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20 December 2012

Ms Anna Brakey
Program Manager
Independent Pricing and Regulatory Tribunal
Level 8, 1 Market Street
Sydney NSW 2000

Dear Anna

Review of Regulated Retail Prices and Charges for Electricity 2013- 2016

Alinta Energy appreciates the opportunity to provide a submission to the Independent Pricing and Regulatory Tribunal (**the Tribunal**) in relation to the above Review.

Alinta Energy is both a generator and retailer of electricity and gas in the West Australian and Eastern States energy markets. It has over 2500MW of generation facilities and more than 700,000 retail customers. As an incumbent retailer in WA and a new entrant retailer in the National Energy Market (**NEM**) it is well placed to comment on this review.

In summary Alinta Energy makes the following comments in relation to the Review:

- Alinta Energy welcomes the AEMC's review of competition in NSW which it believes will show that NSW has strong competition and that customers are adequately protected through the competitive mechanism;
- The Tribunal should consider this next price path as providing an opportunity to transition to price deregulation which will remove the last impediment to competition developing further in NSW. In this regard Alinta Energy supports the implementation of the Relative Price Movement index methodology and the 'opt-in model';
- Alinta Energy supports the Tribunal's use of a mix of Long Run Marginal Cost (**LRMC**) of energy and market prices as appropriate proxies for the way in which retailers contract for energy for their customers;
- LRMC should be set using a stand alone approach and utilising independent, widely accepted input data;
- The Market based energy purchase cost methodology should:
    - not rely on a point in time approach given it does not reflect the way in which retailers buy energy for customers;
    - rely on published market prices where possible. Where there is no liquidity in the market, modelled prices should be used; and
    - account for the risk of an extreme event, therefore a risk allowance must be provided for.
- Operating costs should not be set on the basis of an incumbent retailer. To do so means the value applied for such critical aspects of a new entrant retailer's cost structure, like branding and marketing costs, customer acquisition and network prudential (credit support) costs are not adequately accounted for.

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- Margins should be set in a way that allows headroom for competition.
- Fees and charges should not be regulated by the Tribunal given there are sufficient regulatory protections in place to ensure these costs are reasonable.

Alinta's specific comments on these matters are provided in the attached submission. If you would like to discuss this submission, please contact me on 08 9486 3762.

Yours sincerely

M Shepherd

Michelle Shepherd
General Manager Regulatory and Government Affairs

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Alinta Energy's Submission

Review of regulated retail prices and charges for electricity 2013-2016

Introduction

Alinta Energy has over 2500MW of generation facilities in Australia (and New Zealand), with retail energy customers in Western Australia, South Australia and Victoria and a commitment to growth across the National Electricity Market and is an active participant in Australian electricity derivatives markets, trading over-the-counter and Australian Stock Exchange electricity products. Alinta Energy owns and operates the 240MW Playford B Power Station, and the 2 x 272MW Northern Power Station 1 and 2 in Port Augusta. Alinta Energy holds a retail licence in NSW for gas and electricity, however at this stage only retails to large customers.

Subject to the outcome of the price review, Alinta Energy hopes to enter the small customer market in NSW. However, at this point in time there remains insufficient headroom in regulated retail tariffs to allow for a new entrant retailer such as Alinta Energy to achieve a reasonable return on the investment and risk it faces in entering the NSW small customer market therefore making NSW market entry uneconomical.

Importance of competition and price deregulation

Alinta Energy welcomes the AEMC's review of effectiveness of competition in NSW which is an important step to indentifying, and then addressing, any impediments to the further development of competition in the NSW market. This is particularly important given the benefits that competition brings to the market, including to consumers.

As stated by the Tribunal:

> *"a well-functioning competitive market can provide more effective customer protection and better customer outcomes than price regulation"*[1].

Therefore it is paramount that the NSW market, which is already highly competitive, be allowed to develop and evolve further, unhindered by unnecessary regulatory oversight and interference.

In this regard Alinta Energy notes the main impediment to competition developing further is the continued regulation of retail tariffs which it considers are currently set at levels that do not recognise the true costs of market entry and expansion needed to encourage the further development of competition.

It is widely recognised that the impact of price regulation is asymmetric. That is, if prices are set too high this will be mitigated as competitive tension increases within the margin. However, the consequence of prices not being set at cost reflective levels which results in too little or no headroom is two fold:

- The opportunity to offer price discounts by all retailers is diminished; and
- It discourages new entrants and tier two retailers actively engaging in the market, ultimately entrenching the incumbent position in the market.

Given the impact of price regulation which risks prices not being set at cost reflective levels, Alinta Energy supports moving to price deregulation in NSW. The benefits of price deregulation is that it provides retailers with certainty that their costs can be appropriately reflected in efficient prices and

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[1] IPART "*Review of regulated retail prices and charges for electricity 2013 to 2016*", November 2012, p.23.

avoids concerns regarding the sovereign risk of unexpected regulatory or government interference in the market. In addition, price deregulation provides for the most innovative and competitive offerings being made available to customers.

The benefits to the industry and consumers of price deregulation has been recognised by the Victorian, and more recently by the South Australian governments which have both implemented price deregulation.

However, given the NSW Government's commitment to continued price regulation in the near term, Alinta Energy welcomes the Tribunal's innovative thinking regarding how to approach price setting in the next regulatory period with a view to transitioning to price deregulation in the medium term.

Transitioning to price deregulation

Alinta Energy believes the Tribunal should consider this next price path as providing an opportunity to transition to price deregulation. The two important elements to ensuring price deregulation provides efficient market outcomes is:

- Customers are engaged in the market and understand they can shop around for the best deal; and
- Prices are set at a level now which will encourage retailer entry and innovation in the market so that once price deregulation does occur customers already have significant choice of retailer and products.

To achieve the above, Alinta Energy supports the introduction of:

- the Relative Price Movement (RPM) methodology as currently adopted in the South Australian electricity market. This allows retailers to ensure prices reflect costs while providing overall regulatory protection through a price cap. This model strikes an appropriate balance between providing regulatory protection to customers while providing retailers with some certainty they can recover increases in their costs; and
- the 'opt in model' which will encourage customers to actively engage in the competitive market and seek new competitive offerings. Alinta Energy believes that customer's apathy is the single reason for a portion of incumbent customers remaining on the regulated rate. By engaging proactively with these customers, they will be able to make an informed choice as to the most suitable offer for them and provide for an orderly transition to price deregulation. The success of the opt in model is reliant on customers being informed as to their available options. This can be achieved through both a consumer education campaign and a requirement for the minimum provision of information to consumers on options available to them, similar to the current information requirements for consumers where their contract is due to expire. This will aid in consumer engagement and result in benefits for those consumers who actively participate in the market.

However, Alinta Energy notes the Tribunal is not minded at this stage to introduce the RPM. Accordingly, Alinta Energy has limited the comments in this submission to the methodology for determining the retail cost components as outlined by Frontier Economics and the Tribunal in their respective reports.

Wholesale Energy Cost allowance

<u>Background to how a retailer manages their wholesale energy cost</u>

The primary role of a retailer is to purchase wholesale energy to sell to its customers. Retailers manage their wholesale energy portfolio in a manner that limits its risk exposure and the volatility of their costs.

To do this, a retailer establishes a portfolio of contracts, both long and short term to match its load. It does this in order to manage the following risks:

- Volatile spot prices which can range up to $12,500/MWh (or the level at which the prevailing Market Price Cap (MPC) is set); and
- Volatile demand which is highly correlated with weather patterns and for an individual retailer is difficult to determine in a competitive market.

Due to the asymmetric risks in the NEM, a retailer will generally seek to hedge conservatively, usually to a 1 in 20 year event, to ensure it's covered for extreme price events. If retailers do not hedge to this level then they would be required to have liquid form capital on hand to fund any volume exposure to the MPC. For example, a 200MW exposure at $12,500/MWh for 10 hours would require access to $25m in funding. For many retailers such an exposure could put them in financial distress.

In regards to load, a retailer's demand from its mass market customers is uncertain due to weather patterns and competition. That is, its load is weather dependent given the high correlation of temperature and demand; and in a competitive market a prudent retailer can't forecast its customer numbers and therefore load with certainty well in advance of a period. This is particularly the case for a new entrant seeking to grow market share, and that of a recently established retailer seeking to both maintain and increase its market share.

Accordingly, given price and load risks, a prudent retailer will hedge its load over time using a number of different instruments. These instruments usually consist of the following:

- Long term power purchase agreements or building generation plant for ongoing load which is relatively well known;
- Layering in contract cover over time – flat swaps, peak and off-peak swaps – as load in the nearer term becomes more certain;
- Purchasing caps to manage load which varies either due to seasonal influences (ie hot or cold weather) or due to intraday influences such as the morning and evening demand spikes;
- Managing residual risk through other financial or insurance instruments, eg: weather derivatives; and
- Buying any residual energy from the spot market.

Therefore any model which seeks to represent a retailer's Wholesale Energy Costs (**WEC**) should assume that the retailer has layered in hedge cover over the short, medium and longer term through a mix of contracts and through building or underwriting generation. This assumption should include the relevant risk premiums incurred through a layered portfolio management approach.

The Tribunal's Approach to Determining the WEC

Alinta Energy supports the Tribunal's use of a mix of LRMC of energy and market prices as appropriate proxies for the above portfolio approach. That is LRMC reflects the cost of entering into long term PAAs or directly investing in generation plant; and market prices are a better reflection of the short term costs of managing load.

<u>LRMC methodology</u>

In regards to the methodology proposed to set the LRMC, Alinta Energy supports the use of a standalone approach. In addition Alinta Energy agrees with the use of independent inputs into the model and suggests Frontier Economics use published, generally accepted, market data where

possible. For example AEMO's NTNDP data used in the development of the Statement of Opportunities.

Market based energy purchase cost methodology

Alinta Energy has a number of concerns with the Tribunal's proposed approach to setting the market based energy purchase cost (**MBEPC**) methodology. In particular, its proposed use of a point in time approach to determine market prices.

The reliance on a point in time approach will import the volatility from the wholesale market into the retail market. This is because the WEC will be determined by the applicable contract price published on the day the Frontier Economics' model is run.

In addition, a point in time approach simply (and incorrectly) assumes retailers hedge their entire load at a single point in time using prevailing market prices available on that day. This is not the case for the following reasons:

- The risk management policies applied by all prudent retailers specifically excludes them from purchasing contracts in this way. The most prudent risk management strategy is to layer in contracts over a 2-3 year period;
- Retailers have either a contract with their small customers, or an obligation to supply in the case of the incumbent retailer, which means they can not trade out of their position if market prices change. Given this commitment to supply electricity it must purchase the electricity in advance and over a period of the contract; and
- While retailers do mark their wholesale book to market, this is done for accounting purposes, it is not used to price customers.

Alinta Energy for the reasons outlined above cannot support the point in time methodology and would strongly encourages the Tribunal to reconsider the point in time methodology.

In addition, Alinta Energy makes the following comments in relation to the MBEPC methodology:

- published market prices should be used where possible for each of swaps (peak and off-peak) and caps. Only where there is no liquidity in the market should modelled prices be used. However, where modelled prices are used they must be tested against published market prices prior to accepting them. Any significant variations should be clearly justified; and
- In-line with accounting for the risk of an extreme event as discussed above, a risk allowance must be allowed for in addition to the base WEC. This could be in the form of a volatility allowance as the Tribunal has applied before which reflects the liquid form capital on hand to fund any volume exposure to the market price cap.

Operating costs

Given the Government has indicated it intends to continue with a traditional price setting mechanism for the near future, the new methodology should aim to ensure that regulated prices reflect the cost of an efficient new entrant stand alone retailer, with a reasonably sized customer base. This will ensure a level playing field for all retailers and allow for a transition to price deregulation in the future.

Therefore Alinta Energy is very concerned that the draft methodology sets the operating cost in line with an incumbent retailer. This means the value applied for such critical aspects of a new entrant retailer's cost structure, like branding and marketing costs, customer acquisition are not accounted for.

Alinta Energy believes that setting the operating based on an incumbent retailer will continue to preclude new retailers entering this market.

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Margin

Alinta Energy believes it is critical the margin be set at a level that encourages new entrant retailers into NSW.

As discussed, it is widely recognised the impact of margin setting is asymmetric. That is, if margins are set too 'high' this will be mitigated as competitive tension increases within the margin. However, the consequence of a margin which is too low is two fold:

- The opportunity to offer price discounts by all retailers is diminished; and
- It discourages new entrants and tier two retailers actively engaging in the market, ultimately entrenching the incumbent position in the market.

Given the state of competition in the market, the Tribunal should feel confident that in setting cost reflective pricing including an allowance for a reasonable return / margin than provided in previous determinations, competition will be further encouraged and margins will move to economically efficient levels.

Regulation of fees and charges

In developing a new price setting methodology, the Tribunal should ensure only those prices required to be regulated should be. In regards to fees and charges, most jurisdictions rely on provisions within their regulations which require that fees and charges be set at reasonable levels; and Commonwealth legislation (the Australian Consumer Law) to ensure customers have the benefit of regulatory protection for the setting of fees and charges.

Therefore Alinta Energy does not believe it necessary for the Tribunal to continue to set fees and charges in this regulatory period.