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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 – Issues Paper

Thank you for the opportunity to comment upon the Tribunal's *Review of Regulated Retail Tariffs and Charges for Electricity 2007 to 2010 - Issues Paper*.

TRUenergy welcomes the changes, since the last review, to the terms of reference for the 2007 review and the opportunity they provide for the Tribunal to deliver a tariff outcome that facilitates greater retail competition and new generation investment. The 2004 review has had limited success with respect to both criteria, but the requirement to consider new entrant costs, rather than those of a standard retailer, and the greater focus on achieving cost reflective tariffs, creates the opportunity for these gains to be accelerated in the forthcoming regulatory period.

Retail competition has been in operation across southeastern Australia for almost five years, and our learning's are such that many of the issues raised in the Issues Paper are now self-evident. The level of competitive activity in New South Wales is substantially below that in Victoria and South Australia, regardless of how competition is measured. The overwhelming cause for the differing levels of competitive activity is the relative setting of regulated tariffs.

Retail energy markets have demonstrated that there a few, if any, remaining material impediments to market entry other than the jurisdictional regulated price setting arrangements. All businesses are profit seekers, and more competitive retail margins and cost-to-serve parameters in the southern states have attracted a greater share of marketing and customer acquisition activity. Adjustment of NSW retail tariffs to cost-reflective levels will result in a corresponding shift in resources to the NSW market.

Analysis attempting to replicate market outcomes is, at best, problematic which is one of the main reasons why we support removal of price regulation. In situations where some form of oversight is deemed necessary, price monitoring, rather than price setting, is the preferred regulatory approach. It is only when competitive activity reaches the levels achieved in other jurisdictions that the Tribunal can be confident that cost reflectivity has been achieved, and that the correct pricing policies have been delivered to encourage the investment required to meet NSW's future energy demands.

The level of competition in other jurisdictions, and the absence of material barriers to entry other than retail price regulation, provides the Tribunal with an opportunity to be aggressive in its analysis. Overall TRUenergy was supportive of the framework adopted in the 2004 review, but we believe the outcome was flawed primarily due to assumptions that generally understated each of the components in the price stack, and overly restrictive rebalancing constraints.

We therefore encourage the Tribunal to be less conservative in their approach to the 2007 review, and whenever possible adopt a position above the median level identified in the analysis. This can be done safe in the knowledge that any excess margins will be rapidly competed away by new entrant retailers desperate to establish market share in one of the few jurisdictions not tending towards saturation. The greater risk, with more severe implications for the future of the NSW energy supply, is that retail tariffs will again be set below cost-reflective levels, denying new entrant retailers and generators the price signals they require to deliver new generation capacity.

NSW government's decision to phase out the ETEF

To facilitate the transition to cost-reflective tariffs as soon as possible, the Tribunal should assume that the ETEF ceases at the commencement of the regulatory period.

Concurrently, the hedging, risk management, transaction, and forecasting costs of standard retailers should be assumed to equal those of a mass-market new entrant. Such an approach is consistent with the Review's terms of reference that require the Tribunal to consider costs on a new entrant, rather than incumbent, basis.

COAG endorsement of Ministerial Council on Energy's agenda to phase out retail price regulation

TRUenergy supports the MCE's commitment to phase out retail price regulation. National energy market reform, as an essential component of National Competition Policy, is premised upon an understanding that competitive wholesale and retail energy markets will deliver efficient outcomes.

On any objective assessment retail competition is less developed in New South Wales than in Victoria and South Australia. The only plausible explanation for the variations in competitive activity is the extent to which regulated tariffs reflect cost-reflective pricing. To the extent that regulation remains, it should be as light-handed as possible to enable regulated tariffs to reach cost-reflective tariffs as soon as possible. In this respect the imposition of stringent cross-balancing restraints has the potential to restrain retail competition as much as the overall revenue decision.

COAG's agreement to roll out time-of-use meters

TRUenergy supports a market driven approach to new metering technology, whereby consumers and retailers, seeking benefits and efficiencies, will drive innovation. The findings of governments and regulators from studies on the social benefit of mandating interval meters across the customer base have been mixed, with those studies supportive of such an approach, in our view, based on flawed assumptions rather than objective evidence.

With respect to the current review period, the Tribunal must ensure that the final form of price regulation is sufficiently flexible to allow the relevant price signals, which are the rationale for time of use metering, to be seen by customers.

Form of Regulation

Ideally the market should determine all retail tariffs, as this is the only means to ensure that prices will be set at efficient levels. To the extent that some form of regulation will continue, there is a direct correlation between the level of regulatory intervention and the danger that tariffs will not reach cost-reflective levels. Of particular concern are constraints at the individual customer level, which have prohibited the achievement of cost-reflective tariffs for the past four and a half years.

TRUenergy recommends a pure N + R, tariff basket approach, comprised of the following elements:

- Weighted average price cap for the retail component
- No restrictions at the individual tariff or customer level
- Direct pass through of all network charges
- Full cost recovery for green schemes, based on long-run marginal costs of acquiring renewable certificates, not on short-term renewable market prices
- Direct pass through of all other costs, including NEM fees, energy losses and unforeseen extraneous events

The advantages of such an approach have been well documented, focusing on the flexibility it would provide to ensure that tariffs reach cost-reflective levels as soon as possible. It is of concern that retailers are prevented from achieving cost-reflectivity when opportunities for rebalancing are constrained by overarching limits absorbed by network rebalancing.

Whilst there may be a concern that standard retailers will refrain from moving some tariffs to cost-reflective levels to inhibit competition and protect market share, in our view this is unwarranted. The corollary of such an approach is that other tariffs will be above cost-reflective levels, whereby competition in that market will rapidly erode any benefits.

Long-run marginal cost (LRMC) of electricity generation

TRUenergy supports both the general approach of using the expected LRMC needs of new generation to benchmark future wholesale energy costs, and the intent of the method adopted by IES in the 2004 review to calculate the LRMC of energy for the NSW franchise load. The approach selected an optimum plant combination to meet NSW load shapes, and assumed that in the long run new plant will be required in each plant category to optimally meet demand. We considered that some of the detailed input assumptions required adjustment to ensure that the execution of the methodology delivered the correct results. These concerns were identified in submissions to the review process, and would have resulted in the high range price estimate becoming the mid range estimate.

It is noted that one standard retailer has criticised the LRMC as a theoretical construct. It is TRUenergy's view that LRMC is a real price signal that determines the point at which potential new generators will enter the market. Whilst assumptions are required for its estimation, such a criticism applies equally to all cost stack components, including any basis for estimating wholesale energy costs.

In the short term there will be variations between the LRMC and retailer's energy purchase costs. In addition, energy purchasing costs operate in a saw-tooth approach whereby costs increase over-time to the point at which new generators will enter the market. Initially there can be price signals exceeding LRMC levels, as extended lead times required to plan, approve, build, and commission new generation plant can result in short to medium term supply/demand crunch points. Then, following commercial availability of new plant, the influx of supply will suppress costs prior to them rising again in response to continued increasing demand. It is likely that upward pressure will increase as standard retailers are transitioned off the ETEF and simultaneously enter the wholesale contract markets.

Hedging, risk management and transaction costs

Debate regarding the appropriateness of including an allowance for hedge mismatch, risk management and transaction costs under a LRMC based approach reflects definitional confusion. While over the long term the average costs of energy sourced from the wholesale market can be expected to be equivalent to the LRMC of supply, a prudent retailer's ability to construct an optimal hedge portfolio will entail it incurring costs in each of these categories over and above the optimal generation cost. Such costs, which should be allowed for in the 2007 review, reflect the following factors:

- Contract mismatch - over and under contracting due to variations between actual load and contract volumes caused by variation in customer numbers, demand fluctuations, and extreme demand events;
- Governance costs - the above hedge volume mismatch issue can be further exacerbated by the trading and governance policies of prudent retailers. Such policies set commercial exposure limits, which are a prudent practice designed to protect shareholders from excessive risk taking, and increase costs by limiting hedging options;
- Energy Hedge purchase risk – liquidity levels in the contract market must exist to ensure that retailers are both (a) able to manage their spot market risks, and (b) be compliant with their governance requirements;
- Price Validity – is a cost (like a "call" option) borne by retailers where customer market tariffs are offered in advance at fixed rates for a set period, typically 12 months. A retailer could either purchase a wholesale contract prior to contracting with customers, or alternatively contract with customers prior to purchasing wholesale energy. Such mismatches are

unavoidable and create costs which a prudent retailer would factor into customer pricing;

- Credit considerations – retailers need to source large hedge volumes, and can only trade with counterparties that meet minimum ratings criteria. This can lead to higher hedge costs, as alternative cheaper hedge suppliers may not meet the credit criteria, causing a retailer to revert back to the more expensive alternatives. This may become an issue in the latter part of the forthcoming regulatory period
- Trading room costs – up-front capital establishment costs, including IT and communication facilities, and ongoing operating costs, including the expertise and labour costs associated with large volume trading in a competitive wholesale market. Note that similar costs will be faced by generators with the cost passed onto retailers.

Operating costs and retail margin

The estimation of operating costs and retail margins is an academic exercise which, based on the number and range of parameters that must be considered, has a high margin of error. As such it will be impossible for governments and regulators to know if they have the correct settings until the policy has been implemented and retail competition either thrives (indicating appropriate settings) or struggles to develop (indicating inadequate benchmark settings). In TRUenergy's view, and confirmed by cross-national analysis, the settings in Victoria and South Australia have encouraged a much greater level of competitive activity than in NSW which, by definition, is indicative that they are closer to cost-reflective levels.

This view has been confirmed by analyst reports, for example Citigroup Research Services Group, Review of Australian Utilities[1]:

> *"The maintenance of an uneconomic retail price cap is a barrier to entry for retailers with growth aspirations in the State. The imposition of a price cap that does not allow commercial cost recovery poses a major risk to retailers as they are effectively unable to pass on wholesale price spikes. ... Qld and NSW have substantially lower average retail tariffs in comparison to the more open market states – Vic & SA. It is interesting to note that the wholesale price of power in NSW has been above Vic and relatively close to SA for the last eight or so years. Given that non-wholesale operating costs are broadly equivalent, one can clearly see that retail in NSW has been and remains an unattractive prospect. "*

In this respect, the requirements of the review are again self evident – estimates for operating costs and retail margin must be consistent with those developed in other jurisdictions that have demonstrated, through the emergence of robust competition, they are closer to delivering a cost-reflective tariff outcome.

In addition, a number of other factors should be considered as part of the review:

- Customer acquisition costs - These costs are likely to be higher in NSW than other jurisdictions due to the opportunity that NSW standard

[1] Citigroup Research Services Group, Review of Australian Utilities, 21 July 2006, p. 54, 55.

suppliers have enjoyed to establish strong brand loyalty in the absence of robust competition from other retailers.

- Interval meters - The rollout of interval meters, and the switch from accumulation to interval data, adds significant costs to retailer billing and market systems.
- Higher costs of a stand alone retailer – Standard retailers, operating as stapled business with the network, enjoy a number of cost benefits over a stand alone retailer, including access to market data, intellectual property, and less reliance on external B2B transactions.
- Reversion policy – There is an inherent value in allowing consumers to revert to the standard tariff at the completion of their negotiated contract, at no cost. We recommend a benchmarking exercise against other industries to establish the value of this option, and to include this cost in the operating cost estimate.

Once again we reiterate the importance of the Tribunal adopting an aggressive approach to estimating these costs. The conservative approach to date has merely understated costs for new entrant retailers, admittedly consistent with previous terms of reference, and suppressed competition. Whenever there is an opportunity to base estimations on higher end estimations this should be seized, on the basis that any overestimation will be rapidly eroded by competitive activity.

Finally, the review should consider the costs imposed upon second-tier retailers through the current practice of standard retailers publishing their standard tariffs 1-2 days prior to commencement. This compares to requirements in Victoria to publish two months in advance, and South Australia to publish 10 business days in advance. The shorter time frame in NSW, combined with the requirement to advise negotiated contract customers in advance of any price change, ensures that second-tier retailers are not able to respond to the new tariffs for some weeks after their commencement, whilst also imposing additional implementation costs required by the commercial need to respond as soon as possible.

TRUenergy recommends that, consistent with the South Australian approach, standard retailers should be required to publish their regulated tariffs in the government gazette, or on their web-site, 10 business days prior to commencement.

Other cost components

TRUenergy supports the proposed approach to consider the LRMC of compliance with MRET and GGAS requirements. Cost recovery for green energy obligations must be based on long-run marginal costs of acquiring renewable certificates, not on short-term renewable market prices. Long run marginal cost recovery is appropriate as retailers will be faced with signing long term renewable certificate purchase contracts to underwrite new renewable projects at long-run prices. Adopting a short term AFMA market based approach will ensure that retailers are not able to recover their full costs when the short term AFMA price inevitably falls.

All other cost components, including NEM fees, energy losses, mandatory Green Power contract offerings, new schemes, and any other extraneous costs tariffs, should be direct pass through to consumers, outside the overall R component constraints.

With respect to the new requirement for retailers to offer a 10% Green Power product up front, this will impose additional costs upon new entrant retailers. Many new entrants do not currently provide such a product, whilst those that do will still be required to undergo costly collateral, training, system and procedural changes in order to comply. These costs will be in addition to the upward price pressure on sourcing Green Power electricity to match the potential increased demand.

There is no need for the Tribunal to regulate this product, as it should be considered a negotiated customer contract with prices as agreed with the customer, and likely to include a price premium to reflect the higher costs of green electricity. Any regulation would merely distort the market for Green Power, with the risk of under-recovery borne entirely by the retailer.

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

Yours sincerely,

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