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EnergyAustralia®

18 September 2009

Mr J Cox
Chief Executive Officer
Independent Pricing & Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

Dear Mr Cox,

EnergyAustralia's Submission on IPART's Draft Methodology Paper for the 2010 – 2013 Regulated Retail Price Determination

EnergyAustralia welcomes the opportunity to comment on IPART's Draft Methodology Paper for the Review of Regulated Tariffs and Charges for Electricity 2010 – 2013, Frontier Economics' Report for IPART on Modelling methodology and assumptions and Strategic Finance Group (SFG) Report Estimation of the regulated profit margin for electricity retailers in New South Wales – Methodology and assumptions.

EnergyAustralia is pleased to see the increased level of transparency that is being applied to the 2010 Review and commends IPART for taking such an approach. While EnergyAustralia is generally supportive of the proposed methodology we do have a number of concerns which our submission covers in more detail.

EnergyAustralia looks forward to continuing to work with IPART on this price review. If you have any queries regarding this submission please contact Catherine Marshall, Executive Manager – Energy Pricing on (02) 9269 7256.

Sincerely,

Mike Bailey
Executive General Manager Retail

EnergyAustralia

EnergyAustralia Retail

Response to IPART's Draft Methodology Paper

Review of regulated retail tariffs and charges for electricity 2010 - 2013

September 2009

Response to IPART's Draft Methodology Paper

September 2009

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1 Executive Summary

EnergyAustralia welcomes the opportunity to comment on IPART's Draft Methodology Paper for the Review of Regulated Tariffs and Charges for Electricity 2010 – 2013, Frontier Economics' Report for IPART on Modelling methodology and assumptions and Strategic Finance Group (SFG) Report Estimation of the regulated profit margin for electricity retailers in New South Wales – Methodology and assumptions.

EnergyAustralia is the largest NSW Standard Retailer, supplying electricity under its standard form customer supply contract to over one million regulated customers in the Sydney and Hunter regions. Therefore IPART's review of tariffs in the context of its impact on EnergyAustralia and our regulated customers is a key process for EnergyAustralia to engage in.

The Draft Methodology Paper and accompanying consultants' reports outline the proposed approaches to determining the energy purchase cost allowance, retailer operating costs, customer acquisition and retention costs and the retail margin. These are critical cost components in setting the regulated tariffs and it is important that the methodology is appropriate and that any assumptions are valid.

EnergyAustralia is pleased to see the increased level of transparency that is being applied to the 2010 Review. This increased transparency enables stakeholders to better understand the modelling that is being undertaken and theoretically should result in a more robust outcome.

The Terms of Reference require that the approach of the 2007 Determination is preserved. It is EnergyAustralia's view that IPART has achieved this while still making enhancements to take account of the evolving nature of the electricity retailing environment. We do, however, have a number of concerns regarding the proposed methodology and, on the whole, have focussed our comments on those areas of the methodology that in our view could be improved.

EnergyAustralia has framed its response to IPART's methodology paper using the same outline structure used by IPART. Consequently, here we focus on addressing risks and uncertainties, establishing the energy purchase cost allowance, establishing the retail cost allowance and establishing the retail margin.

Addressing risks and uncertainties

IPART needs to give full weight and consideration to those non-systematic risks not currently measured in the methodology. The assumption underlying the treatment of non-systematic risks, that is, that a Standard Retailer is able to mitigate risks through diversification potentially establishes vertical integration as the minimum requirement to enter the retail market. This outcome is in direct contrast to IPART's definition of the NSW Standard Retailer and inconsistent with the Government's Terms of Reference.

Further EnergyAustralia believes that there are a number of risks that are not compensated for under the current proposal. These risks include the asymmetric risk in supplying regulated customers and the volatility in wholesale spot and contract prices. These risks must be compensated for within the regulatory package.

Establishing the energy purchase cost allowance

As stated in our submission to IPART's Issues Paper, EnergyAustralia believes that due to the uncertainty surrounding the proposed Carbon Pollution Reduction Scheme (CPRS) the energy purchase cost allowance should be modelled on a carbon exclusive basis with carbon costs included as a result of an event based trigger mechanism.

EnergyAustralia has a number of concerns about the proposed approach to model the energy purchase cost allowance. We believe a rolling average approach should be used to determinate the cost allowance rather than the proposed point in time approach. The rolling average approach reflects the manner in which an efficient retailer operates in the market and should help ensure that the efficient costs of supplying small retail customers are recovered.

In order to model the energy purchase cost allowance Frontier Economics need to make a number of assumptions. EnergyAustralia believe that some of these assumptions are invalid. In particular we question the assumptions around the hydrology conditions, the spot price forecasts and the market based purchase costs.

EnergyAustralia also has concerns about the outcome of the Frontier Economics' modelling. Even at the conservative point the potential exists for significant changes in the theoretical hedge construction to the point that the portfolio is unachievable from a practical perspective. Additional constraints need to be added to the model to limit the changes in composition to an achievable level.

Establishing the retail cost allowance

EnergyAustralia believes that IPART risks understating the Customer Acquisition and Retention costs for existing customers. The activities required to convert a customer from a regulated tariff to a negotiated contract are not dissimilar to those required to acquire a new customer on a negotiated contract. These activities do not appear to have been reflected in IPART's preliminary thinking on costs.

Establishing the retail margin

The proposed increased use of re-openers as part of the 2010 Determination escalates the importance of recalculating the retail margin. As a consequence of the 2009-10 annual wholesale energy cost re-opener and the network tariff increase, when IPART carried forward the absolute dollar value originally determined and included in the 'R' value, the proportional return from the regulated tariff was diminished. It has been recognised by most, if not all parties, that the 2010 Determination period is a time of increased uncertainty. Given this uncertainty, the calculation of the retail margin as a dollar allowance fixed for the Determination period is more likely to result in the under (or over) recovery of margin.

The triangulation methodology proposed by SFG relies heavily on a number of assumptions in order for the resultant margin ranges to be sensible. EnergyAustralia believes the benchmarking approach proposed has a number of flaws and feels that the benchmarking groups should be limited to companies that are more reflective of the Standard Retailer and the environment in which it operates. The remaining approaches (the expected returns approach and bottom-up approach) are reliant on the use of an appropriate WACC. EnergyAustralia believes that the WACC proposed by IPART is too low and should be increased to be in the range 9 to 11% (pre-tax real) to reflect the cost of capital for a Standard Retailer.

2 Addressing risks and uncertainties

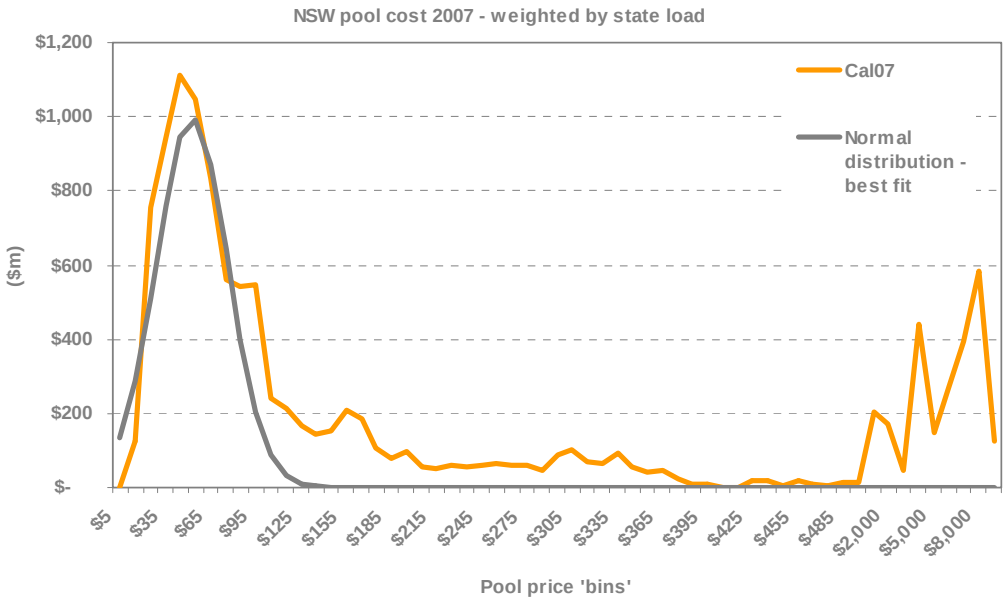
The methodology used by IPART must encompass all the risks a NSW Standard Retailer faces. If this is not the case, the regulated tariff will continue to act as an overwhelming barrier to entry and expansion in the retail energy market.

IPART needs to ensure the regulatory framework compensates Standard Retailers for the burden of carrying asymmetric risk in supplying regulated customers – if not in the retail margin allowance, then in the energy purchase cost allowance.

The volatility allowance only compensates for variation between expected (forecast) load and actual load. It does not compensate for volatility in wholesale spot and contract prices. This should be compensated for elsewhere in the regulatory package.

Asymmetric risk

Asymmetric risk is the significant mismatch between the gains and losses accruing from the movement in the value of an underlying asset. Asymmetric risk is faced by a standard retailer in the ordinary course of conducting its business. It arises as a function of managing the wholesale pool price exposure of its regulated customer base. If a retailer hedges more than its resultant regulated load, whilst not ideal, the negative consequences are linear to the extent of superfluous length. On the other hand, if a retailer hedges less than their regulated load, that retailer runs the risk of insolvency, as the negative consequences of under-hedging is exponential to the degree of being short. This is because pool prices are not normally distributed, but rather are biased towards higher prices, as shown in the following graph:



The graph above plots the NSW spot price for 2007 volume-weighted to state load. It is visually apparent that wholesale pool prices do not follow a normal 'bell-shaped' distribution curve, which is the second trace on the graph. Rather, the distribution is positively skewed, appearing as a cluster of outcomes on the right side of the graph. The skew towards higher prices creates a bias in wholesale cost outcomes. In this period, twenty six percent (26%) of total pool costs were due to the top one percent (1%) of pool prices.

Thus, a prudent retailer's approach to managing a hedge portfolio would be to err on the conservative side. For this reason, EnergyAustralia endorses the continued use of the conservative point on the efficient frontier for determining the energy cost allowance. However, we do not believe that in selecting this point, IPART is completely addressing its intent to compensate Standard Retailers for non-systematic risk associated with normal variation in regulated load. This risk commands a load volatility premium, to compensate for the exposure (or cost of additional hedging) resulting from the difference between forecast (expected) load and actual load. This risk applies at any point on Frontier Economics' efficient curve of hedging constructs.

Hedge mismatch and load volatility premium

It is clear from the 2007 Review that IPART understood and appreciated that retailers face asymmetric risk. Unfortunately, EnergyAustralia does not believe that this risk was appropriately compensated for in the 2007 Determination. A 'volatility allowance' was constructed which, in principle, does compensate for the difference between expected (forecast) load and actual load, however, EnergyAustralia believes the allowance was understated by a factor of up to eight.

With an appreciation that Standard Retailers face asymmetric risk, and IPART's Draft Methodology Paper providing some preliminary views on how to manage that risk, EnergyAustralia would like to take the opportunity of setting out a more descriptive approach to determining appropriate compensation for this risk. This approach relies on managing the resultant exposure from hedge mismatch by purchasing caps, using the cost / pay-off outcome against the product of the difference between actual and expected load and forecast pool prices to determine the load volatility premium. Cap volumes would be purchased at a fixed volume across a year, recognising the practical limitations of purchasing more granular or 'calibrated' volumes at, say, a discrete date type / month segment.

Results from EnergyAustralia's internal analysis suggest that, in NSW for a mass market portfolio, this risk commands a premium of up to 14.4% - far higher than the current allowance of $0.90/MWh (or approximately 1.8%) set in the 2007 Determination[1].

EnergyAustralia would like the opportunity to discuss this analysis with IPART and Frontier Economics, with a view to ensuring that the load volatility allowance is understood and adequately determined.

Other asymmetric risks - Reversion Optionality

In EnergyAustralia's submission to IPART's Issues Paper, we raised the issue of reversion optionality for regulated customers: customers who take up a competitive market offering but have the option of returning to a regulated tariff should they choose. Reversion policies are valuable to a customer, but also carry a cost to the Standard Retailer. That cost is in the form of open-ended validity for a regulated retail supply offer to the customer. Wholesale portfolios must be structured in such a manner as to carry sufficient hedging to allow for the potential of mass market customers reverting to the regulated tariff (which may occur when wholesale market prices are relatively high). Therefore we feel that in setting regulated tariffs at cost-reflective or competitively neutral levels, it is important that the energy purchase cost or retail margin incorporates the additional benefits regulated tariffs provide to customers and the considerable costs borne by the Standard Retailers in offering this flexibility.

EnergyAustralia believes that the wholesale cost of holding sufficient hedge cover to facilitate customer reversion can be calculated, based on swaption price modelling (as provided in EnergyAustralia's response to IPART's Information Request) at volumes which reflect

[1] IPART, *Regulated electricity retail tariffs and charges for small customers 2007 to 2010*, Final Report and Final Determination, June 2007, p 76 Table 6.2

historical changes in regulated load. The additional cost can be amortised over total regulated load and included as an additional premium in the retail margin. While ETEF historically handled this, there is no alignment between the ETEF timetable and the obligations of the Standard Retailer to supply under the 2010 Determination.

Non-Systematic Risks

A distinction has been drawn between systematic and non-systematic risks, with the systematic risks being compensated for in the retail margin. Unfortunately the risks identified as non-systematic are far greater than the systematic risks and have been specifically excluded from the margin allowance. While some of these risks are addressed through other mechanisms such as pass through provisions or cost allowances there remains a number of non-systematic risks that have not been allowed for. EnergyAustralia is of the view that in the absence of these risks being adequately compensated for through other mechanisms the retail margin should be adjusted to allow for non-systematic risks. These risks are further addressed in Section 3.

In their discussion of CAPM theory, SFG reiterate that investors can minimise their exposure to non-systematic risks by holding a diversified portfolio of assets The assumption underlying the treatment of non-systematic risks, that is, that a Standard Retailer is able to mitigate risks through diversification potentially establishes vertical integration as the minimum requirement to enter the retail market. This outcome is in direct contrast to IPART's definition of the NSW Standard Retailer and inconsistent with the Government's Terms of Reference. This would indicate that IPART must give serious consideration to these non-systematic risks, and their potential cost to the Standard Retailer supplying a regulated customer.

3 Energy Purchase Cost Allowance

3.1 IPART Draft Methodology Paper

EnergyAustralia believes that IPART should attempt to determine an energy purchase cost allowance based on a 'carbon exclusive' price, and widen the definition of the general cost pass through mechanism to capture the possible start of an emissions trading scheme or carbon tax during the 2010 Determination Period.

Selecting the conservative point of the efficient frontier will not compensate Standard Retailers for all non-systematic risks faced in relation to normal load variation. A load volatility premium can compensate for this if appropriately priced.

Carbon exclusive versus carbon inclusive

In its response to IPART's issues paper, EnergyAustralia noted that Frontier Economics could model the CPRS as it is currently drafted and determine a carbon inclusive energy purchase cost allowance. However, uncertainty surrounding the CPRS, including the deferral in its start date, fundamental changes to its structure, or a complete abandonment of the scheme altogether, would result in a mis-priced cost allowance that would ultimately fail the efficiency test imposed on IPART through the Minister's Terms of Reference. Concerns around fundamental changes to the scheme are not unfounded, as the development of an emissions trading scheme over time has a demonstrated history of significant changes and compromises.

EnergyAustralia is inclined towards the adoption of a carbon exclusive approach to modelling energy purchase costs. We believe the most fair and efficient approach would be for IPART to modify the definition of the general pass through provision to ensure that it captures any introduction of carbon price legislation, as an events based trigger, and assess the impact on Standard Retailers at that time. This mechanism best addresses the issue of uncertainty in timing. Moreover, the carbon allowance can be calculated with greater accuracy once the carbon scheme regulations are detailed.

Publicly available data versus market price model

IPART questions the reliability of publicly available price data in its Draft Methodology Paper, noting that it had originally determined that the AFMA Curve was open to manipulation. EnergyAustralia contests this assertion, as AFMA prices are the average outcome of

surveyed market participants' views of end of day electricity contracts, across different states and time periods, where participants are either naturals (generators or retailers) or financial intermediaries. Contributors generally have visibility of both the futures market and the Over The Counter (OTC) market. Mean prices quoted also exclude outliers and have minimum input quotas, helping to avoid biasing results and hence "manipulation".

Rolling average approach

The rolling average approach to assessing wholesale purchase costs is far more sensible than a point in time estimate. It is consistent with a practical, 'real life' approach to managing a wholesale portfolio; is consistent with regulatory approaches adopted in other jurisdictions such as in Queensland and the ACT; smoothes year on year profitability; and avoids concerns around selecting contract prices in a volatile market that are not representative of the actual cost of hedging.

Indeed, Frontier Economics acknowledges that a retailer will tend to purchase contracts over time[2]. It notes that forward (spot) price models only change when there is new information about fundamental characteristics of the market and so, with the exception of this new information, would be considered static. EnergyAustralia appreciates that the point in time approach to modelling is convenient for the purposes of setting an energy cost allowance but is neglectful of the practical challenges faced by a Standard Retailer in attempting to hedge its regulated load.

Concerns have been raised by Frontier Economics and IPART that the rolling average approach to assessing wholesale costs is inconsistent with the principle of marking a wholesale book to market. Presumably, if a prudent retailer carries out of the money hedge contracts in its portfolio, it cannot expect to recover these costs from the market. Yet, if it is industry practise for prudent retailers to hedge over time, hedging costs across the industry should be generally consistent and consequently passed through to consumers at the levels at which they are contracted.

Contracting premium

The contracting premium adopted by Frontier Economics should be a function of both the information provided by Standard Retailers in response to IPART's Information Request and more recent historical contract to spot market premiums. This issue is addressed in further detail in Section 3.2.3 of this response.

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[2] Frontier Economics, *Modelling methodology and assumptions*, August 2009, p. 73

Market Liquidity

Frontier Economics' modelling assumes that the contract volumes they determine as optimal are readily available at their modelled price in the quantities required for the efficient portfolios they are developing. The total NSW regulated load is circa 25-30TWh pa depending on the degree of contestable activity in any given year, thus representing 35-43% of total NSW annual energy consumption and an even greater proportion of contracted capacity given the low load factor of this customer segment. With just three main suppliers, any intransigence by one party to contract supply necessarily leaves Retailers exposed to the vagaries of the spot market.

Prudent generator hedge strategies further diminish available contract supply. To avoid exposure to the physical markets, both in times of scheduled and unscheduled maintenance, generator companies will generally only contract 75% of their nominal capacity. Hence the market is left structurally short of capacity (with regard to contracts) even prior to the often observed reluctance of generators to contract. Consequently the assumed application of efficient capital markets theory in a dual phased market (both contract and physical supply) with just three known suppliers is somewhat inappropriate. The only time liquidity is likely to be high is when the market has been mis-priced or is skewed at a level where it is economically advantageous for a generator to release increased contractual supply. Where the visibly traded market does not sufficiently reward generators to enter into contracts they will severely diminish their supply and/or offer volume "well above" the market price. Accordingly, market liquidity at any given time is seriously affected by the prevailing price level, market design and the small number of available volume contract suppliers.

Therefore, the ability to source such material volumes without moving market prices is inconceivable – consideration must be given to the impact and limitations of sourcing such volumes of hedge cover and recognised as a premium to the efficient "marginal cost" since these volumes are not "marginal".

Using NSLP

EnergyAustralia believes it is important that IPART continue to use regulated load forecasts, as submitted by all Standard Retailers, in determining an energy cost allowance. This is consistent with the Minister's Terms of Reference, which requires that "(r)egulated tariffs should reflect the efficient costs faced by a Standard Retailer Supplier meeting the forecast demand of the regulated customers they are obliged to serve".

Notwithstanding, EnergyAustralia is open to the use of the relevant NSLP for each of the Standard Retailer's distribution network areas, where the results are materially similar to using regulated load forecasts, such that this information can therefore be released to the public. Some caution needs to be exercised given that controlled load will need to be blended with the NSLP to provide a proxy for the regulated load. For EnergyAustralia, this will be an approximation only given the large number of regulated customers in EnergyAustralia's area that are now Type 5 metered.

Risk in normal variation of regulated load

EnergyAustralia will separately provide IPART with its current risk management policy to assist in the selection of an appropriate point on the efficient frontier.

3.2 Frontier Economics' Methodology Paper

EnergyAustralia is generally comfortable with the modelling approach adopted by Frontier Economics. We believe, however, that some modifications are necessary in relation to:

- Hydrology conditions;
- Assumed contracting levels; and
- Hedge portfolio construction

This will help ensure IPART delivers on its requirement to set cost allowances at the efficient level for Standard Retailers. These issues are expanded upon in further detail below.

3.2.1 Long run marginal cost

In light of a growing consensus amongst weather forecasters that the Australia is entering into an El Nino pattern, and continued low hydro storage levels, EnergyAustralia questions the low hydrology assumptions proposed by Frontier Economics.

Hydrology conditions

EnergyAustralia is concerned with Frontier Economics' hydro plant assumption. It is not clear why normal hydrology assumptions are held. Frontier Economics notes that "the response of hydro and base-load coal generators, will drive market outcomes over the period of the current determination" renders their normal hydrology assumption "obvious". It is not obvious to EnergyAustralia.

There is growing consensus among weather forecasters that Australia is entering into an El Nino pattern. The El Nino-Southern Oscillation (ENSO) describes the cycle of El Nino, neutral and La Nina patterns in the Pacific Ocean. The El Nino weather pattern often leads to drier conditions over large parts of Australia. The Weather Company, for example, notes that "almost all coupled climate models are indicating the continued development of an El Nino event."[3] This is supported by the Bureau of Meteorology which concludes that "the odds remain strongly in favour of 2009 being recognised as an El Nino year."[4]

Although it is unlikely that an El Nino event will last much longer than 12 months, the impact on hydro storage levels can be enduring. Recent Snowy Hydro reports indicate that their "water position for the year remains well below average and storages continue to be at very low levels as a result of the major drought that continues to impact the region." [5] Indeed, recent work performed by the ARC Centre for Complex Systems notes that, as a consequence of "declining inflows into their dam storage network… Snowy's future viability as a generator of clean renewable electricity for peak demand is under question"[6].

EnergyAustralia submits that Frontier Economics' assumptions regarding hydrology conditions be changed to reflect continued low dam storage levels and the enduring drought conditions that weather forecasters expect.

[3] The Weather Company, *EnergyAustrralia Climate Outlook Briefing*, August 2009, Slide 17.
[4] http://www.bom.gov.au/climate/enso/#summary (accessed on 9 September 2009)
[5] http://www.snowyhydro.com.au/levelTwo.asp?pageID=322&parentID=6 (accessed on 9 September 2009)
[6] http://www.accs.uq.edu.au/projectsNEM.html#5 (accessed on 9 September 2009)

3.2.2 Spot price forecasts

The modelling assumptions around minimum hedging levels held by generators in Frontier Economics' SPARK model need to be reasonably consistent with the assumed contracting levels held by retailers in Frontier Economics' STRIKE model.

Consistent contracting levels between models

The level of contracting in the market is an important factor in the level of spot prices. For instance, if generators are heavily contracted, this is likely to have a dampening effect on pool prices as generators bid in their sold capacity at a level that ensures they are dispatched. EnergyAustralia would like to ensure that the modelling assumptions around minimum hedging levels held by generators in the SPARK model are reasonably consistent with the assumed contracting levels held by retailers, as a natural buyer, in the STRIKE model. The importance of this consistency is evident when you consider an extension of the example above: the soft pool prices resulting from a heavily contract market modelled in SPARK, if not consistently modelled in STRIKE, may lead to an efficient inflexion point based on a relatively low level of contracting. We of course know that in this example generators are heavily contracted, so there would be incongruity between models.

EnergyAustralia has concerns associated with forecasting risks in the modelling work conducted by Frontier Economics. Historically around 20 percent of the value of spot prices comes from 0.2 percent of price bids – clearly where a majority of the risk is in ascertaining hedge coverage. By using a selection of points rather than the full 17,520 points in SPARK, Frontier Economics can potentially preclude resolution around a most volatile component of their modelling.

3.2.3 Market-based energy purchase costs

The contracting premium adopted by Frontier Economics should be a function of both responses from Standard Retailers to IPART's Information Request and more recent historical contract to spot market ratios.

STRIKE'S efficient frontier should include parameters that constrain substantial changes in portfolio construction from quarter to quarter, to better reflect practical hedging arrangements.

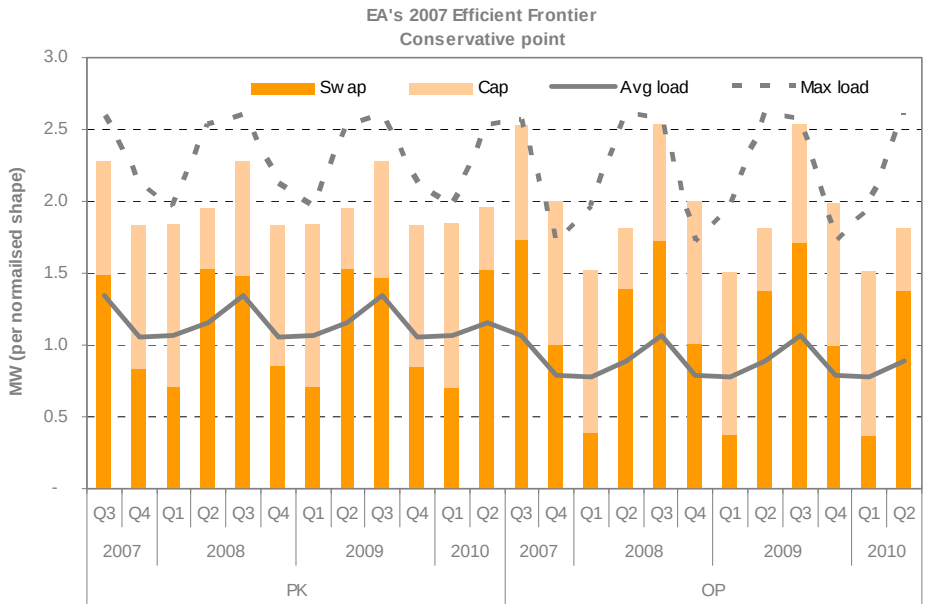
Assumed contracting premium

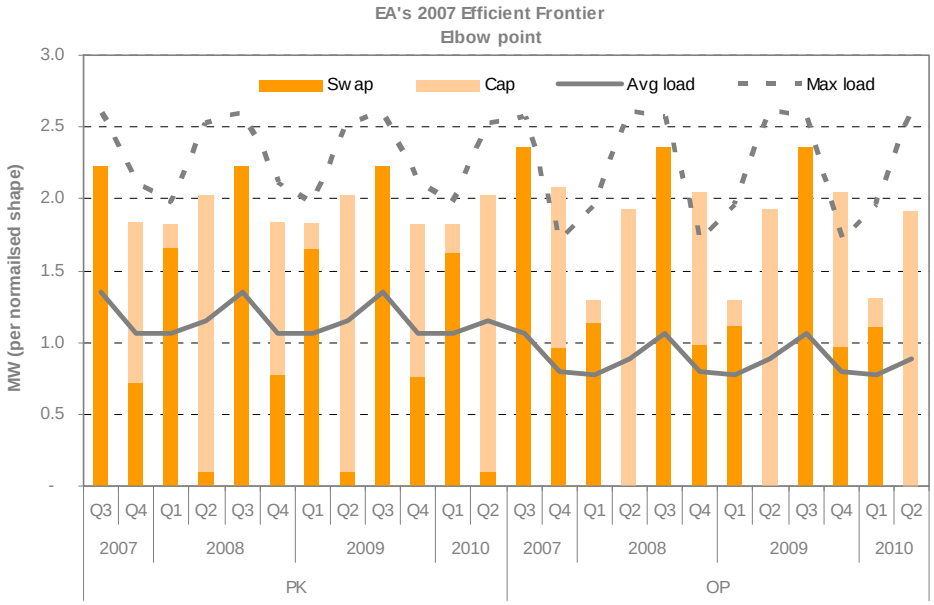
Frontier Economics employs a spot price model, SPARK, to determine forward prices that are used as inputs into their contract optimisation model, STRIKE. Importantly, the market prices for contracts were uplifted by a certain fixed percentage as part of the 2007 Review and it is this percentage that matters, as the bulk of a Standard Retailer's load is hedged at the conservative point. EnergyAustralia believes this element of Frontier Economics' analysis has not been subject to an appropriate level of scrutiny. EnergyAustralia have previously provided both spot and forward contract price forecasts in response to IPART's Information Request and suggest that the differential between the two traces be employed as the appropriate uplift for a contract premium to Frontier Economics' modelled spot outcomes. Frontier Economics may also consider examining recent historical contract prices to pool, over reasonable time horizons, as an alternative determinant of the market contract premium.

Portfolio construction

Frontier Economics' STRIKE model will develop an efficient frontier of hedge contracts for a Standard Retailer's regulated load for a given level of risk. EnergyAustralia wants to ensure that IPART adopts an efficient point on the frontier, reflecting a portfolio construction that is practically achievable by Standard Retailers in managing the wholesale price risk of their regulated customer base.

Presented below is the theoretical hedge construct determined by Frontier Economics for EnergyAustralia at the 'conservative' and 'elbow' points of its efficient frontier.





The graphs above reveal that, even at the conservative inflexion point ultimately adopted by IPART in the 2007 Determination, there is a marked change in the proportion of swaps and caps held from quarter to quarter. For example, when we compare peak hedging levels in Q1 2008 and Q2 2008 we note that the swap hedge cover increases 215%. Across the same period, the cap hedge cover falls by 63%.

EnergyAustralia believes that marked changes in hedging levels from quarter to quarter, in the volumes sought to cover regulated load, are practically unachievable. We believe that to maintain such an approach to what is labelled 'conservative' hedging compromises IPART's efforts to enable "Standard Retailer Supplier(s) to recover efficient costs", as NSW Standard Retailers are unable to achieve these hedging structures.

EnergyAustralia therefore submits that Frontier Economics should either include some constraints or additional assumptions in the operation of the STRIKE model to prevent substantial changes in the composition of the hedge portfolio from quarter to quarter.

3.2.4 CPRS

Carbon exclusive energy purchase costs should be supplemented with a pass through mechanism that references an agreed carbon market price and average carbon intensity.

Maintaining annual re-opener

As EnergyAustralia noted in Section 3.1, we believe that the energy purchase cost should be carbon-exclusive, and this cost to be passed through when it is known. Frontier Economics suggests that "stakeholders were not clear on how such a mechanism would account for the need to determine the appropriate carbon cost pass through".

EnergyAustralia believes the mechanism would function in a manner similar to that agreed by AFMA members in their development of a carbon pass through addendum for commodity transactions. The "AFMA carbon benchmark addendum" enables the passing through of carbon costs, as a function of a carbon reference price and average carbon intensity of the NEM. Further details of the addendum can be found in Section 3.8.20 of the AFMA Guide to Australian OTC transactions.

4 Retail Cost Allowance

EnergyAustralia supports the categorisation of retail costs into Retail Operating Costs (ROC) and Customer Acquisition and Retention Costs (CARC), however, some minor modifications are required.

4.1 Retail Operating Costs

EnergyAustralia notes that IPART intends to move marketing costs from ROC and to include this as part of the customer acquisition and retention costs. The marketing cost information EnergyAustralia has provided to IPART includes general activities which are not directly related to customer acquisition such as market research and we believe these costs should form part of the ROC. EnergyAustralia is happy to supply further information to IPART on a confidential basis.

Bad Debt

EnergyAustralia does not adhere to IPART's assertion that the risks associated with bad debt are not particularly significant ones. In managing bad debt EnergyAustralia believes that the ROC should allow for the recovery of debt from standard customers. The retailer should be allowed to recover costs associated with late payment separately through the late payment fee. With higher prices the cost of debt recovery increases for the Standard Retailer as most payment channel costs are incurred as a percentage of payment received.

Additionally IPART should allow sufficient cost recovery in the ROC to cover costs associated with the management of customer hardship programs. Market regulations require that retailers establish and maintain a program to assist customers in financial hardship. Historically this has seen a continuing balance of 3000 - 4000 customers provided assistance. With increasing prices EnergyAustralia expects that this service may need to increase.

EnergyAustralia expects that IPART will consider the impact of price increases from the network and environmental costs when setting the retail operating cost level and ensure it is adequate to recover the increasing collection costs.

EnergyAustralia has addressed the issue of non recovery (write-off) of bad debt in Section 5. In both cases EnergyAustralia expects that costs associated with managing and collecting debt will increase with increasing prices and that IPART will need to consider this when setting the appropriate ROC and retail margin.

4.2 Customer Acquisition and Rentention Costs

While EnergyAustralia agrees with IPART's view that the new customer being signed to a negotiated contract scenario forms the cap on the Customer Acquisition and Retention costs (CARC), we believe the scenarios for existing customers have been understated.

In EnergyAustralia's experience the CARC for an efficient standard retailer would be:

Scenario	DARC	TPC
New customers switching from another retailers to a negotiated contract	Prominent	Prominent
New customers reverting from another retailers to a standard contract	Limited	Prominent
Existing customers switching from regulated tariff to a negotiated contract	Prominent	Limited
Existing customers reverting to or remaining on a standard contract	Limited	Limited

Table 2.1 Costs involved in a Standard Retailer acquiring and retaining existing customers

Existing Customers Switching From Regulated Tariff to a Negotiated Contract

The methods used to convert existing customers to negotiated contracts are very similar to those used to sign new customers to negotiated contracts. These are generally proactive campaigns primarily using telesales channels and have similar costs to a campaign seeking to sign new customers to negotiated contracts. Using the categories of customer acquisition costs that IPART has previously requested information on, the activities that are common for

both converting existing customers onto negotiated contracts as well as signing new customers onto negotiated contracts are:

- Sales overheads
- Communication
- Stationery
- Terms and Conditions booklets
- Confirmation packs
- Commission/agent costs
- Data and mailhouse processing
- Postage
- Telco cost per sales (for telesales)

When the activities of switching a customer from a regulated tariff to a negotiated contract are examined in detail it is clear that the DARC for an existing customer is similar to that of a new customer as the sales activities are primarily the same. In addition, there is no difference in the retention cost of a new customer versus an existing customer. Similar processes are followed regardless of the original source of the customer.

The only area experiencing savings when comparing customers switching from the regulated tariff to a negotiated contract with new customers signing a negotiated contract is in the TPC as a credit check is not required for existing customers nor are MSATS customer transfer procedures required. There are, however, still costs in processing the customer's authority to switch from a regulated contract to a negotiated contract hence the setting of these costs at a limited level rather than a negligible level.

Existing Customers reverting to or remaining on a Standard Contract

EnergyAustralia agrees with the view that the CARC for existing customers reverting to or remaining on a standard contract are the lowest of the four options. However, we do not agree with the view that either the DARC or the TPC are negligible. In reverting customers to a standard contract there will be costs associated with contacting the customers and costs attached to any loyalty reward. While these costs are obviously not as high as they are for new customers it would be incorrect to say these costs are negligible.

5 Retail Margin

EnergyAustralia would like to see a recalculation of the retail margin during the Determination period to reflect updates in costs. Additionally, greater consideration of potential increase in the risks of bad debts is required.

Recalculation of the retail margin

EnergyAustralia notes that IPART is still considering whether the dollar allowance for the retail margin should be fixed for the determination period or recalculated during the Determination period to reflect updates to the energy purchase cost allowance or the forecast network costs. We are firmly of the view that the margin allowance should be recalculated during the Determination period when the energy purchase allowance is varied or when the network costs are significantly different from those forecast. In the absence of the margin allowance being recalculated the potential exists for the allowed margin to be eroded (or alternatively over recovered). The increased use of re-openers (with a broader scope of review) proposed for the 2010 Determination makes this a very real possibility.

Bad Debt

Bad debts reflect a significant impact on a standard retailer's margin. Historically the write off of bad debt can impact a retailer's margin by up to 1% of revenue per annum. EnergyAustralia believes that as the prices increase as a result of network price changes, emissions trading impacts and other increases to the retail tariff this percentage may also increase. EnergyAustralia would like to ensure that IPART considers this increasing risk to the business when it sets an appropriate margin level for the retail business going forward.

5.1 SFG's Methodology Paper

SFG's Methodology Paper outlines the three approaches they will use to triangulate the retail margin range. EnergyAustralia has a number of concerns regarding the benchmarking approach and believes the approach as proposed will not result in a retail margin that gives consideration to the risks not compensated for elsewhere as required by the Terms of Reference.

The appropriateness of the remaining approaches is dependent on the assumptions used. The rate of return currently proposed by IPART is not reflective of the cost of capital for a Standard Retailer.

Benchmarking

The benchmarking approach proposed by SFG is similar to that used for the 2007 Determination with the addition of energy retailers in the United States and the United Kingdom as well as a third benchmarking group, namely, listed retailers from Australia, the United States and the United Kingdom. The addition of these groups is based on an underlying assumption that margins for an electricity retail business should be broadly consistent with margins for other comparable retail businesses[7]. EnergyAustralia does not accept the assumption that non-energy retailers or overseas energy retailers are necessarily comparable businesses as the obligations and risks faced by a Standard Retailer are significantly different. For example a non-energy retailer does not have an obligation to supply and there can be enormous differences in operating environments between local and overseas energy retailers (e.g. regulatory and legislative obligations, average wages, license conditions, accounting standards etc).

Further issues exist with the use of listed utilities for benchmarking. SFG recognise that the set of listed utilities are "almost always vertically-integrated businesses"[8] which by definition the Standard Retailer is not. While SFG will attempt to remove the network and/or generation components, the "remains" attributable to the retailing arms will only be estimations based on a number of assumptions and averages. There then remains a further question as to whether the remaining segment will be representative of the Standard Retailer or whether it will still contain inappropriate customers (e.g. large customers and/or non-electricity customers). EnergyAustralia questions the value of this exercise as we believe that there is significant scope for error in reducing the information to be equivalent to that of a Standard Retailer - especially where the original data is not transparent.

From the report it is unclear as to how many sets of companies and exactly what these sets comprise of. The report proposes to use three sets of comparable firms – listed energy utilities from Australia, the United States and the United Kingdom; listed retailers from these three markets and listed and non-listed Australian energy retailers[9]. Later on reference is made to the benchmarking analysis relying on two sets of listed companies – 81 energy utilities and 335 retailers listed in Australia, the United States or the United Kingdom[10].

[7] SFG, *Estimation of the regulated profit margin for electricity retailers in NSW – Methodology and Assumptions*, August 2009, p 14
[8] ibid p 21
[9] ibid p14
[10] ibid p 20

EnergyAustralia notes that SFG only intends to have "regard" to other regulatory decisions. This is consistent with EnergyAustralia's previously expressed view that the role of benchmarking regulatory decisions should be limited to ensuring a "sensible" outcome[11]. We do, however, believe that these decisions (with some correction to allow for the different assumptions and increased uncertainty) are more relevant for any benchmarking exercise than data sets based on overseas energy retailers or non-energy retailers.

It is essential that the benchmarking process carried out by SFG provide for transparency of the subjectivity exercised in terms of weighting the relevant subsets. Moreover, as a result of the described complications associated with the benchmarking procedure, EnergyAustralia believes that benchmarking should be used only as prudence check. Additionally, EnergyAustralia requests that the extent to which benchmarking is used as a check be limited to:

- Electricity retailers of known scale and scope operating in the domestic market.
- Most recent Regulatory decisions (corrected to account for different assumptions and the increased uncertainty).

Expected returns approach

EnergyAustralia agrees with the use of the expected returns approach to the calculation of an appropriate retail margin provided the correct assumptions are applied. Similarly we concur that this method must be supported by reference to other approaches to ensure sensibility.

EnergyAustralia is pleased that IPART has acknowledged high levels of risk associated with an electricity retail business. However, we believe that the assumptions used to calculate the discount rate and final WACC do not reflect this. IPART have issued a preliminary retail WACC (pre tax Real) of between 7.5% and 10.2%. EnergyAustralia has concerns that as a result of using the proposed assumptions the WACC range understates the cost of capital for a Standard Retailer. While we have looked at the individual building blocks below, we recognise that it is how these are combined in the WACC calculation that is important. EnergyAustralia believes that the WACC (pre tax Real) should be between 9% and 11%.

Risk Free Rate

EnergyAustralia acknowledges that the risk free rate is appropriate today, however, as the determination is spanning a 3 year period it is appropriate that this be reviewed closer to the final decision.

[11] EnergyAustralia Submission, February 2007, p 40

Inflation Adjustment

EnergyAustralia believes that the inflation rate assumed in the WACC calculation is overstated as it does not reflect the current inflation projections for the 2010 Determination period. Current market projections for the period are between 2.0% and 2.5%. The reduction in the inflation adjustment to align with the forecast inflation rates for the Determination period would increase the WACC rate.

Market Risk Premium

Recently the AER determined that Market risk premium for NSW distributors was 6.5% and with this as a starting position EnergyAustralia believes that the range provided by IPART of 5.5% to 6.5% understates the market risk premium likely to be applied to a retailer.

Debt Margin

EnergyAustralia believes that the proposed debt margin may not adequately reflect the margin that commercial lenders would apply to a standard retailer. Additionally IPART have provided no evidence as to underlying assumptions on credit ratings for a standard retail business. EnergyAustralia notes that it is not clear how a 40% geared retail business could receive an investment grade credit rating.

Debt Funding

EnergyAustralia feels that the debt funding rate percentage proposed is set at a level that does not reflect the actual gearing ratio of a standard retailer. A high level review of retailing businesses across in Australia and Internationally indicates an average debt funding percentage of approximately 20% based on 2008 results as well as the 5 year average.

Equity Beta

EnergyAustralia has concerns that the equity Beta range proposed by IPART does not adequately reflect the inherent risk associated with being a standard retailer and should be increased to reflect the risks associated with being an electricity retailer.

We note that IPART intends to update these parameters closer to the date of its decision. However, we believe that IPART also needs to reconsider and seek independent advice on the proposed components to the WACC calculation so that it better reflect the risks inherent to a Standard Retailer. EnergyAustralia believes that where common values apply across both generation and retail that the inputs are updated in both calculations.

Bottom-up approach

The appropriateness of this methodology hinges on use of the correct WACC. Our comments in the previous section regarding WACC also apply here.

6 Conclusions

EnergyAustralia appreciates the opportunity to examine and comment on IPART's Draft Methodology Paper, Frontier Economics' Report for IPART and SFG's report.

EnergyAustralia has confidence that IPART will consider and give full weight to our concerns surrounding the addressing of risks and uncertainties particularly the treatment of non-systematic risk; the asymmetric risk in supplying the regulated customer; and the volatility in wholesale sport and contract prices.

EnergyAustralia would like IPART to further consider their approach to modelling the energy purchase cost allowance. We firmly believe a rolling average approach is more reflective of the reality of electricity portfolio management as opposed to a point in time approach. Furthermore, we would hope that Frontier Economics reflect on and revise some of the assumptions underlying the modelling, particularly those surrounding hydrology conditions, spot price forecasts and market based purchase costs. It is also essential that constraints be added to the model to limit the changes in composition so that the outcome is one that could be practically achievable in the wholesale marketplace.

In establishing the retail cost allowance, EnergyAustralia would like to see the activities required to convert customers from regulated tariffs to negotiated contracts reflected in IPART's calculation of retail cost allowances. Additionally, further consideration of the management of bad debts would be beneficial.

Finally, when calculating the retail margin, EnergyAustralia believes the role of benchmarking should be limited and that WACC components require updating in the remaining approaches.