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8 December 2003

Review of Gas and Electricity Regulated Retail Tariffs
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

Re: Tribunal Review of Gas and Electricity Regulated Retail Tariffs

TXU welcomes the opportunity to present this submission to assist the Tribunal in its investigations into the determination of regulated retail tariffs and regulated retail charges to apply to small retail gas and electricity customers in New South Wales for the period from 1 July 2004 to 30 June 2007.

TXU plans entry as a retailer into the competitive market to supply small customers in New South Wales in the near future provided that the appropriate regulatory and commercial environment exists within that market. It is in the light of these plans and TXU's experience, both as a provider of default tariff structures in Victoria and a competitive retailer in other markets, that TXU provides this initial submission.

This submission is made primarily in reference to the regulation of retail electricity tariffs although, in most cases, the principles espoused herein and comments made in reference to electricity tariffs can also be equally applied to retail gas pricing issues.

TXU has provided this submission at approximately the same time as the standard retailers' submissions so that the Tribunal may be informed by the views of a new entrant retailer when it considers the issues. TXU plans to participate actively in the Tribunal's consultation process and provide more detailed comments as the process continues. In the meantime, we would be happy to expand further on the matters raised in this submission should the Tribunal wish to explore any of them in greater depth.

GENERAL COMMENTS

Terms of Reference

TXU believes that the matters raised for consideration in the Tribunal's Issues Paper are broadly consistent with the Terms of Reference provided by the Minister of

Energy and Utilities in relation to the investigation and report into regulated retail tariffs and regulated retail charges to apply from 1 July 2004 until 30 June 2007.

TXU endorses the Terms of Reference's acknowledgment that *"the level of regulated retail tariffs relative to market-based prices is the key determinant of how many customers remain on regulated arrangements"*.

It is TXU's experience that where regulated tariffs are cost reflective or in excess of cost reflective levels then customers will switch from regulated tariffs to market contracts. TXU believes the current low levels of NSW regulated tariffs is the single most significant barrier to entry for new retailers wishing to compete in the NSW market.

TXU believes that a regulated price path that is sustainable in the longer term is an essential ingredient in transition to a competitive electricity market. Sustainability can be measured in terms of the level of cost reflectivity in tariffs and the degree of certainty that those cost reflective levels will be achieved/maintained well into the future.

Long term sustainability is the essential ingredient needed to not only enable existing and new entrant retailers to compete strongly in the NSW small customer market, but also to ensure a robust and stable generation sector where investments are made in a timely fashion. In a truly sustainable competitive environment, market forces would be the only form of price control necessary as evidenced in other competitive markets such as the United Kingdom. In considering the issue of sustainability via cost reflective pricing structures, the wholesale energy cost component needs to specifically be set at Long-Run Marginal Cost and incorporate the requirement for new generation investment in NSW around 2007 i.e. new entrant generation costs.

TXU notes and supports the objective of applying price constraints to avoid unacceptable price impacts upon customers, especially low income and vulnerable customers. This is a necessary component in a transition to cost reflective pricing.

Tribunal Issues Paper

TXU notes the Tribunal's identification of four key areas of issue on which it is seeking comment. This submission focuses primarily on the first two key areas identified in the Issues Paper, namely,

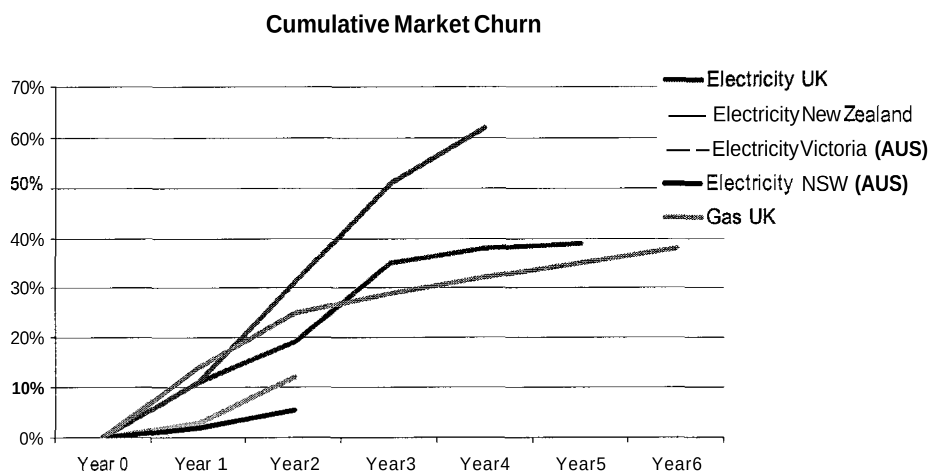
> *"What is the most appropriate form of regulation for retail tariffs?"*
>
> *"What are the appropriate levels of costs to be recovered?"*

Detailed comments on each of these issues are incorporated in the Specific Comments section of this document.

On a more general note TXU wishes to comment on the Tribunal's reference to switching statistics in its report. The Tribunal points out that there have been around 450,000 small retail customers (both gas and electricity) who have entered into market based contracts.

TXU does not have access to statistics which identify the number of customers who have switched to an alternate retailer versus the number of customers taking up a market-based offer with their existing retailer. TXU would be interested is seeing such a breakdown of these figures. Our perception is that the number of customers taking up market-based contracts with their existing retailer is far higher than the number of customers entering the market by transferring to a new retailer. If the statistics verify our perceptions, then it reinforces one of our key points that the barriers to new entrant retailers are significant. TXU requests the Tribunal provide such a breakdown of transfer statistics, with associated analysis of the underlying reasons, if possible.

Regardless of the method by which customers are "entering the market", the "Cumulative Market Churn" chart below demonstrates that the level of market activity in NSW is below that of other comparable markets. TXU contends that the key reason for this is that tariffs are not at cost reflective levels.



SPECIFIC COMMENTS

Clearly TXU believes that there is no substitute for robust competition as the ultimate appropriate form of customer protection. However it is recognised that there needs to be a transition path to **a** fully competitive market and TXU supports the need to manage the transition smoothly as long as the goal of moving all regulated tariffs to cost reflective levels is realised by no later than June 2007. By that time competition at the small customer level would have been in place for well over 5 years.

The following specific comments are made in reference to various issues impacting this transition process and in response to the key issues raised in the Tribunal's issues paper.

1. Appropriate Form of Regulation

> ***"The Tribunal seeks comment on what form of regulation will best assist the Tribunal in meeting its objectives of moving all regulated tariffs towards cost-reflective levels without exposing customers on under-recovering tariffs to unacceptable price shocks."***

Regulatory Framework

Light-handed regulation coupled with a clear, concise and transparent regulatory framework is TXU's preferred approach. This approach is consistent with facilitating competition and will reduce administrative and compliance resource issues associated with ongoing management of regulated tariff prices. This in turn will lead to reduced retail costs and the potential for greater customer savings.

Based on our interpretation of the operation of the Voluntary Pricing Principle's (VPPs) utilised in the establishment of gas prices during the current regulatory period, TXU believes that the VPP approach has a number of merits.

The VPP approach appears to provide a consultative framework for retailers to work with the Tribunal to achieve outcomes consistent with stakeholder's objectives of moving towards full cost reflectivity in a sustainable and transparent manner.

Notwithstanding the above comments with regard to framework and process, it is the outcomes within the framework and process that are of crucial importance.

Use of Target Tariffs

TXU supports the current regulatory approach of using a target tariff price path as being consistent with establishing a road map towards cost reflectivity. This process is a relatively transparent, building block approach allowing for component costs to be considered individually thus providing an ability to both forecast, back test and review cost components with a reasonable degree of robustness if required.

In considering the development of target tariffs TXU believes that the tariff structures should support cost reflectivity both across and within individual tariffs i.e. any intra-tariff cross subsidies should be minimised.

Price Controls

As previously indicated TXU notes and supports the Tribunal's views on avoiding adverse price impacts for small customers. In particular TXU believes that price constraints need to be placed on prices applying to low income and vulnerable customers, however lack of cost reflectivity in default tariffs should not be used as a mechanism to restrict access to competitive market offerings.

Further TXU supports the view espoused by the Tribunal under the current gas regulation determination findings that industrial and commercial customers should not be subject to any price controls. TXU concurs that "the competitive market will impose sufficient pressure to ensure that these customers are protected from 'price shocks"'.

In terms of considering the form of price control regulation that the Tribunal should use to manage 'price shocks', TXU believes that prices within a default tariff category that is priced below target tariff levels should be controlled at the average price level per customer class via an "Average Increase +X" factor *[Where the 'increase' is generally CPI but note in the first year a reset may exist and drive the retail price increase up above CPI]*.

TXU would also argue that the rebalancing percentage should be allowed where a tariff is already at or above target tariff levels provided such a price movement is used to address inter- and intra- tariff cross subsidies. This allowance is required due to possible volume movements between price blocks.

Notwithstanding the above views, if the Tribunal still feels that a significant price impact would occur in order for some default tariffs to reach target levels by June 2007, then the approach of making these tariffs obsolete is seen to be one mechanism to more readily facilitate this tariff moving towards cost reflectivity.

A one-time step change in prices to customers as a result of the need to achieve cost-reflectivity is a difficult issue to manage. TXU has experience with this issue in the Victorian market. Our experience is that average price increases of up to 9-10% can be implemented providing an independent regulatory body has reviewed the price adjustments and customers expectations and reactions are managed sensitively.

The recent mid term review of AGL Retail Energy's default gas prices reinforces TXU's views on managing step changes in prices. The Tribunal allowed an average price increase of 8.8% under that review meaning that some customers would have received price increases well in excess of that amount.

TXU believes that whatever the form of price control that the Tribunal may wish to utilise such controls should not impact the ability to allow all default tariffs to be cost reflective (i.e.. at target tariff levels) by no later than June 2007. Consequently the Tribunal will need to consider what constitutes an acceptable rate of change of prices for some customers.

2. Cost Components

"The Tribunal seeks comment on the most appropriate treatment of the various cost components to ensure that retail charges are at, or close to, cost reflective levels for all small retail customers by 2007".

The following comments are offered in relation to the specific cost components comprising development of the target tariff levels:

Network Charges

The Tribunal has appropriately identified network charges as "pass through" costs to the retail business. The Tribunal's current review of network prices will obviously impact on the future cost reflectivity of target tariffs. To this end TXU offers the following comments:

- Retail price controls should be no more onerous than any network price controls provided by the Tribunal. Any network price inter-tariff or intra-tariff price restructuring may lead to issues with retail tariff target levels and the price controls for retail must be less restrictive than those applying to network tariffs

- The network determination process should be resolved to allow sufficient time for potential retail impacts to be analysed and discussed with the Tribunal and to allow retailers to develop competitive market offerings.

Wholesale Energy Costs

TXU is disappointed with the decision to extend the operation of ETEF until the end of June 2007. There have been many comments made in other forums in relation to the market distortion effects that ETEF creates in terms of impacts such as:

- Reducing liquidity in the wholesale contracts market
- Impacting contract price levels
- Reducing access to contracts to support contestable customer retail contracts

However, given that ETEF is part of the market until June 2007, TXU would strongly argue that, in order to facilitate market development, the ETEF price setting process should be very transparent including publication of ETEF rates applicable to various default retailers.

TXU also believes the level of wholesale purchase costs incorporated into ETEF needs to factor in:

- The load-weighted LRMC of electricity generation. TXU notes that the Tribunal has engaged a consultant to carry out modelling in relation to LRMC costs and would suggest that the consultancy consider some of the issues raised herein. TXU would welcome the opportunity to comment on the initial findings of the consultancy. TXU believes that it can offer some relevant information in this matter given that TXU has recently acquired the Tallawarra potential generation site in NSW.

- The need for investment in new generation in NSW in the period 2006 to 2008. Thus the ETEF costs should be reflective of new entrant generation long run marginal costs with the next increment of generation likely to be gas fired generation. Such pricing signals are necessary to facilitate the required investment in new generation capacity. If this cost signal is not considered and allowed for in the price review period then the cost reflective price path may well be subject to a large spike just prior to the new generation coming online.

- The ability for new entrant retailers with no access to physical generation to obtain contract hedges to manage their price and volume risks associated with hedging current default customer profiles. The price of electricity forward and options contracts is not necessarily reflective of actual physical generation costs.

Retail Operating Costs

In its most recent determination on electricity pricing the Tribunal quoted $45 to $75 per customer per annum as being an appropriate level of retail cost to serve in its most recent determination. TXU believes this range to be inadequate and offers the following points for the Tribunal's consideration:

- CRA, in its report to the Victorian Government for the 2003 standing and deemed tariffs, believed a cost to serve of $90 per customer per annum was reasonable.

- TXU has this year performed an Activity Based Costing analysis of its retail cost to serve, and found the actual cost in 2002 dollars is $90[1] per customer per annum.

- The costs that drive the cost to serve are all affected by inflation. The $45-$75 figure is a 2001 figure.

- The Tribunal should take advantage of access to multiple incumbent retailer actual cost data in its consideration of a retail cost to serve benchmark. Any benchmark based on 2003 costs should be escalated by CPI to obtain a figure reasonable for use in 2004 and further escalated out until 2007.

[1] Exclude several cost and regulatory elements

It is also TXU's contention that certain specific costs related to individual attributes of the NSW small customer retail market should be explicitly incorporated outside of any benchmarked costs. Examples of these include:

- Increasing Retail Licence costs and the complexity of retail licence compliance reporting in NSW.
- Increases in B2B costs required under the NEM
- Costs associated with FRC market obligations in NSW
- Ombudsman costs.

Retail Margin

TXU believes that an appropriate Retail margin is one that will provide a rate of return and will ensure sustainability in the long term for a retailer operating in the market. The margin must cover the risk associated with operating in the market and provide transition to competition for all customers.

Whilst TXU has been conservative in its margin assumptions in some of its submissions to other price enquiries there is an argument that margins of 5% (refer ESCOSA 2002) are required to attract entrants and provide compensation for the operational, compliance and regulatory risk faced by businesses operating in an open and competitive energy market.

A key component in achieving effective competition is the availability of cost reflective price levels for competition. In the Victorian ESC paper "Special Investigation: Review of the Effectiveness of Full Retail Competition for Electricity – Final Report – September 2002, the Victorian ESC noted that a lack of retail margin was a barrier to effective competition. At item 7.3 "Possible impediments" the Commission states:-

> *"The extent and impact of competition for those customers who exhibit positive margins below the standing offer tariffs appears to have been reasonably effective in that price savings have been offered, prices have evidently moved towards efficient supply costs and more varied service options have been offered. This suggests that a broadening of the reach of competitive activity could be achieved in future by relaxing the standing offer tariff arrangements to provide more "headroom" for competition to determine market prices below the safety net price cap."*

In order to ensure the sustainability of the electricity industry in NSW and deliver choice to customers there needs to be an appropriate retail profit margin. TXU believes a benchmark margin that enables market entrant and transition to competition covering costs and risks is greater than the historical Tribunal benchmark and recommends that a benchmark margin of a minimum 4% be adopted.

Whilst the Tribunal had indicated that it has used a lower margin reflecting the hedging nature of ETEF and the funding costs of government owned entities, this philosophy does not extend to reflecting the actual efficient costs under a competitive market and the Tribunal should recognise the true cost of capital not the cost in a distorted market environment.

Other Cost Components

The following comments are offered in relation to other cost components:

- Ancillary Service Charges, Pool Fees

TXU believes that these should be reflected on an estimated pass through basis and that these can be reasonably estimated for the next **3** years. The mechanism for pass through should allow for adjustments in allocation of ancillary services within the NEM between market participants

- MRET compliance Costs

There is a forward market for RECs which can be reasonably translated into allowable pass through costs. TXU is happy to provide its estimated figures for the cost of RECs for the period 2004-2007.

- NSW Licence Compliance Costs (including NGACs)

There is a forward market for NGACs which, although not as clear as that offered by RECs, can be reasonably translated into allowable pass through costs. TXU is happy to provide its estimated figures for the cost of NGACs for the period 2004-2007.

TXU believes that the NSW Licence Compliance costs should be included as a separate subcomponent of retail operating costs (refer to previous comments). NSW has by far the most onerous licence reporting regime requiring significantly higher costs to report compliance activity.

CONCLUSION

In summary, we wish to reiterate our view that the present artificially low levels of regulated tariffs presents a significant barrier to entry for new retailers looking to compete for small NSW customers. TXU advocates that IPART moves regulated tariffs to cost reflective levels, and bases its assessment of these cost reflective levels around the principle of sustainability in the long term. This may result in a step price change in year one to ensure cost reflectivity by the end of the price path period.

A sustainable approach considers more than just the costs presently incurred by incumbent retailers in servicing the customers who have not entered the competitive market. **A** sustainable approach takes account of the need to:

- facilitate robust and active competition,
- consider as a benchmark the costs incurred by new retail entrants in competing in the NSW market and
- facilitate new investment in generation.

If these issues are not adequately considered, then it is likely that true competition will not take hold in the 3 years of this price path period. Further, it is likely that consumers will suffer a price spike within the next 5 years as supply/demand tightens and the next increment of generation investment is required. This is similar in concept to the distribution network investment price spike that is presently being encountered.

It is preferable to take account of these issues now to ensure the long-term sustainability of NSW retail prices for small customers.

TXU would be delighted to discuss its submission with IPART should you have any questions or require further detail. Please feel free to contact me on (03) 8628 1100.

Yours sincerely,

Demarte

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