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Australian Energy Market Commission
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Australian Energy Market Commission Advice on Best Practice Retail Price Regulation Methodology EMO0027

Alinta Energy Retail Sales Pty Ltd (**Alinta Energy**) welcomes the opportunity to comment on the Australian Energy Market Commission's (the **Commission**) Issues Paper on Best Practice Retail Price Regulation Methodology (**Issues Paper**).

Alinta Energy is both a generator and retailer of electricity and gas in Western Australia and the Eastern States energy markets. It has over 2500MW of generation facilities and in excess of 700,000 retail customers, including around 108,000 customers in Victoria and South Australia. As an incumbent retailer in Western Australia and a new entrant retailer in the National Energy Market, Alinta Energy is well placed to comment on the Commission's issues paper on Best Practice Retail Price Regulation Methodology.

At the outset, and whilst recognising it is not part of the Commission's terms of reference for the review, Alinta Energy would reinforce its position that a well-functioning competitive market can provide better protection and benefit for consumers and that these markets operate best under a structure of price de-regulation.

Currently within the National Electricity Market (**NEM**) jurisdictions Victoria & South Australia have moved to remove price regulation with Queensland having stated it will seek to remove price regulation in July 2015. In addition New South Wales are currently in the process of completing its review of the effectiveness of competition where the draft decision has recommended that price regulation be removed. Given current market developments we would, at this time, question the relative benefit of Commission's review of best practice retail price regulation given the majority of NEM jurisdictions are moving to deregulation.

In addition, as highlighted in the issues paper the complexities faced when attempting to set a cost reflective price for the supply of energy are significant. These complexities enhance the risk of getting the level of efficient pricing wrong. The associated impact of incorrect or non-reflective pricing can be quite prolific.

Price deregulation creates certainty that drives long term investment. Deregulation allows retailers to recover their prudent costs of operating in a market. Where retailers fail to invest prudently, and operate in an efficient manner competitive tension will drive change or ultimately see inefficient retailers exit the market.

This market and price certainty is of particular importance for "new entrant" retailers seeking to enter and grow market share. It is with these issues in mind that we would reinforce our position that through price deregulation the greatest benefit can be provided to consumers.

However understanding that the review as it currently stands is to look at the most appropriate form or (forms) of regulation where price regulation is to be maintained Alinta Energy's detailed comments are contained in the following attachment.

Whilst Alinta Energy appreciates the opportunity to participate in the consultation we are concerned that key stakeholders, such as retailers will not have the opportunity to comment on the Commission's recommendation prior to it being presented to SCER. We recognise this is due to the tight timeframe for consultation; however the opportunity to provide comment on any recommendation being presented to SCER would be beneficial to the process.

Should you wish to discuss any aspect of our submission I may be contacted on (02) 9372 2653, or via email: shaun.ruddy@alintaenergy.com.au

Yours sincerely

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Australian Energy Market Commission Review, Advice on Best Practice Retail Price Regulation Methodology EMO0027

Proposed Objective for Retail Electricity Price Regulation

The objectives stated in the issues paper are consistent with the requirements needed to develop an effective energy market. That is,

Having regard to the long-term interests of consumers, retail price regulation should determine electricity prices for small customers which;

- *Reflect the efficient costs of providing retail electricity services, and*
- *Facilitate the development of competition in retail electricity markets, where competition may be feasible,*

It may be said however that both these objectives are better achieved through price deregulation rather than through regulation. Price deregulation in a competitive market forces retailers to operate in an efficient manner in providing goods and services to consumers in order to gain and retain market share.

The market certainty provided through price deregulation facilitates new entry which further enhances competition. It is the risk associated with price regulation, and the setting of regulated prices below the prudent costs of supply that inhibits market entry and stifles competition.

Key Cost Components

The Issues paper looks at the key cost components to be considered when determining a prudent level of regulated retail price. These being;

- Wholesale energy costs,
- Retail margins,
- Environmental scheme costs,

Where the Commission refers to "Retail Margins" we conclude this to cover the "Retail Cost Allowance." The retail cost allowance generally includes two components.

- Retail Operating Costs (ROC). The ROC is generally considered to include the operating costs an efficient Retailer would incur in performing the retail functions required to serve its small retail customer base. They include, among other things, the costs of billing and revenue collection, call centres, IT systems and regulatory compliance, as well as an appropriate proportion of corporate costs.

- Customer acquisition and retention costs (CARC), which are primarily marketing costs associated with acquiring new customers and retaining existing customers, and transferring customers.

Wholesale Energy Costs

As stated in the report, when assessing wholesale energy costs two broad approaches are commonly used to estimate the wholesale energy cost allowance the Long- Run Marginal Cost (LRMC) or a Market Based Approach.

<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 its 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.

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.

In determining the WEC Alinta Energy supports the use of the LRMC. The LRMC analysis should develop a simple transparent methodology which captures the theoretical costs a generator would seek to recover from supplying electricity to small retail consumers. The LRMC should be determined using the "Greenfield" (stand-alone) method, assuming the generation plant is built to supply volume and shape within each relevant distribution / network area.

Retail Operating Costs
[Retail Margin / Customer Acquisition and Retention costs]

The level of the retail operating cost allowance within a regulated price needs to be set at a level that recognises the prudent costs of a retailer operating in a market, including an allowance for the risk and reasonable return on investment earned from the retailers operations.

The issues paper identifies the previous use of a "standard retailer" profile by regulators when attempting to estimate the prudent cost of a retailer operating in a market. The continued use of the standard retailer profile in assessing the prudent costs of a retailer operating in a market is no longer (and has not been for some time) appropriate. Market dynamics have shifted to where a greater number of second tier or new entrant retailers operate in the market. It is these costs, the efficient costs of a second tier / new entrant retailer that should be used in determining the appropriate operating cost allowance.

The continued use of a standard retailer profile would underestimate the level of efficient retail operating costs creating a potential barrier to market entry and development and therefore be at odds with the Commission's own proposed objective of facilitating the development of competition in retail electricity markets, where competition may be feasible.

Likewise when attempting to estimate the customer acquisition and retention costs (CARC), the more reflective method would be to use the costs incurred by second tier / new entrant retailers. The costs faced by second tier / new entrant retailers in acquiring customers are significantly different to those of an established standard retailer which is able to rely on scale and significant brand awareness and loyalty.

Environmental Scheme Costs

Large-scale Renewable Energy Target (LRET) Costs

Alinta Energy holds the view that any methodology used to attempt to determine the cost of compliance with the LRET should be based on either the future market data methodology or the LRMC methodology. Alinta Energy does not support the use of historical market data methodology. An assumption that the price for certificates in the past is likely to be similar over a determination period to the historical period that data is sourced from where significant market developments are occurring, is a methodology that carries with it to greater risk.

Small Scale Renewable Energy Scheme (SRES) Costs

As for the LRET, the use of historical market data is not an appropriate methodology for estimating the SRES. The more significant issue with SRES is the timing difference between when the STP is set and when regulated retail prices are set. We would note that removing price regulation goes some way to elevating the risk faced by retailers due to this issue.

In terms of the preferred methodology used to estimate the SRES cost a mixt of clearing house and penalty price could be used to arrive at a reasonable estimate of the compliance costs

Jurisdictional Energy Scheme Costs

A national approach to estimating the costs of jurisdictional energy schemes is not appropriate given the differences with the operation of the schemes and the markets they operate in. The issue of a national approach to estimating these costs gives rise to the wider question as to whether the jurisdictional schemes should be discontinued in favour for a single NEM wide energy scheme or whether under current energy efficiency initiatives such as an emissions trading scheme or price on carbon, whether there is a need for these additional energy schemes.

In estimating the cost and impact of the jurisdictional schemes each scheme and its cost impacts would need to be assessed on an individual basis taking into consideration how the jurisdictional scheme is structured, timing of compliance obligations (e.g. scheme compliance period runs calendar or financial year), whether the scheme is tradable or requires retailers to directly undertake activities to create certificates to extinguish their compliance obligations. These factors will drive the costs that need to be recovered through the price setting mechanism.

Form and Timing of Price Controls

As has been previously stated the preference is for competitive (and developing markets) to operate under a regime where retail pricing is deregulated. Where price regulation is to continue the form and timing of price controls and the methodology used must be transparent, consistent and stable. A lack of transparency and stability in setting a price path creates a significant level of risk such that it will deter new entrants from entering the market, and those that are current operating in the market from expanding.

Period for setting a price determination should not exceed a 12 month period, allowing for annual reviews and limiting the need for "re-openers" that are necessary where longer determination periods are in operation.