Executive summary – energy costs, retail costs and retail margin

PUBLIC

INTRODUCTION

The Independent Pricing and Regulatory Tribunal of NSW (IPART) is responsible for setting the regulated electricity price to be offered by standard retailers in NSW. The existing determination on regulated prices will expire on 30 June 2007. The Minister for Energy has asked IPART to investigate and determine regulated electricity prices to apply from 1 July 2007 until 30 June 2010.

As part of its current investigation and determination, IPART has engaged Frontier Economics (Frontier) to develop cost allowances for:

- energy costs and other NEM fees; and
- retail costs and retail margin.

The recommended allowance for energy costs and other NEM fees is set out in *Energy costs*, a report by Frontier. The recommended allowance for retail costs and retail margin is set out in *Mass market new entrant retail costs and retail margin*, a report by Frontier and Strategic Finance Group:SFG Consulting.

As discussed in both of Frontier's reports, there are important relationships between the allowances for energy costs, retail costs and retail margin. In particular, some of the costs and risks that a retailer faces can reasonably be allowed for in more than one of energy costs, retail costs or retail margin. As a result, it is important that a consistent approach to developing these cost allowances is adopted. This executive summary sets out the results of both Frontier's reports.

ENERGY COSTS

With regard to energy costs, the Minster for Energy's Terms of Reference (ToR) require the cost be considered from two perspectives: the long run marginal cost (LRMC) of electricity generation and the hedging, risk management and transaction costs faced by retailers in the absence of the Electricity Tariff Equalisation Fund (ETEF). In each case, the ToR require that costs are defined for each standard retailer; that is, having regard to unique characteristics of each retailer's regulated load. This differs from the 2004-2007 determination, where the Tribunal set the long run marginal cost allowance based on regulated load across the whole of NSW.

Adopting the LRMC perspective, the energy purchase costs depend primarily on assumed plant costs and customer load shape. Using generally accepted and publicly available generation plant cost assumptions, and the retailers' reported load profiles, including updated load data provided by Integral Energy since Frontier's draft report, we estimate LRMC as set out in Table 1.

Adopting the market-price perspective, the energy purchase costs depend primarily on assumed spot and contract prices and customer load characteristics. Using a range of forecast prices, including updated price forecasts provided by the standard retailers since Frontier's draft report, and the retailers' reported load profiles, we estimate the market-price energy costs as set out in Table 1. Importantly, energy purchase costs will depend on the contracting strategy adopted by a retailer: the riskier the contracting strategy, the lower the energy purchase costs. We estimate the energy purchase costs associated with the full range of efficient contracting strategies, but report, in particular, two contracting strategies: a conservative strategy and a strategy defined as an 'elbow point', which represents a higher but prudent risk position, with lower costs than the most conservative hedging position.

		Country Energy	EnergyAustralia	Integral Energy
LRMC	2007/08	$43.0	$49.9	$52.0
	2008/09	$42.9	$50.1	$51.9
	2009/10	$43.0	$50.2	$52.0
Market price (conservative)	2007/08	$48.07 to $49.09	$55.58 to $56.62	$57.68 to $59.02
	2008/09	$45.89 to $48.75	$53.32 to $56.26	$55.49 to $58.84
	2009/10	$44.00 to $49.09	$49.80 to $56.71	$52.23 to $59.91
Market price (elbow)	2007/08	$42.48 to $46.98	$47.56 to $54.29	$48.80 to $56.11
	2008/09	$41.69 to $45.79	$47.21 to $52.23	$48.54 to $53.89
	2009/10	$41.30 to $46.43	$46.72 to $53.36	$48.24 to $55.84

Table 1: Estimated energy costs ($/MWh in 2006/07 dollars)

Note: Does not include green costs or NEM fees

The ToR also require an allowance for the costs of compliance with greenhouse gas reductions schemes. Frontier estimates the costs of complying with three green energy schemes: the Commonwealth Mandatory Renewable Energy Target

(MRET), the NSW Greenhouse Gas Abatement Scheme (GGAS) and the NSW Renewable Energy Target (NRET). The long run marginal costs (as distinct from the current market price) of meeting these various greenhouse gas schemes are as set out in Table 2.

The ToR also require an allowance for fees imposed by NEMMCO. These fees include general participant fees, FRC fees and ancillary service costs. The estimated fees for each of these are as set out in Table 3.

LRMC of greenhouse gas schemes	2007/08	2008/09	2009/10
MRET	$0.9	$1.2	$1.5
GGAS – Country Energy	$3.6	$3.5	$3.6
GGAS – EnergyAustralia	$3.2	$3.2	$3.3
GGAS – Integral Energy	$3.4	$3.4	$3.4
NRET[1]	$0.2	$0.4	$0.6

Table 2: Green energy costs based on LRMC ($/MWh in 2006/07 dollars)

NEM fees	2007/08	2008/09	2009/10
General participant fees	$0.35	$0.33	$0.32
FRC fees	$0.06	$0.06	$0.05
Ancillary service costs	$0.30	$0.29	$0.29

Table 3: NEM fees ($/MWh in 2006/07 dollars)

RETAIL COSTS

With regard to retail costs, the ToR require an allowance for retail costs based on a Mass Market New Entrant (MMNE). There are two broad categories of retail costs that are incurred by a retailer: the costs of acquiring new customers, and the operating costs of supplying these customers. Separate allowances for these two categories are estimated.

Customer acquisition costs vary between residential customers and business customers, principally because residential customers will, on average, remain with

1 These cost estimates may vary depending upon the final scheme design and how the scheme is implemented.

a retailer for longer, so that the costs of acquiring a residential customer can be amortised over a greater number of years. The estimated customer acquisition costs for a retailer, for each year of the Determination period, are as follows:

- Residential customer acquisition costs – between $25 and $45 per customer per annum.
- Business customer acquisition costs – between $40 and $80 per customer per annum.

Retail operating costs include call centre costs, customer information costs, corporate overheads costs, regulatory compliance costs, marketing costs, billing and revenue collection costs, and costs of bad debt. The estimated retail operating costs for a MMNE, for each year of the Determination period, are expected to be between $60 and $80 per customer per annum.

RETAIL MARGIN

The ToR require an allowance for retail margin. The retail margin represents the return that a MMNE requires in order to attract the capital needed to provide a retailing service. In order to estimate the appropriate retail margin, we determine the difference between the price that a retailer requires in order to earn a sufficient return and all of the costs, excluding depreciation, that a retailer incurs.

The estimation of the appropriate retail margin therefore uses Frontier's estimates of allowances for energy costs, green energy costs, NEMMCO fees, customer acquisition costs and retail operating costs as an input. The estimation also uses forecast network charges as an input, based on information provided by IPART.

In principal, the estimated allowance for energy costs is a particularly important input into the appropriate retail margin. Not only are energy costs a large proportion of retailers' total costs, but, with the phasing out of the ETEF, retailers are increasingly exposed to the risk that energy purchase costs will exceed their energy selling price. The ToR require that these risks be considered in forming a Determination. This highlights the importance of adopting a consistent approach to the estimation of energy costs and retail margin. Using the market-price perspective on energy costs, retailers face a range of efficient energy purchasing strategies, reflecting different levels of risk. The allowance for energy costs recommended by Frontier, and used as an input to the estimation of the retail margin, are energy costs associated with a significant amount of contract cover for energy purchase risk: the energy cost allowance is therefore higher than an energy cost allowance associated with a more risky contracting position. In effect, energy purchase risk is substantially captured in the allowance for energy costs.

This is not to say that retailers are not exposed to risk. In fact, the 'expected returns approach' to estimating the retail margin used in our assessment is based on the principal that businesses should be compensated for the systematic risk to which they are exposed. In the case of a retailer, this systematic risk is principally a result of volume risk. Based on the expected returns approach, and using the relevant cost inputs and an examination of market data from comparable firms, the estimated margin for each year of the Determination period is between 4.3 per cent and 6.4 per cent.

Results from two other approaches to estimating the retail margin – the bottom-up approach and benchmarking – confirm that the appropriate retail margin is in the range of 4 per cent to 6 per cent.