Long run marginal cost



Justin De Lorenzo – Group General Manager Finance and Business Development



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



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



Market based energy purchase costs

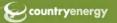


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Market based energy purchase costs

- 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



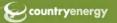
Market based energy purchase costs

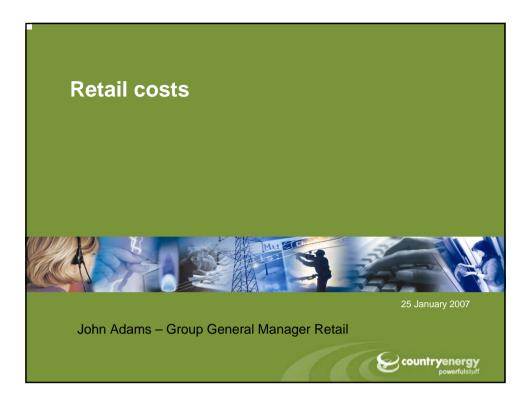
- Energy purchase allowances need to include a 'risk premium' that reflects this transition adopting a prudent and sustainable risk management approach
- ☐ Frontier's Report states that ... the most conservative point is at or below the energy price included in the current determination
- In other words, 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



Market based energy purchase costs

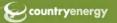
- ☐ The Terms of Reference state that ... the Tribunal must consider the Government's policy aim of reducing customer's reliance on regulated prices and the effect of its determination on competition ...
- Underestimated energy pricing will deter competition and may threaten standard retailers' sustainability
 - □ 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





Retail costs - operating

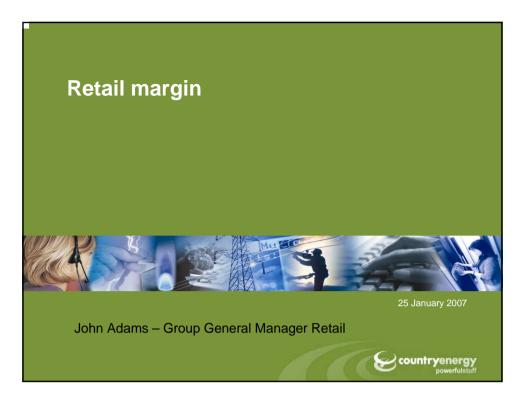
- Operating costs are not inconsistent with Country Energy's experience to date as a standard retailer, but are increasing
- A mass market new entrant may face a higher level of costs due to the inability to share costs within an established and diversified business



Retail costs - acquisition

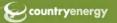
- Costs of acquisition are not inconsistent with Country Energy's experience to date
- However the 'expected life of a customer' is overestimated
 - ☐ 6 and 10 year life reflects low levels of churn
 - ☐ Increased margin will increase levels of churn
 - ☐ 'Move in and move outs' also impact customer 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

- ☐ 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.

