AGL Response

to

Independent Pricing and Regulatory Tribunal Draft Decision

on

Market-based electricity purchase cost allowance – 2008 review

April 2008

PREAMBLE

In June 2006 the NSW Minister for Energy (***Minister***) issued a Terms of Reference (***TOR***) to the Independent Pricing and Regulatory Tribunal of NSW (***IPART, Tribunal***) requiring the Tribunal to investigate and report on the regulated electricity retail tariffs and charges that will apply from 1 July 2007 until 30 June 2010.

Following consultation with stakeholders, IPART released its 2007 final determination (***2007 determination***) on regulated electricity retail tariffs and charges for small customers 2007 to 2010. Incorporated within the final determination was the decision by IPART to include an annual price review[1] of the market-based electricity purchase cost allowances ***(the review)***, to factor into the determination any material step-changes in this allowance, if required.

The extent of these reviews is limited to the following:

- The review will only examine the market based electricity purchase cost allowance only – it will not consider Long Run Marginal Cost, the volatility allowance, green energy costs, NEM fees, retail operating costs, customer acquisition costs or the retail margin;
- IPART will engage an expert to advise it on the appropriate future market-based electricity cost allowance;
- IPART will adopt a conservative approach and focus on changes to the spot and contract prices for electricity;
- IPART will use the same load profiles as it used in the 2007 determination ;

If in any year, the market based electricity purchase cost allowance is at least 10 per cent higher or lower than IPART's determined market-based electricity purchase cost allowance, then IPART will reconsider the transition path to 2010 prices and recalculate the R[2] values.

The TOR for the 2007 determination, to which this review is a part of, require the Tribunal's determination to ensure that:

- Regulated retail tariffs and charges for all small retail customers are at cost reflective levels by 30 June 2010; and
- Any 'price constraints' allow for further rationalisation of regulated retail tariffs and movement to full cost recovery over the determination period.

AGL Energy Ltd (***AGL***) is pleased to be able to provide comment on the Tribunal's Draft Report and the recommendations provided to the Tribunal by Frontier Economics.

[1] To commence in March 2008 and March 2009

[2] As set out in section 7.3 and 7.4 of the 2007 determination

EXECUTIVE SUMMARY

AGL is a new entrant retailer in the NSW electricity market committed to providing its customers with electricity at reasonable prices and has always endeavoured to ensure prices that reflect the costs and risks incurred in supplying electricity. AGL welcomes the opportunity to comment on the draft decision. Specifically that:

- The current characteristics and market arrangements of the NSW electricity market result in new entrant and incumbent retailers not competing on the same terms. While in its 2007 determination, the Tribunal aimed towards costs that are reflective of those incurred by a mass market new entrant, the costs and risk profiles of the new entrants and incumbents remain significantly different;
- The Wholesale Electricity costs (***WEC***) as recommended by Frontier Economics (***Frontier***) are not, in AGL's view reflective of the actual costs for a retailer to purchase electricity for supply to the NSW market.
- AGL believes there are a number of factors that have contributed to, and will continue to contribute to the higher WEC. These being:
  - An increase in new generation requirement and increased new generation costs;
  - Hydrology limitations;
  - Changes in the underlying trends affecting contract prices; and
  - General uncertainty in the market (eg. Uncertainty surrounding the introduction of a carbon tax and Emissions Trading Scheme)
- AGL is concerned that should the WEC remain at the same level as was allowed in the final determination, without any adjustment to allow for the increased wholesale electricity cost component, new entrant retailer participation in the NSW electricity market may diminish;
- Competition in the NSW electricity sector has yet to reach current levels in other states such as Victoria and South Australia. In AGL's view a primary contributor to the lower level of competition in NSW is the existence of the Electricity Tariff Equalisation Fund (***ETEF***). While AGL acknowledges that the ETEF is being phased out progressively during the determination period, AGL would support the immediate removal of this market distortion between standard retailers and new entrant retailers. As outlined in our submission to the Tribunal's *Issues Paper on Regulated Electricity Tariffs 2007 to 2010* AGL considers that one way to remove the distortion arising from the ETEF during the phase out period is to develop a view of an appropriate benchmark for WEC without regards to the ETEF arrangement. This would require the Tribunal (and its consultants) forming a view on the WEC on the basis that the standard retailers were required to hedge their load using instruments such as over the counter or futures contracts;
- Determining future WEC is a complex, dynamic task and the views of experienced market participants and actual market data (such as d-cypha) should be given adequate consideration. In particular, where such actual data leads to different conclusions to theoretical desktop models, the actual data should take precedence in the Tribunal's deliberations. This is particularly so for

the 09/10 forecasts where the actual forward prices are considerable higher than recommended by Frontier.;

- In order to reduce customers' reliance on regulated prices, it is essential that the Tribunal look to set wholesale electricity costs at a level that reflects the costs of a mass-market new entrant. AGL estimates the wholesale electricity costs to be up to 30% greater in some instances than that proposed in the 2007 determination.

AGL has engaged ACIL Tasman to assist in preparation of our submission to the Queensland Competition Authority regarding the determination of the energy component of the cost of supply of the Queensland load for 2007/08 and 2008/09. ACIL Tasman have provided AGL with a report that contains data and findings that are very relevant to the NSW energy market, such as the increase in coal costs. AGL will provide the Tribunal with a copy of this report to assist in its review of NSW energy costs.

In addition, AGL are considering a further study of the cost to supply energy, with NSW as the primary market in the early part of next year.

With regards to this annual review, AGL is prepared to meet with members of IPART to provide further assistance and industry insight into the actual and expected future changes to wholesale energy costs.

SPECIFIC COMMENTS ON DRAFT REPORT

Competition in NSW

In the 2007 determination, a key aim of the Tribunal was to consider prices that not only reduce a customer's reliance on regulated prices but also facilitate retail competition. The driving factor for this is the Council of Australian Governments (***COAG***) Australian Energy Market Agreement (***AEMA***), which sets out all parties' agreement on the phase out of retail price regulation for electricity and gas where effective competition can be demonstrated.

AGL strongly supports the removal of retail price regulation where a market is deemed to be operating effectively. AGL supports market based retail energy pricing and believes that competition is the best mechanism for producing efficient prices, providing the price signals for new investment and providing incentives for the most efficient use of energy.

AGL is however, particularly concerned that as a result of any component of regulated retail tariffs being set at below cost reflective levels for all retailers, competition will be stifled therefore directly impacting customer churn, retailer rivalry and product innovation.

To effectively manage the growth of competition in the NSW energy market, it is important that both governments and regulators pro-actively encourage retailers to enter and compete in a market by ensuring a level playing field for all retailers to operate. In this regard, AGL strongly encourages the Tribunal to give consideration to ensuring that regulated electricity tariffs are set at cost reflective levels that do not take into consideration the protection afforded by the ETEF. There is further discussion of the ETEF and its effects on wholesale electricity prices later in this document.

In addition, Frontier notes that retailers will be hedged and that standard retailers have the ETEF. However, unless regulated tariffs are set 'in advance' at cost reflective levels, Mass Market New Entrant (***MMNE***) retailers are unlikely to extend hedging arrangements out a couple of years while it is uncertain of the ability to on-sell that load. Ie, customers will go where the electricity is cheapest, and if the regulated tariffs are at below cost reflective levels (due to wholesale costs not reflecting actual market costs and available hedging cover), then that is where the customer may switch to, leaving MMNE retailers with too much cover.

Allowance for energy costs

In it's draft decision the Tribunal has determined, following recommendation from Frontier that the 10 percent threshold has not been met and there is therefore no change to the electricity cost purchase allowance from tat set out in the 2007 determination. In fact, Frontier has revised their estimate of the 2008/09 WEC downward by around 2 – 3 per cent.

AGL does not support this conclusion and believes that there has been a significant increase in the WEC during the previous year and that these increases will continue.

AGL estimates the cost to hedge a new customer for a mass-market new entrant retailer to be, in some instances, greater than that allowed for in the 2007 determination by 30%. As wholesale energy costs constitute around half of the total cost of providing electricity, competing retailers stand to face a significant reduction in margin and may fail to recover their costs.

As outlined earlier, it is important to the continuation and growth of competition in NSW to ensure all retailers are competing on equal terms and that customers are subject to energy prices that reflect the true cost of supplying energy to their homes. The Tribunal has the unique opportunity to adjust the WEC through the annual adjustment mechanism to ensure that by 2009/10 regulated tariffs are at cost reflective levels. AGL looks forward to competing in NSW where the tariffs to deliver energy to NSW customers can achieve sufficient recovery of costs incurred.

Modelling the Electricity Cost of Energy

Methodology and Approach

IPART has utilised the expertise of Frontier to provide recommendations on the appropriate allowance for the cost of wholesale electricity. In undertaking its analysis, Frontier has used their 3 stage modelling approach being:

- Long-term NEM investment model – Whirlygig
- Market model – Spark
- Optimisation model - Strike

While AGL approves of the Tribunal's overall approach to calculating energy cost allowances, particularly its decision to accept market-based electricity purchase costs over long run marginal costs, we do believe that relevant, credible data, industry knowledge and expertise are essential to ensure the inclusion of costs that are pertinent to a given market structure and that allow competition to thrive. AGL recommends that the Tribunal take into consideration the views of experienced industry participants and actual market data and not rely solely on the results of a model alone. In particular, where actual market data and industry experience leads to different conclusions to theoretical desktop models, actual data should take precedence in the Tribunal's deliberations. Desktop models are, at best, only ever simplified representations of the reality of a complex market.

Notwithstanding the above, where possible our comments on the modelling and assumptions undertaken by Frontier and the resulting wholesale electricity costs are presented in a similar manner to the 3 stage separate modelling approach.

Electricity Tariff Equalisation Fund

AGL continues to support the adoption of market based approaches for estimating electricity costs; for example, such approaches lead to more appropriate wholesale costs than, say, the use of the Long Run Margin Cost methodology. However, in supporting the market based electricity cost, AGL is of the view that adjusting the results of the modelling to allow for continued protection afforded by the ETEF is not appropriate. Such adjustments do not result in realistic wholesale costs and do not reflect existing market conditions for MMNE retailers. The resulting 'skewed' costs do not promote competition in the retail sector.

As outlined in our submissions to the 2007 determination, AGL is a strong advocate for the expeditious removal of the ETEF. For standard retailers, the ETEF arrangements mitigate their risk expose to wholesale energy prices, a safety net that is not available to mass market new entrant retailers.

In order to effectively promote competition in the NSW energy market, consistency in determining regulated retail tariffs through the 'cost build up' exercise is essential. The terms of reference for the 2007 determination required IPART to determine the costs for a MMNE retailer. However, it appears that this may not have been applied to the wholesale cost component, which is being adjusted to take into effect the artificial 'protection' that standard retailers are provided with as a result of the ETEF.

IPART recognised in its 2007 determination that the roll-off of the ETEF would impose additional risks to standard retailers supplying regulated customers[3]. Non-standard retailers who choose to participate in the NSW market currently face these risks. In order for non-standard retailers to compete effectively, a discount of anywhere up to 10 percent on the regulated retail tariffs is usually the preferred competitive product. However, it is not feasible for discounts to be allocated on already below cost regulated tariffs. The wholesale cost component must be adjusted to reflect the true costs, which is based on a portfolio containing a range of contracts.

AGL would also welcome a greater understanding and explanation as to how Frontier has modelled the expected effects of the ETEF roll off. With the increased wholesale energy load purchases being subjected to contract prices, it is AGL's view that there is likely to be a substantial effect on electricity wholesale pricing arrangements. The likely outcome being upward pressure on electricity contract prices.

[3] IPART, *"Promoting retail competition and investment in the NSW electricity industry, Regulated electricity retail tariffs and charges for small customers 2007 to 2010, electricity – Final report and Final Determination"*, June 2007

Long-term Investment - Plant Build

Frontier have suggested in their report to IPART that there were two main factors that have been adjusted for since the original modelling was undertaken in November 2006. These being:

- Update of demand and supply forecasts from the latest information in NEMMCO's 2007 Statement of Opportunities; and
- New plant specification update – Delta's Colongra 660MW gas turbine.

In addition to the changes outlined above by Frontier, AGL is of the view that there will continue to be an increase in new generation requirements due to the ongoing drought and the general increase in market load. The actual costs of building new generation have also increased during the last year, and are expected to continue to increase which has a flow on effect to the wholesale electricity costs. The increase in new generation costs can be attributed to:

- cost of capital (debt, equity)
- materials (for example, steel)
- O&M (for example, labour)

It is AGL's experience that these costs will continue to rise as the underlying demand for energy changes and environmental targets, such as carbon tax impacts on primary products.

Pool Prices and Plant Output

There has been extreme price volatility during the last year in both the spot and forward electricity markets, which highlights the reality that determining the cost of future wholesale electricity is a very complex and dynamic task. In attempting to estimate plant output, spot and forward contract prices, a prudent expert would take into consideration changes in such aspects as the following:

- Hydrology;
- Change in underlying trends affecting contract prices; and
- General uncertainty in the market.

These are discussed below.

Hydrology

Frontier has suggested that while the review is being undertaken in the context of the long-term drought that has gripped Australia for a number of years, until the Queensland Government decided to restrict the water available for electricity generation to its generators in the South-East of Queensland the drought had not materially affected energy purchase costs for retailers[4].

AGL strongly objects to this statement. While the impact of the Queensland water restrictions did have a sharp impact on forward prices, the long-term drought

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[4] Frontier Economics, *Annual energy cost review*, March 2008, pg. 4

throughout Australia has also had and will continue to have an impact on the forward prices.

NSW witnessed a very mild summer in 2007/08, which has spared the region periods of very substantial volatility that occurred in other states. Because the most recent summer was exceptionally mild, it would therefore, be incorrect to assume that the demand (and hence price) patterns of recent months will continue into the future. Underlying load increases (due to economic and population growth) will have continued in NSW, despite the absence of specific extreme weather events over the summer, and it is highly likely that this growth will manifest itself in the coming winter and next summer.

On the supply side, despite recent rain, the Snowy Hydro Scheme storages remain seriously depleted, thereby constraining its available supply. The reservoirs will need several years greater than average rainfall to return to normal operating levels. On 1 February 2008, Snowy Hydro Limited stated that "Snowy Scheme storages are still around their lowest levels since construction as a result of the major drought that continues to impact the region" and that "it is expected that water levels in Snowy scheme storages...will gradually decline over summer and into autumn"[5]

Change in underlying trend in contract prices

Irrespective of unique incidents, such as the restriction of water to generators in Queensland, there has been a marked change in the underlying trend in both pool prices and the forward curve in the market. AGL attributes this change to a number of factors including:

- General increase in the underlying load profile of the market - With the underlying load increasing (due to economic and population growth), the uncertainty surrounding available energy to meet the market needs and uncertainty with regards to hedging requirements is adding to the need for tailored contracts;
- Increased water and transportation costs as a result of the shortage due to drought; and
- Ongoing increases in generation fuel costs
  - The cost of coal has increased and may increase further in the event that a carbon tax is imposed. The introduction of coal futures contracts on the intercontinentalExchange by mid-2008 will have a further impact on coal prices. In Newcastle the surge in coal prices has been attributed to the "soaring energy demand and tight supply"[6].
  - The delivered cost of gas may also increase as demand becomes 'peakier' and gas becomes increasingly utilised as a fuel for transition to a lower carbon environment; and
  - Fuel costs will increase in line with current contract escalations.

[5] http://www.snowyhydro.com.au/sysFiles/Media/SnowyHydro_MR_162.pdf

[6] Australian Financial Review, "*Coal set for futures contracts*" 3 April 2008, pg 22

Uncertainty in the market

While there was a period of extreme volatility in the energy market during the middle of 2007, there continues to be uncertainty in the market, which reduces market liquidity and puts upward pressure on forward contract prices. Ongoing uncertainties include:

- Uncertainty in the market surrounding Carbon costs and the structure of future Emissions Trading Schemes;
- Current negotiations regarding coal prices for the NSW generators; and
- The NSW Government announcement to privatise energy assets.

Optimal Portfolio

Frontier has used contracts only to the extent that load is not covered by the ETEF. AGL does not support this methodology of determining the optimal portfolio. As noted earlier, AGL is of the view that the modelling of wholesale electricity costs should be undertaken without consideration of the ETEF.

A 'prudent retailer' is typically regarded as one that "layers in" its contracts over time and would therefore be subject to higher 09/10 forward prices. The energy cost allowance should therefore, incorporate aspects of the forward prices as these costs are included in constructing a 'prudent' retailers portfolio.

Comparative data and industry expertise

Frontier has stated that the results in their March 2008 modelling for the 08/09-year are consistent with publicly available data, such as d-cypha and that this re-alignment of the d-cypha data to levels consistent with Frontier's analysis is predominantly due to the removal of water restrictions in Queensland. As a result, Frontier considers their forecast estimates to be relatively accurate. However, Frontier has then discredited the d-cypha 09/10 data due to it being based on 'thinly traded instruments'[7]. The d-cypha forward contract prices for 09/10 are approximately 14% higher than those estimated by Frontier.

AGL does not support the views held by Frontier that the 09/10 contract prices are thinly traded, and is disappointed that Frontier has simply 'dismissed' independent and relevant 'actual' market data for the following reasons:

- The quantum of futures traded for 09/10 represents approximately half of the expected energy consumption for NSW; and
- In theory, futures prices are representative of expected future pool price outcomes. Futures prices provide one of the most accurate views of current and expected future market conditions.

Such readily available public information that is reflective of an active energy market should be taken into consideration.

[7] Frontier public presentation - Annual wholesale price review - 17 March 2008