Long run marginal cost

25 January 2007

Justin De Lorenzo –
Group General Manager Finance and Business Development

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Long run marginal cost – energy

- Terms of Reference state that … *The Tribunal must consider the Government's policy aim of reducing customers' reliance on regulated prices and the affect of its determination on competition in the retail electricity market. …*
- LRMC is a benchmark used historically in the absence of markets and competition
- LRMC may provide a reference point, but it is not the most appropriate measure for the forecasting of energy purchase prices in an active and competitive market

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Long run marginal cost – ‘green’

- Underlying LRMC is the appropriate methodology for greenhouse gas schemes in the *absence* of an active and competitive market
- Underlying LRMC appears to be adequate for MRET and NRET
- GGAS estimates appear to understate the current cost of compliance

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Market based energy purchase costs

25 January 2007

Justin De Lorenzo –
Group General Manager Finance and Business Development

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Market based energy purchase costs

- ETEF represents a perfect, risk free hedge position
- As ETEF falls away, retailers will attempt to purchase energy for regulated loads through hedge contracts
- This will require a transition period to allow the market to adjust to the new situation, which reflects the requirement under the Terms of Reference to recognise … *hedging, risk management and transaction costs faced by retailers in the absence of ETEF*

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Market based energy purchase costs

- Energy purchase allowances need to include a ‘risk premium’ that reflects this transition adopting a prudent and sustainable risk management approach
- Frontier’s Report states that … *the most conservative point is at or below the energy price included in the current determination*
- In other words, Frontier’s report anticipates that Country Energy will both assume higher risk, *and* accept lower energy purchase cost allowances than those that currently apply – increased risk, reduced allowance

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Market based energy purchase costs

- The Terms of Reference state that … *the Tribunal must consider the Government’s policy aim of reducing customer’s reliance on regulated prices and the effect of its determination on competition …*
- Underestimated energy pricing will deter competition and may threaten standard retailers’ sustainability
  - A concern has been stated that overestimated energy pricing could lead to barriers of entry – this may be valid in the short term, but will be corrected by competition
  - The impact of underestimation outweighs the risk of overestimation
- Accordingly, the Tribunal should favour a conservative position

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Retail costs

25 January 2007

John Adams – Group General Manager Retail

Retail costs – operating

- Operating costs are not inconsistent with Country Energy’s experience to date as a standard retailer, but are increasing
- A mass market new entrant may face a higher level of costs due to the inability to share costs within an established and diversified business

Retail costs – acquisition

- Costs of acquisition are not inconsistent with Country Energy’s experience to date
- However the ‘expected life of a customer’ is overestimated
  - 6 and 10 year life reflects low levels of churn
  - Increased margin will increase levels of churn
  - ‘Move in and move outs’ also impact customer life
- The discount rate also lies below the appropriate range for an mass market new entrant
  - Independent analysis supports a range of 8.1 to 12.8 per cent

Retail margin

25 January 2007

John Adams – Group General Manager Retail

Retail margin

- The retail margin recommended is considered appropriate for current retailers provided that the risks involved with purchasing energy in the absence of the ETEF are adequately captured in energy costs
- If energy costs are inadequate, the recommended level of retail margin is unlikely to provide sufficient incentive for a MMNE to enter the market

Retail margin

- Retail margin is closely related to churn assumptions and ultimately the expected life of a customer

- The Terms of Reference state that … *if the level (regulated prices) is set too low, it is not possible for new retailers to attract small retail customers away from the regulated price.*