19 March 2002

Attention: Mr Thomas Parry
Chairman
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office
NSW 1230

Dear Mr Parry

Re: Regulated Retail Tariffs

Pulse welcomes the opportunity to comment on the Minister's terms of reference for the Independent Pricing and Regulatory Tribunal (IPART) to investigate and report on the determination of regulated electricity retail tariffs.

Pulse is of the view that electricity retail tariffs in NSW are currently below competitive levels. We therefore support the NSW Government's efforts to reassess tariffs and ensure they adequately reflect all retail costs.

General Comments

Pulse believes that in a competitive market there is no need for regulators to control retail prices. The presence of competition ensures that consumers are provided with value in the form of efficient prices and services.

In addition, regulating tariffs at levels which are too low to sustain effective competition will be detrimental to both the industry and consumers long term. Wrongly calculated input costs mean

pulse energy pty ltd
acn 090 538 337
level 19 HWT building
40 city road
southbank vic 3006
g.p.o. box 4728UU
melbourne vic 3001

tel: (03) 9926 5555

that market contracts become meaningless as no retailer is able to compete with regulated prices. This raises barriers to entry to new retailers and competition is stifled.

We consider that the current NSW regulatory environment has prevented meaningful competition from non-incumbent retailers. Regulated tariffs have been set too low and together with the Electricity Tariff Equalisation Fund (ETEF) competition has been stifled with little incentive for customers to switch. In the long run NSW customers will suffer from too little choice and limited product innovation.

The experience in Victoria following the government's 2002 electricity price decision for regulated tariffs is further evidence of tariffs being set too low. There has been far less competitive activity since full retail contestability (FRC) began on 13 January 2002 than that expected prior to the government's decision and it is unlikely that competition will be aggressive until such time as prices rise to efficient levels. We believe that the electricity price decision has undermined FRC in Victoria.

Therefore, in setting regulated electricity prices, IPART should ensure they are cost reflective and allow headroom for competition. It should be noted that evidence from the United Kingdom shows that consumers will generally not switch suppliers for a discount of less than 10 per cent.

Retail Costs

The terms of reference lists the costs which IPART should consider as part of its review of electricity tariffs. Pulse believes there are a number of costs which have been omitted from the list or inappropriately accounted for, which should also be considered. These costs are outlined below.

Wholesale Cost of Energy and Risk Premiums

It is important that any assessment of energy costs removes the impact of the ETEF which favours incumbent retailers and distorts the efficient cost of energy. [1]

Pulse does not consider that the long run marginal cost of generation reflects the true cost of energy to a retailer. While energy costs which are equal to the long run marginal cost of generation may be an optimal market outcome, it is currently unrealistic for most retailers. A more accurate way to measure wholesale costs is to determine the actual energy prices paid by retailers and make an allowance for wholesale market risks.

In relation to the addition of risk premiums, the types of risk which should be accounted for in the wholesale cost of energy include, for example, retailers self-insuring against the risk of being under hedged on a high demand day and being forced to buy electricity from the spot market at high pool prices. Incumbent retailers do not bear this risk as they are compensated where the wholesale price rises above their regulated energy cost component under the ETEF scheme.

[1] The ETEF scheme results in NSW incumbent retailers bearing a low degree of wholesale market risk compared to second tier retailers who purchase electricity from the spot market or through bilateral contracts with generators. This is because incumbent retailers and generators effectively buy and sell electricity at a regulated rate which does not reflect market risks.

Full Retail Contestability Costs

It is important that any review of regulated electricity tariffs ensure that tariffs reflect the costs of FRC. In the long run, all customers benefit from FRC through lower market prices (relative to what would have been otherwise) and innovative products and services. A customer does not need to switch retailers to enjoy such advantages. Accordingly, it follows that all customers should pay the costs of FRC, even those on regulated tariffs. If a retailer solely recovered FRC costs from customers who switch from a regulated tariff, market based prices will increase and effective competition won't exist.

The costs of FRC are wide ranging and include a retailer's operating costs, for example, the cost of new information systems to allow large numbers of customers to churn and which comply with the NSW and National FRC related regulations. Other important FRC costs are those that relate to information to customers about FRC.

A full review of electricity FRC costs should be performed by IPART to ensure they are fully reflected in regulated retail tariffs.

Retail Margin

Retailing electricity is not a risk free business and this risk needs to be reflected in the return investors can achieve to maintain robust and dynamic businesses. One of the primary roles of an electricity retailer is to bear the risk of energy procurement from the wholesale market where production and weather variations can have a significant impact on pricing down to half hour intervals and millions of dollars can be lost in a single day. This is somewhat unique to this industry and must be considered in any reasonable assessment of financial return requirements.

Accordingly, investors should be able to earn a return (earnings before tax) on their investment which reflects a "market" risk (6% – 8%) premium over and above "risk free" levels such as the Government 10 year bond rate (currently around 5.75%).

Based on Pulse's knowledge of the size/demographics of the NSW host retailers and our own experience on operational costs and risk provisions, Pulse believes a return (earnings before interest, tax, depreciation and amortisation) on revenues of 8% -10% is required to sustain an ongoing efficient business which generates returns to shareholders which will encourage long term involvement in the industry. This return would equate to $12-$15 per MWh.

The Need for Price Increases

Both the NSW Government and the energy industry has made significant investments in the NSW electricity market to promote effective competition. However, a number of Government decisions, including the development of the ETEF and retail price caps, has lead to inefficient competition in NSW. Churn rates in NSW have been extremely low since the market opened (just 483 customer switched between 1 January and 14 March 2002) reflecting the stifled competitive environment which exists.

Until NSW electricity tariffs rise to efficient levels FRC will continue to be unsuccessful and consumers will suffer in the long term. Pulse's analysis of the difference between NSW and Victorian electricity prices for urban customers shows that while Melbourne customers pay about $140 per MWh, equivalent Sydney customers pay just $110 per MWh. The difference can, to a small extent, be accounted for by the lower wholesale energy and distribution use of system costs in NSW and the higher overall consumption by NSW customers. However, even removing these factors there is still a significant difference between Victorian and NSW prices.

Pulse believes that NSW prices would need to rise by at least 5-10% to encourage an efficient, competitive environment.

For NSW off-peak customers, prices would need to rise by at least 10% to cover the costs to serve these customers. This increase would avoid current cross subsidisation between peak and off-peak customers, which distorts competition.

Conclusion

Pulse encourages IPART to review retail tariffs in light of the comments made in this submission. It should ensure that tariffs fully reflect all retail costs including wholesale market risks, FRC costs and an appropriate retail margin.

If retail prices are set too low IPART risks stifling competition by raising barriers to entry. In the long run customers will suffer from little choice and limited product innovation.

If you require further information, or have any queries in relation to the contents of this submission, please contact Michelle Tandy on ph: (03)9926 5545.

Yours sincerely

Stephen Robertson
Manager Regulatory Relationships