

2007 – 10 Retail Price Review

**Presentation to IPART Public Forum
8 September, 2006**

**Tim O'Grady
Executive General Manager, Retail**

OUTLINE

- Outline
- Understanding Minister's Terms of Reference
- Current issues
- Appropriate cost allowances
- Form of regulation
- Protecting vulnerable customers
- Final remarks

Outline

Understanding
Terms of Reference

Current framework
issues

Appropriate cost
allowances

Form of regulation

Protecting
vulnerable
customers

Final remarks

UNDERSTANDING TERMS OF REFERENCE

- In setting regulated tariffs and charges, the terms of reference require IPART to:
 - Capture true cost of supply
 - Move to cost-reflective tariffs by end of Determination
 - Facilitate tariff rationalisation
 - Consider impact on demand management.
- The Determination will then help to promote:
 - Greater competition
 - Investment in generation.

Outline

Understanding
Terms of Reference

Current framework
issues

Appropriate cost
allowances

Form of regulation

Protecting
vulnerable
customers

Final remarks

CURRENT FRAMEWORK ISSUES

- Phase out of ETEF
 - ETEF should reflect cost allowance underpinning regulated retail tariff.
- COAG endorsement of removing retail price regulation
 - Competition exists in the NSW market and...
 - will increase with when regulated retail tariffs are set at cost-reflective levels.
- CoAG agreement to roll-out time of use (ToU) meters
 - EA supports ToU tariffs as a way to send price signals to customers.
 - Determination must continue to support moving regulated customers onto ToU tariffs where an interval meter is in place.

Outline

Understanding
Terms of Reference

**Current framework
issues**

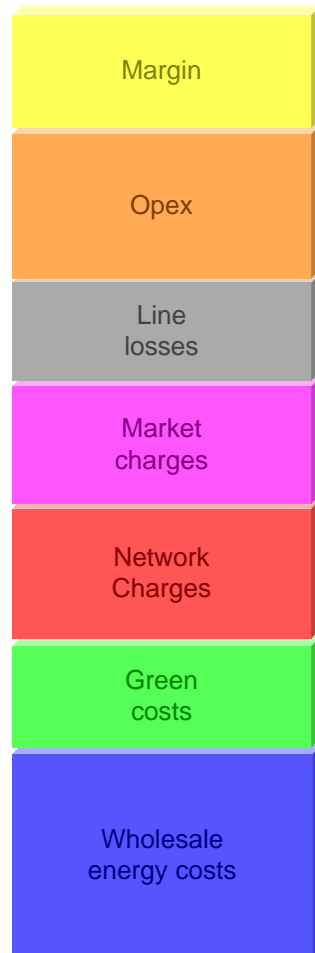
Appropriate cost
allowances

Form of regulation

Protecting
vulnerable
customers

Final remarks

APPROPRIATE COST ALLOWANCES



- The terms of reference direct IPART to have regard to a number of different costs allowances.
- These cost allowances are essentially 'building blocks' that stack together to form an efficient, cost-reflective price.
- EA will present the basis for assessing each of these 'building blocks'.

Outline

Understanding
Terms of Reference

Current framework
issues

**Appropriate cost
allowances**

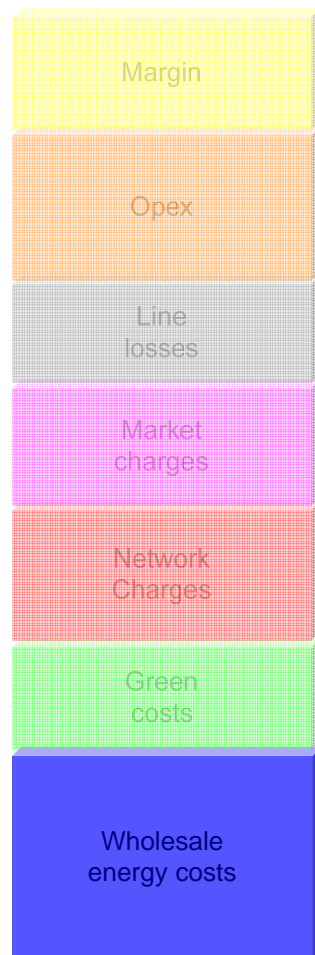
Form of regulation

Protecting
vulnerable
customers

Final remarks

WHOLESALE ENERGY COSTS

The WHOLESALE ENERGY COST allowance should be based on **the cost of a hedge portfolio**.



- Reflects the reality of retailing & purchasing electricity.
- Assessing the cost of a hedge portfolio would require consideration of:
 - Contracting strategy
 - Hedge mismatch
 - Customer churn
 - Credit risk
 - Demand risk
 - and so forth...

Outline

Understanding
Terms of Reference

Current framework
issues

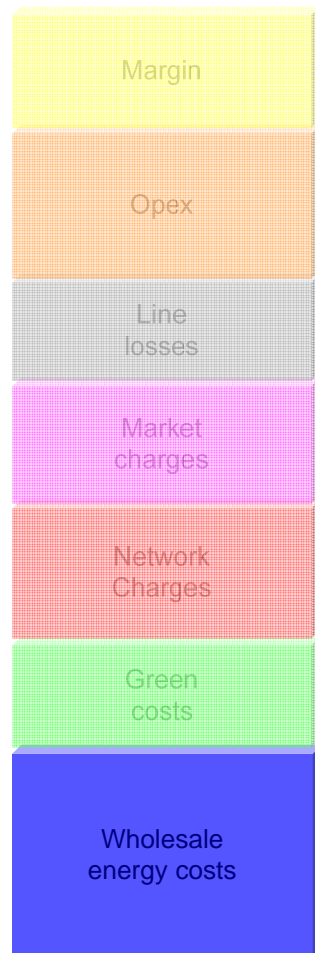
**Appropriate cost
allowances**

Form of regulation

Protecting
vulnerable
customers

Final remarks

WHOLESALE ENERGY COSTS



- Retailer offers fixed price to small customers for their future consumption which is uncertain.
- Retailer must purchase electricity for this uncertain demand at an unknown price.
- The following slides highlight these load and price uncertainties...

Outline

Understanding
Terms of Reference

Current framework
issues

**Appropriate cost
allowances**

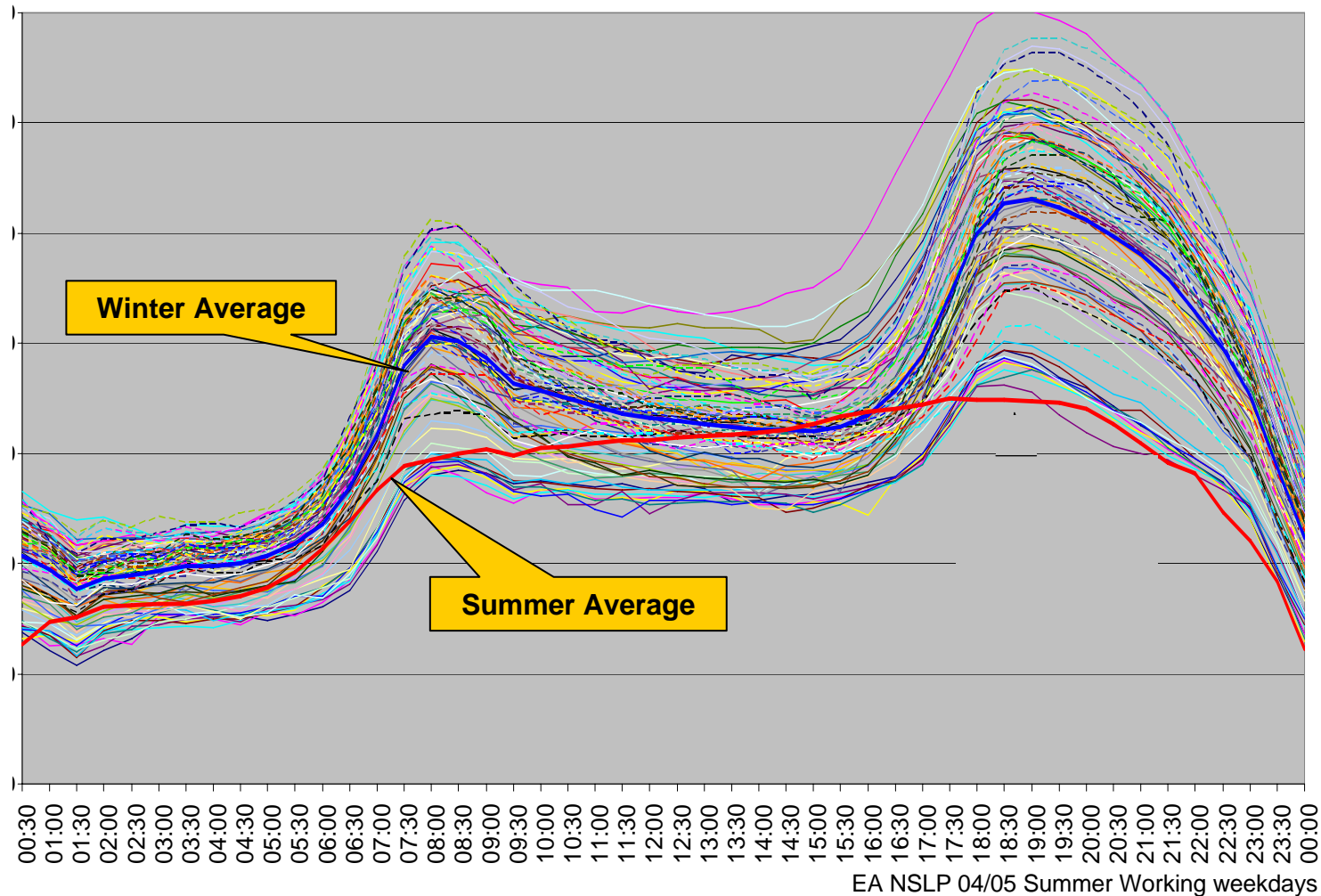
Form of regulation

Protecting
vulnerable
customers

Final remarks

WHOLESALE ENERGY COSTS

We know *approximately* what the load shape looks like



Outline

Understanding
Terms of Reference

Current framework
issues

**Appropriate cost
allowances**

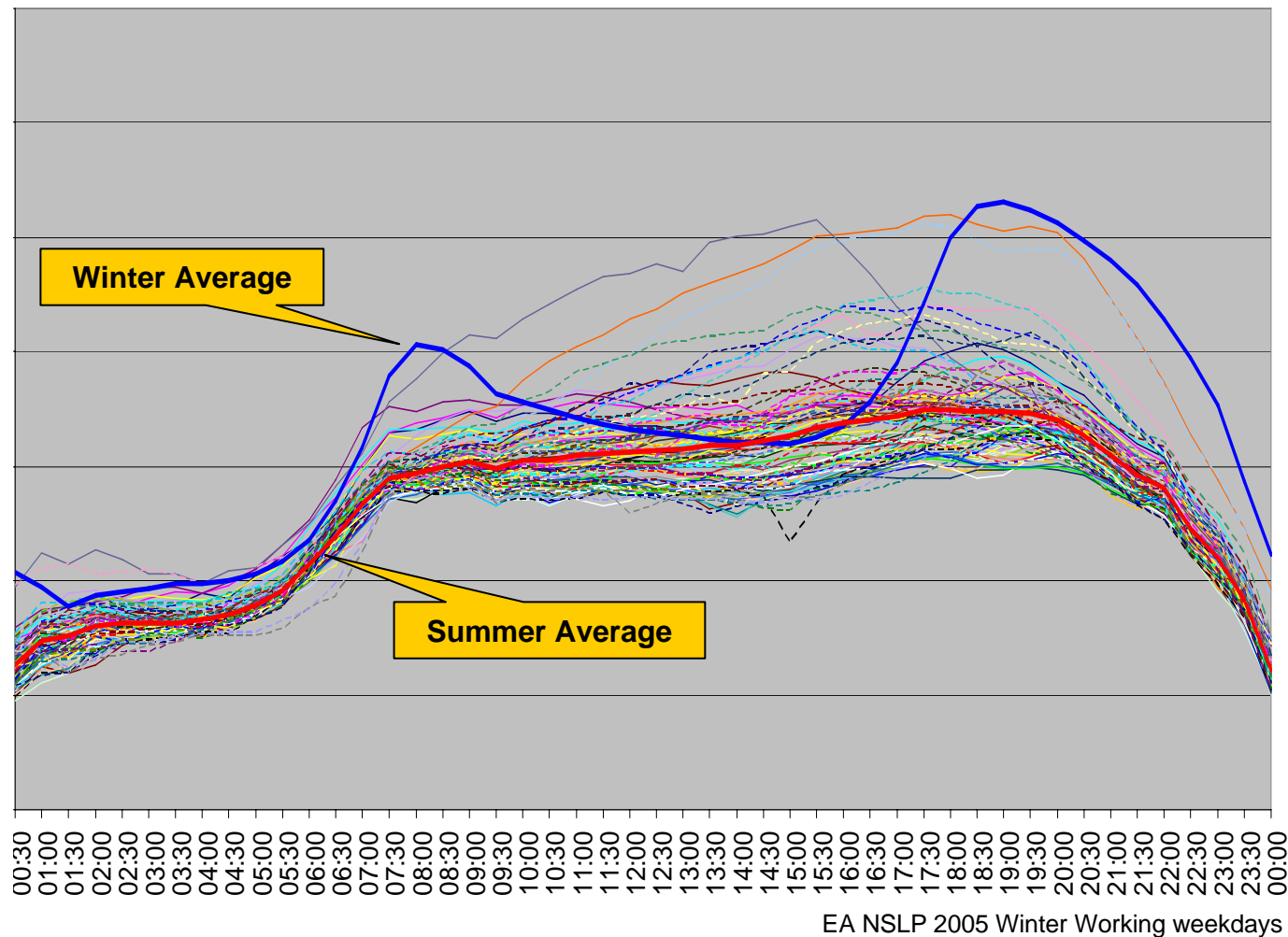
Form of regulation

Protecting
vulnerable
customers

Final remarks

WHOLESALE ENERGY COSTS

But the world is full of surprises!



Outline

Understanding
Terms of Reference

Current framework
issues

**Appropriate cost
allowances**

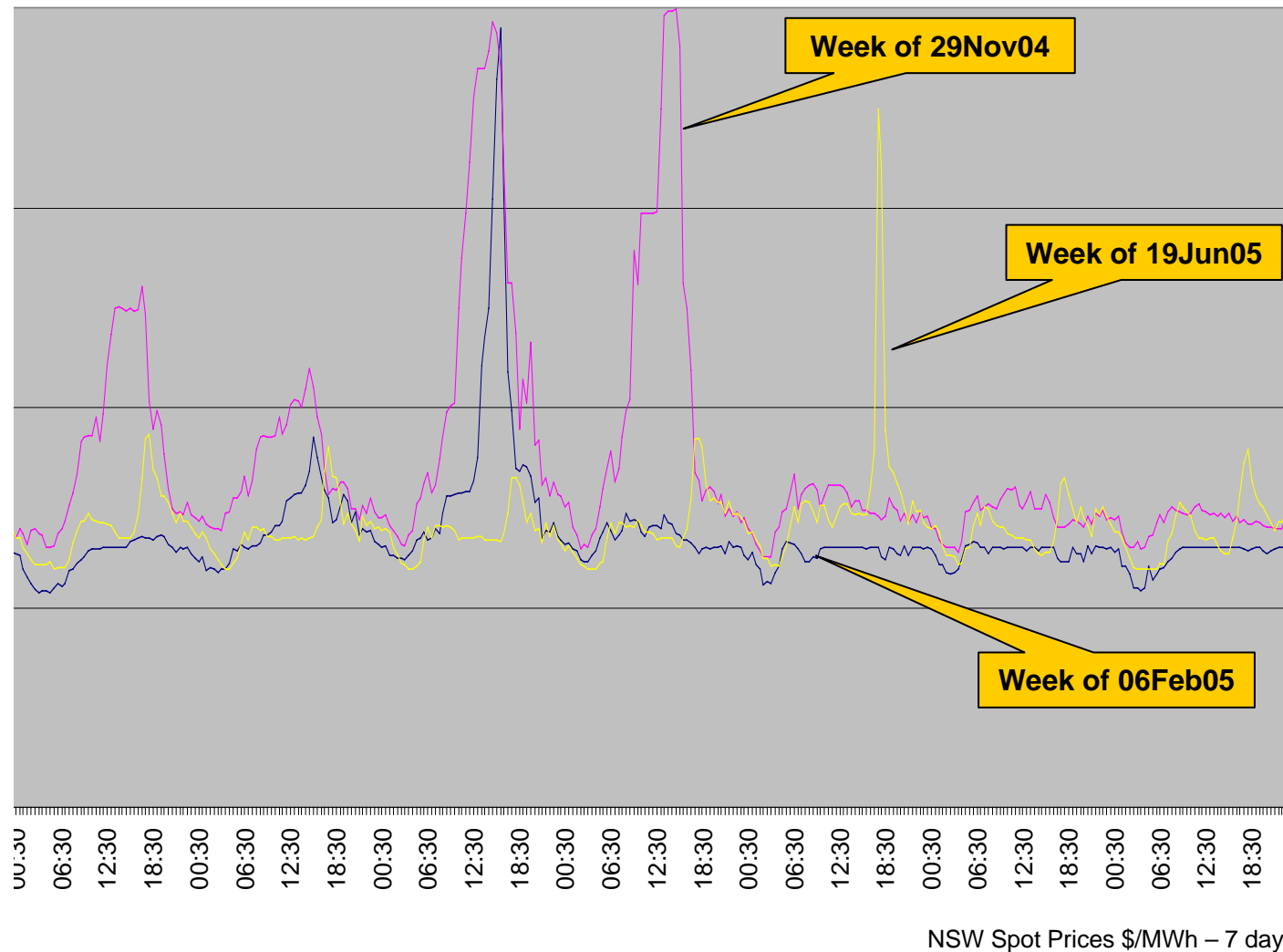
Form of regulation

Protecting
vulnerable
customers

Final remarks

WHOLESALE ENERGY COSTS

... and we are never quite sure how much it is going to cost ...



Outline

Understanding
Terms of Reference

Current framework
issues

Appropriate cost
allowances

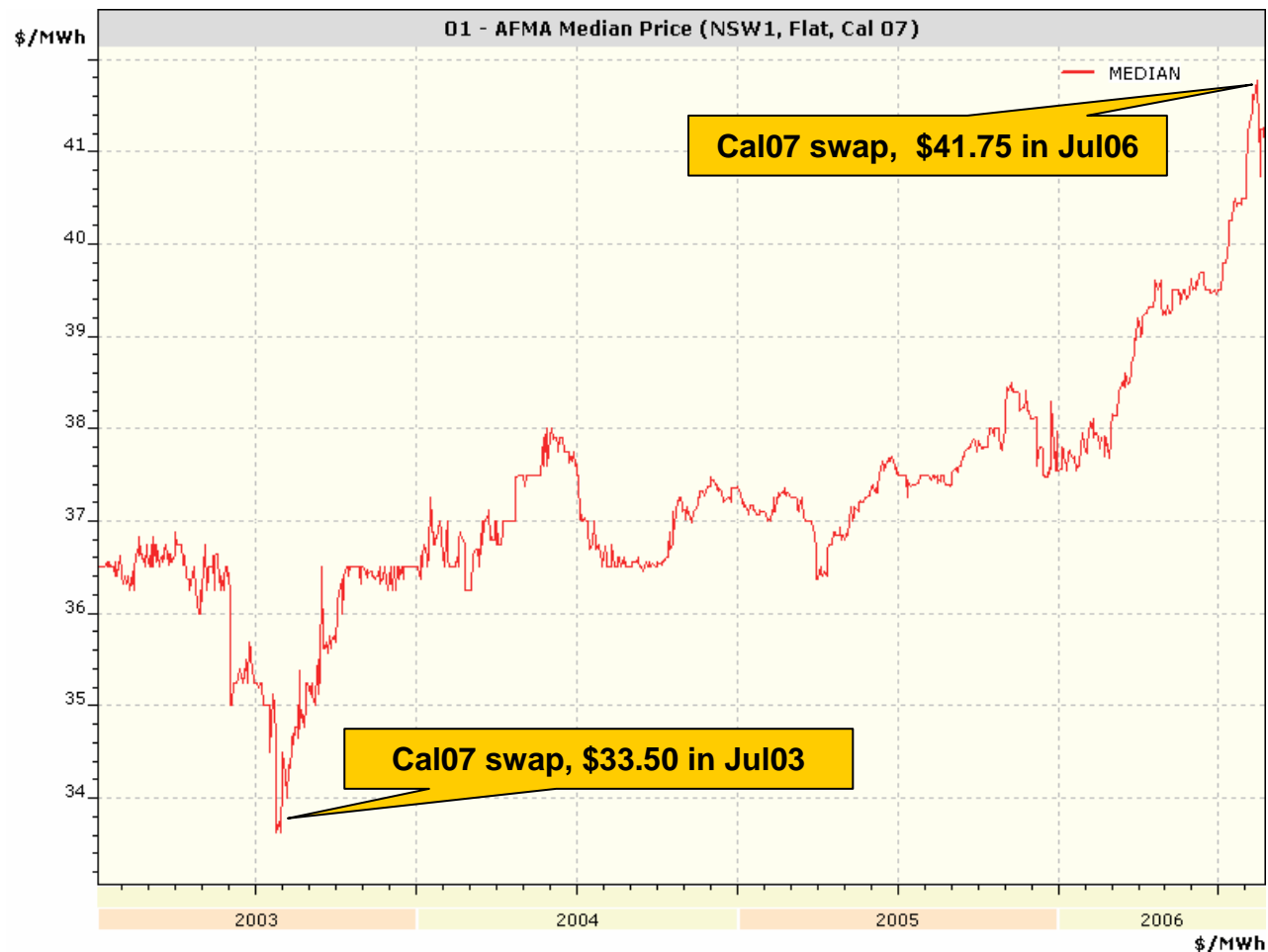
Form of regulation

Protecting
vulnerable
customers

Final remarks

WHOLESALE ENERGY COSTS

... and we are never quite sure how much it will cost to hedge.



Outline

Understanding
Terms of Reference

Current framework
issues

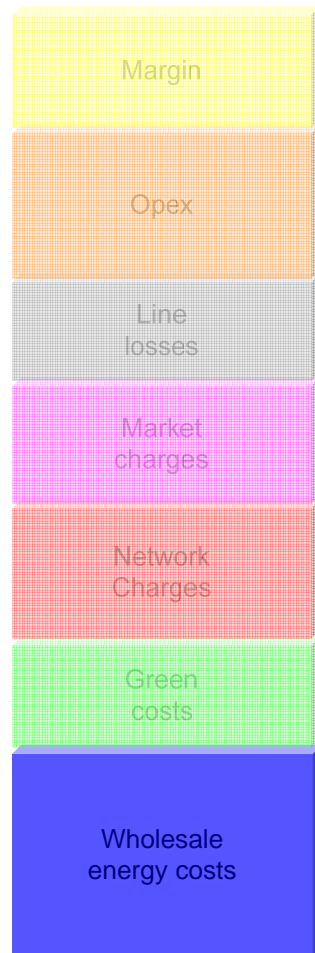
Appropriate cost
allowances

Form of regulation

Protecting
vulnerable
customers

Final remarks

WHOLESALE ENERGY COSTS



- Retailer attempts to limit demand and price risk by entering into contract arrangements.
- Not feasible to hedge perfectly.
- Invariably there's mismatch between sold demand and hedge position.
- Additional risk where regulated price is set up front before retailer has purchased.

Outline

Understanding
Terms of Reference

Current framework
issues

**Appropriate cost
allowances**

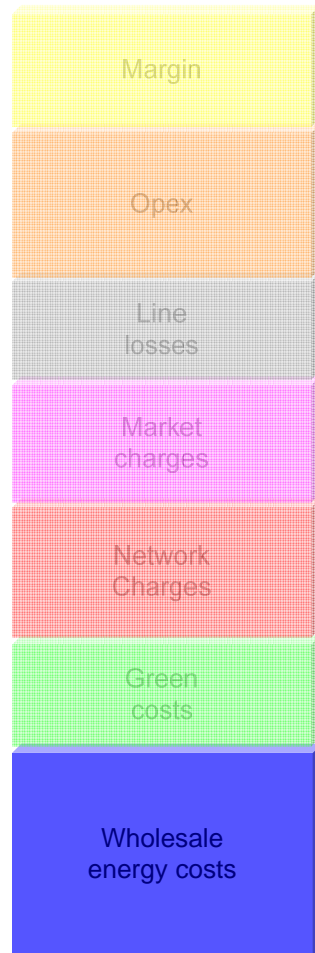
Form of regulation

Protecting
vulnerable
customers

Final remarks

WHOLESALE ENERGY COSTS

The WHOLESALE ENERGY COST allowance should **not** be based on **Long Run Marginal Cost**.



- LRMC is an artificial construct that bears little resemblance to market-based costs faced by retailers.
- Limitations associated with LRMC include:
 - Lead time requirements
 - Uncertainty of future fuel costs
 - Uncertainty in operating costs for labour & materials
 - Ignores ability of generators to exercise mkt power

Outline

Understanding
Terms of Reference

Current framework
issues

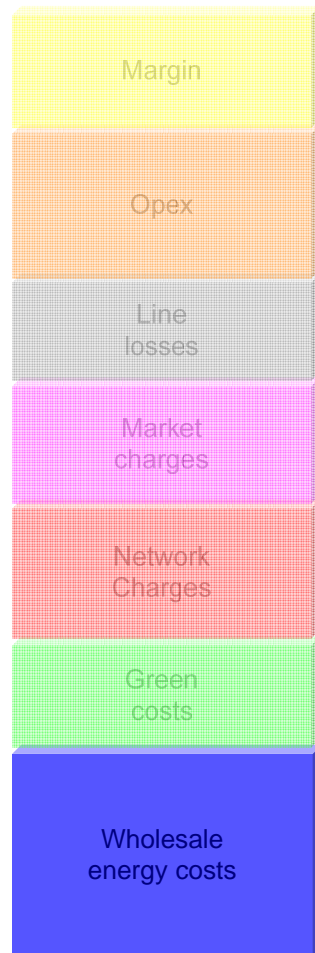
**Appropriate cost
allowances**

Form of regulation

Protecting
vulnerable
customers

Final remarks

WHOLESALE ENERGY COSTS



- In last price review, IES provided an LRMC amount ranging from ~ \$35 / MWh to ~ \$58 / MWh.
- Broad range highlights difficulty and risk in using LRMC.

Outline

Understanding
Terms of Reference

Current framework
issues

**Appropriate cost
allowances**

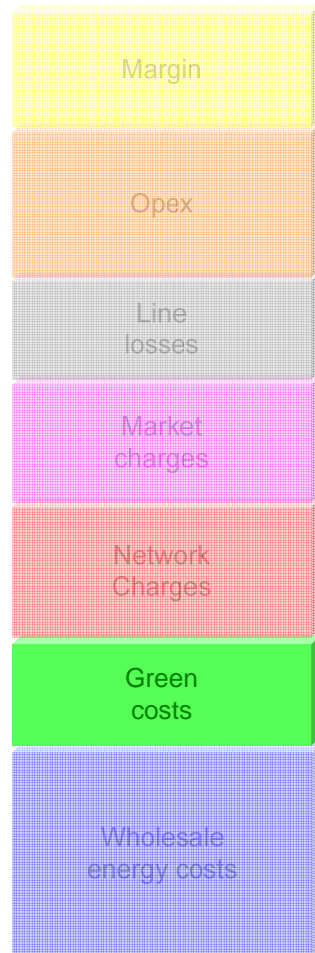
Form of regulation

Protecting
vulnerable
customers

Final remarks

GREEN ENERGY COSTS

The GREEN ENERGY COST allowance should be based on the **cost of investing in relevant technologies.**



- Two types of green costs
 - Renewable Energy Certificates (RECs)
 - National Greenhouse Abatement Certificates (NGACs)
- Observable spot markets are available for these certificates **but ...**
 - ... these markets are ‘thinly’ traded and so do not have the capacity to support the bulk of retailers’ green energy obligations.

Outline

Understanding
Terms of Reference

Current framework
issues

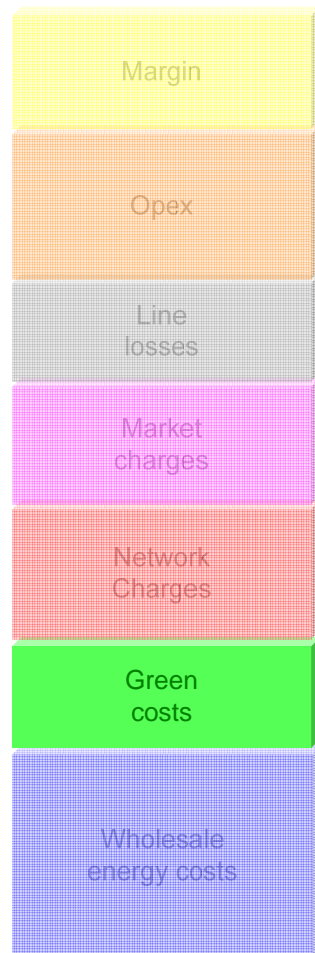
**Appropriate cost
allowances**

Form of regulation

Protecting
vulnerable
customers

Final remarks

GREEN ENERGY COSTS



- Retailers meet compliance obligations through underwriting the construction of new plant
 - Long-term deals of at least 5 years.
- Allowance should reflect reality of procurement
 - RECs: latest technology wind generation.
 - NGACs: latest technology combined cycle gas turbine generation.

Outline

Understanding
Terms of Reference

Current framework
issues

**Appropriate cost
allowances**

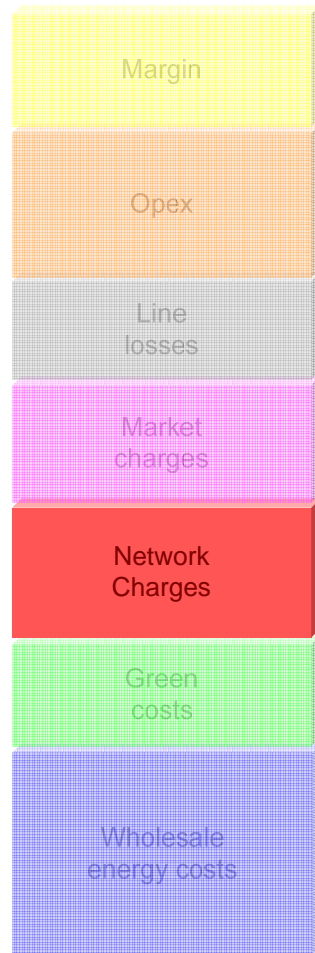
Form of regulation

Protecting
vulnerable
customers

Final remarks

NETWORK CHARGES

NETWORK CHARGES should be directly **passed through** to the customer



- Network charges are already subject to rigorous regulatory oversight and price control.
- Imposing second-order constraints, such as total bill price constraint, will:
 - Undermine integrity of price Determination
 - Dampen intended price signals by Network business.

Outline

Understanding
Terms of Reference

Current framework
issues

**Appropriate cost
allowances**

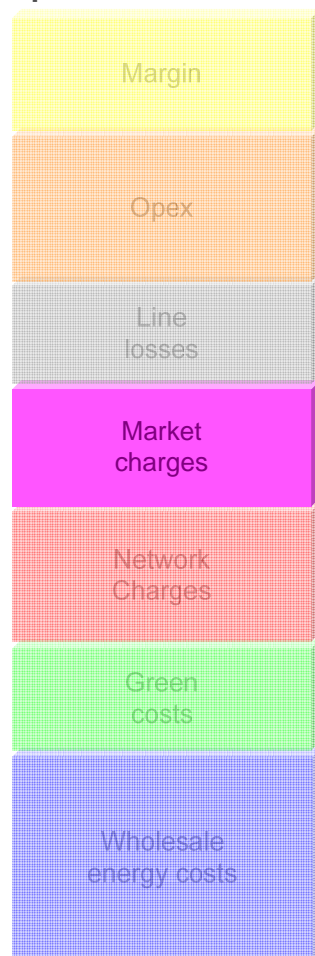
Form of regulation

Protecting
vulnerable
customers

Final remarks

MARKET CHARGES

MARKET CHARGES should be directly **passed through** where possible.



- NEMMCO-related charges or costs include:
 - Pool fees
 - Ancillary charges
 - Reserve trader event
 - Directions event
- Conceptually, all costs outside retailers influence or control should be passed through where possible and practical.
- EA believes NEMMCO pool fees, and costs associated with reserve trader & NEMMCO direction events fit this definition and should be passed through.

Outline

Understanding
Terms of Reference

Current framework
issues

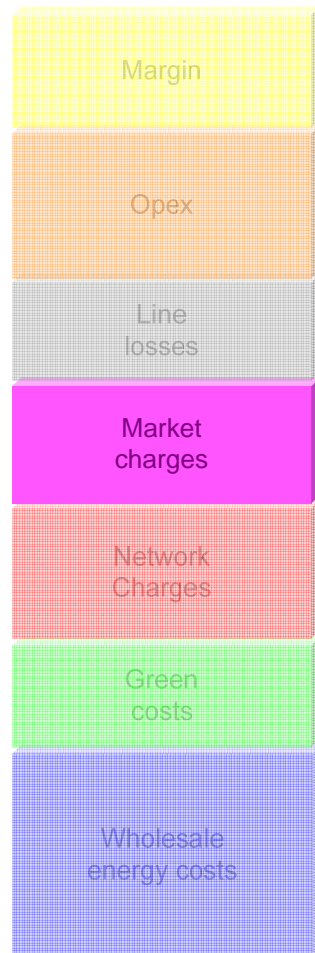
**Appropriate cost
allowances**

Form of regulation

Protecting
vulnerable
customers

Final remarks

MARKET CHARGES



- Ancillary charges can be traded and so are, to some extent, controllable.
- Therefore, allowance based on reasonable assessment of future compliance burden

Outline

Understanding
Terms of Reference

Current framework
issues

**Appropriate cost
allowances**

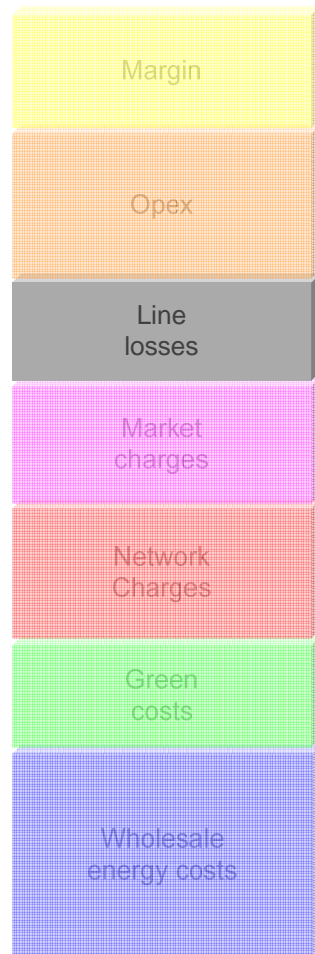
Form of regulation

Protecting
vulnerable
customers

Final remarks

LINE LOSSES

LINE LOSSES should be directly **passed through** where possible.



- Line losses affect the:
 - Distribution Network
 - Transmission Network
- Again, all costs outside retailers influence or control should be passed through where possible and practical.
- EA believes costs associated with distribution line losses fit this definition and should be passed through.

Outline

Understanding
Terms of Reference

Current framework
issues

**Appropriate cost
allowances**

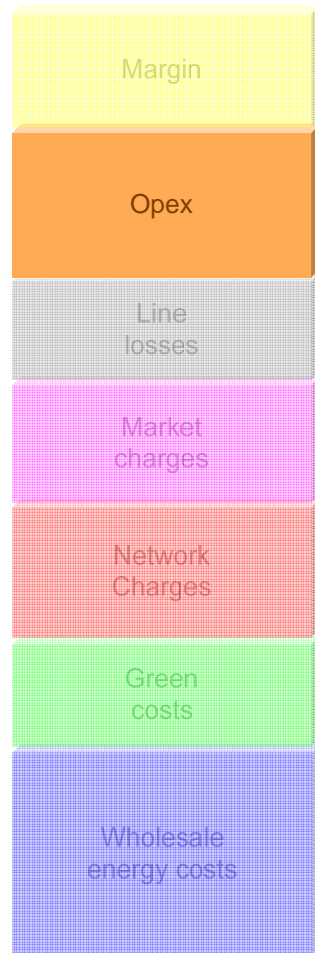
Form of regulation

Protecting
vulnerable
customers

Final remarks

OPERATING COSTS

An OPERATING COST allowance should be based on **benchmarking** a mass market new entrant (MMNE).



- First, define what a MMNE is
 - Terms of reference suggest “sufficient size to achieve economies of scale”.
 - EA has attempted to define MMNE.
- Characteristics include
- Service NSW market
 - Stand-alone, non-vertically integrated
 - Customer base of approx. 250K
 - Robust customer info system
 - Facilitates flat and ToU pricing.

Outline

Understanding
Terms of Reference

Current framework
issues

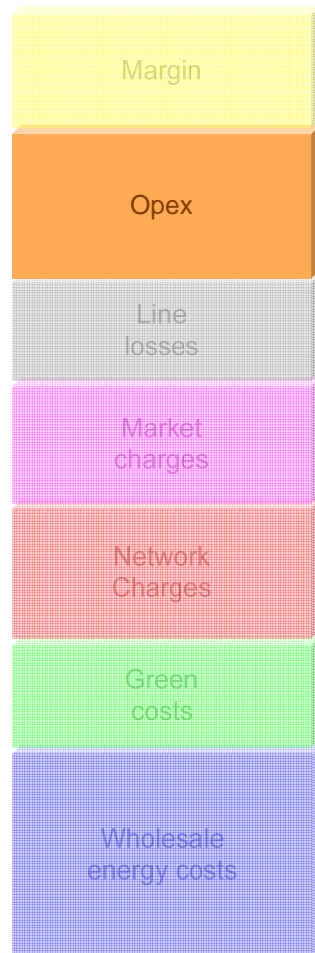
**Appropriate cost
allowances**

Form of regulation

Protecting
vulnerable
customers

Final remarks

OPERATING COSTS



- Next, perform best-practice benchmarking against key cost drivers such as:
 - Billing and collection
 - Call centre
 - Advertising and marketing
 - Legal and regulatory
- Finally, determine appropriate level of sustainable operating costs.
- Need to be mindful of standard retailer left with larger number of small-consumption customers.

Outline

Understanding
Terms of Reference

Current framework
issues

**Appropriate cost
allowances**

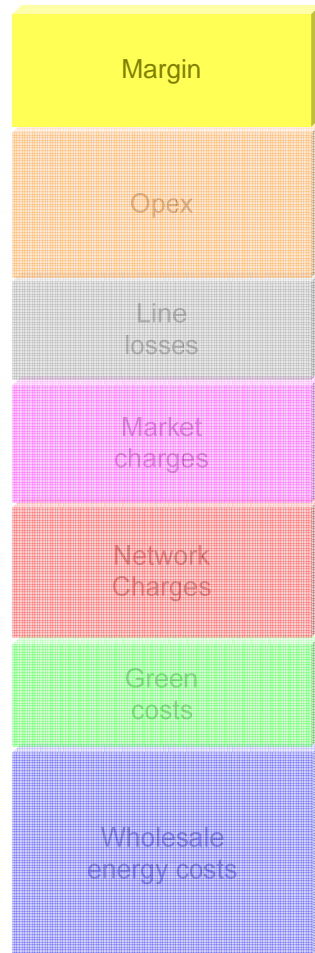
Form of regulation

Protecting
vulnerable
customers

Final remarks

NET MARGIN

A NET MARGIN allowance should be based on **market-based evidence**.



- Market evidence is likely to provide the best available indication of the sustainable margin a MMNE might reasonably expect to earn, which might justify the decision to enter a market.
- Examples include:
 - Independent expert reports
 - Broker reports
- Jurisdictional benchmarks used as a reasonableness test.

Outline

Understanding
Terms of Reference

Current framework
issues

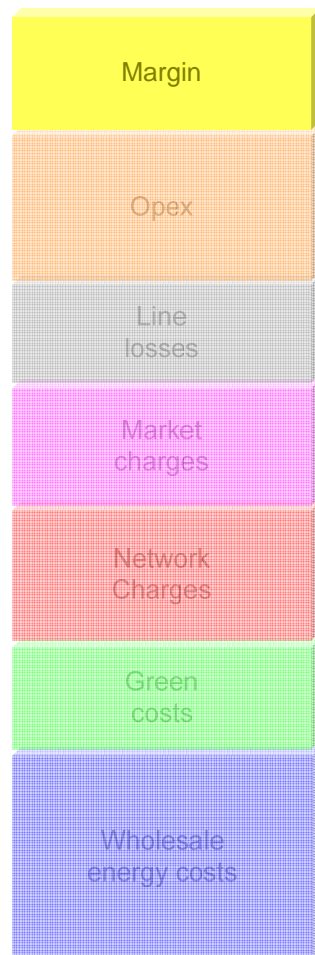
**Appropriate cost
allowances**

Form of regulation

Protecting
vulnerable
customers

Final remarks

NET MARGIN



- Regulated tariffs include additional benefits not always provided by the market:
 - Benefit of a fixed price with flexible term
 - Reversion opportunity.
- The allowance for margin should account for these additional benefits.

Outline

Understanding
Terms of Reference

Current framework
issues

**Appropriate cost
allowances**

Form of regulation

Protecting
vulnerable
customers

Final remarks

FORM OF REGULATION

- The form of regulation should be characterised by:
 - minimal constraints on individual tariff movement to achieve cost reflectivity;
 - pass through of uncontrollable and unforeseen costs; and
 - administrative simplicity.
- This is best achieved through the use of a ‘tariff-basket’ approach.

Outline

Understanding
Terms of Reference

Current framework
issues

Appropriate cost
allowances

Form of regulation

Protecting
vulnerable
customers

Final remarks

PROTECTING VULNERABLE CUSTOMERS

- EA has developed a number of programs to help customers who have difficulty managing the payment of their electricity bills:
 - EnergyAssist program
 - CentrePay
 - Energy Concessions
 - No Interest Loan Schemes.
- EA's targeted EnergyAssist scheme provides comprehensive protection to vulnerable customers without distorting price signals to the broader marketplace.

Outline

Understanding
Terms of Reference

Current framework
issues

Appropriate cost
allowances

Form of regulation

Protecting
vulnerable
customers

Final remarks

PROTECTING VULNERABLE CUSTOMERS

- EA will continue to improve and build on these programs
- To ensure the programs meet the needs of vulnerable customers, EA is keen to work closely with consumer advocate groups.

Outline

Understanding
Terms of Reference

Current framework
issues

Appropriate cost
allowances

Form of regulation

**Protecting
vulnerable
customers**

Final remarks

FINAL REMARKS

- We support a move towards retail price deregulation
 - competition needs to be effective.
 - regulated retail tariffs need to reflect true cost of supply.
- Only in this environment will competition thrive and investment in new generation occur.
- 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

Outline

Understanding
Terms of Reference

Current framework
issues

Appropriate cost
allowances

Form of regulation

Protecting
vulnerable
customers

Final remarks