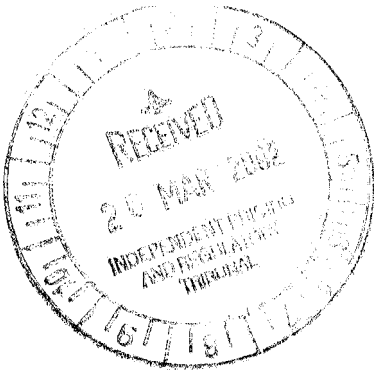

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Paul A Broad
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25 March 2002

Dr Tom Parry
Chairman
Independent Pricing and Regulatory Tribunal
Level 2 44 Market Street
SYDNEY NSW 2000

Dear Tom

IPART's mid-term review of retail price regulation

EnergyAustralia warmly welcomes IPART's mid-term review of retail price regulation, which provides a timely opportunity to re-appraise the current retail regulation in the context of full retail competition.

EnergyAustralia's submission to this review is attached. The submission includes EnergyAustralia's completed cost information template as requested by IPART. Please note that the input page of the cost information template is confidential. All others aspects of EnergyAustralia's submission can be publicly released.

EnergyAustralia would be pleased to discuss these comments at your convenience. Should you require further information or assistance, please feel free to contact Graeme Lees on 9269 2317.

Yours sincerely

(PAUL A. BROAD)
Managing Director
EnergyAustralia

Submission to IPART's mid-term review of retail price regulation

25 March 2002

Executive summary

This document is EnergyAustralia's submission to IPART's mid-term review of regulated retail tariffs. IPART foreshadowed this review in its initial determination of retail regulation in December 2000. EnergyAustralia warmly welcomes and supports IPART's review, as it provides a timely opportunity to reconsider the existing retail regulation in the light of a fully contestable retail market.

IPART's initial determination set regulated retail tariffs that were intended to reflect the cost of supply while providing for a net margin of between 1.5 and 2.5%. In its regulatory accounts for the 2000/01 year, EnergyAustralia reported a regulated retail net margin of 0.8% and in the first half of 2001/02 EnergyAustralia's net margin was 1.1%. Even with a CPI increase across all tariffs the increase in greenhouse gas abatement costs combined with the problem of the disparity between the current benchmark costs and EnergyAustralia's actual costs, will deliver a forecasted negative net margin for EnergyAustralia in 2002/03. It is therefore essential that IPART recognises the increases in costs facing retailers in **NSW** in this mid-term review to ensure EnergyAustralia achieves an appropriate net margin from its regulated retail business.

Changes to EnergyAustralia's R Tariffs

In this submission EnergyAustralia proposes tariff increases that will deliver an appropriate net margin. These increases are less than CPI for domestic customers without controlled load and CPI+3% on average for domestic customers with controlled load. The reason for the additional increase for customers with controlled load is that EnergyAustralia's off peak tariffs are currently below market cost, which is hindering the development of competition and restricting the ability of EnergyAustralia to positively respond to the Government's greenhouse gas abatement initiative.

The table below shows the dollar impact these increases would have on domestic customers.

Domestic Customers	3 MWh pa		6 MWh pa		9 MWh pa	
	$	%	$	%	$	%
Single Rate only	11.10	2.87%	20.00	2.87%	28.89	2.87%
Single Rate + Off Peak 1	16.05	5.15%	25.41	4.65%	34.77	4.45%
Single Rate + Off Peak 2	17.68	4.95%	28.66	4.49%	39.65	4.32%

EnergyAustralia proposes increases within the current side constraints of CPI+5% or $50 for business customers without controlled load and increases within CPI+8% or **$50** for business customers with controlled load.

Changes to the IPART Determination

In order *to* allow EnergyAustralia to change its retail tariffs as outlined above and to improve the operation of the current determination, EnergyAustralia recommends the following changes.

Side Constraints

EnergyAustralia's view is that environmental issues are critical in considering the appropriate level of the side constraints, especially in relation to Off Peak 1 and Off Peak 2 customers. Off peak hot water systems potentially provide the greatest opportunity to implement

greenhouse gas abatement activities in NSW. In view of this, EnergyAustralia believes that more flexibility should be provided in relation to Off Peak 1 and Off Peak 2 customers in order to allow the off peak tariffs to reach their respective market costs of supply within the remaining period of the determination.

New Targets

EnergyAustralia recommends the introduction of separate Business and Domestic targets for variable and fixed components to reflect the different costs associated with supplying business and domestic customers. It is also recommended that separate Off Peak 1 and Off Peak 2 targets be introduced to reflect the different costs associated with supplying these controlled load customers. In addition to the approach recommended in this submission EnergyAustralia examined a proposal to remove all targets. This scenario would establish appropriate bench mark costs and increase tariffs accordingly to deliver a net margin within the permitted range. Its simplicity is attractive but it would involve a departure from IPART's initial determination. EnergyAustralia would however be happy to develop this concept further.

New Tariffs

EnergyAustralia recommends that the retail regulation should explicitly provide **a** mechanism for the introduction of new regulated retail tariffs. Of particular significance are problems arising from the introduction of new tariffs by the network business for which retail has no corresponding tariff and greenhouse emission obligations imposed on EnergyAustralia that necessitate continuing innovation in tariff development.

Effect of Competition

IPART's initial determination reflected an averaging approach across the entire regulated customer base. As competition continues to identify profitable customers the average profitability of the regulated customer base will diminish. EnergyAustralia has factored its changing customer base into the benchmark costs proposed in this submission and requests that IPART make similar allowance in its calculation of target tariffs.

Net Margin

Finally EnergyAustralia recommends that IPART should set a benchmark range for the retail net margin of between 2.5% and 5% in recognition of the amount of working capital and level of risk associated with a regulated retail business operating in a fully contestable market.

Benchmark Costs

EnergyAustralia recommends that the level of new and existing targets should be set based on revised benchmark costs and an appropriate net margin. In this submission EnergyAustralia re-examines the costs benchmarked in IPART's initial determination and proposes revised benchmarks where costs have materially changed since the time of the initial determination. EnergyAustralia also proposes benchmarks for costs not included in the initial determination.

Key Recommendations

EnergyAustralia's key recommendations in this submission are:

1. That its regulated retail tariffs be increased on 1 July 2002 within the following side constraints:

Customer Type	Maximum Increase
Domestic Customers - No Off Peak	CPI
Domestic Customers - With Off Peak	CPI + 3% or $25
Business Customers - No Off Peak	CPI + 5% or $50
Business Customers - With Off Peak	CPI + 8% or $50

2. That the determination be amended to allow for:

   - The introduction of separate side constraints for customers with off peak tariffs, to be set at CPI + 3% or $25 for domestic customers and CPI + 8% or $50 for business customers
   - The introduction of separate Business and Domestic targets for variable and fixed components and separate Off Peak 1 and Off Peak 2 targets that reflect the different costs of supply
   - The introduction of a mechanism to allow new regulated tariffs
   - The effect of competition on the regulated customer base
   - That IPART set a benchmark range for the retail net margin of 2.5 to 5%
   - The resetting of existing target levels and establishment of new target levels based on revised benchmark costs and an appropriate margin

EnergyAustralia would welcome further dialogue with IPART on any aspect of this submission.

Table of contents

Introduction and background

In July 2000, the Premier asked the Independent Pricing and Regulatory Tribunal (IPART) to prepare a report under section 9 of the Independent Pricing and Regulatory Tribunal Act, 1992. The terms of reference required IPART to investigate and report on a system of regulated retail tariffs and miscellaneous charges for regulated customers, for the period from 1 January 2001 to 30 June 2004.

In making its recommendation to the Premier, IPART was asked to consider the Government's objective of promoting competition in the retail market for electricity. In particular, IPART's recommendation was required to:

- facilitate a smooth transition to a contestable retail market;
- keep the arrangements as simple as possible; and
- have regard to the costs of supply.

In December 2000, IPART published its recommendation in accordance with the arrangement it entered into with the Premier. This recommendation operates as a determination under the *Electricity Supply Act, **7995*** (the ESA) as amended by the *Electricity Supply Amendment Act, 2000.*

IPART's recommendation ("IPART's initial determination") sets the regulated retail tariffs and regulated retail charges that "standard retail suppliers", such as EnergyAustralia, can charge small retail customers. The determination only applies to customers whose:

(a) premises are in a standard retail supplier's supply district; and

(b) are supplied electricity at those premises by a standard retail supplier under a standard form customer supply contract.

IPART's initial determination established target levels for regulated retail tariffs that were intended to reflect the cost of supply. These targets comprise a network component ("N") and a retail component ("R"). The retail component consists of a fixed $ amount per customer and a variable c/kWh amount which depends on the type and location of the load.

In essence, IPART's initial determination establishes only two types of retail tariff targets for EnergyAustralia, one for controlled load and one for standard load. IPART's determination recognised that this approach created tariff targets that in some cases are significantly different from the existing tariff levels

To address this issue, IPART developed transition paths to move regulated retail tariffs towards the target levels by 30 June 2004. Specifically, where existing tariff charges exceed the target levels the initial determination prevents further price increases. Conversely, tariff charges that are below the target level can increase to the target providing that annual increases do not exceed side constraints.

In commenting on its initial determination, IPART stated:

> *IPART's initial determination, forward **by** Dr Parry.*
>
> "This review has not been an easy task. The Tribunal hopes that its decision will facilitate a smooth transition to competition while protecting customers. However, the electricity market will

change considerably as it is opened to competition. Therefore, the Tribunal proposes that it reviews its decision in late 2002 to ensure that the framework established remains robust."

As foreshadowed in its initial determination, IPART has now embarked on its mid-term review. More formally, the mid-term review is conducted in accordance with section 43EB (2)(a) of the *Electricity Supply Act* ***1995.*** The terms of reference for the mid-term review requires IPART to consider whether there are any factors that have led to a material change in the following cost components:

- an allowance for electricity purchase costs based on an assessment of the long-run marginal cost of electricity generation;
- an allowance for purchases of 'green energy' consistent with retailer license obligations;
- energy losses as published by NEMMCO;
- network charges as determined by the Independent Pricing and Regulatory Tribunal and the Australian Competition and Consumer Commission;
- fees (including charges for ancillary services) as imposed by NEMMCO under the National Electricity Code;
- an appropriate Retail Gross Margin; and
- the allowance for annual indexation based on the Consumer Price Index and expected movements in regulated components and NEMMCO fees.

In considering these costs, IPART's terms of reference requires it to determine whether this justifies a change in the level of the target tariffs to apply from 1 July 2002 to 30 June 2004.

IPART is also required to review the system of tariffs to determine whether the tariffs that are currently below the relevant target level are likely to materially undermine the effective operation of the competitive electricity retail market. If the market is adversely affected by these below target tariffs, IPART is required to determine the changes necessary to the system of regulated retail tariffs to ensure the market operates effectively.

The terms of reference also requires IPART to take account of the following matters in undertaking its mid term review:

- the effect of side constraints in facilitating the rationalisation of existing regulated tariffs and the transition to the target retail tariffs by 30 June 2004;
- clarification of the circumstances in which standard retail suppliers may introduce regulated retail tariffs in addition to the transitional and target retail tariffs, in particular arrangements for introducing 'green tariffs';
- clarification of off-peak versus controlled loads including the merits of introducing a 'shoulder' target retail tariff; and
- arrangements for the recovery of all reasonable full retail competition costs.

This document is EnergyAustralia's submission to IPART's mid-term review. It seeks to address IPART's terms of reference, taking particular account of IPART's objectives and EnergyAustralia's practical experience with the operation of the initial IPART determination. The remainder of this submission is structured as follows:

Section 2	Presents EnergyAustralia's view on the approach that IPART should adopt in conducting its mid-term review
Section 3	Identifies operational issues arising from IPART's initial determination
Section 4	Re-examines the benchmark cost allowances adopted in IPART's initial determination
Section 5	Proposes retail target levels based on the benchmark costs discussed in Section 4.
Section 6	Outlines the effects on customers of EnergyAustralia's proposed tariff increases.
Section 7	Considers the issue of protecting NSW's customers from high retail prices
Section 8	Presents EnergyAustralia's conclusions.
Attachment 1	Includes EnergyAustralia's cost information as requested by IPART. The information on the input page of the template is confidential and is not included in the publicly available version of this submission.

2 EnergyAustralia's suggested approach for IPART's mid-term review

EnergyAustralia warmly welcomes IPART's mid-term review. This review provides a timely opportunity to reappraise the current retail regulation in the context of full retail contestability. In particular, it is vital that retail regulation protects customers from high retail prices without hindering the development of effective retail competition. Therefore, the mid-term review should avoid a forensic examination of each standard retail supplier's costs of providing retail services. Such an approach would weaken incentives to deliver efficiency improvements. Moreover, contrary to competitive market outcomes, efficiency differences between companies would not translate into different net margins. EnergyAustralia's view is that IPART should maintain the benchmark approach to retail regulation that it adopted in the initial IPART determination. In particular, IPART made the following observations regarding the benchmark approach:

IPART's initial determination, page 50

> "In response to consultation in December, the Tribunal stated its belief that in principle it is appropriate to set an industry benchmark rather than a retail supplier-specific cost because in an efficient retail market, through retailer entry and exit, standard retail supplier costs would converge to a similar 'efficient' level. The Tribunal highlighted that even if market entry and exit could not occur, then standard retail suppliers could 'contract out' these retail activities to an efficient operator. In addition, the Tribunal noted that it was mindful of imposing costs on small retail customers as a consequence of inappropriate industry structure."

EnergyAustralia's view is that IPART should adopt a similar benchmark approach to this mid-term review. Therefore, whilst EnergyAustralia has completed the cost information requested by IPART, this is only one of a number of pieces of information that IPART should consider in determining the appropriate level of regulated retail tariffs. Adopting an approach which sets regulated retail prices according to each company's own costs will inevitably lead to more regulation and less competition. Whilst this might be attractive in terms of delivering short-term benefits to customers, it would cause immeasurable longer term damage by stifling competition.

It must be recognised that whilst a benchmark approach is preferred, it is essential that these benchmarks are robust and credible. In this regard, it should be noted that IPART's initial determination has not provided EnergyAustralia with a reasonable net retail margin. In its regulatory accounts for the 2000/01 year, EnergyAustralia reported a regulated retail net margin of 0.8% and in the first half of 2001/02 EnergyAustralia's net margin was 1.1%. This contrasts with IPART's suggested target of 1.5% to 2.5%.

In the light of the adverse financial impact of IPART's initial determination, EnergyAustralia's view is that IPART should revisit the initial benchmark costs. To some extent, IPART's initial determination recognised that certain decisions regarding allowable costs were stop-gap measures that reflected uncertainty at that time. For example, IPART commented as follows:

IPART's initial determination, page 42

> "The impact of a change to a market-based system on actual ancillary service charges is uncertain. Charges may increase or decrease under a market-based system. In view of the uncertainty, it seems reasonable to assume that total ancillary services costs continue at around the same level in real terms over the next few years. The Tribunal will assess the impact of any move to a market-based system for ancillary charges at its mid-term review."

IPART further commented that it may assess the impact of the Commonwealth renewables legislation (if it proceeds) on standard retail suppliers' costs at the time of its mid-term review. In reaching this view, IPART commented that:

> *IPARTs initial determination, page 33*
>
> "The potential costs of the Commonwealth's proposed **'2** per cent renewables' legislation have not been taken into account, as this was outside the terms of reference and the legislation was not finalised at the time of the study."

EnergyAustralia strongly supports IPART's consideration of those costs that were not appropriately addressed at the time of the initial determination. This reflects a timely reappraisal of the decisions that were made prior to the introduction of full retail contestability. However it is essential that IPART also considers whether the benchmark costs established in the initial determination are still appropriate. This assessment should have a sharp focus on the process for transitioning to effective retail competition. Ultimately, it is competition, not regulation, that best protects the interests of customers.

Apart from the determination of benchmark costs and regulated prices, the mid-term review should also consider the form of retail regulation. In particular, it is essential that the form of retail regulation does not prevent the transition to effective competition. One particular area of concern relates to the impact of customer churn on the net margins earned in the regulated retail business. As competition develops further, standard retail suppliers will retain a growing proportion of less profitable and loss-making customers

The mid-term review should also address whether the retail targets established by IPART's initial determination would create cross-subsidies between tariff groups. Cross-subsidies distort the prospect for competition and create the risk of cherry-picking for EnergyAustralia. EnergyAustralia warmly welcomes the following acknowledgment of this issue in IPART's terms of reference for this mid-term review:

> *IPARTs terms of reference for the mid-term review, page 2*
>
> "However, it seems likely that a number of customer tariffs will remain below the target level for some time and this indicates that customers are being charged less than it costs to supply them. The presence of these under-recovering tariffs may undermine the proper functioning of the competitive retail market. If the market is adversely affected by these below target tariffs the Tribunal should determine the changes necessary to the system of regulated retail tariffs to ensure the market operates effectively."

EnergyAustralia has prepared the remainder of this submission to address IPART's terms of reference. In particular, EnergyAustralia's view is that IPART should:

- Address operational issues arising from IPART's initial determination;
- Re-examine IPART's retail cost benchmarks, taking account of recent regulatory decisions and updated information on actual costs;
- Consider tariff pricing issues in considering whether the existing IPART tariff targets should be modified; and
- Protect **NSW** customers from high retail prices, with particular reference to the retail prices in other States.

The submission synthesises this analysis by recommending some modifications to IPART's initial determination.

SUMMARY RECOMMENDATIONS FROM SECTION 2

- IPART's mid-term review should avoid a forensic examination of each standard retail supplier's costs of providing retail services.
- IPART should maintain the benchmark approach to retail regulation that it adopted in the initial IPART determination.
- It is appropriate for IPART to reconsider whether the benchmark costs established in the initial determination are still appropriate, especially in the light of the adverse financial impact of IPART's initial determination.
- IPART should re-examine costs that were uncertain at the time of its initial determination, particularly costs in relation to greenhouse obligations.
- IPART should ensure that the form of retail regulation does not prevent the smooth transition to effective competition.

3 Operational issues arising from IPART's initial determination

The initial determination has been operational since January 2001. IPART and EnergyAustralia now have a better appreciation of how the initial determination applies in practice. IPART's mid-term review provides an ideal opportunity to identify areas where the initial determination could be improved. To assist IPART in this task, this Section discusses the following operational issues arising from IPART's initial determination:

1. The appropriateness of the side constraints developed by IPART in its initial determination. A particular concern is whether the side constraints provide sufficient flexibility to EnergyAustralia to re-balance tariffs to reflect the market costs of supply.

2. The limitations resulting from common target tariffs for domestic and business customers and for Off Peak 1 and Off Peak 2 customers.

3. The process in IPART's initial determination for introducing new regulated retail tariffs. EnergyAustralia also addresses the issue of obsolete tariffs and the need to encourage customers to move to more cost reflective tariffs.

4. The impact on the regulated retail net margin of customer churn. Specifically, EnergyAustralia's view is that IPART's intended level of net retail margins will not be achieved as competition develops further

5. The need to clarify the interpretation of certain aspects of IPART's initial determination.

6. The appropriateness of a net retail margin of 1.5% to 2.5%.

3.1 Side Constraints

EnergyAustralia's view is that environmental issues are critical in considering the appropriate level of the side constraints, especially in relation to Off-Peak 1 and Off-Peak 2 customers. Off peak hot water systems potentially provide the greatest opportunity to implement greenhouse gas abatement activities in NSW. Reducing greenhouse gas emissions on standard load requires the construction of new renewable generation in the national market, which can take years to be fully operational. In contrast to this, electric hot water systems can be replaced with gas or solar systems now, which means that greenhouse gas benefits can be realised today, rather than in a few years time.

The potential impact of encouraging the conversion of customers from electric to solar hot water systems is significant. Electricity supplied to electric hot water systems accounts for approximately 15% of EnergyAustralia's total load from regulated customers. If only 10% of these customers converted to solar hot water, it would remove up to 144,000MWh from EnergyAustralia's regulated load, which represents 1.34million tonnes of CO_2 that would not be emitted into the environment.

In the past year EnergyAustralia has implemented a solar hot water initiative with the aim of encouraging customers to convert their existing electric hot water systems. This initiative involves the promotion of solar hot water systems on customers' bills and giving customers the option to pay for the system in instalments on their energy bill.

Sales as a result of this initiative have been significantly lower than expected however and one of the main reasons for this is the artificially low price of electricity supplied to electric hot

water systems. As solar hot water systems are more expensive than electric systems to install, the savings in terms of ongoing energy supply need to be sufficient to warrant the customers' extra initial cost. Increasing the target level of off peak electricity in the manner proposed by EnergyAustralia can therefore be seen as a crucial contributing factor to the success of the NSW Government's greenhouse gas reduction policies.

The table below shows the cost comparisons using current prices:

Domestic	Installation Cost	Yearly energy cost	Payback (years)
OP1 - Electric	1,300	142	4.7
OP1 - Solar	1,800	36	
OP2 - Electric	1,300	264	2.5
OP2 - Solar	1,800	66	

EnergyAustralia believes that a coordinated approach must be taken to promote the conversion of Off Peak 2 customers in the coming years. This approach would essentially involve:

1. Making the Off Peak 2 tariff obsolete;

2. Increasing the price of Off Peak 2 by CPI+3% for existing domestic customers and CPI+8% for existing business customers to cover market cost and provide incentives to customers to convert their existing electric hot water system.

3. Introducing a new controlled tariff, to replace the existing Off Peak 2 tariff for new customers, but which would be cost reflective.

4. Introducing a new Solar Booster tariff, similar in nature to the existing Off Peak 2 tariff, however it would only be available to supply Solar Hot Water systems

In view of these concerns, EnergyAustralia believes that more flexibility should be provided in relation to OP1 and OP2 customers. This enhanced flexibility would provide an opportunity for a "catch up" given previous restrictions in annual tariff increases. Moreover, the increase would provide some assistance to greenhouse gas reduction, a critical component of which is to encourage off-peak customers to switch to gas or solar.

EnergyAustralia proposes that the side constraints in relation to customers with off peak be relaxed to CPI+3% or $25 for domestic customers and CPI+8% or $50 for business customers. This would allow the off peak tariff components to increase sufficiently to reach market cost, while also ensuring that each customer's total bill does not increase by more than CPI+3%[1].

(It should be noted that in this submission EnergyAustralia has interpreted that side constraints of $25 and $50 for residential and business customers applies to 30 June 2004 and that the statement in Section 5.3 of the IPART's initial determination that these only apply to 30 June 2002 is a drafting error.)

[1] This distinction arises because off-peak customers are also served by the standard domestic tariff. Therefore, side constraints that apply to customers' overall bills would allow the off-peak tariff rate to increase by more than the side constraint.

3.2 Introducing new targets

While the proposed relaxation of side constraints goes part of the way to ensuring tariffs reach market costs, it is only effective if it is done in conjunction with an introduction of separate and increased Off Peak 1 and Off Peak 2 targets to reflect the different costs associated with these controlled load customers.

The increases proposed for IPART's controlled load targets must therefore be seen as a fundamental component of EnergyAustralia's response to the Government's Greenhouse Gas Reduction strategy. Increasing the targets in the manner proposed by EnergyAustralia not only aligns them with the true market cost of supplying the energy, it also allows EnergyAustralia to send price signals to its customers that encourages them to convert to cheaper and more greenhouse friendly sources of energy for the hot water systems.

EnergyAustralia also recommends the introduction of separate Business and Domestic targets for variable and fixed components to reflect the different cost make up associated with business and domestic customers.

The benchmark costs that are the building blocks for these targets and the make up of the targets themselves are addressed in Sections **4** and 5 for this submission.

3.3 Introducing new tariffs

EnergyAustralia's view is that retail regulation should as far as possible encourage innovation and provide incentives to improve performance. In particular, significant greenhouse emission abatement obligations imposed on EnergyAustralia requires continuing innovation in tariff development. It is therefore a major concern that the existing regulatory framework does not facilitate the introduction of new retail tariffs. This is especially problematic if the network business introduces a new tariff and the retail business is prevented from introducing a corresponding retail tariff.

EnergyAustralia' view is that the retail regulation should explicitly provide a mechanism for the introduction of new regulated retail tariffs. A pragmatic approach would be to automatically allow the appropriate controlled load or standard load targets to apply to the new tariff. In cases where a standard retail supplier believes that the target rate would be too low, the regulation could provide for an IPART determination. This determination would consider the costs of providing the new retail tariff, and the associated benefits that would arise from its introduction.

EnergyAustralia also believes that customers supplied by obsolete tariffs should be actively encouraged to move to more cost reflective tariffs. Whilst it **is** important that customers are protected from significant price increases, it is equally critical that uneconomic tariffs are not maintained indefinitely. Allowing customers to enjoy uneconomically low prices is not consistent with the transition to effective retail competition. To address this issue, EnergyAustralia proposes that customers on obsolete tariffs can be transferred to an alternative tariff, subject to receiving 12 months notice.

3.4 Customer churn

IPART's initial determination adopted an average approach to setting retail tariff targets. This average approach included a net retail margin in the range of 1.5%to 2.5% of sales turnover. In setting the required net retail margin, IPART did not differentiate between

customer size or customer type. Essentially, IPART's determination reflected an average approach across the entire regulated customer base.

This average approach to setting retail target levels is sustainable in the absence of competition. However, the introduction of full retail contestability now provides the dynamic for identifying those customers whose profitability is higher than average. It should be noted, however, that small customers might not be attractive to a second tier retailer even if their profitability is at or above the 1.5% to 2.5% level. This is because the total dollar profitability for small customers is low compared to larger customers.

The implication of competition and customer churn is more critical when the differences in customer profitability are more pronounced. In particular, as competition continues to identify the more profitable customers, the standard retail suppliers will retain a growing proportion of less profitable or unprofitable customers. Customer churn therefore has the effect of reducing the average profitability of the regulated retail base.

EnergyAustralia's view is that IPART's initial determination will deliver even less than the intended net retail margin as competition develops further. Therefore, IPART's mid-term review will need to adopt a more disaggregated approach to retail regulation if the allowed regulated retail margin is to be achieved. This issue is discussed in more detail in Section 5 of this submission. In Section 6, EnergyAustralia proposes a modest unbundling of IPART's retail target structure to address this issue.

3.5 Interpretation of IPART's initial determination

Inevitably, the initial determination is open to different interpretations in a number of areas. Whilst IPART and EnergyAustralia have agreed to adopt a common-sense interpretation of the initial determination, our view is that this arrangement is not ideal. The mid-term review provides an ideal opportunity to address formally any outstanding issues of interpretation with regard to the initial determination.

3.5.1 Variation of Tariffs

The current determination provides that regulated retail tariffs must be amended on 1 July each year, or if special circumstances exist, no later than 14 days after this date. Establishing such an inflexible time constraint does not make allowance for the fact that in some situations retail tariffs cannot be finalised due to circumstances beyond the retailer's control, such as the finalisation of network prices. EnergyAustralia requests that this constraint be able to be extended if IPART is satisfied that circumstances warrant.

The determination also restricts retail suppliers to just one price change in a **12** month period, which prevents amendments being made to retail tariffs if unforeseen circumstances eventuate. Again, EnergyAustralia requests that this restriction be able to be varied if IPART is satisfied that circumstances warrant.

3.5.2 Calculation of Target Level tariffs

For the purposes of calculating the target level, EnergyAustralia seeks confirmation that the N component refers to the actual network price charged to the retailer.

EnergyAustralia would welcome a separate dialogue with IPART on these issues.

3.6 Net Retail Margin

IPART's previous determination provided for a net retail margin in the range of 1.5% and 2.5% of sales turnover is appropriate. In reaching this view, IPART reviewed:

- its 1999 determination, including a study undertaken by London Economics in 1996,
- IPART's own decision in relation to AGLRE's allowed profit margin in its regulated gas business;
- decisions made by OFFER in the UK; and the views of a US commentator.

In addition, IPART also considered the risks applying to different customer groups, and the argument that margins should be increased to encourage competition.

EnergyAustralia's view is that this mid-term review should build on the recent work undertaken by ORG in relation to the appropriate level of net margins. In essence, ORG takes a similar approach to IPART, but has updated its view on appropriate returns, having regard for more recent evidence from the UK and advice from its consultants, Charles River Associates (CRA). The relevance of bad debt and working capital costs (discussed in Section 4.6 above) should also be considered by IPART.

- CRA recommended a significantly higher net profit margin range, 2.5% to 5%, for Victorian retailers compared to the 1.5% to 2.5% allowance in NSW.

The ORG concluded that the appropriate net margin should be between 2.5% and 5%.

EnergyAustralia accepts that there are differences between the retailers' existing risk exposure that could justify a different rate of return[2]. However, the ORG's view that the appropriate net margin is between 2.5% and 5% establishes an important benchmark. Essentially, net margins below 2.5% are inconsistent with ORG's view of the appropriate returns

EnergyAustralia's view is that IPART should set a benchmark range for net retail margin of between 2.5% and 5%. The increase in the net retail margin is justified by the provision for bad debt and working capital. It should **be** noted, however, that establishing appropriate net retail margins across the entire customer base does not necessarily ensure that net margins are appropriate for particular customer groups. EnergyAustralia believes that this issue will require detailed analysis in subsequent retail price reviews. Working Capital and bad debt costs are addressed in Section 4 of this submission.

[2] It should be noted, however, that EnergyAustralia does not accept that its cost of capital is lower as a result of Government ownership. This issue is addressed in more detail in Section 3.4 of this submission.

SUMMARY RECOMMENDATIONS FROM SECTION 3

- EnergyAustralia proposes that the side constraints in relation to customers with off peak be relaxed to CPI+3% or $30 for domestic customers and CPI+8% or $50 for business customers.
- IPART's determination should explicitly provide a mechanism for the introduction of new regulated retail tariffs.
- EnergyAustralia proposes that customers on obsolete tariffs can be transferred to an alternative tariff, subject to receiving 12 months notice.
- EnergyAustralia recommends the introduction of separate Business and Domestic targets for variable and fixed components and separate Off Peak 1 and Off Peak 2 targets
- IPART should clarify outstanding issues of interpretation in relation to its initial determination.
- IPART should note that as competition continues to identify the more profitable customers, standard retail suppliers will retain a growing proportior of **less** profitable or unprofitable customers.
- IPART's mid-term review will need to adopt a more disaggregated approach to retail regulation if the allowed regulated retail margin is to be achieved
- IPART should set a benchmark range for net retail margin of between 2.5% and 5% to include a provision for bad debt and working capital

4 Re-examining IPART's benchmark cost allowances

4.1 Generation purchase costs

IPART's initial determination estimated that the long run marginal cost (LRMC) of purchasing electricity and green energy is between $36 to $56 per MWh. In setting this range, IPART took a number of factors into consideration, namely:

- the government's proposed electricity tariff equalisation fund
- the Cap Gemini Ernst and Young study that IPART commissioned
- other studies of LRMC of electricity generation
- licence requirements for greenhouse energy purchases
- NEMMCO fees and ancillary charges incurred by generators.[3]

It should be emphasised that the generation purchase cost allowance did not include the costs of the Commonwealth's requirements with respect to green purchases. EnergyAustralia's strategy with respect to these environmental obligations and the costs of these obligations are discussed further in the next section.

In reaching its view on the appropriate range of LRMC costs, IPART noted that pool prices can deviate from LRMC for prolonged periods. Specifically, IPART commented that:

> *IPART's initial determination, page 34*
>
> "The Tribunal recognises that for significant periods of time, the LRMC of electricity generation can depart from pool prices. The LRMC could be higher than pool prices in times of excess capacity, but in the lead up to capacity constraints, it could be below the pool price for extended periods."

The volatile nature of the generation market exposes retailers to risk. In EnergyAustralia's view, it is essential that standard retail suppliers are not trapped between increasing energy purchase costs and fixed retail prices. This is the situation that contributed to the difficulties in the Californian electricity industry. In part, the Government's electricity tariff equalisation fund (the ETEF arrangement) was established to manage this risk exposure.

In reaching a view of generation purchase costs, it is essential to consider the inherent risk in the generation wholesale market, and the retailer's costs of adopting a prudent hedging strategy. IPART's initial determination commented on the uncertain nature of pool prices. Despite the relatively low level of pool prices at the time of the initial determination, IPART commented that:

> *IPART's initial determination, page 35*
>
> "The Tribunal is aware of expectations that there may be higher pool prices in early 2001, flowing from the tighter supply-demand position in Victoria and South Australia. As demand increases over the medium term, prices are expected to increase. The impact on pool prices of

[3] The relevant studies are described in more detail in IPART's initial determination, pages 32 to 35

> interconnections under way or planned from New South Wales to Queensland and South Australia and new generation capacity in Queensland is uncertain.
>
> In the lead up to new investment in generation capacity, pool prices could exceed LRMC for an extended period. How quickly pool prices and short to medium term contract prices will increase in advance of new investment is not known. Nor is the effect of the relatively small number of suppliers."

IPART's comments in relation to the NSW pool price were indeed accurate. The monthly average pool price in NSW for the month of January 2001 was nearly $67/MWh compared to a 6 monthly average of $36/MWh up to 31 December 2000, an increase of 85%. Pool prices have since returned to monthly average levels below those existing at the time of the initial determination. Notwithstanding the particular movement of pool prices in NSW, IPART's general observation regarding the unpredictable nature of pool prices remains valid.

From EnergyAustralia's perspective, this mid-term review should consider whether IPART's existing LRMC benchmark is an appropriate market–based benchmark for generation purchase costs. In considering this issue, EnergyAustralia has revisited CapGemini Ernst & Young LRMC study which was an important element in IPART's initial determination.

Cap Gemini Ernst & Young essentially adopted a three step process for assessing the LRMC of generation for each retailer in NSW:

1. Determine the optimal generation plant mix to meet NSW system demand, after optimising existing plant to reflect new entrant generation costs;

2. Assess the costs of base load, shoulder and peak generation plant using publicly available cost data; and

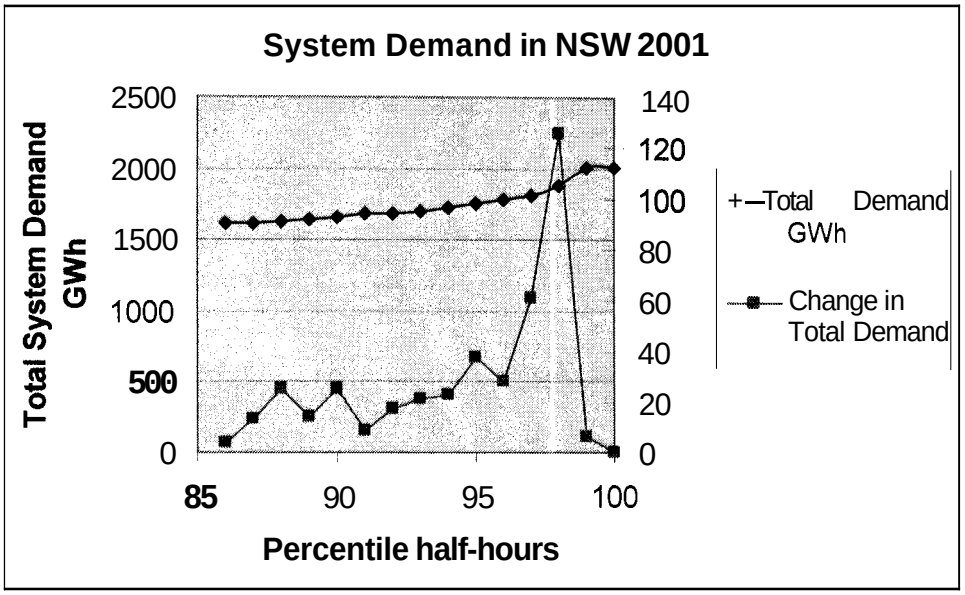
3. Calculate the LRMC of peak, shoulder and base generation for the NSW system and apply these costs to individual retailers' load shapes to assess each retailer's LRMC of generation.

Although EnergyAustralia does not have access to the model used by Cap Gemini Ernst & Young, it is possible to consider whether their findings tended to under-estimate the LRMC of generation in NSW. In particular, the system load information, cost information and EnergyAustralia's franchise load is now better understood than at the time of the Cap Gemini Ernst & Young report.

In relation to the plant mix, Cap Gemini Ernst & Young suggest that the percentage of system demand which is defined as peak should be less than **5%.**

> ***Cap Gemini, final report to IPART, September 2000, page 3***
>
> "Peak load is the demand that occurs during periods of high system demand. Typically, these periods relate to less than 5% of the annual half-hourly demands"

In considering whether this assumption is reasonable, EnergyAustralia has examined the actual NSW system load in 2001. The following graph shows the increasing system load for the 85 to 100 percentiles of peak half-hour periods in 2001. It also depicts the "peakiness" of the system load during each percentile by showing the change in the total demand.



The graph shows the change in system demand increased markedly between the 94th percentile half-hour demand and the 95th percentile. This suggests that peak demand should be defined as the 94th percentile of peak half-hour periods. This contrasts with Cap Gemini Ernst & Young's report which commented that the peak demand is typically less than 5% of the system half-hours. Whilst this is a relatively minor difference, it has implications for EnergyAustralia's assumed LRMC of peak generation.

The next step in the process is to consider the costs of the relevant generation plant. In reviewing Cap Gemini Ernst & Young's report, EnergyAustralia's view is that the cost of gas in NSW has been under-estimated as gas prices of $3.00 - $3.20/GJ were assumed. The gas price needs to be reviewed to account for current gas supply to NSW. Additionally, it needs to be considered that further infrastructure development will be required to supply gas to the assumed NSW gas fired power plant. These factors will have an upward pressure on delivered gas prices in NSW.

Using publicly available data, the indicative delivered cost of gas to power plants in NSW is in the range of $3.50 - $4.00/GJ. This range is made up of the current Victorian market price of $2.70/GJ[4] and transmission costs of $0.80 - $1.00/GJ[5]. An allowance for distribution charges should also be included. This indicative range can be compared to EnergyAustralia's current cost of gas supply, which is in the range of $3.85 - $4.40/GJ.

Using a conservative gas price of $4.00/GJ (2002 dollars) increases the LRMC by 12%, i.e. the peak cost as detailed in the CGEY report increases to approximately $45/MWh, and the shoulder cost to approximately $41/MWh for the standard LRMC approach. Similarly, for the CGEY Snowy/Gas LRMC approach the peak and shoulder costs would rise to $131/MWh and $53/MWh respectively.

[4] February 2002, obtained from VENCorp's website.

[5] Victorian gas is transported to NSW sites via the Eastern Gas pipeline. The Duke International website indicates that this pipeline has a capital cost of $450milliion with an initial capacity of 65PJ.

In relation to the third step in CGEY's analysis, converting the system LRMC costs to a retailer-specific LRMC, EnergyAustralia also believes that a revised approach is appropriate. In particular, in its final report to IPART, Cap Gemini Ernst & Young commented that:

> *Cap Gemini, final report to **IPART,** September 2000, page 19*
>
> The retailers' estimated load shapes were obtained from **NSW** Treasury. In general, the data appeared to be of reasonable quality, although CGEY did not undertake any further validity checks. The only exception in relation to data quality was Energy Australia's franchise estimates, where Bulk Supply point data was the best available estimate of franchise load. Unfortunately, the residential load profile for Energy Australia was not of sufficient quality to provide a better estimate the franchise load shape.
>
> CGEY recognises that the Energy Australia data is likely to underestimate the 'peakiness' of its franchise load, and therefore underestimate the LRMC of its franchise market. IPART should consider whether a further allowance for Energy Australia's LRMC of generation to reflect the use of bulk supply point data is appropriate.

EnergyAustralia has calculated the percentage of its franchise load that is peak, shoulder and base load, using **2001** data. In particular, this analysis correct the CGEY analysis to include the percentage of EnergyAustralia's franchise load that occurred during the 94th percentile of peak half-hours.

The first table below replicates CGEY's calculated LRMC for EnergyAustralia together with the implied percentage allocation between peak, shoulder and base load generation. The second table shows how this LRMC estimate should be revised in the light of the above discussion.

CGEY's original analysis of EnergyAustralia's LRMC

	Base Load	Shoulder	Peak	Total LRMC for EnergyAustralia
Percentage of Franchise load %[6]	**0.15**	**0.8**	**0.05**	
LRMC Standard $/MWh	**$35.20**	**$36.60**	**$40.00**	**$36.5**
LRMC Snowy/Gas $/MWh	**$35.90**	**$47.40**	**$117**	**$49.1**

Updated analysis of CGEY calculations

[6] This percentage split is EnergyAustralia's best estimate in order to produce LRMC estimates as close as possible to those quoted in the CGEY report.

	Base Load	Shoulder	Peak	Total LRMC for EnergyAustralia
Percentage of Franchise load %[7]	15%	76%	9%	
LRMC Standard $/MWh	$35.20	$41.00	$45.00	$40.50
LRMC Snowy/Gas $/MWh	**$35.90**	$47.40	$117	$52.61

In considering the appropriate LRMC figure within this range, EnergyAustralia's view is that IPART should consider the following comments made by CGEY in their report:

Cap Gemini, final report *to IPART,* September 2000, page 26

> Our modelling makes no attempt to examine the 'actual' generation costs that retailers are currently paying through pool or contract arrangements. In particular, we have not considered whether the current level of pool prices and contracts is materially different to the LRMC estimates in this report.

> In estimating the LRMC of generation, each approach is dependent upon the proportion of peak franchise energy supplied by each retailer. For Energy Australia, it is likely that the data presented understates the peakiness of the franchise load. This issue is discussed in more detail in Section 3. Moreover, retail competition could increase the peakiness of the incumbent retailers' residual franchise load, assuming that customers with flatter load profiles are more likely to churn. This tendency may lead our estimates to understate the upper bound of LRMC.

EnergyAustralia strongly supports these comments. For the purposes of this submission, EnergyAustralia has adopted a benchmark LRMC for EnergyAustralia of $49/MWh. This is within CGEY's original range, and also within the revised range provided in this submission. This amount does not include the greenhouse compliance costs of $1.55/MWh.

4.2 Green Energy Strategies and Costs

4.2.1 Regulatory Obligations

EnergyAustralia is subject to two regulatory obligations with regard to the purchase of green energy.

[7] As per EnergyAustralia's calculations based on 2001 franchise data.

1. Federal Renewables Legislation

The Federal Renewable Energy (Electricity) Act 2000 imposes liabilities on certain classes of electricity purchase. The legislation establishes a fine that must be paid to discharge the liability, which can be reduced by surrendering renewable energy certificates (RECs) to the Office of the Renewable Energy Regulator (ORER). The rate of liability (renewable power percentage) grows each year in line with an increasing industry-wide target of renewable energy purchase.

2. NSW Licence Conditions

The NSW Electricity Act imposes licence conditions on electricity retailers to reduce greenhouse emissions. In January 2002, the NSW Government released a proposal to include penalties in these licence conditions for electricity purchases that produce CO_2 beyond an allowable target. The target level is set to reduce from 8.42 tonnes of CO_2 per capita to 7.27 in 2006107.

4.2.2 EA's Strategy for Meeting its Obligations

EnergyAustralia has pursued three major initiatives in order to meet its greenhouse obligations. These are:

1. *Purchasing renewable energy generation* - EnergyAustralia forecasts that it will purchase 155 GWh of renewable energy for the 2001102 year. Through its PureEnergy product, EnergyAustralia continues to sell this renewable energy to its business and residential customers.

2. *Promotion of energy efficiency activities* - In 200112002 EnergyAustralia embarked on a major energy efficiency advertising campaign including TV advertisements, radio, print media, billing inserts (including a coupon booklet providing discounts on efficient appliances and services) and information brochures for residential energy efficiency.

3. *Encouraging fuel substitution* – as a dual fuel retailer, EnergyAustralia is in a position to encourage fuel switching from electricity to gas. Also, EnergyAustralia has actively promoted the installation of solar hot water systems by its customers.

EnergyAustralia will continue to explore alternative approaches to achieving greenhouse gas abatement initiatives with its customers. However, it is anticipated that the three major initiatives outlined above will continue to form a significant component of EA's overall greenhouse gas reduction strategy. Unfortunately, there are a number of constraints restricting the effectiveness of these initiatives at this time:

1. *Purchasing renewable energy generation* – EnergyAustralia's ability to purchase renewable energy is constrained by the prevailing shortage of renewable energy in the NSW marketplace. EnergyAustralia continues to seek opportunities to be involved in new renewable generation projects.

2. *Encouraging fuel substitution* – the main opportunity for EnergyAustralia to promote fuel substitution by its customers is by encouraging the conversion of electric hot water systems to solar and gas. Despite the reduction of installation costs resultant from the Federal and State compliance benefits, the uneconomically low cost of electricity supplied to electric hot water systems acts as a significant barrier to conversion.

4.2.3 Expected Cost of EA's Greenhouse Obligations

EnergyAustralia is fully committed to meeting its greenhouse gas reduction obligations and is investing considerable resources to achieve this. The table below shows the expected costs of compliance applicable to EnergyAustralia's regulated customers.

Table 3.1 – Cost of Greenhouse Compliance

$million	2002103	2003104
Federal REC's	2.27	3.28
NSW Licence Compliance	11.83	12.82
Total Cost	14.09	16.10

These costs equate to an amount of $1.55/MWh, which is then added to the IPART variable target level for 2002/03.

EnergyAustralia believes that it is adopting a proactive and environmentally responsible approach to mitigating greenhouse gas emissions. It is essential that IPART recognises the associated costs in its mid-term review in accordance with its initial determination:

IPART's initial determination, page 33.

"If necessary, the Tribunal may assess the impact of the Commonwealth renewables legislation (if it proceeds) on retail supplier costs at the time of its mid-term review."

4.3 Network Charges

IPART's approach to retail regulation ensures that reductions in network charges are passed through to retail customers. However, it is questionable whether the regulatory mechanism would allow increases in network charges to be similarly passed through. This is because the operation of IPART's side constraints could prevent retail charges from increasing sufficiently to recover the increase in network charges.

Indeed, distribution charges are expected to increase by two per cent annually for the next two years. These pricing predictions do not include the anticipated growth in transmission charges.

The residential side constraint is currently set at CPI however the side constraint that applies to the network charges is set at CPI+2 per cent. This causes potential problems in maintaining adequate commercial returns for retail businesses. Although EnergyAustralia recognises the attractiveness of side constraints to the Tribunal, EnergyAustralia believes that the current disparity between side constraint rates is a major risk to retail businesses. Whilst this is unlikely to have a material effect on EnergyAustralia during the remainder of the regulatory period, it will potentially be an issue in the next regulatory period and may currently be an issue for other retail businesses.

It is also important to recognise that transmission and distribution charges will not always change at the same rate or even in parallel directions. Given the increasing moves towards the unbundling of transmission and distribution charges it would appear to be appropriate to recognise this fact in the construction of the 'N' factor. The 'N' factor should be explicitly derived from both the transmission and distribution use of system charges, ie T+D. Although this is unlikely to be a major issue for default tariffs over the next couple of years, it is important to ensure that the Tribunal's framework is flexible enough to support the separation

of transmission and distribution charges if and when they apply to default customers. Therefore, EnergyAustralia believes that the Tribunal should consider loosening the side constraint rates applied to default residential customers to CPI+2 per cent, and that the 'N' term in the N+R calculation should be explicitly derived from the separate TUoS and DUoS charges.

4.4 Retail Operating Costs

IPART's determination provided a retail operating cost allowance in the range of $40 to $60 per customer. This allowance was described by IPART in the following terms:

> ***IPART's** initial determination, page **44.***
>
> The purpose of a retail gross margin is to allow standard retail suppliers to recover efficiently incurred retail costs (not captured elsewhere), and an appropriate profit margin. In making its Recommendation on regulated retail tariffs, the Tribunal estimated retail operating costs as ranging between $40 to $60 per customer per annum (in $2001), allocated on a fixed ($ per customer) and variable (c/kWh) basis, and allowed a net profit margin of 1.5 to 2.5 per cent. The $40 to $60 cost estimate includes $5 for costs associated with full retail competition (FRC).

The retail operating costs "not captured elsewhere" in IPART's Determination included items that were subject to some uncertainty, including:

- The costs of mitigating greenhouse gas emissions in accordance with licence and federal requirements;
- The costs of NEM fees including ancillary services; and
- The impact of customer churn on average losses.

Taking each of these additional items in turn, EnergyAustralia's views are as follows:

- The cost of mitigating greenhouse gas emissions has been addressed in detail in Section 4.2 of this submission;
- In relation to the costs of NEM fees, updated forecasts are provided in the cost information attached to this submission.
- Customer churn can affect the average losses, and therefore generation purchase costs. EnergyAustralia believes that the benchmark approach to generation purchase costs should provide sufficient allowance to manage this risk. EnergyAustralia's views on the appropriate benchmark generation purchase cost are provided in Section 4.1 of this submission.

The remainder of this section addresses the appropriateness of the $40-$60 per customer allowance, including the **$5** per customer for FRC, provided by IPART in its initial determination.

EnergyAustralia recognises that this is a mid-term review, rather than a full retail price determination. Against this background, there is considerable benefit in reviewing the approach adopted by the Office of the Regulator-General (ORG) in Victoria in its recent investigation into retail price proposals. ORG's analysis includes a comparison of retail operating costs across Australia and internationally, in addition to a detailed examination of each company's submission. In this sense, ORG's investigation has adopted a very similar approach to that described by IPART in its initial determination:

*IPART's initial determination, page **45***

"In making its estimate of retail costs, the Tribunal analysed and considered a range of factors, including:

- the reported operating costs of the standard retail suppliers
- information on the costs of electricity retailing in other states and countries
- the differing costs of standard retail suppliers due to economies of scale, and
- the appropriateness of reflecting retail operating costs in regulated retail tariffs."

Given the similarity in approach, it is noteworthy that following its detailed analysis and discussion of the appropriate level of retail operating costs, ORG concluded that:

The Office of the Regulator-General's special investigation into retail price proposals, page 30.

"Having regard to those comments and actual data submitted by the retailers, the Office believes that a benchmark for retail operating costs in the range of $50-80 (including the costs associated with FRC[8]) is appropriate."

In the light of ORG's analysis and conclusion, EnergyAustralia's view is that a benchmark operating cost in the middle of ORG's range is appropriate for NSW retailers. Therefore, EnergyAustralia recommends that IPART adopt an operating cost benchmark range of $65 to $70 per customer, which includes a suitable allowance for FRC costs. This range allows for an increase in an initial benchmark cost of $65 to take account of a decreasing customer base over the two years while fixed operating costs increase by CPI. The benchmark range of $65 to $70 is an average and residential and business operating costs which differ significantly. This is addressed in Section 5 of this submission.

This approach would provide significantly lower revenue in NSW than the Victorian retailers' expected costs, which ORG described in the following terms:

*The Office **of** the Regulator-General's special investigation into retail price proposals, page 35*

"It should also be noted that the costs implied by the retailers' proposals are generally higher than the benchmark range [$80 per customer], and in particular, the assumptions adopted by IPART with respect to the **NSW** retailers."

In this context, establishing a NSW benchmark range of $65 to $70 per customer represents a continuing challenge to NSW retailers. However, it also represents a more realistic benchmark than the $40 to $60 per customer benchmark in IPART's initial determination.

4.5 Bad debt and working capital

It should also be noted that bad debt and working capital requirements need to be addressed in establishing appropriate regulated retail tariffs. EnergyAustralia is particularly concerned that bad debt will grow significantly as retail competition develops further. Unlike the Victorian and UK markets, retailers in NSW are not allowed to object to a customer transfer

[8] ORG allowed between $5 and $10 per customer for FRC.

on the grounds of an outstanding debt. The NSW approach will lead to significant "skipping" where customers avoid payment by changing retailer.

There are alternative methods of including bad debt and working capital costs in the building blocks that underpin regulated retail tariffs. For example, in relation to bad debt an allowance could be included as an operating cost; reflected in the allowed net retail margin; or taken into account in the expected cashflows. Similarly, working capital requirements could be met through an additional allowance in the retail margin or through a financing charge in the operating costs.

The **ORG** adopted the following approach to working capital and bad debt in its recent investigation into retail prices:

The Office of the Regulator-General's special investigation into retail price proposals, page 26

"The benchmarks established by the Office for retail margins provide for working capital, including the prospect that retailers may not bill or receive all revenue. Implicitly, bad debts are treated as a reduction in the quantity of revenue received in the working capital calculation rather than an accounting expense."

For the purposes of this mid-term review, it should be noted that IPART only made an oblique reference to the issue of working capital in its initial determination:

IPART's initial determination, page 51

"The net profit margin ultimately represents the reward to investors for committing capital to the business."

The mid-term review is an opportunity for IPART to reconsider the issue of working capital in more detail. EnergyAustralia has modelled bad debt and working capital costs at $36.9 million pa. We believe these costs should be reflected in the required net retail margin. This view is consistent with the approach adopted by ORG.

SUMMARY RECOMMENDATIONS FROM SECTION 4

- IPART should adopt a more conservative generation purchase cost benchmark of $49/MWh based on current NSW market conditions.
- IPART should note EnergyAustralia's green energy strategies demonstrate that it is adopting a proactive and environmentally responsible approach to mitigating greenhouse gas emissions. It is essential that IPART recognises the associated costs in its mid-term review, estimated at $1.55/MWh.
- IPART should adopt a benchmark operating cost range of **$65** to $70 per customer, which is in the middle of the range recently proposed by the Office of the Regulator-General.
- IPART should ensure that bad debt and working capital requirements are properly reflected in regulated retail tariffs. EnergyAustralia is particularly concerned that bad debt will grow significantly as retail competition develops further..

5 Developing revised retail tariff targets

Section **4** of this submission re-examined the benchmark costs that formed the basis of the regulated retail tariffs in IPART's initial determination. This section addresses how these cost benchmarks should be reflected in revised retail targets. The benchmark costs are as follows:

- Benchmark costs for generation purchase costs of $49/MWh;
- Benchmark retail operating costs of $65 per customer;
- Net retail margin benchmark range of 2.5% to 5% of sales revenue; and
- EnergyAustralia's updated projected costs for NEM market fees; line losses; greenhouse costs; and network charges.

In designing retail tariff targets, it is important to consider how these costs differ between customer groups. Where there are marked differences between the costs of serving customers, this should be reflected in IPART's retail targets. Presently, there are only two variable retail target components – one for standard load and one for controlled load, and a fixed allowance per customer.

Section 5.1 presents a breakdown of the benchmark costs between tariff categories. It is proposed that revised retail targets should be based on this analysis. Section 5.2 compares IPART's existing targets, EnergyAustralia's existing revenue and the proposed retail targets for Off-peak 1 and Off-peak 2 customers. This demonstrates the urgent need to introduce revised targets for Off-peak 1 and 2 customers.

5.1 Analysis of benchmark costs for tariff categories

The following table shows the breakdown of the benchmark costs between tariff categories. The allocation of costs is based on EnergyAustralia's best estimates of the costs of serving customers given their load profile and billing frequency.

Table 5.1 Cost Build Up for *2002103*

Cost Categories		Benchmark costs	Residential	Business	Controlled Load A	Controlled Load B
Generation	c/kWh	4.90	4.94	5.53	2.93	4.69
Line Losses	c/kWh	0.27	0.28	0 30	0.17	0.27
Green Cost	c/kWh	0.155	0.155	0.155	0.155	0.155
NEM Fees	c/kWh	0.14	0.14	0.14	0.14	0.14
Operating Cost	$/cust	65	62	106		
Net Margin	% of rev.	2.5%	2.5%	2.5%	2.5%	2.5%

It is important that the impact of customer churn is also taken into account in setting retail targets. In particular, two issues are highly relevant in this regard:

1. Customers of a particular size (typically small customers) may be unprofitable if the fixed and variable components of IPART's retail targets do not match the costs of supply.

2. As the customer mix changes, the load profile and therefore the average costs of supply tend to increase. This would arise if customers with a flatter than average load shape moved to competitive market contracts;

The following table provides details of the implied retail targets and a comparison with the existing IPART retail targets.

Table 5.2 Comparison of Target Levels

Variable - c/kwh	Existing	Proposed
	2001102	2002103
Standard - Domestic	9.16	9.76
Standard - Business	9.16	10.28
Controlled Load A	4.26	4.22
Controlled Load B	4.26	7.70

Fixed - $/year	Existing	Proposed
	2001102	2002103
[Standard - Domestic	79.12	88.93
(Standard- Business	152.85	199.91

EnergyAustralia's off-peak tariffs are currently subject to the same IPART controlled load target. However, as shown in Table 5.1 the costs of supply are significantly higher for off peak 2 than for off peak 1.

The difficulty with IPART's Off Peak 2 retail target is exacerbated by its relationship with the existing tariff rate. To meet IPART's retail target for the Off-peak 2 tariff would require substantial reductions in real terms in the existing tariff rate. This required reduction is contrary to the cost of supply that implies that the current tariff rate should be increased sharply. In contrast, IPART's Off-peak 1 retail target is substantially above the existing tariff rate. This provides the potential to increase charges to reflect more closely the market costs of supply. However, the side constraints (discussed in Section 2.2) largely prevent substantial increases taking place.

SUMMARY RECOMMENDATIONS FROM SECTION 5

- IPART should note EnergyAustralia's tariff analysis that strongly supports different retail targets for Off-peak 1 and Off-peak 2 tariffs.
- IPART should note that rebalancing Off-peak 1 and Off-peak 2 tariffs is a critical component of EnergyAustralia's green energy strategy.
- IPART should note EnergyAustralia's tariff analysis that strongly supports different retail targets for business and domestic customer groups.
- IPART should consider the environmental issues associated with Off-peak tariffs in revising the target levels.
- IPART should accept the revised target levels proposed by EnergyAustralia.

6 Impact on customers of modifications tariffs and targets.

Acceptance by IPART of EnergyAustralia's proposed target levels provided in Section 5 will allow increases in tariffs in accordance with the relaxed side constraints proposed in section 3. This would allow increases in tariffs of

- 2.87% for domestic customers without controlled load
- CPI+3% for domestic customers with controlled load
- CPI+5% or $50 for business customers without controlled load
- CPI+3% or $50 for business customers with controlled load

The below tables show the dollar impact these increases would have on average customers

Domestic Customers	3 MWh pa		6 MWh pa		9 MWh pa	
	$	%	$	%	$	%
Single Rate only	11.10	2.87%	20.00	2.87%	28.89	2.87%
Single Rate + Off Peak 1	16.05	5.15%	25.41	4.65%	34.77	4.45%
Single Rate + Off Peak 2	17.68	4.95%	28.66	4.49%	39.65	4.32%

Business Customers	10 MWh pa		20 MWh pa		40 MWh pa	
	$	%	$	%	$	%
Single Rate only	69.39	5.59%	103.41	4.44%	171.44	3.81%
Single Rate + Off Peak 1	73.84	6.30%	107.81	4.92%	175.74	4.16%
Single Rate + Off Peak 2	73.47	6.07%	107.06	4.73%	174.23	3.98%

7 Protecting NSW customers from high retail prices

EnergyAustralia recognises that IPART must also have regard to the prices paid by NSW customers. It is possible to address this question entirely in terms of the prices currently paid in **NSW.** As customers will be concerned by significant price increases, this approach has some merit. However, it also introduces a circularity that has allowed prices to be maintained at artificially low levels. To break this circularity, in EnergyAustralia's view, IPART should have regard to prices in other states. This section provides a comparative analysis of EnergyAustralia's proposed tariffs (as detailed in Section 6) with tariffs in Queensland, South Australia and Victoria.

The following tables compare retail tariffs in other states as a percentage of EnergyAustralia's proposed tariffs. Therefore, percentages above 100% show other states as more expensive than EnergyAustralia. The analysis has been conducted on a typical customer basis for each tariff. In addition, the network component has been excluded in the second table so that the differences in network prices are removed from the analysis.

Table 6.1 – Total retail tariff comparison – 2002/03

Tariff	EA	QLD	SA-AGL	Vic - Pulse	Vic - AGL	Vic – Citipower	Vic - TXU	Vic - Origin	Integral	Country Energy / North Power
DAT	100%	110%	139%	142%	149%	140%	152%	157%	111%	122%
D.OP1	100%	**110%**	137%	146%	145%	142%	166%	160%	109%	121%
D.OP2	100%	104%	N/A	127%	126%	124%	138%	139%	106%	115%
GSLV	100%	121%	144%	194%	186%	193%	169%	224%	105%	137%

The above comparison shows that on average customer costs in Queensland, South Australia and Victoria are significantly higher than EnergyAustralia's proposed price path. Even allowing for the proposed increase outlined in Section 6 of this submission, EnergyAustralia's customers are still receiving considerably lower prices than customers in other states and other NSW businesses.

This analysis should provide assurance to IPART that it can approve the proposed increase in EnergyAustralia's charges whilst continuing to provide significant protection to customers in terms of price.

8 Conclusions

This submission has examined the key aspects of IPART's mid-term review and provided additional information and analysis for IPART to consider. In summary, EnergyAustralia's views on the mid-term review are as follows:

- IPART's mid-term review is a timely reappraisal of IPART's initial determination;
- EnergyAustralia supports IPART's benchmark approach to retail regulation;
- A competitive retail market is the principal objective and residual retail regulation should not stifle the development of competition;
- IPART's initial determination established retail targets based on unrealistically low benchmark costs:
- Evidence from the Office of the Regulator-General's recent investigation into retail price proposals in Victoria supports the view that the benchmark costs should be increased;
- EnergyAustralia faces significant greenhouse abatement obligations which necessitates that retail tariffs reflect the true costs of supply;
- IPART's initial determination is widening rather than eliminating cross subsidies between tariffs, particularly in relation to off-peak tariffs;
- EnergyAustralia proposes new retail target rates that reflect the true costs of supplying electricity to its regulated customers;
- Protecting NSW customers from high retail prices is important. EnergyAustralia has shown that even with these price increases, its customers will continue to enjoy prices that are lower than comparative charges in Victoria, South Australia and Queensland; and
- Modifications to IPART's determination as proposed by EnergyAustralia would provide an improved outcome for customers, the industry and the environment.

Special Information Requirement for the Electricity Retail Business (2002)

PUBLIC INFORMATION

Agency: **EnergyAustralia**

Financial year ending 30 June	Unit	1999 Actual	2000 Actual	2001 Actual	2002 Projected	2003 Projected	2004 Projected
NOTE: Customer numbers have been project		**as if there is a**	**customer "ch**	**n" after 30 Ju**	**2001**		
Urban residential	no.	1,227,163	1,247,596	1,300,446	1,319,953	1,339,752	1,359,848
Urban business	no.	138,095	133,288	127,454	129,366	131,306	133,276
Rural residential	no.	11,372	11,558		-	-	
Rural business	no.	2,299	2,229		-	-	
Total customers	no.	1,378,929	1,394,671	1,427,900	1,449,319	1,471,058	1,493,124
% growth in total customers	%		1.1%	2.4%	1.5%	1.5%	1.5%

Financial year ending 30 June	Unit	1999 Actual	2000 Actual	2001 Actual	2002 Projected	2003 Projected	2004 Projected
Urban residential	MWh	8,442,112	8,604,312	9,393,831	9,232,950	8,207,249	8,083,363
Urban business	MWh	3,089,903	3,234,367	3,018,699	2,886,358	1,798,617	888,019
Rural residential	MWh	95,978	95,729				
Rural business	MWh	42,159	39,337				
Total sales	MWh	11,670,152	11,973,745	12,412,530	12.119,308	10,005,866	8,971,382
% growth in total sales	%		2.6%	3.7%	-2.4%	-17.4%	-10.3%
2.2 Sales per customer (calculated - MWh pe		**ustomer per y**	**ar)**				
Urban residential	MWh	6.9	6.9	7.2			
Urban business	MWh	22.4	24.3	23.7			
Rural residential	MWh	8.4	8.3				
Rural business	MWh	18.3	17.6				
Average per customer	MWh	8.5	8.6	8.7			

	Unit	Actual	Actual	Actual
Benchmark electricity purchases	$/MWh	534,700	539,597	560,560
Line costs (DUOS & TUOS)	$/MWh	581,800	553,427	527,300
NEM fees	$/MWh	14,589	25,837	15,200
- Full retail contestability costs				21,566
- Other retail operating costs	$'000	53,609	68,100	83,854
Total operating costs	$'000	1,184,698	1,186,961	1,208,480
Depreciation expense	$'000	4,928	5,266	5,243

Fixed and variable costs

Please estimate the proportions of the operating and maintenance expenses that are fixed and variable costs respectively

% fixed cost	75%	71%	62%
% variable cost	25%	29%	38%

Please explain (in words) the basis on which the split is made between fixed and variable costs

0

0

0

0

(nominal $'000, excluding GST)

Financial year ending 30 June	1999	2000	2001
Unit	Actual	Actual	Actual
5.1 Sales revenue from franchise and "defaui	**customers (excluding "green p**		**emium" revenue)**
Urban residential	828,979	847,348	818,083
Urban business	319,873	333,199	301,505
Rural residential	8,791	8,893	
Rural business	4,311	4,040	
Total revenue from sales	1,161,954	1,193,480	1,117,588

)0, excluding GST)

miscellaneous charges			
5.4 Sales revenue by category (calculated)			
Urban residential	9.82	9.85	8.69
Urban business	10.35	10.30	9.99
Rural residential	9.16	9.29	
Rural business	10.23	10.27	
Average revenue per kWh	9.96	9.97	