Eraring energy

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Dr Michael Keating
Chairman
Independent Pricing and Regulatory Tribunal
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Dear Dr Keating

FRONTIER ECONOMICS ANALYSIS OF ENERGY COSTS, RETAIL COSTS AND RETAIL MARGIN

Eraring Energy welcomes the opportunity to comment on the Frontier Economics Reports to IPART.

Eraring Energy has the following comments:

- Eraring Energy considers that the long run marginal cost of electricity generation is largely of academic interest and that the hedging, risk management and transaction costs measurement for the energy cost is a better benchmark to use when setting the regulated retail tariffs. This is because the market measurement incorporates the realities of transacting in the National Electricity Market, to the best of the market's knowledge, whereas the long run marginal cost does not.

- The Frontier Economics long run marginal cost estimates are based on ACIL Tasman work provided to NEMMCO. There are a range of expert estimates on long run marginal cost of which the ACIL Tasman work is just one. Typically the range of estimates is from ~5% lower than the ACIL Tasman estimate up to ~20% higher than the ACIL Tasman estimate.

- The Frontier Economics long run marginal cost estimates do not limit black coal being able to supply load growth. Given the current uncertainty regarding climate change policy this may not be the case. If it is assumed that black coal is limited in its ability to supply load growth and that combined cycle gas turbines are predominantly used to supply load growth then the long run marginal cost estimates would be of the order of 50% higher.

- In the Frontier Economics estimates of the energy cost based on hedging and risk management, Frontier Economics has constructed efficient frontiers for maximising the value of the retail portfolio. As modellers Frontier Economics are able to be dispassionate about the risks faced by electricity market participants (both generators and retailers) where the electricity spot price can range from $30/MWh to $10,000/MWh within a day. Thus Frontier Economics are able to promote the "elbow" of the efficient frontier as an optimal balance between risk and reward. Due to the extreme risks associated with $10,000/MWh electricity spot prices, electricity market participants tend to be conservative, potentially even more conservative than is shown in Frontier Economics' efficient frontiers. Eraring Energy considers that it is entirely plausible that a retailer could take a very highly hedged contract position, which would put them on the "wrong" branch of the efficient frontier.

- At the stakeholders' forum held on 25 January 2007, the Tribunal requested participant's views on "how active and competitive the market is". Since the Tribunal's last determination there has been a significant increase in the number of "micro-retailers", significant increase in activity among the financial intermediaries and significant increase in turnover of electricity futures on the Sydney Futures Exchange. (For further information, the Energy Reform Implementation Group has undertaken an investigation into the energy financial markets as detailed in their November 2006 Discussion Papers. Their finding was that the "Energy financial markets are evolving in a generally positive way. Market liquidity has strengthened in the more visible markets (SFE and brokered OTC)".) Within the three year period covered by the next IPART determination on regulated retail tariffs, Eraring Energy's view is that the market is sufficiently active and competitive.

Gregory Wong, Manager Modelling and Forecasting, can be contacted on (02) 8268 4248 and is available to discuss with you any aspect of this submission.

Yours faithfully

Stephan Boras
Acting Managing Director