that the average price control is the mechanism for setting the future price, path taking into account movements in underlying costs represented

by the target tariffs. Customer level side-constraints would then be a tool to allow for tariff rationalisation and to ensure that no individual customer receives an unacceptable price shock.

The average selling price constraint has acted as a tighter control than the customer level constraints during the current regulatory period. This has unnecessarily obstructed the introduction of efficient cost reflective pricing, and precluded any significant rebalancing or unification of prices.

As discussed earlier, Country Energy believes that a direct pass through of network charges to customers can be achieved without “unbundling” the current retail tariff. This could be achieved by a transparent application of certain rules at price change time each year which would include the actual network price change in the price constraint formulae.

To explain this approach Country Energy has developed some guidelines that we believe warrant further consideration. In summary these proposed guidelines are as follows:

- Determine the network component and retail component of the regulated retail tariff prior to the price change;
- Determine the incremental change between the network component prior to the price change and post the price change;
- Add the incremental network difference to the current regulated retail tariff;
- Determine the allowable retail component increase;
- Add the incremental difference in the retail component to the current regulated retail tariff.

This approach is summarised below using the 2004/05 period as an example where a formula could be applied at each price increase, to both the variable and fixed components of a regulated retail tariff

At each price change date, a standard retail supplier must limit prices increases as follows:

- 1) in the case of a price change date for the 2004/05 period:

$$\text{Allowed increase}_{04/05} = \text{CPI} + \left\{ \left( \frac{N_{05} - N_{04}}{N_{04}} - \text{CPI} \right) \times \left( \frac{\text{Network Revenue}}{\text{Regulated Retail Revenue}} \right) \right\} + R_{05}$$

Where

- a) Allowed increase is the percentage by which the average retail price is allowed to move on 1 July 2004.
- b)  $N_{04}$  is the average network price for the small retail customer for 2003/04

- c)  $N_{05}$  is the average network price for the small retail customer for 2004/05
- d)  $R_{05}$  is the real percentage change allowed for in the retail component.

The above approach would address issues such as network increases outweighing allowable retail increases at each price change. Depending on the level of the allowable retail increase, this approach at minimum would ensure that the “status quo” is maintained, and the gap to cost reflective prices does not worsen.

The current target tariff allows pass through of network changes, however in reality the retail side constraints do not always allow pass through of network increases to the customer. This occurs when the increase of the network charges is greater than that of the total increase allowed under the retail determination. The result is that tariffs can not maintain cost reflective levels, and ultimately erosion of the retail gross margin.

The above alternative approach proposed in this submission provides a linkage between network and retail price setting which would allow any network price signals to flow through to customers. This would significantly improve any demand side management in the future.

### **2.3.3 Customer Side Constraints**

Once the price path which reflects underlying costs has been developed, a tool to allow for rationalisation of tariffs and protection of customers should be considered.

Country Energy is committed to tariff reform to achieve a uniform and cost reflective pricing structure. However, this may take a significant number of years to achieve if the current side constraints were to remain in place. Tariff rationalisation generally involves transitioning like tariffs to a single tariff. This may be achieved by increasing, decreasing and restructuring tariffs.

Country Energy currently has a significant number of regulated retail prices. The large number of prices is historically driven, with many of the price structures generally linked to the 21 former county councils which now make up Country Energy. The recent implementation of a consolidated price list effectively reduced the number of tariffs available to new customers but does not reduce the number of tariffs applying across Country Energy's customer base.

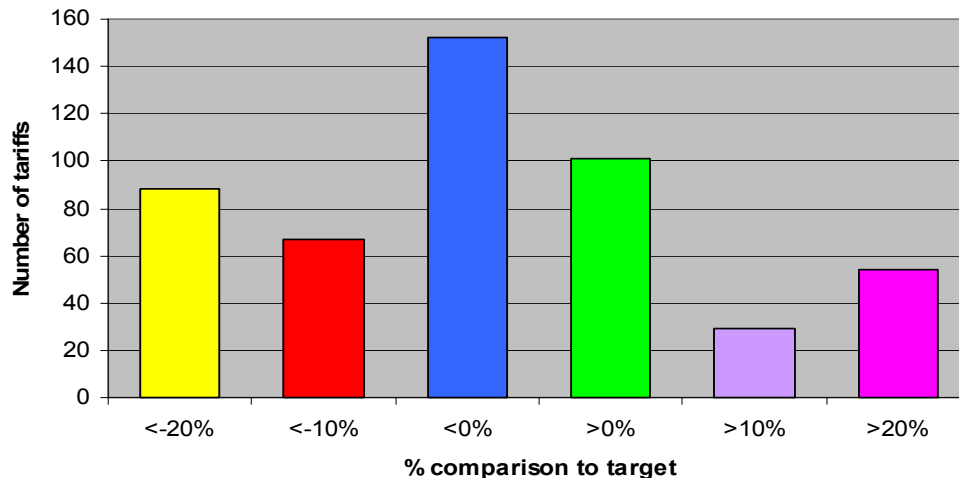
The implementation of the consolidated Country Energy price list was the first step in the delivery of price equity to customers, and will provide both short and long term benefits.

However, it will be a significant number of years until all customers transition to these tariffs, and as such, a relaxation of the side constraints will allow a progressive transition of existing prices to the consolidated Country Energy price list.

Country Energy currently has 160 individual tariffs that are in excess of ten percent below the corresponding target tariff for 2004. For a domestic tariff that is ten percent below target, assuming costs increase on average by CPI each year and a customer side constraint of  $CPI + 2$  is in place, it would take 5 years for the regulated retail

tariff to reach the target tariff provided no other constraints are in force. With the operation of the existing overall CPI constraint this estimated time period would be significantly lengthened. The chart below demonstrates the number of under recovering tariffs in respect to target revenue.

**Figure 3 Tariff count by under/over recovery level**



A relaxation of the side constraints would firstly allow as a priority, transition of the consolidated Country Energy price list to target levels and secondly, rationalisation of the majority of remaining prices. It is unrealistic to expect that all tariffs can be transitioned in this fashion as it would inevitably lead to unacceptable price shocks delivered to a minority of customers. As such, Country Energy would propose an increase which would see a large proportion of these prices transition to a single Country Energy price list, whilst meeting the Tribunal's key objective of delivering cost reflective prices and minimising unacceptable price shocks to consumers.

Based on our analysis we believe that if side constraints of CPI + 5 were in place for all customers, seventy three percent of our tariffs would be at cost reflective levels by 2007, without price shocks to customers. The purpose of a side constraint should be to minimise price shocks to consumers and Country Energy believes this could still be achieved without a strict and standard approach to side constraints.

Side constraints are only one tool and should not be considered in isolation. If side constraints are developed in isolation of the overall price path they become the form of regulation. This outcome needs to be avoided and Country Energy believes that flexibility in side constraints should be considered to avoid any unforeseen outcomes. The flexibility of side constraints is discussed in more detail in section 2.3.4.

Side constraints can be a relatively blunt instrument, and can result in inefficient and inequitable pricing outcomes. Country Energy believes that side constraints should not be evaluated without considering the customer base of each retailer and the equity issues that need to be addressed by individual retailers. Country Energy implemented a program to assist customers in times of hardship, with long term payment solutions - not just short term fixes. This program is known as Country Support and has been widely advertised within our supply district. The availability of Country Support is also widely communicated during regulated retail price change communications and media releases, to ensure customers are aware of the options

available to them. We believe this type of support gives us the ability to protect those customers in genuine need, and still have the flexibility to transition customers to cost reflective pricing.

A possible approach for the transition of customers to the recently implemented consolidated retail prices would be to allow customers to voluntarily choose to switch to a retail price, whilst the old (obsolete) retail price is increased over a reasonable timeframe approved by the Tribunal. The increase in the retail network price would create an incentive for the customer to switch to the new retail prices or the competitive market. Under the current side constraints, it is difficult to increase the obsolete prices quickly enough and create any significant incentive for the customer to move to the new price as the new prices in some instances are already below cost reflective levels. This approach would provide the ability to introduce products such as time of use that can provide better pricing signals to customers.

### **2.3.4 Flexibility in side constraints**

The primary purpose of a side constraint should be to minimise price shocks to consumers. However, large increases in costs can be detrimental to both standard retail suppliers and to retailers in the competitive market who may not be able to compete with artificially low regulated retail tariffs. As such flexibility in the side constraints should be allowed. Minimisation of price shocks could still be achieved without a strict and standard approach to side constraints.

We believe that side constraints need to be delivered through a flexible framework that reflects the retailers current position compared to the target tariff, and price reform strategies. A framework where variation from any determined side constraints can be sought needs to be developed. Retailers would then be able to apply for relaxation of the indicative side-constraint if pre-determined events occur.

Country Energy believes that the constraints should be relaxed to allow;

- Recovery of approved unforeseen costs;
- To recover increases in network charges (as previously discussed); and
- To allow for tariff restructuring or rationalisation, for example side constraints should be less restrictive for obsolete residential prices or where only a small number of customers are affected.

An example of the current difficulties faced in restructuring tariffs is provided in section 4 of this submission.

If one of the above mentioned events occurred the retailer would be able to apply for the relaxation of the side constraints. Depending on the quantum of the change, the Tribunal would then have the discretion to undertake consultation processes.

This would ensure that the right price signals are developed, which ultimately will lead to efficient pricing. At the moment regulated retail tariffs below the target retail tariff will remain there resulting in other customers having to subsidise these price levels.



It is important to note that regulated retail tariffs only apply to those small retail customers who are supplied electricity by a standard retail supplier under a standard form customer supply contract. Therefore, it is also important to remember the purpose of the target retail tariff, which is to provide a “safety net” that represents the efficient cost of supply to be used for customers who choose not to, or cannot enter the competitive market, whilst not inhibiting competition.

### 3 Appropriate Cost Recovery

*The Tribunal seeks comment on the most appropriate treatment of the various cost components to ensure that retail charges are at, or close to, cost reflective levels for all small retail customers by 2007.*

Country Energy has reviewed each of the cost components relating to gas and electricity supply and offers the following comments in relation to the treatment of the various cost components, to ensure that retail charges are at cost reflective levels by 2007.

#### 3.1 Electricity Purchase Costs

The regulated energy cost is currently based on the Long Run Marginal Cost and is annually indexed by CPI. Country Energy is not in a position to determine if the current long run marginal cost is appropriate, however we must have the ability to pass on increases in electricity purchases to customers. As discussed throughout the paper, increases in revenue are consistently below the increases seen in costs to the retail business.

It is important to note that the electricity purchase costs are the predominant contestable component of a retail price. The remaining costs components are either:

- identical for all retailers, for example network and market charges; or
- closely related, for example gross margin and green energy costs

Therefore it is important that the Long Run Marginal Cost is not set too low, as much of the incentive for customer choice lies within the electricity purchase cost. The appropriate cost recovery for electricity purchases in principle should be based on not only the Long Run Marginal Cost but also the wholesale risks involved for a retailer to trade in the competitive market. These risks include but are not limited to, regulatory risk, forecast risk, volume risk, credit risk and operational risk.

In reality, standard retailer suppliers are not subject to excessive risks with purchases of regulated electricity load. However, when determining the appropriate costs of supply, it would be unreasonable to assume that an allowance for wholesale risk is unnecessary. Whether in the competitive market or regulated market, Country Energy believes that when determining an allowance for electricity purchases, an allowance for risk must be included so as to accurately reflect the true costs of electricity supply.

Additionally, investors in generation capacity need to be assured that Retail prices are cost reflective to give certainty to future upstream investments.

Country Energy will provide further comments once the Tribunal's consultants report is available.

### **3.2 Wholesale Gas Costs**

Wholesale gas costs are the costs associated with purchasing gas from the field. The majority of gas supply within Country Energy's supply district is contracted and includes arrangements for gas supply as well as gas capacity.

Country Energy would be opposed to a wholesale gas cost benchmark based on the LRMC of gas supply or industry wide gas supply as contractual arrangements are in place which expire well into the proposed period of the forthcoming Voluntary Pricing Principle. A benchmark that is not accurately stating the true cost of gas supply, would lead to tariffs not being reflective of the underlying costs of supply.

For regulated gas tariffs to achieve cost reflectivity, it is important that the actual wholesale gas costs are incorporated into the final price delivered to customers. The Electricity Tariff Equalisation Fund ensures all standard retail suppliers are purchasing energy at a consistent rate and therefore an industry wide benchmark is appropriate, however such a scheme does not exist in the regulated gas market. Therefore to apply an allowance for wholesale gas costs based on a benchmark would be unsuitable.

Our preference is for a wholesale gas cost allowance to be based on Country Energy's likely contract prices throughout the period of the Voluntary Pricing Principle. Country Energy has provided wholesale gas costs schedules within the commercial in confidence submission as we consider wholesale gas costs to be of a confidential nature.

### **3.3 Network Charges**

In the past there has been a disconnect between the allowable network increases passed through to the retail business and the increase the retail business are able to pass through to the customer. This disconnect means that retail has not always been able to pass through network price changes.

The effect of the inability to pass through network charges, which at times are CPI plus increases, negatively impacts the gross margin. If this trend continues, coupled with the current side constraints, the retail component will be eroded due to the inability to pass through this uncontrollable cost. This also increases the gap between target and actual prices.

Although the target tariff effectively allows direct pass through of these costs, any increase above CPI in the network component rarely translates to an equivalent increase in the regulated retail tariff. Ultimately, this has an impact on customer choice, as the incentive for a customer to enter the competitive market gradually diminishes as the retail margin is squeezed.

Over time this situation would be exacerbated further if greater than CPI increases are consistently seen in network prices. This is due to the ability of retailers to pass through network increases in the competitive market

As discussed previously, network price increases that will be seen during the retail determination period of 1 July 2004 to 30 June 2007, are yet to be determined, namely:

- electricity network price increases to be allowed in the network determination which is currently being reviewed by the Tribunal,
- gas network price increases to be allowed in the Wagga Wagga Access Arrangement is also currently being reviewed.

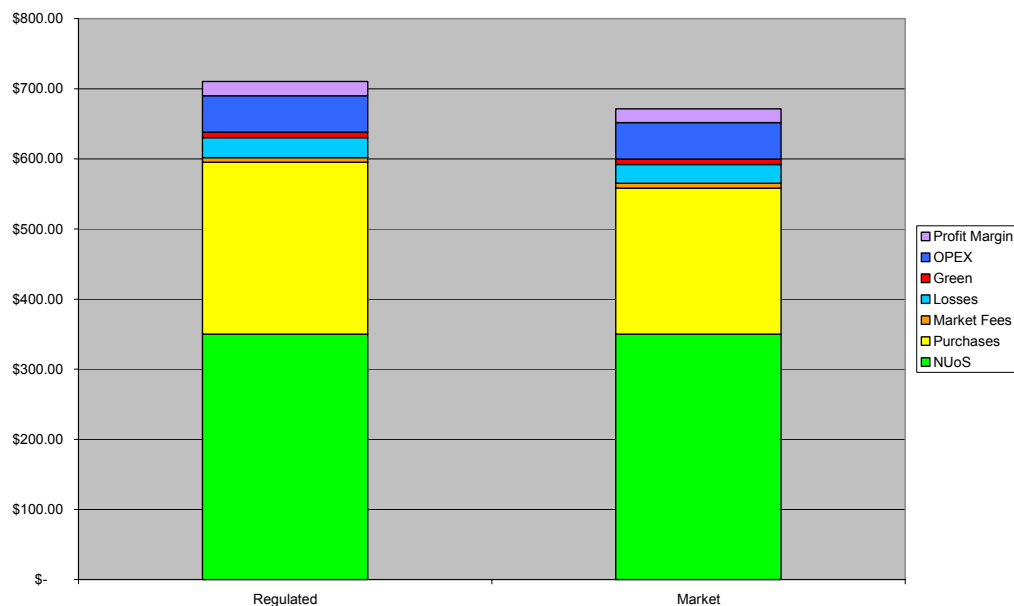
The competitive market effectively allows retailers to directly pass through increases in costs to customers. If a situation were to arise where CPI plus increases in the network charges were consistently seen, and a standard retail supplier did not have the ability to pass these costs through to customers, incentives for customers to move into or stay in the competitive market will gradually reduce over time.

To demonstrate the effect of CPI plus increases in network charges coupled with regulated retail prices regulated via a total price constraint, a comparison between the cost components of a regulated retail price and a competitive retail price is shown below in two stages.

The first stage is assumed to be the base year where two comparable customers with identical annual consumption are supplied electricity. The first is supplied under a standard form contract where the second customer is supplied under a negotiated contract. The network charges, market charges and green compliance costs are theoretically identical in both environments. We have assumed the competing retailer has been able to negotiate reduced electricity purchase costs, and the regulated retailer is offering a cost reflective tariff.

As shown below, the approximate saving is \$40 or 5.5% per annum.

**Figure 4 Base Year Cost Components**



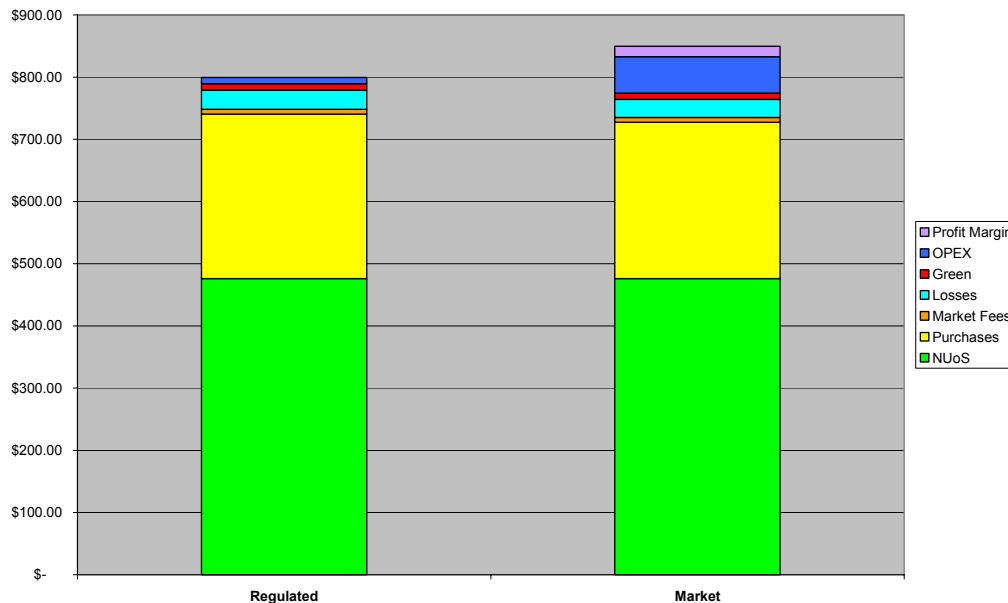
Assuming over a number of years, the network component applicable to both environments consistently increases by more than CPI each year. In addition, all other cost components of the price increase by CPI in both the regulated and

competitive environments. The second stage shown below demonstrates the effect of CPI plus network increases if the regulated retail price is capped at CPI and the competing retailer has taken the option to pass through increases in costs directly to the customer.

As shown below, the customer who has elected the competitive market now has a disincentive to remain in the competitive market in the order of \$42 or 5% per annum when compared to the regulated tariff.

The example also demonstrates the effect on the regulated retailer's gross margin. The competitive market has allowed the retailer to maintain a profit margin and recover the appropriate costs of supply. Conversely, the price constraint on the regulated price has effectively squeezed the retail margin, as the standard retail supplier is now forced to operate at a negative net margin and can not recover the operating expenditure.

**Figure 5 Future year cost components**



Regulated retail tariffs below the target retail tariff undermine the effective operation of the competitive retail market. The target retail tariff, if set correctly, effectively represents the cost of supply. Regulated retail tariffs below this target may remove the incentive for small retail customers to move to the competitive market. Given the uncertainty of network prices for both electricity and gas, it is necessary to provide a mechanism for retailers to ensure tariffs are at, or will reach, cost reflective levels.

Country Energy strongly recommends that uncontrollable costs such as network charges should be specifically catered for when setting limits on price movements, and thus directly passed through in the regulated retail tariff. As discussed earlier, this could be achieved by applying a set of rules at price change which allow the network increase to be passed through directly to the customer, without unbundling the tariff.

The current network determination, states that average prices across the network can not increase by more than CPI. However, if a distributor can demonstrate to the Tribunal that the average selling price constraint prevents recovery of transmission prices from their customers due to changes in transmission prices resulting from the expiration of the derogation on transmission prices, this price limit can be relaxed.

This principle can be equally applied to the retail determination and Country Energy requests that the Tribunal gives consideration to such a mechanism where retailers can recover increases in costs resulting from events that are uncontrollable by the retailer.

### **3.4 Retail Operating Costs**

Country Energy differs from other standard retail suppliers in that the supply district contains a significant rural customer base, which is geographically dispersed. Community expectations require minimum service levels and Country Energy carries a degree of responsibility to fulfil the needs of customers. Country Energy has a strong regional focus demonstrated through our commitment to rural areas.

Country Energy maintains a number of customer centres throughout its supply area. Customer centres are generally a fixed cost, which is disproportionate for retailers with lower population densities. In regional NSW the population density is significantly below that of our city counterparts and thus the cost per customer of maintaining these centres cannot be compared to a standard retail supplier with a predominantly urban supply district.

Customer churn resulting from full retail competition will also impact Country Energy as most costs associated with the regulated customer base are fixed. Over time this will result in an increase in the cost per customer supplied under regulated retail tariffs. Country Energy requests that the above factors be considered when reviewing the current allowance for retail operating costs contained within the target tariff.

There are significant differences in the size of NSW retailers in terms of customer numbers, retail revenue, and franchise area. Given the significant investment in information systems required to operate in the retail market a large proportion of operating costs are fixed. These costs may be disproportionately larger per customer across retail businesses.

The key components of regulated retail operating costs are:

- Costs associated with operating call centres and customer centres, including customer care systems;
- Billing, revenue collection and credit control systems;
- Provision for bad debt and debt management;
- Marketing and advertising, including regional sponsorships;
- Information systems;
- Regulatory compliance;

- Corporate costs and overheads, including administration, legal; services and human resources; and
- Complaint management.

The majority of the above costs are fixed, in that generally a loss of customers will not see a reduction in costs. Country Energy believes that variable operating costs, would theoretically decrease through customer churn, however in reality, for total variable operating costs to decrease a significant proportion of customers would need to churn. As such, variable costs should be considered as fixed, until a significant churn of customers to full retail competition occurs.

In summary, Country Energy also believes that a fixed retail gross margin across all retailers is inappropriate, primarily because of the relatively different operating environments. Country Energy, in particular has a significant rural customer base,. This may involve operating customer centres in a rural area that services a significantly reduced customer base compared to a city counterpart.

### **3.5 Retail Margin**

The retail component of the target tariff effectively smears all costs for an entire supply district. Country Energy has a unique supply district, which is predominantly rural. Although, a proportion of Country Energy's cost components do not vary significantly throughout the supply district, the cost of transmission losses can vary quite dramatically.

The variance between the minimum and maximum transmission loss factor is approximately 9%, and is especially prevalent in the northern part of our supply area. This variability is not as prevalent in other distribution areas within NSW.

Country Energy has previously considered the appropriateness of introducing target retail components, which are reflective of, the variability in transmission losses for Country Energy. The result would have been a regulated retail tariff that is reflective of the underlying costs of supply; however the implementation costs would have far outweighed the benefits of introducing a new regional specific target.

Unfortunately the issue of cost smearing still remains, and represents a significant risk to Country Energy, as smearing of costs may have an impact on gross margin. With the introduction of Full Retail Competition, customer churn will have an impact on the level of profitability within the regulated retail customer base.

As Full Retail Competition progresses, a number of customers may have a greater incentive to churn due to the averaging of loss factors. It is more than likely that these customers will experience savings in the competitive market. On the other hand, customers that do not have an incentive to churn due to the averaging of loss factors will be impeded from entering the market. The result is a customer base which does not contribute to the full cost of supply.

Therefore Country Energy recommends that an allowance be added to the retail margin to cover the risks associated with the smearing of loss factors.

The current electricity framework provides an allowance for 1.5 percent to 2.5 percent 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 percent. However it should be noted Country Energy has not returned this margin to date, and without the relaxation of pricing constraints these margins will not be achieved.

Country Energy's gas retail margin is substantially below the industry average and as such we are seeking to transition to a higher level over the course of this review.

### **3.6 Other Costs**

#### **3.6.1 Green Compliance Costs**

Standard Retail Suppliers are required to comply with various environmental obligations. Two such obligations that directly affect regulated retail customers, are the Commonwealth Mandatory Renewable Energy Target (MRET), and the NSW Benchmarks scheme.

In response to these environmental obligations, Country Energy has developed the Corporate Renewable Energy and Greenhouse Gas Abatement Strategy paper. This strategy paper reinforces our commitment to address greenhouse issues, and has recommendations that every endeavour will be made to meet the target imposed by each scheme. These conditions pose a significant financial and administrative burden on the organisation and our efforts are constrained by the availability and cost of alternative energy sources.

In the current target tariff for regulated customers, IPART allows a pass through of between 50 cents and \$2.20. Evidence from modelling completed by Country Energy shows that this will not be sufficient for the next determination period.

Consideration must also be made for the potential outcomes of the MRET review and the Premiers recent announcement on 20 November of the possibility of an Emissions Trading Scheme. This adds to the weight of uncertainty from the COAG ("Council of Australian Governments") Energy Market draft report "Toward a Truly National and Efficient Energy Market" and the recommendation for development of a carbon emissions trading scheme.

The NSW Government has stated that the benchmark scheme will be phased out if the Commonwealth establishes a national scheme. However, there is no plan outlining how the transition from the state to a national scheme will be achieved. This raises a serious risk that projects may not gain backing from lending institutions in this environment.

Some key power station developers have indicated that they are not prepared to bring new projects forward due to the uncertainty associated with NSW Greenhouse Abatement Certificates (NGAC) income. Existing project owners are also concerned that MRET and NSW Benchmarks scheme termination could leave them with stranded non-financial producing assets. Uncertainty exists in the market regarding the expected impact this may have on the ability to source NGACs in the later years of the program.

This has the potential to drive up the prices of these financial instruments, and if project owners do not do not invest in new power stations, the lack of supply would

again act to drive up the price of green instruments and increase the cost of compliance, and therefore pass through rates.

### 3.6.2 Energy Losses

The target levels of regulated retail tariffs include a retail supplier specific allowance for electricity losses. During the mid term review of regulated retail prices for electricity to 2004 the Tribunal; assumed Country Energy's average losses to be 10.8 percent for urban customers and 17.7 percent for rural customers.

For the 2003/2004 financial year the allowances for losses are much lower than actual losses based on the distribution loss factors and transmission loss factors. A 2 percent difference between losses allowed for in the target and actual losses theoretically translates to a 1 percent decrease in the allowed profit margin, which is a significant impact given the allowance for net margin is 1.5-2.5 percent.

To ensure tariffs reach cost reflective levels, it is important that any allowance for losses is reflective of actual losses. The target retail component should initially be set reflective of underlying costs, however if at the time of price change if an increase in losses has occurred, retailers should have the ability to recover unforeseen increases not only in losses but also other key components of the retail tariff.

In addition, losses do not only form an important part of the retail component in terms of electricity purchases but are also important components of market fees and green compliance costs. The target retail tariff is applied to consumption excluding losses, therefore an allowance for green energy obligations and market fees should also include:

- an allowance for distribution losses on market fees. These charges are imposed on retailers at the transmission node, therefore any allowance for market fees should also include distribution losses; and
- Mandatory schemes such as the Commonwealth Mandatory Renewable Energy Target and the NSW greenhouse gas abatement scheme define a certain level of compliance in relation to retail suppliers' total purchases. Therefore an allowance for the product of distribution losses and transmission losses should be included in addition to green compliance costs.

### 3.6.3 Unrecovered FRC Costs

Country Energy argues that due to the under recovery experienced within the current regulatory period, the current allowance for costs associated with Full Retail Competition have not been recovered for electricity. The FRC costs associated with gas have been partially recovered.

Country Energy should not be financially disadvantaged because of the costs of implementing FRC and should be provided with sufficient capacity in terms of return on capital invested to fund future IT investments required under FRC. We believe that an approach to full cost recovery smoothed over the next regulatory period, represented by a small legitimate real price increase, would not create a price shock to customers.

In the current target retail tariff a fixed amount per customer has been allocated for FRC costs. Based on the Tribunal's determination on prudent FRC costs, this amount is an appropriate level and should continue. Country Energy maintains that this revenue has not been recovered from all customers in the current environment due to actual prices being below the target level. If all regulated retail tariffs were at the target level, then FRC cost would have been collected, however this is not the case.

On average Country Energy regulated retail tariffs are below the target level, therefore FRC costs remain uncollected, and will remain uncollected. The result is that returns to the retail business are eroded, and as customers transition to the competitive market these costs will become more difficult to recover.

In summary, Country Energy recommends that FRC costs not recovered are allowed for within the next regulatory period as;

- FRC costs associated with the gas business have only been partially recovered, therefore the voluntary pricing principle must allow for recovery of the remaining costs; and
- FRC costs associated with the electricity business have not been recovered; therefore the current allowance for FRC costs should be maintained.

## 4 Appropriate Structure for regulated tariffs

*The Tribunal seeks 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 retail tariffs.*

Country Energy's view is that the determination should allow for the introduction of new regulated retail tariffs. Standard Retail suppliers should be allowed sufficient scope to introduce new tariffs, provided that the proposed tariff complies with the determination.

It is also appropriate that the tariff represents the fixed and variable costs of supply. Country Energy agrees that the costs of supplying energy to small retail customers include fixed and variable components and as such, for default tariffs to be cost reflective, they must be structured to reflect both fixed and variable costs.

Country Energy considers inclining block structures appropriate if the cost of supply represents this. For example, if the underlying network charge is representative of an inclining block structure then it is prudent for the retail price to also be representative of this structure. This principal applies equally to pricing options such as time of use or summer peak. Given that Country Energy's distribution business is intending to obsolete all single rate network prices, it is also important that Country Energy retail can reflect these underlying costs in the retail tariff.

### 4.1 Restructuring Tariffs

Country Energy maintains a multitude of regulated retail tariffs with vast and varied structures. There are a number of legacy tariffs which recover the fixed costs of supply via a minimum charge. For most customers, the total amount that would be billed under a minimum charge tariff compared to a fixed charge tariff is minimal. In our experience, the minimum charge tariffs appear to confuse customers where a fixed charge tariff provides simplicity and transparency to customers. Our preference would be to abolish all minimum charges and replace them with fixed charges, however for a handful of customers the side constraints are breached and the tariff restructuring can not occur.

Tariff structures can vary significantly, and applying the current determination, reduces the scope for tariff rationalisation. Additionally, unwinding current tariff structures to a fixed and variable component, in most cases is difficult without:

- foregoing revenue and consequently breaching the determination; or
- conversely, breaching side constraints.

An example of the difficulty of restructuring a tariff that is not already in the fixed plus variable structure is demonstrated below. The tariff used in this example has a minimum charge and no fixed component, while the target does. The example is designed to show the difficulty in transitioning just one tariff. As you can see not all customers breach side-constraints in this modelling, yet any restructuring is effectively impossible because of the small percentage of customers impacted. It is

also worth noting that a relaxation of the side constraint to CPI+5% would allow for this restructuring in the majority of cases. This would be a one-off price change that would correct pricing inequities.

It is important to remember that while customer level side constraints theoretically apply to individual customers, they actually apply to classes of customers as you can not adjust a tariff for just one customer, because any tariff change will impact all customers on the tariff.

Five tariff restructuring scenarios were modelled as follows:

- 1. Implementing the target tariff in place of the regulated tariff**  
 This scenario had the best results in terms of transitioning to the target tariff and restructuring to the fixed plus variable structure, however the side constraint of CPI +2% or \$25 would be breached for a large number of customers.
- 2. Performing a linear regression on the current tariff structure to determine the best fit fixed plus variable tariff structure**  
 This scenario effectively structures the current tariff into the fixed plus variable structure however the side constraint is breached for some customers.
- 3. Unwinding step 1 of the regulated tariff into a fixed charge with a view to unwind step 2 at a later price change date together with a CPI increase.**  
 This method does not achieve the desired structure immediately, however over time, the tariff will transition to the target retail tariff structure. There is also a small number of customers who breach the side constraint.
- 4. Applying a flat increase of CPI + 2%, where CPI is assumed to be 3%**  
 This method does not restructure the tariff to the desired structure however achieves the best results in terms of maximum revenue increase in line with the current retail determination. It is interesting to note that this is the most common approach applied by Country Energy under the current framework, but fails to address the equity issues.
- 5. Introducing a \$25 fixed charge, as per the current side constraint**  
 This method takes the first step in transitioning to the target structure, however revenue increases are limited for other tariffs as the entire side constraint is effectively utilised for this tariff and cannot be applied again to other tariffs which the customer may be connected to.

The results of this modelling are as follows:

Figure 6 Tariff increase scenarios

	Target Revenue	Current Revenue	% under target	Customers	MWh
<b>Current Statistics</b>	\$ 8,687,445	\$ 8,078,986	-7.53%	13,297	54,445

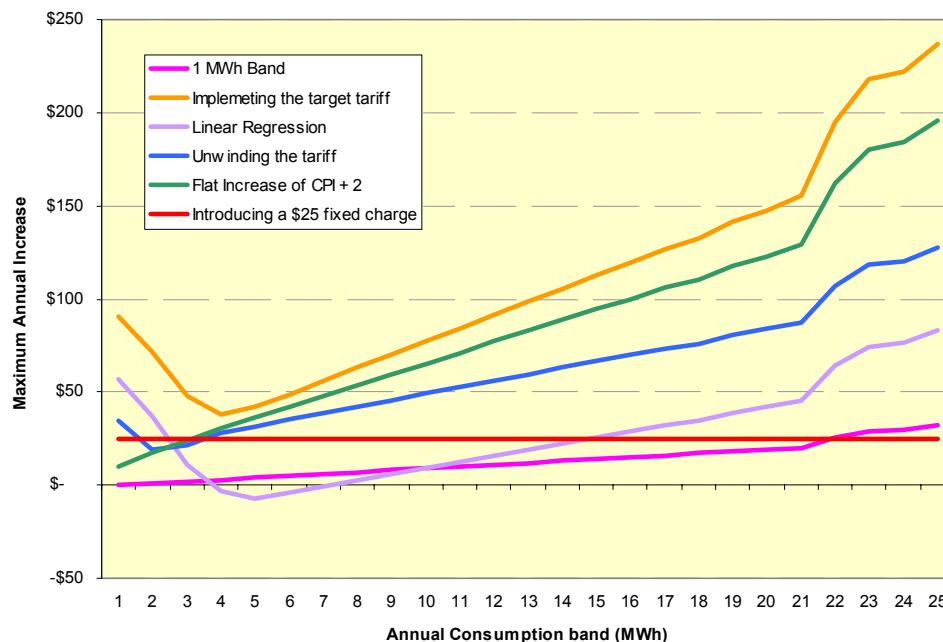
  

Scenario	Side Constraint (CPI = 3%)	New Revenue	Increase	Increase (%)	Number of side constraint breaches	% Under Target
Implementing the target tariff	The greater of \$25 or CPI + 2%	\$ 8,687,445	\$ 608,460	7.53%	13,170	0.00%
Linear Regression		\$ 8,078,986	-\$ 0	0.00%	400	-7.53%
Unwinding the tariff		\$ 8,416,639	\$ 337,653	4.18%	120	-3.22%
Flat Increase of CPI + 2		\$ 8,482,935	\$ 403,949	5.00%	-	-2.41%
Introducing a \$25 fixed charge		\$ 8,411,411	\$ 332,425	4.11%	-	-3.28%

The chart below displays the absolute maximum increase for customers in each consumption band under each tariff increase scenario. As shown, the scenario which consistently delivers the highest maximums is Scenario 1 - Implementing the target tariff. Scenario 4 – Flat Increase of CPI + 2 consistently delivers the second highest maximums. For most customers the difference between these two lines is minimal.

98% of the customers on this tariff consume between 0 and 10 MWh per annum. The maximum increase for this group under Scenario 1 - Implementing the target tariff is approximately \$1.73 per week.

**Figure 7 Maximum Annual Increases by Consumption Band**



Key points to note are:

- Implementing the target tariff results in almost all of the customers being outside the maximum allowable increase, and this percentage is prior to any other increases in tariffs. Given the significant difference between the controlled load regulated retail tariffs and the target retail tariff, increases are necessary to maintain the current levels;
- Linear regression has restructured the tariff into the desired structure, however no increase in revenue is seen. The situation is worsened with a small number of customers outside the maximum allowable increase of CPI +2% or \$25, which in addition may affect increases to other tariffs;
- Unwinding the tariff has resulted in a better than CPI increase, however a small number of customers are outside the maximum allowable increase. This method involved equalising step 1 and step 2 in terms of price, with the difference between step 1 and step 2 multiplied by the number of units allowed for step 1 to form a fixed charge. Customers that have annual consumption, falling between step 1 and step 2 breach the side constraint;

- Applying a CPI + 2% increase yields a significant increase in revenue whilst not breaching the side constraints. An increase of this type will not inhibit other related tariffs, which are under the target retail tariff from increasing, thus a desirable outcome is achieved; and
- Introducing a \$25 fixed charge achieves a CPI plus increase of 4.11% without breaching customer side constraints, however other related tariffs under the target retail tariff can not be increased without breaching customer side constraints.

As demonstrated, the effect of customer side constraints limits the restructuring of regulated retail tariffs. The fixed plus variable can be achieved in most cases, within side constraints, by foregoing revenue.

## **4.2 Pricing Signals**

The other important factor when considering pricing structures is price signals. It is important that appropriate price signals are available to customers. If retailers are going to be able to provide appropriate demand management signals which reflect transmission and distribution systems, as well as the wholesale energy market, structural changes will be required. As demonstrated above, if the current framework is not changed, this will not be possible.

Unwinding current tariff structures to a fixed and variable component, in most cases is difficult without:

- foregoing revenue and consequently breaching the determination; or
- conversely, breaching side constraints.

Restructuring complex tariff structures can be extremely difficult, and as such, any introduction of such structures in a regulated environment must be given careful consideration as it may take many years to unwind or remove a tariff if the tariff does not represent the underlying costs of supply

Country Energy believes that complex and innovative pricing options are best left to the competitive market, otherwise differentiation between the competitive market and the regulated market will be diminished. Innovative and complex prices are essentially a product decision, and thus Country Energy does not foresee any merit in introducing complex pricing structures to the regulated market.

The purpose of regulated retail tariffs should be to provide a safety net for those customers who choose not to, or can not enter the competitive market. Country Energy agrees that in order for regulated retail tariffs to best perform as a safety net for those that choose not to enter the competitive market, the tariff should be a basic option without special features, but it should reflect costs and deliver appropriate price signals.

In summary, our preference is that the structure of default tariffs represents the underlying costs of supply. Complex and innovative pricing options that do not represent the underlying costs of supply should be left to the competitive market. In



addition it is important that the framework provide the flexibility to ensure price signals to customers are not eroded due to historical tariff structures.

### **4.3 Introduction of a 'peak' target**

An important consideration if the current form of regulation continues is the introduction of a new target being the peak and shoulder component of time of use tariffs. This will ensure that any time of use pricing will be reflective of costs, the correct price signals are sent to the customer and demand management can be encouraged.

There are many benefits to demand management, and Country Energy believes that progressive roll out of time of use prices to customers has the potential to reduce average electricity prices for consumers, improve reliability of supply, and provide environmental benefits. Time of Use pricing gives the customer some control over the price they pay for electricity by encouraging the customer to consumer energy in off peak times.

Country Energy's distribution business is proposing to incorporate a number of new network prices into the price schedule in order to more appropriately tailor low voltage prices to the domestic and business market.

The number of residential and small business customers on Time of Use network prices will progressively increase over the forthcoming regulatory period, to provide signals to customers to better manage their loads, and to reflect the cost of supplying energy at peak supply periods.

The major restriction on the introduction of more TOU network prices has been the absence of adequate metering technology, particularly for smaller domestic and business customers. The gradual introduction of meters with a capability of measuring usage over different time periods will enable the greater deployment of TOU network prices.

All new residential customers will be placed on the time of use network price. It is proposed that a domestic customer will no longer elect to be placed on a single rate price. Due to their higher contribution to the network peaks, business customers will be transferred more rapidly. It is expected that during the forthcoming regulatory period all business customers will have been transitioned from their current network prices to time of use.

Therefore, it is important to ensure that retail targets can accurately reflect pricing structures such as Time of Use. The current retail component is split into a fixed and variable component, *Variable R*. The variable R has been determined for each retailer, in three categories as shown below:

- Standard;
- Off Peak; and
- Extended Off Peak.

These are further differentiated by urban and rural classifications.

Under the current determination, the peak and shoulder components of time of use tariffs are compared and assessed against the standard variable R. Country Energy has analysed the effects of moving customers to time of use pricing, in particular the target levels. Country Energy has developed a number of scenarios surrounding the transition of single rate customers to Time of use prices. This analysis concluded that the current standard targets are not cost reflective, and the impact on revenue, and in particular gross margin, would be in some instances severe. This means the price signals to customers are effectively lost, and even if a customer chose to more closely manage consumption, there would be little or no price incentive, effectively undermining this possible demand management initiative.

The Terms of Reference indicate that the determination should ensure, as far as practicable, that alternative ways be considered to facilitate transition to full cost recovery by 2007, or by an appropriate later date, such as the setting of regulated retail tariffs at cost reflective levels for all new connections and new customers. In the case of Time of Use, much benefit would be achieved by firstly setting targets appropriately, and secondly allowing the implementation of these cost reflective targets as the regulated retail price.

Country Energy requests that these categories be expanded to include a target for the peak and shoulder components of a time of use product. Country Energy recommends that the Tribunal considers the introduction of such targets for the following reasons:

- Inaccurate target levels will result in the regulated tariff not being representative of the underlying costs of supply, which ultimately is an impediment to competition, particularly if a regulated tariff is significantly below the costs of supply but is also at the target level. Customers may not have an incentive to move to the competitive market due to the tariff being below cost reflective levels;
- It is important to ensure that the correct price signals are sent to customers. To meet the demand management objectives of Country Energy, it is imperative that the retail component also participates in meeting this objective; and
- Country Energy's gross margin over time may be adversely impacted, as the number of customer's moving to time of use pricing increases.

Consideration should be given to a 'peak' target to reflect the underlying purchase costs. Country Energy considers that the current standard variable target, which is assessed against continuous retail tariffs, is inappropriate to be applied to the peak component of retail time of use tariffs, as it is not cost reflective of purchasing energy during the defined peak period.

In summary, Country Energy recommends that the current retail components remain in place with the addition of a further target tariff, that being a 'peak' target which should be reflective of supplying energy in times other than off peak. The proposed target levels would be as follows:

- Standard;
- **Peak**
- Off Peak;

- Extended Off Peak,

The urban and rural differentiation should also be maintained for the existing targets as well as the proposed peak target.

The expansion of the current retail components will ensure that:

- Incorrect price signals are not sent out to the customer; and
- Customer choice is facilitated in a deregulated market.

This approach will also minimise change to the current form of regulation as it would essentially only involve the introduction of a new target retail component, that being a Peak component. Country Energy has prepared the following table, in an effort to summarise the recommendations discussed above. The table below is effectively definitions and applicability of the current variable R targets plus the peak target proposed by Country Energy.

**Figure 8 Variable R retail components**

Variable 'R' Component	Applicability	Rationale
<b>Standard</b>	➤ Continuous supply;	Energy consumed on these tariffs is generally in peak, shoulder and off peak periods and thus a weighted peak and off peak component of the regulated energy cost best represents the cost of supply.
<b>Peak</b>	➤ Peak and Shoulder periods of Time of Use Tariffs.	Energy consumed on these tariffs is entirely within the traditional peak and shoulder components, and thus the peak component of the regulated energy cost best represents the cost of supply.
<b>Off Peak</b>	<ul style="list-style-type: none"> <li>➤ Off Peak 1;</li> <li>➤ Off Peak periods of time of use tariffs.</li> </ul>	Energy consumed on these tariffs is generally in the off peak period and thus the off peak component of the regulated energy cost best represents the cost of supply.
<b>Extended Off Peak</b>	<ul style="list-style-type: none"> <li>➤ Off Peak 2</li> <li>➤ Off Peak 3</li> </ul>	Energy consumed on these tariffs, depending on the network, can be in all periods however should be weighted predominantly more to the off Peak period than the peak period of the regulated energy cost according to an average profile.

## 5 Regulation of non-tariff charges

*The Tribunal seeks submissions relating to the regulation of non-tariff charges including where possible the incidence and cost of different types of charges.*

There are two key issues in relation to non-tariff charges that Country Energy would like IPART to consider:

➤ **Credit card surcharge**

Country Energy currently offers payment by credit card via BPay, IVR – Phone Direct, Internet Banking and Phone.

On 1 January 2003, the Reserve Bank's standard and regulations on merchant pricing came into force. The standard removes the restriction imposed by the international credit card schemes which prevents merchants from recovering from cardholders the costs of accepting credit cards. The standard provides that neither the rules of a designated credit card scheme nor any participant in the scheme may prohibit a merchant from charging a credit cardholder any fee or surcharge for use of a credit card in a transaction.

The standard will apply to the MasterCard and Visa credit card schemes; the Bankcard scheme does not impose restrictions on merchant pricing. On 1 January 2003, the undertakings provided by American Express and Diners Club to the Reserve Bank to remove merchant restrictions in their respective schemes also came into force. Surcharging can vary from 1% to 10%.

This means retailers businesses and service providers are allowed to charge credit card holders a fee or surcharge for credit card transactions. These reforms are part of the Reserve banks overhaul of the credit card system which is aimed at promoting greater efficiency, transparency and competition within the credit card network.

To give IPART an indication of the cost of complying with credit card transactions, if a customer had a \$200 account due and choose to pay by credit card through Australia post, the total cost would be \$3.96 for this payment option.

Standard retail suppliers should have the ability to pass through this cost to customers if they choose.

Accordingly, Country Energy's recommendation is for the introduction of a credit surcharge fee for regulated customers based on direct passthrough of the merchant fees applied on Country Energy to the customer.

➤ **Dishonour fees**

Under the current provisions of the Retail miscellaneous charges list retailers can charge twice the regular fee charged by the Bank to which the cheque is presented. However, there are no dishonour fees in relation to direct debit.

If a customer does dishonour a direct debit, banks pass these costs onto retailers. For example, Country Energy is charged \$2.50 for every direct debit dishonour. In addition to this cost there is the internal administration cost of following up with the customer. If the customer dishonours three times, retailers have to generate reports, cancel the direct debit and notify the customer of that action and appropriate recourse.

Standard retail suppliers should be able to reflect this cost to the customer in the event that they do not meet their payment obligations. Accordingly Country Energy's recommendation is the introduction of dishonour fees for direct debit customers of twice the regular fee charged by the bank.

## Appendix 1 – Terms of Reference

**Terms of reference for an investigation and report by the Independent Pricing and Regulatory Tribunal on regulated retail tariffs and regulated retail charges to apply between 1 July 2004 and 30 June 2007 under Division 5 of Part 4 of the *Electricity Supply Act 1995*.**

### Reference to the Tribunal under section 43EA

The Minister refers to the Tribunal for investigation and report under section 43EB of the Act:

The determination of regulated retail tariffs and regulated retail charges to apply to small retail customers in each distribution area in New South Wales for the period from 1 July 2004 to 30 June 2007.

### Background

In accordance with its commitment to retain the offer of regulated retail tariffs, the Government has extended the current scheme for regulated retail tariffs and charges to apply to small retail customers supplied under a standard form contract. A regulation will be made for these purposes under section 43EJ of the *Electricity Supply Act 1995* to allow the Tribunal to make a further determination of regulated retail tariffs and charges that will apply from 1 July 2004 to 30 June 2007. The Electricity Tariff Equalisation Fund (ETEF) arrangement, which complements regulated retail tariffs, will also be extended for the same period.

Since January 2002, every electricity customer in NSW has had the option to negotiate a retail supply contract with any licensed retailer. Small retail customers who do not seek supply from the competitive market are deemed to receive electricity under a 'standard form' customer supply contract from their 'standard retail supplier'. Customers can also switch backwards and forwards between these alternatives. These arrangements were designed to encourage customers to test the market by providing an assurance that they can return to regulated retail tariffs.

While retail competition has delivered benefits for those participating in the market, the majority of residential and some small business customers have chosen to remain on standard form customer supply contracts which include regulated retail tariffs and charges determined by the Tribunal.

International and national experience shows that the level of regulated retail tariffs relative to market based prices is the key determinant of how many eligible customers remain on regulated arrangements. For example, if regulated retail tariffs do not adequately reflect all of the costs of supply to small retail customers, both those customers and prospective competing retailers have little incentive to enter the

competitive market. Therefore, in order to promote retail competition, regulated retail tariffs which are below the cost of supply should be moved towards full cost reflectivity, as far as practicable.

### **Matters for consideration**

For the purposes of section 43EB (2)(a) of the *Electricity Supply Act 1995*, the matters the Tribunal is to consider in making its investigation and report on the setting of tariffs for small retail customers to apply from 1 July 2004 to 30 June 2007 include:

- an allowance for electricity purchase costs based on an assessment of the long-run marginal cost of electricity generation, given the characteristics of the demand of customers remaining on regulated tariffs;
- appropriate retail costs;
- appropriate retail margin;
- an allowance for retailer compliance with any Commonwealth mandatory renewable energy target (MRET) requirements and the licence requirements relating to the NSW Greenhouse Gas Benchmark Scheme;
- energy losses as published by the National Electricity Market Management Company (NEMMCO);
- network charges as determined by the Tribunal and the Australian Competition and Consumer Commission;
- fees (including charges for ancillary services) as imposed by NEMMCO under the National Electricity Code;
- an allowance for expected movements in regulated components and NEMMCO fees.

For the purposes of section 43EB (2)(b) of the *Electricity Supply Act 1995*, the Tribunal must consider the Government's policy aim of reducing customers' reliance on regulated prices and the effect of its determination on competition in the retail electricity market. The level of regulated prices for small retail customers is a crucial factor in encouraging new entry in the retail sector. If the level is set too low, it is not possible for new retailers to attract small retail customers away from the regulated price. This can reduce scale economies for new entrants, increasing their costs and making it more difficult for them to compete. More specifically, the Tribunal is to take account of the following matters in undertaking its review:

- ensuring regulated tariffs cover the costs listed above while recognising consumers' ability to adjust to new prices;
- consider options for restructuring tariffs to promote demand management.

The determination should ensure, as far as practicable, that:

- regulated retail tariffs and regulated retail charges are at cost reflective levels for all small retail customers by 30 June 2007;
- the setting of any 'price constraint' should allow the further rationalisation of regulated retail tariffs and movement to full cost recovery over the determination period with regard to the need for a smooth transition for customers; and



- alternative ways be considered to facilitate transition to full cost recovery by 2007, or by an appropriate later date, such as the setting of regulated retail tariffs at cost reflective levels for all new connections and new customers.

The Tribunal should also consider and report on the basis for regulating miscellaneous charges and security deposits.

## **Consultation**

The Tribunal should consult with stakeholders, conduct public hearings or workshops and consider submissions, within the timetable for the investigation and report. The Tribunal must make its report available to the public.

## **Timing**

The Tribunal is to investigate and provide a report of its determination of regulated retail tariffs and charges by 1 May 2004.

## **Definitions**

*'Regulated retail tariff'* means a tariff for or in relation to the supply of electricity required to be charged to a small retail customer under a standard form customer supply contract, being a tariff specified in a determination in force under Division 5 of Part 4 of the *Electricity Supply Act 1995*.

*'Small retail customer'* means a customer that consumes electricity at less than 160 MWh per year as prescribed in clause 7 of the *Electricity Supply (General) Regulation 2001*. A small retail customer is eligible for supply under a standard form customer supply contract.

*'Standard retail supplier'* means a retail supplier to whose retail supplier's licence is attached a standard retail supplier's endorsement. A standard retail supplier must impose tariffs and charges for or in relation to supplying electricity under a standard form customer supply contract in accordance with any relevant determination of the Tribunal under Division 5 of the *Electricity Supply Act 1995*.

*'Standard form customer supply contract'* means a contract entered into under Division 3 of Part 4 of the *Electricity Supply Act 1995*.