

14 May 2004

NSW Electricity Retail Pricing 2004/05 to 2006/07
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

Re: Review of regulated retail prices for electricity to 2007 – Draft Report and Draft Determination

TXU welcomes the opportunity to make this public submission on the Tribunal's Draft Determination on regulated retail electricity tariffs to apply to small customers in New South Wales for the period from 1 July 2004 to 30 June 2007.

It is with concern that we note the findings outlined in the draft determination. In our view, if the Tribunal carries these findings into its final determination, it will have missed a critical opportunity to:

- place future investment in NSW electricity supply infrastructure on a sound footing and
- facilitate the development of competition in the NSW small consumer electricity market
- address the problem the Tribunal tellingly highlights in its media release and draft report, that regulated customers are being supplied on an unsustainable basis as they are being supplied at below cost.

The opportunity to address these matters will not be available until the next major regulated tariff review. At the next review, the same investment and competition matters will emerge, but with increased urgency. In particular, if new entrant generation investment has not been forthcoming then the supply/demand balance will be under substantial pressure and there will be serious concerns about supply reliability. The Tribunal at this time will be left with no choice on its retail tariff decision and in our view, a significant price shock to consumers will be unavoidable at this time. Large customers will already be feeling the consequences of supply reliability, with rising wholesale prices and uncertainty about supply reliability and therefore investment in NSW.

Such a situation creates substantial concern for the community and business, and places significant pressure on regulators and governments to take tough and unpopular decisions. We have seen this situation arise in South Australia, where the very significant regulated retail tariff rises there could have been avoided through a smooth transition path started earlier. Similarly, Victoria experienced a significant price rise in 2002 that could similarly have been managed in a smoother fashion. Indeed, the scenario is not dissimilar to the issues presently being encountered by the Tribunal as it approves a significant tariff increase for the distribution businesses to ensure long-term investment in the distribution network is adequate to ensure reliability of supply.

This scenario can be avoided. It is within the Tribunal's power to take a long-term view and provide the environment now that appropriately promotes supply-side investment and the development of competition. With the appropriate retail tariff decision now, a smooth transition can be provided for and the risk of a step increase can be avoided. We urge the Tribunal to re-consider its draft decision and make a decision in its final determination that addresses these matters.

The specific areas of the draft determination that cause concern are as follows:

1. Development of competition

The Tribunal has appropriately devoted an entire appendix in its report to the issue of competition. In section d) of this appendix, the Tribunal lists possible barriers to entry in the NSW small consumer electricity market. Unfortunately, the Tribunal has failed to identify the primary entry barrier, which is the prevalence of non-cost reflective tariffs. In an environment where incumbent retailers cannot recover the costs of serving their consumer base, it is unrealistic of the Tribunal to expect significant market entry from new entrant retailers, and consequent competition.

The Tribunal notes (p. 32 of the Draft Determination) "At 1 July 2003 market concentration remained high with the three largest retailers retaining in excess of 98 per cent of market share". This is an insightful and telling statistic, re-affirming the point that new entry to NSW is not possible at the current tariff levels and competition is not developing in the NSW market.

The Tribunal also noted TXU's strong interest in entering the small consumer market (p. 32 of the Draft Determination). However, the Tribunal needs to be aware and to understand that the primary criteria dictating TXU's entry to the NSW small customer retail market is the level of the regulated retail tariff. It will be very difficult for TXU to enter the small consumer marketplace and we will be forced to re-consider our market entry intentions if the draft determination is carried through as a final decision. In our view, the Tribunal's decision actively dissuades new entrants.

In its assessment of the reasons for the slow development of competition, we believe it is essential the Tribunal acknowledges the primary limiting factor is the low level of the retail tariff. The other barriers listed by the Tribunal are legitimate, but are second

order. Until the Tribunal acknowledges the effect of the artificially low retail tariffs on retail competition, and addresses this, new entrants will be unable to enter the market.

This will result in the Tribunal having failed to meet the Terms of Reference set out by the NSW government in this review. Moreover, NSW consumers are unlikely to experience the benefits of competition and product innovation in relation to electricity supply that is the objective of competition reform and Government policy.

In order to address these matters, we recommend the Tribunal adopts the following parameters in its final decision:

- Adopt a retail cost to serve of \$90 per customer, consistent with the benchmark adopted by other jurisdictions
- Adopt a retail margin of 4%, again consistent with the benchmark adopted by other jurisdictions.

Both of these parameters fall within an efficient range, and will assist with promoting competition and enabling the Tribunal to better fulfill its Terms of Reference.

2. New generation investment

The Tribunal sought the expert opinion of an independent consultant, IES, to develop an appropriate LRMC that supports timely investment in new generation. TXU believes IPART has overlooked some important aspects of IES's recommendations that will hold the LRMC below the level it should rightly be set at. In our view, the matters that need to be addressed are:

- IPART has adopted an LRMC of \$47/MWh, where the IES median case was \$47.84/MWh. This appears to be an arbitrary decision by the Tribunal. Advisors commissioned by TXU and TXU's own internal analysis estimate a higher LRMC than the median case calculated by IES. Given that the median case is based on several aggressive input assumptions, we believe the Tribunal is wrong to hold the LRMC figure below IES's median case. We consider it essential the Tribunal adopt IES's recommended median case of \$47.84 as the LRMC at a minimum, and we urge the Tribunal to adopt a figure of \$50/MWh as a more realistic LRMC figure.
- IES estimate that the impact of ensuring sufficient reserve is accounted for in the NSW generation fleet is \$0.98/MWh. While we suspect this figure underestimates the true cost, there is no justification for IPART to arbitrarily exclude this charge in its total LRMC estimate. We recommend the Tribunal adopts the recommendations of its independent consultant and adds \$0.98/MWh to cover the cost of reserve.

- IES has not taken account of the fact that the NSW load factor is forecast to deteriorate over the review period. This changing load shape will lead to increasing load weighted energy prices over the review period. The energy price needs to be escalated in years 2 and 3 of the review period to account for this deterioration in the load shape.
- IPART has adopted a \$3/MWh premium for green energy and generator NEM fees. This price does not factor in the significant uncertainty around the market pricing for greenhouse related schemes across the review period. We suggest this premium should be increased to at least \$3.50/MWh.
- IPART has adopted historically based NEM fees and Ancillary Service costs. With major changes in the structure of the regulators in the NEM, it is highly likely that NEM fees will increase over the review period as a result of the implementation of these regulatory changes. We suggest a risk margin of 10% be applied to the \$1/MWh fee to provide scope for fee increases across the review period.

The inadequate energy price has been further compounded by the Tribunal's use of insufficient cost to serve estimates and un-commercial net retail margin assumptions. The combination of these factors has left the overall retail tariff in a position that will leave retailers with insufficient or barely sufficient revenue to cover their existing costs, let alone underwriting new generation projects that will be required to meet NSW's growing energy demands.

We would strongly encourage the Tribunal to review NSW's future generation requirements before committing to the inadequate tariffs contained in the draft determination, as the emerging industry consensus indicates that commitments will need to be made toward the establishment of additional generation capacity within the upcoming review period. Clearly if retail companies (who will need to ultimately underwrite any new generation projects through contractual commitments or the market), are not able to recover the full costs of energy production, it is unlikely that they will make the financial commitments required to ensure that generation capacity can be developed in a timely manner. We strongly urge the Tribunal to reconsider its determination in the light of this information.

3. Excessive constraints on tariff rebalancing

One of the major issues that we understood would be addressed in the current review was that the complex rebalancing arrangements to which incumbent retailers have been subjected in NSW would be simplified, and a more light-handed form of regulation adopted. This reform is required if cost reflective tariffs are to be achieved within the three year review period covered by this determination. This issue was raised in many of the submissions delivered to the Tribunal through the consultation process, and at the industry round table held by the Tribunal in March.

Unfortunately however, the Tribunal has chosen to continue along the path of prescriptive regulation in the area of rebalancing. Our modeling suggests that under the rebalancing constraints proposed in the draft determination, it will not be possible for the regulated retailers to achieve the target tariff levels¹ until the last year of the review period, if at all. This conclusion appears to be supported by the Tribunal's own modeling laid out in table 5.2 of its report. The outcome of this will be that regulated retail tariffs will, in many cases, remain well below target tariff levels throughout the review period, in contravention to the terms of reference for this review, which indicated that the Tribunal should attempt to achieve cost reflectivity, competition, and economically efficient outcomes in this review.

We urge the Tribunal to reconsider its approach to price constraints and adopt a more light-handed approach in this area in its final determination. We believe:

- the limits on increasing customers' bills are unnecessary, as the N and R component limits are adequate. If the Tribunal's major concern is the customers' ability to understand the bill impact, then we suggest that bill impact guidelines rather than regulated limits are more appropriate
- the limits on not increasing over-recovering tariffs are unnecessary, as other retailers will quickly act to win customers if tariffs are over-recovering and indeed moves by incumbent retailers not to address over-recovering tariffs will actually promote competition
- limits on increasing the fixed retail component is highly prescriptive and unnecessary.

In summary, we are concerned that the draft determination indicates that the Tribunal has missed an ideal opportunity to create a market environment conducive to competition and product innovation. Further, by imposing highly prescriptive price rebalancing constraints and inadequate target tariff levels, the tribunal runs the very real risk of delaying necessary generation investment, thereby threatening medium term supply reliability by attempting to inappropriately use tariffs as a tool to address consumer protection issues.

We encourage the Tribunal to rethink this approach, and establish a tariff policy that will set the NSW energy industry on a solid footing to meet the needs of the community over the coming review period, and beyond.

Please feel free to contact me on (03) 8628 1244, should you wish to clarify any aspects of this submission.

¹ This is particularly concerning since we are of the view that the Target tariff levels adopted by the Tribunal are inadequate to fully cover the costs of an efficient retail business in NSW.

Yours sincerely,

Peter Carruthers
Public and Government Affairs