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2 February 2007

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

Thank you for the opportunity to comment upon the consultant's draft reports on the *Review of Regulated Retail Tariffs and Charges for Electricity 2007 to 2010.*

The challenge for regulators of retail energy prices is that the only short-term transparent indicator that regulated prices are set at cost-reflective levels following a pricing decision is that robust competition ensues. On all present indicators it is clear that New South Wales regulated tariffs are yet to achieve cost-reflectivity. Amendments to the current determination's terms of reference to focus upon new entrant costs were welcomed by industry participants as a commitment to correct this regulatory error. TRUenergy's investment at Tallawarra was predicated upon such an approach being adopted.

The consultant's market price (conservative) estimates appear, from an initial review, to provide an appropriate benchmark for retail competition and generation investment. We note that the Tribunal is required to consider long-run marginal cost (LRMC) as part of the terms of reference. However, the consultant's LRMC estimate does not reflect market reality, and cannot be accepted.

Counter intuitively the estimate for LRMC is actually below the level provided for in the 2004-07 determination, despite all cost pressures increasing over the intervening period. No detail is provided in the report to allow stakeholders to identify where the errors may have occurred. Further discussion directly with the consultants is required to facilitate such work. Unless an adequate energy cost is allowed for in the determination, sub-optimal level of competitive activity will remain, and the price signals necessary to encourage new entrant generation will not be provided.

Energy Costs

TRUenergy has supported adopting the expected LRMC needs of new generation, representing the price signal which determines the point at which potential new generators will enter the market, to benchmark future wholesale energy costs. Our investment at Tallawarra was taken after reviewing the Terms of Reference for this determination, and having developed a level of confidence that retail tariffs would increase to levels that reflect new entrant generation investment.

However, the LRMC calculated by the consultants significantly understates these costs. It is generally acknowledged that in the 2004-07 determination the consultant's LRMC estimate of $47.84 MWh understated actual costs by approximately $2-3 MWh due to errors in the cost estimates for new gas-fired generation. Specifically, it assumed peaking gas could be procured on a fully interruptible basis, whereas the reality is that gas procurement and transportation is charged on a fixed basis for the required capacity to ensure the gas is firm.

Since the 2004-07 determination, new plant input costs have increased, in particular the cost of steel, and the standard retailers NSLP shape has deteriorated, whereby an increase in LRMC is to be expected. Therefore, we are at a loss to explain how the consultant's estimate, on a weighted average, has fallen to approximately $44 MWh.

We note that the estimates are based upon historical data, which may not have adequately taken into account expected load shape changes in the determination period. However, it is not possible to comment upon the discrepancy given that the report does not provide any detail to enable the errors to be identified. TRUenergy would welcome an opportunity to discuss this matter in more detail with the consultants.

In our view the appropriate LRMC level is closer to the market price (conservative) estimate, as a shaped energy cost, excluding losses. With respect to the market price (elbow) estimates, it is likely that the corresponding portfolio represents a position that would not be acceptable under a prudent retailer's allowable risk parameters. Further detail would be required from the consultant to demonstrate that this is not the case.

Other Costs

Estimates for MRET and NRET appear reasonable. However GGAS costs are underestimated by 20-25%. Additional information regarding the consultant's underlying assumptions is required to identify where the error in the report has occurred.

In addition:

- Allowance should be made for a possible carbon charge, or at the very least an additional risk premium based on the likelihood of such a charge.
- Ancillary service costs are underestimated by approximately 75%.

Operating costs and retail margin

TRUenergy supports the inclusion of customer acquisition costs in the operating cost estimate, as they represent legitimate costs that a new entrant retailer will incur in building market share in New South Wales. However, we question the assumption that these costs should be amortised over 6-10 years. Evidence from Victoria and South Australia is that once retail tariffs approach cost reflective levels for new entrant retailers, the objective of the Tribunal's review, customer transfer rates will rise to an annual rate of approximately 25%. Consequently we believe these costs should be amortised over 4 years.

We are also concerned that the consultants have recommended a cost-to-serve allowance well below the benchmarks provided in other jurisdictions. It is likely that this has been caused through the use of data provided by the standard

retailers (although we note that two of the standard retailers also challenge these estimates). As a stapled entity, the standard retailers are likely to have the capacity to attain efficiencies not available to a stand-alone retailer, thereby significantly understating the cost-to-serve allowance for a mass market new entrant. In our view, operating costs should be set at levels which the level of competitive activity in Victoria and South Australia have shown to be closer to cost-reflective levels, at current values of approximately $100 per customer.

In addition:

- A further allowance for the cost of providing credit support is required. In the most recent Victorian review CRA has allowed $0.1 MWh.
- The treatment of energy losses is unclear, and must be explicitly included within the analysis to allow for external validation.

Retail margin

An adequate retail margin requires not only an appropriate setting, but also appropriate underlying cost estimates upon which the margin is derived. Whilst the consultant's report benchmarks against 5% in South Australia, and 5-8% in Victoria, these jurisdictions have provided more realistic energy and retail operating costs than identified by the consultants for New South Wales.

Clearly 5% is the minimum margin that should be allowed to facilitate a competitive retail market. However, if the necessary adjustments are not made to the underlying cots estimates in the determination, the upper end of the acceptable range, ie 6.4%, should be adopted. This would also allow for the additional volatility in the forward market which has been demonstrated across recent months.

Please contact me on (03) 8628 1122 if you require additional information.

Yours sincerely,

Graeme Hamilton
Regulatory Manager

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