2007 – 10 Retail Price Review

Presentation to workshop on Frontier Economics' draft reports on energy costs, opex & margin

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INTRODUCTION

- We support a move towards retail price deregulation
  - competition needs to be effective.
  - regulated retail tariffs need to reflect true costs & risks of supply.
- Only in this environment will competition thrive and investment in new generation occur.
- ToR Require price "cap" to ensure that it reflects the true costs and risks of the business
- IPART can facilitate move to 'cost reflectivity' by:
  - Focus on 'R' and pass through separate 'N' charges
  - Minimising regulatory involvement
  - Passing through unforeseen & uncontrollable costs
  - Cost allowances reflect reality of retailing

LRMC

- Very Sensitive to Input parameters [eg WACC]
- Suspect issue with input Load Data as EA/IE/CE relativities are incorrect. Also affects the Hedge Cost Analysis.
- Have not yet received Frontier's input data to comment for in our formal response.
- LRMC methodology most applicable to REC and NGAC costs as it reflects the contracting arrangements more so than does the spot market.

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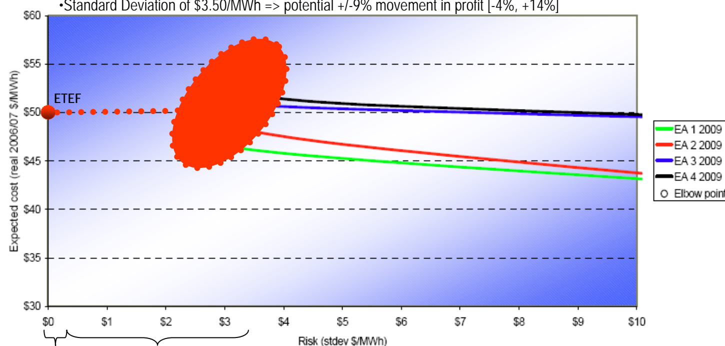
HEDGE COSTS

- ETEF – effectively Zero Market Risk, Estimation Risk etc.
- IPART previously considered appropriate to earn 2% Margin
- Introducing significant Risks
- Portfolio construction outside limits in EA's risk management policy / Treasury guidelines
- Frontier Claim they are diversifiable [Non Systematic]……and therefore not in the margin…..
- ..but……..even when hedged [diversified] this chart shows there is still significant variability
- Margin Now recognised at [say] 5% ie. Increase of 3% Margin recognising Systematic risks only
- This Margin allowance is completely swamped by volatility in "Non Systematic Risks"
- Standard Deviation of $3.50/MWh => potential +/-9% movement in profit [-4%, +14%]



Non Systematic Risks
[excluded from margin]

Systematic Risks
[Included in margin]

EA Reg Load 08/09

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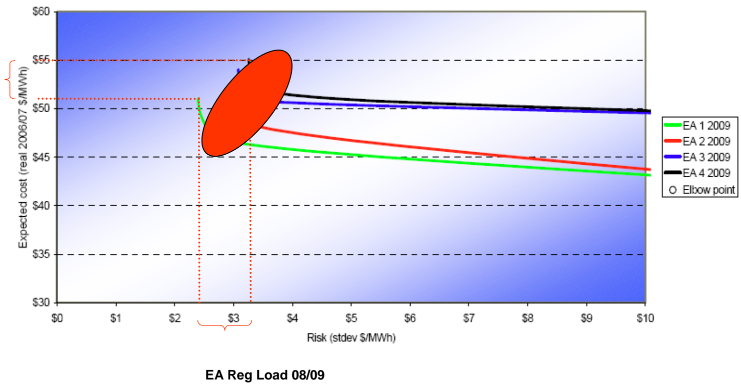
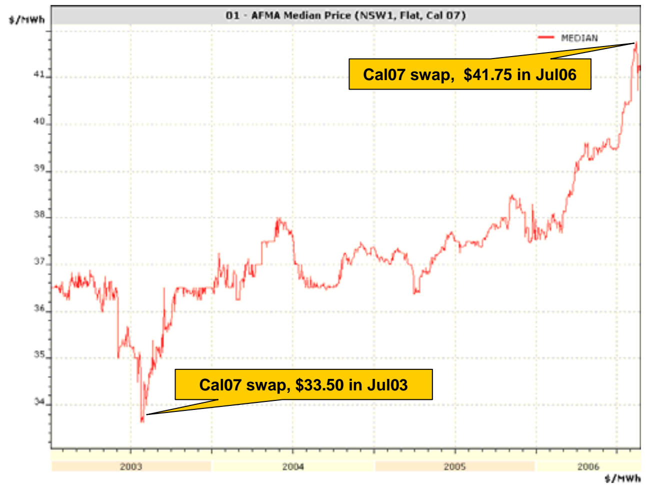
HEDGE COSTS



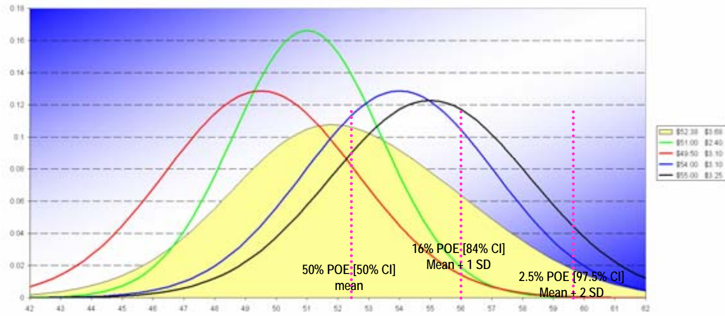
EA Reg Load 08/09

HEDGE COSTS

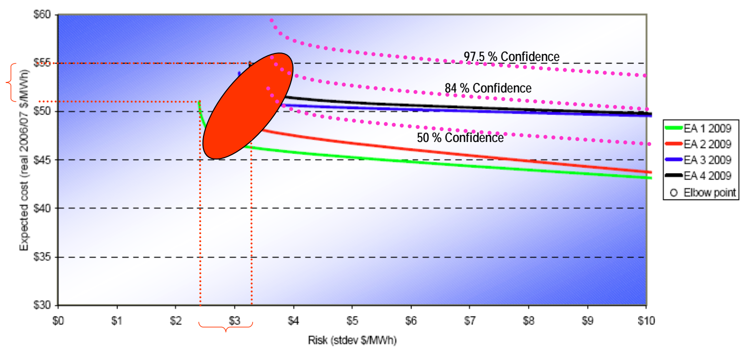


HEDGE COSTS

Distilling the Conservative Result



HEDGE COSTS



EA Reg Load 08/09

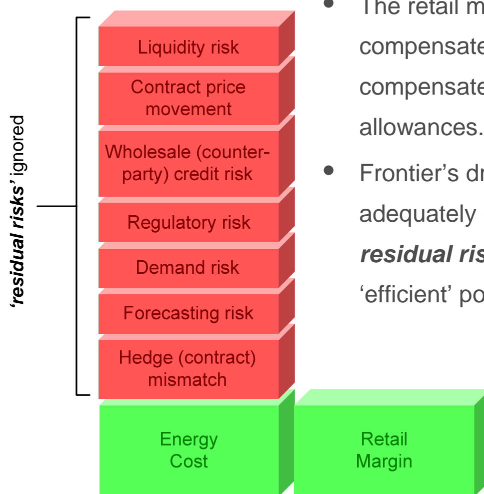
HEDGE COSTS

- Input Data should be revisited:
  - Load Data is suspicious given the relativity of EA/IE/CE profiles
  - Spot Price ‘Forecasts’ insufficient – require several thousand to correctly capture the risk of this market
- “Estimation Risk” and movements in the Contract Market [Forward Curve] are common and significant. [eg.$4/MWh]
- These “Non Systematic” risks are clearly NOT diversifiable, residual risks swamp Systemic Risk and margin allowance.
- Portfolios presented as the Elbow point are not possible under our Risk policies, Treasury Guidelines and contravene basic commercial prudence [eg. 90/10 -> 10/90 by Quarter]
- Efficient Frontier’s represent 50% Confidence that costs will be covered – does NOT Ensure that costs and risks are captured.

RETAIL OPEX

- The Minister’s Terms of Reference require the operating cost allowance be based on a “mass market new entrants” costs.
- Yet Frontier have used the standard retailers’ historical costs as the basis for its recommended allowance.
- There are inherit differences between a standard retailer and MMNE that would suggest the latter is higher:
  - Standard retailer enjoys synergies with Distribution Network business.
  - MMNE must face new entry establishment costs.

RETAIL MARGIN



- The retail margin should compensate retailers for costs not compensated for elsewhere in the allowances.
- Frontier's draft report does not adequately compensate for the ***residual risk*** that results from its 'efficient' portfolio construction.

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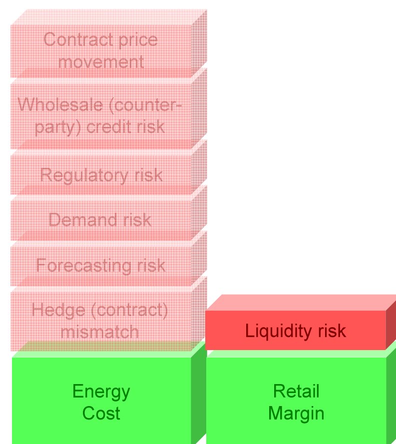
RETAIL MARGIN

Liquidity risk occurs when there is insufficient contract supply in the market to meet demand, pushing prices up.



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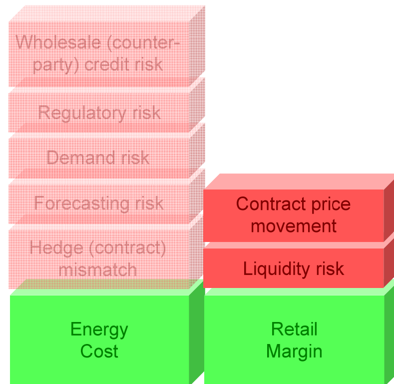
RETAIL MARGIN

Contract price movements present a risk - the estimation risk referred to in the Hedge Costs presentation. Normally this would be managed by buying [in the market] and selling [to customers] simultaneously – but here we are fixing the price for 3 years before buying.



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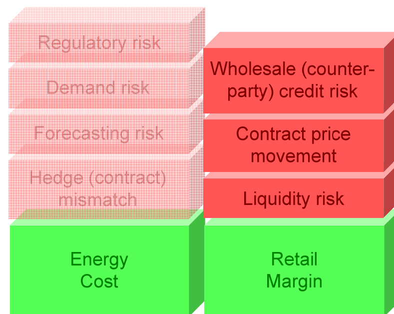
RETAIL MARGIN

Wholesale (counter-party) credit risk arises where counter-parties may default on contractual arrangements.



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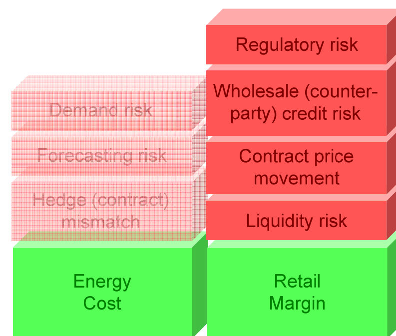
RETAIL MARGIN

Regulatory risk occurs in relation to the wholesale energy market. Examples include changes in the definition of VOLL, regional boundary changes, definition of 'green' schemes, etc.



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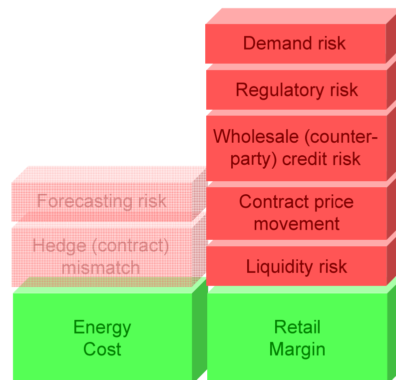
RETAIL MARGIN

Demand risk arises with demand fluctuations in half-hourly load shapes.



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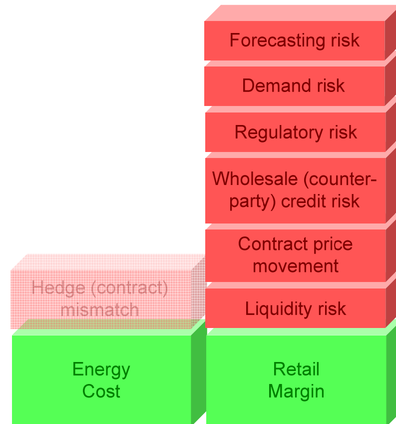
RETAIL MARGIN

Forecasting risk arises in the estimation of both prices and load shape.



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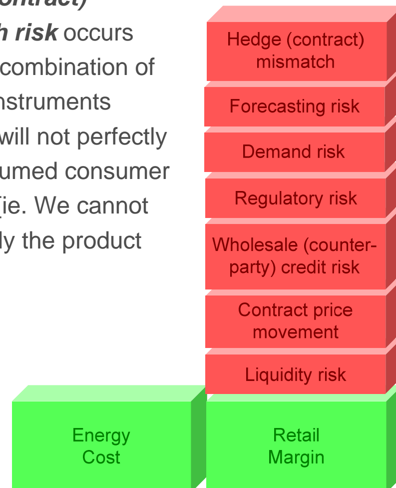
RETAIL MARGIN

Hedge (contract) mismatch risk occurs when the combination of hedging instruments available will not perfectly cover assumed consumer demand. [ie. We cannot buy exactly the product we sell].



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RETAIL MARGIN

- We understand that Frontier may have assumed that these residual risks would be captured in the standard retailers' forecasts of pool prices and hedging instruments. ***This is not the case***.
- The Minister's Terms of Reference provide for cost allowances associated with "hedging, risk management and transaction costs"
- EnergyAustralia is indifferent to whether these risks are compensated for in the energy cost or retail margin – as long as they are ***included,*** consistent with the Minister's Terms of Reference***.***

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