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Queensland Competition Authority
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QUEENSLAND COMPETITION AUTHORITY – DRAFT METHODOLOGY REGULATED RETAIL ELECTRICITY PRICES 2012-13

Alinta Energy (Alinta) appreciates the opportunity to comment upon the Queensland Competition Authority's (the Authority) Draft Methodology Report for the setting of regulated retail electricity prices in 2012-13.

Alinta is an active investor in the energy retail, wholesale and generation markets across Australia. Alinta has over 2500MW of generation facilities in Australia (and New Zealand), and maintains over 670,000 retail energy customers in Western Australia, South Australia and Victoria with a commitment to growing its retail energy business in Australia. Alinta applied for a retail electricity licence with the Queensland Government on 8 December 2011, with the intention to begin selling to customers within this market in 2012.

A summary of Alinta's key points are:

- Current levels of competition in the Queensland market are providing benefits to consumers;
- The negative impact on competition caused by setting price caps below efficient levels significantly outweighs the risks from setting price-caps with a sufficient level of head room for retailers to compete away;
- To ensure competition continues to develop, the Authority should provide certainty to both consumers and market participants in the Queensland market by committing to a consistent methodology for future price reviews;
- Basing a cost stack upon a new entrant retailer rather than a representative retailer, is likely to better promote competition and innovation within the sector;
- Supports the N+R methodology proposed by the Authority;
- The Wholesale Electricity Cost component needs to reflect the actual portfolio contracting strategy and costs to retailers;
- The retail margin and retail operating cost allowance should be determined with sufficient weight given to further developing the competitive market in Queensland.

Effective Competition Exists in the Queensland Market

Alinta believes that competition is currently effective in the South-East Queensland electricity market, and that a competitive market is, and will continue to, provide the best outcomes for consumers of electricity in that market. Alinta strongly urges the Authority to consider any potential impacts to the level of competition within the Queensland electricity market when setting the level of price caps for 2012-13.

However Alinta notes that in assessing the level of current competition in the electricity market, the current churn rates may overstate the true level of competition, given much of the churn is within the same incumbent retailer (i.e. customers moving from regulated prices to a market contract or vice versa with the same retailer). While a wide number of competitive offerings are currently available to customers in South-East Queensland, the level of regulated price-caps can still have a significant impact on the competitive framework for the market. Therefore, while the Authority can be confident that competition is working in Queensland, Alinta does not believe that the published churn figures support any conclusions that retailers are in fact making excessive profits at the expense of Queensland consumers.

There needs to be sufficient headroom in tariffs

The risks in setting regulated price caps in markets that are competitive, and have low barriers to entry and no evidence of a single player having substantial market power, are asymmetric. Should price caps be set at a level that allows retailers to make windfall gains in the market, it is likely that retailers will actively target customers whose tariffs are set at the price caps, effectively competing away excess margins within the industry. On the other hand, if price-caps are set too low, retailers will not choose to be active within the Queensland market due to the lack of headroom within tariffs. Existing retailers with a presence in the market will not actively target customers with alternative competitive offerings, and potential new entrants in the market (such as Alinta) may choose to completely bypass the Queensland market. This is likely to create structural barriers to re-introducing competition, and the benefits from competition, in the Queensland electricity market.

Lack of Certainty in the Longer Term will Impede the Development of Competition

For competition to continue to work retailers need price certainty in the short to medium term. This is because retailers are making decisions about entering the market and offering medium term contracts to customers. Therefore while the Authority has been tasked to conclude a one year price, it should consider setting and committing to a methodology that can be consistently applied year on year, and which allows for predictable outcomes. This should allow certainty for retailers and consumers who are making long-term investment decisions in the market.

New Entrant Model vs Representative Retailer Model

Alinta supports a new entrant methodology rather than a 'representative retailer' model that accounts for the cost structure of a large incumbent retailer chosen by the Authority. The 'representative retailer' model proposed will allow for greater economies of scale benefits than would actually exist for most retailers operating in the QLD market. If smaller or new entrant retailers can't recover their efficient costs, this will restrict their ability to compete in the market, which will ultimately have a negative impact on competition and consumers in the long term. Retailers have an incentive to invest and upgrade the systems that they utilise to provide services to customers. Alinta's principal concern with the use of the representative retailer model is that it will potentially stifle the incentive for all retailers to continue to be innovative in how retailers manage

their costs structures. Using a new entrant model, while perhaps providing a different cost structure, is likely to provide the correct incentives for retailers over the medium term to ensure that their platforms and customer management systems are continually efficient relative to their competitors operating in the market. Using a representative model effectively 'locks-in' the cost structure of the present incumbents, despite the fact that technological innovation will over time result in much different operating base costs structures for retailers developing and expanding their businesses in Queensland.

Pass-through of Network Costs

Alinta supports the N+R methodology proposed by the Authority, and believes that network prices should be directly passed through to regulated retail prices at this review, and for future reviews.

Wholesale Energy Cost Component

Alinta acknowledges the difficult task before the Authority in determining a Wholesale Energy Cost (WEC) allowance. Any methodology which attempts to predict future prices and therefore cost outcomes, in a volatile and at times uncertain environment, is a challenge.

However, we agree with the Commission's consultant (ACIL Tasman) which suggests that there are essentially four options available to it to forecast the WEC of a retailer operating in Queensland. These are:

- Approach 1: Long Run Marginal Cost (LRMC);
- Approach 2: Pool price projection overlaid by contract prices and contracting strategy;
- Approach 3: A modelled approach – i.e.: distribution of annual price projections; and
- Approach 4: A combination of the approaches above.

In considering which of the four approaches should be adopted by the Authority, it's worth noting the Ministerial Terms of Reference which require that in setting any cost component that it be cost reflective. In identifying the wholesale portfolio costs of a prudent retailer the Authority should be mindful of the volatility and uncertainty that exists in the wholesale market with regard to both price and load.

Prices in the NEM can range up to \$12,500/MWh (or the level at which the prevailing Market Price Cap (MPC) is set) and to avoid being exposed to such high prices a prudent retailer would always seek to match its hedge cover with its load. Moreover, due to the asymmetric risks in the National Electricity Market, a retailer will generally seek to hedge to a 1 in 20 year event to ensure it's covered for extreme price events. If retailers do not hedge to this level then they would be required to have liquid form capital on hand to fund any volume exposure to the MPC. For example, a 200MW exposure at \$12,500/MWh for 10 hours would require access to \$25m in funding. For many retailers such an exposure could put them in financial distress.

In regards to forecasting its 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 risk, a prudent retailer will hedge its load over time using a number of different instruments. These instruments usually consist of one or more of:

- entering 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 (i.e. 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, e.g. weather derivatives; and
- buying any residual energy from the spot market – this price exposure usually arises for periods where demand is higher than the level at which a retailer has purchased swaps but the price exposure is capped at \$300/MWh.

Therefore, in determining which methodology to adopt the Authority should be comfortable that it reflects the above realities.

Alinta's preferred approach to setting the WEC component of regulated tariffs

Alinta understands the Authority does not support a LRMC modelling approach, that is Approach 1.

Accordingly, Alinta is of the view the model which should be applied in this Review is a market based modelling approach which appropriately represents the portfolio costs of a retailer using Approach 2. That is, an approach which has a pool price projection overlaid by contract prices and a contracting strategy.

In determining the contracting strategy in this model, the Authority should assume that retailers layer in hedge cover over the short, medium and longer term.

To determine contract prices in the shorter term (e.g. up to 2 years prior to the start of the period) the Authority should rely on published market prices for swaps and caps. It should be assumed half of a retailer's forecast load is hedged in this period using these instruments.

For the medium to longer term period where there is an absence of published market prices (eg: more than 2 years prior to the start of the period) the Authority should rely on LRMC, using either a greenfields or brownfields (i.e: depreciated optimised replacement cost) approach. LRMC is an appropriate proxy for a retailer's medium to longer term hedge costs given it reflects the cost of:

- Hedging for the medium term, ie 2-4 years prior to the start of the period where generators will seek to recover their LRMC;
- Power Purchase Agreements; and/or
- Direct investment in generation.

Therefore this market based approach adequately reflects the portfolio of contracts entered into by prudent retailers which hedge over time to manage their price and volume risk using a number of different instruments. This approach also has the advantage of resulting in more predictable price outcomes and less price volatility.

Alinta understands that, at least for the current review, the Authority is concerned there is inadequate published market data for the period required to undertake the modelling work for Approach 2. This is likely to only be a short term problem caused by previous carbon price uncertainty, which should not deter the Authority from using this robust approach for this and future years. For the current review, Alinta suggests using ICAP prices for flat swaps (ex-carbon) and if there is inadequate cap data using the LRMC of an Open Cycle Gas Turbine as a proxy for this price.

Alinta would be happy to discuss the use of this data with the Authority further.

Alinta's concerns with a modelled approach (Approach 3)

Alinta's least favoured approach is Approach 3, which is a modelled outcome. Alinta's concerns with the approach include:

- There is no transparency and the modelled outcomes are unpredictable;
- There is no reference to actual costs incurred by retailers for the 2012/13 year;
- The outcomes are solely reliant on the model's assumptions which are not based on the actual conduct or costs of a prudent retailer. Retailers will have already entered into forward wholesale contracts to meet a large proportion of their expected FY13 load – this is not accounted for;
- It doesn't take into account the risk management strategy of a retailer and their desire to cover their downside risk; and
- Selecting the mean as the appropriate pool price average is flawed. The distribution of outcomes is asymmetric, meaning that the risks imposed if 2013 falls 'above' the mean will be greater than the benefits which accrue should it fall 'below' the mean.

In relation to the last point regarding the fact that the distribution of outcomes is asymmetric, we refer to the average volume weighted pool prices for Queensland by financial year from 2002 to 2011 (nominal dollars). Using this price distribution, then taking the mean (\$39.50/MWh), would infer that for a 5TWh load, a retailer's annual returns would oscillate from a wind fall gain of \$44 million to a loss of \$93 million. This highlights the fact Approach 3 inadequately covers the annual costs of a retailer hedging its load prudently.

Approach 3 can only be reasonably applied if the following adjustments are made:

- not use the 'mean' average of pool price outcomes but use the 90th percentile. This will allow for the cost of managing wholesale risk and hedging conservatively for each individual year. As explained earlier in this submission, a retailer is primarily concerned with downside risk and managing its total portfolio cost; and
- compare the modelled outcomes with the actual market costs and the LRMC for the period to test its reasonableness. The outcome of Approach 3 should fall in the range of LRMC and market costs, given it should reflect the medium term costs of a retailer buying from the pool.

Retail operating costs

Alinta supports the benchmarking approach proposed by the Authority for the determination of a retailer's operating costs. As discussed earlier in this submission, we are concerned about setting a retail operating cost allowance on the basis of a 'representative retailer' modelling approach. Alinta questions whether 2nd tier retailers will be able to recover their operating costs if the model is based on the costs of an incumbent retailer

which currently benefits from economies of scale. If retailers are unable to fully recover their costs, they are likely to be prevented from competing in the market.

Retail margin

Alinta believes that current margins are at a minimum level in Queensland and in fact need to increase in order for 2nd tier retailers (such as Alinta) to recover both their efficient costs, and to compensate investors for the risks of retailing electricity in the Queensland market. The retail margin and cost stack adopted by the Authority need to be reflective of the actual commercial realities of operating a retail electricity business. While the methodology for establishing a retail margin is subject to considerable debate, Alinta agrees with the Authority that the margin should reflect the systematic risks of operating and investing in the retail market. The establishment of a benchmark retail margin is a forward-looking exercise, and thus a range for retail margins can be justified in assessing these forward risks. While the Authority has previously adopted a 5.0% retail margin, Alinta proposes that in retail energy markets where there are a significant number of retailers with an existing presence, regulators can be comfortable that setting a margin at a higher level within what would be considered an 'acceptable range' would not have an overall detrimental impact upon consumers. Alinta therefore requests that the Authority revisit its previously determined 5.0% margin, noting that at present it would be considered at the lower level of an acceptable benchmark range.

Should you wish to discuss Alinta's submission further, please feel free to contact me on 08 9486 3762.

Yours sincerely



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