Ms Ruth Lavery
Program Manager
Independent Pricing and Regulatory Tribunal
Level 2, 44 Market Street
SYDNEY NSW 2000

22 March 2002

Dear Ms Lavery,

**MID TERM REVIEW OF THE TRIBUNAL'S DETERMINATION 'REGULATED RETAIL PRICES FOR ELECTRICITY TO 2004'.**

Thank you for the opportunity to submit to the Tribunal in respect of the regulation of retail prices for electricity to 2004. We submit our views in relation to the following matters:

1. The impact of regulated retail prices on competition and the proper functioning of the competitive retail market

2. An allowance for electricity purchase costs and related charges; and

3. Appropriate Retail Gross Margin.

## 1. The impact of regulated retail prices on competition and the proper functioning of the competitive retail market

The setting of regulated retail prices is an issue that not only has implications for the profitability of incumbent retailers, but is an issue that will impact on the establishment of a competitive and viable energy market in New South Wales. TXU submits that cost reflective pricing for customers is needed in order to permit effective competition. Whilst TXU recognises the need to for customer protection through appropriate safety net provisions, we believe that a viable competitive market is the best protection in the long term for customers. We recommend that any transition process for increasing under-recovering tariffs should occur sooner rather than later. We note that the Ofgem Supply Price Control Review during December 1999 also recognised the need to set prices at a level that allows the new entry of competing suppliers. This is supported by research which demonstrates that a price differential of up to 10% need to be available, in order to encourage customers to move. [1]

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[1] See for example Financial Times Energy Inc., 2000 - *"...As a rule of thumb, unless customers can save more than about 10% on their total bill, don't expect more than about 5% of them to switch in the first year."*

## 2. Allowance for electricity purchase costs and related charges

Electricity purchase costs are a significant component of regulated retail tariffs. TXU suggests that the Tribunal should consider the following factors in its current review:

i. The purchase cost allowance should be derived from wholesale market indicators. In a competitive retail market, retail prices would be developed from the purchase cost incurred by competing retailers. New entrant retailers are not necessarily able to access hedge cover at "the long-run marginal cost of electricity generation", but are rather required to assemble a hedge portfolio in the wholesale market;

ii. The choice of the appropriate wholesale market indicators should take into account the variability and volatility of both market price and retail load volumes. Hedge products chosen should be available in the market, and then assembled into a portfolio that provides a good match to the load;

iii. A wholesale portfolio would normally be assembled over time. Hence the wholesale price indicators should be based on an averaging of wholesale prices available in recent periods (eg. the preceding 12 or 18 months);

iv. The cost of hedge protection for load spikes must be included. The load shape of small customers tends to exhibit significant peaks, and these are often partly correlated with very high pool prices. The retailer is expected to ensure that these load spike demands from the customer are met, and the pricing mechanism must therefore provide revenue sufficient to ensure that the required generating capacity is paid for, and hence made available. Failure to allow for this cost will threaten the viability of the retailer, and will also prevent the retailers from providing contractual support to developers of new generating capacity;

v. Sufficient allowance should also be made for remaining wholesale risks, such as the remaining mismatch between load and hedge shapes, counterparty credit risk and the consequent cost of portfolio diversification, forecast risk, operational risk, regulatory risk, force majeure, etc; and

vi. Whilst the pricing mechanism currently recognises the costs of 'green energy' obligations, energy losses and market fees, the review should ensure that pricing includes the increase in the volumes of renewables required under Federal regulations. It should also include an allowance for the financial costs of NEMMCO bank guarantees, and the financing of the up-front option payments usually required for the purchase of cap products.

The actual cost of purchases seen by the incumbent retailers in NSW is not consistent with the above. The Regulated Energy Charge and the Electricity Tariff Equalisation Fund arrangements provide cost certainty to the incumbent retailer that is not available to competing retailers. These mechanisms do not fully recognise the risks and costs seen by a wholesale market participant who is trying to hedge volatile small customer load. We anticipate that the full cost of purchases for a non-incumbent retailer is greater than the allowance in the current regulated retail prices. This is detrimental to competition and should be altered to create an environment within which full retail competition can prosper.

**3. Appropriate Retail Gross Margin**

TXU submits that the decision and determination of an appropriate retail gross margin is an issue of importance, and one which has serious implications for the market dynamics in New South Wales. Discussion around gross margin should not exclude consideration of cost to serve and net margin. Establishing these at an appropriate level which accurately reflects the true costs and risks of operating in the energy market is crucial for the long term viability of energy retailers. In light of this, our comments are as follows:

i. TXU submits that an appropriate Retail margin is one which will provide a rate of return which will ensure sustainability in the long run as a retailer operating in the NSW environment and one which sufficiently covers the risks associated with operating in the electricity industry and current market environments. Tariffs should be reflective of the true costs of operating in the market and these should be based on actual costs incurred by current incumbents in the NSW market;

ii. Care should be taken when comparing one operating environment with another. The use of benchmarks for making comparative assessments should also be treated with caution as they can be misleading and often are not comparing like for like;

iii. FRC costs should be included in a retailers cost stack as it is significant and represents the additional costs of operating as a host retailer without which competition could not effectively take place;

iv. Tariffs should be cost reflective without cross subsidisation of customer groups eg. cross subsidisation between peak and offpeak/rural & urban; and

v. There should be a formal Review Mechanism to address significant changes in the variable components of the cost stack over time (eg Commodity costs, Network charges).

In addition to the specific items discussed above, we are interested in an opportunity to discuss the mechanisms of judging effective energy competition, given the experience of the TXU group of companies in Australia and internationally. We are also keen to participate in further review and discussion of this issue with the Tribunal.

Yours sincerely,

Caryle Demarte
General Manager
Government & Regulatory Affairs