



**Stanwell Corporation Limited
Submission**

**Queensland Competition Authority
Draft Methodology Paper**

**Regulated Retail Electricity Prices
2012-13**

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About Stanwell Corporation

Stanwell Corporation Limited (Stanwell) is a diversified energy company and Queensland's largest power generator with a capacity to supply more than 45% of the state's power needs. A State Government-owned corporation employing almost 1000 people and with a \$1 billion turnover, Stanwell provides safe and reliable electricity for sale through the National Electricity Market (NEM).

On 1 July 2011, Queensland's government owned generators of Tarong Energy, Stanwell and CS Energy merged into two entities. Stanwell's portfolio was strengthened with the addition of Tarong, Tarong North, Mica Creek and Swanbank B and E power stations.

Stanwell now has a generation capacity of 4,526 megawatts, and generation assets valued at more than \$4.3 billion, with diversified gas, hydro and coal-fired plants operating from 11 geographically dispersed sites.

Key Issues with Respect to the Energy Cost Component of Retail Tariffs

The Queensland Competition Authority's (QCA) revised regulated retail electricity prices methodology will have a significant impact on market outcomes, as it sets out how much retailers can afford to pay for energy. It is important that the methodology does not distort the market, but instead relies on the development of a competitive market (both wholesale and retail electricity markets) to ensure efficient price signals, which in turn are passed through to customers as efficient retail prices.

Stanwell recognises that the greatest risk to competition and incumbent retailers is if the Energy Price Component is underestimated.

Energy Costs

Stanwell recommends maintaining a weighted cost of the long-run marginal cost (LRMC) and the market-based cost of purchasing electricity (incorporating the previous hedging-based approach in the short-term), similar to the current BRCI methodology. Stanwell believes that the pricing methodology requires both components, however the market price component is the most important aspect to pass through to customers as the market should realise pricing efficiencies quicker than may be realised in LRMCs, at the expense of slightly increased volatility.

The LRMC component provides a smoothing effect and a lead indicator of where pricing should be over the long term, however it is of secondary importance to the market pricing component. Given the relative importance of the two measures, Stanwell is of the view that

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the weighting between the two elements should be adjusted to reflect this. Stanwell recommends moving from the current 50/50 weighting to a weighting of 40% LRMC, 60% market-based approach and over the longer term to a weighting of 30% LRMC, 70% market-based approach as market participants adjust to the revised retail tariff methodology.

Both LRMC and the market-based approach require assumptions to be made with respect to the market. The QCA needs to focus on the appropriateness and accuracy of these assumptions, to ensure the regulated tariffs are cost-reflective. Getting the assumptions right will address a number of the issues with the current BRCI methodology.

Long-Run Marginal Cost Approach

There are a number of benefits of including LRMC in the energy purchase cost, including:

- Promotes price stability (unlike short-term fluctuations in wholesale pool prices);
- As a forward-looking indicator, LRMC should reflect the sustainable, long-run cost of providing electricity in the Queensland market, which the wholesale market should tend towards over time;
- LRMC has an increased relevance in terms of market outcomes as the Queensland market approaches demand/supply balance;
- Encourages retail competition;
- Is more transparent and less reliant on a significant number of modelling assumptions than a single market-based approach; and
- Will assist in smooth transition to a true reflection of generation fleet carbon tax costs.

The ACIL Tasman discussion paper raises concerns about LRMC not capturing the impacts of extreme weather events such as the drought. However, the proposed rolling average market price would result in a significant portion of the market price also not reflecting the impact of extreme weather events. In addition, Stanwell questions the value of the volatility that extreme one-off events would bring to retail prices if they were priced in such a fashion as to fully reflect these events. The volatility in market prices at such times, tempered by long run marginal costs inclusion, should see a relatively accurate portrayal of costs and risks flow through to customers.

Stanwell acknowledges the QCA's concerns about incorporating a cost-based approach for assessing wholesale energy costs likely to be faced by retailers, but the LRMC reflects the sustainable wholesale price of electricity over the long-term and supports retail tariff stability. Over the long-term, Stanwell recommends shifting from a weighting of 40% LRMC, 60% market-based approach to a weighting of 30% LRMC, 70% market-based approach as market participants adjust to the revised retail tariff methodology.

Market-Based Approach

Stanwell recommends incorporating a market-based approach to energy purchase cost, reflecting the recent actual costs of supplying energy in the Queensland market, which satisfies the Government's key consideration of cost-reflective retail tariffs.

It is recommended the assumptions underpinning the market based approach are:

- Hedge strategy (the combination of flat swaps, peak swaps and caps) as per the current BRCI methodology;
- Contract prices based on black + AFMA from ICAP since 1 July 2011;
- AFMA pass through i.e. \$23/tonne carbon price, passed through at forecast NEM intensity; and
- Spot price forecasts, SRMC bids adjusted for carbon.

By aligning the market component of the retail price setting methodology with the wholesale market standards, transparency is increased and the incentives for market distorting activities are reduced. It is for this reason Stanwell recommends the use of the wholesale market standard of utilising the AFMA carbon pass through clause at NEM intensity to provide the uplift to retail prices that carbon will bring to the wholesale market. In conjunction with the carbon price uplift to LRMC, this should see the most cost-reflective effect of carbon passed through to customers.

Currently, the only source of published black + AFMA contract data is from ICAP Broker Service. ICAP started publishing this data on 1 July 2011. It is expected that the QCA will commence preparing the draft price determination in early 2012 (to be published on 30 March 2012), meaning at least 6 months of black + AFMA market data will be available. While it could be argued this is not enough data to estimate the market price, the use of market data is preferable to a non-market methodology. Further, it is not unreasonable to expect that retailers ramped up their hedging activities in February 2011, as the announcement of carbon price details provided retailers more certainty around carbon costs.

The only qualifier for the market-based approach is that average market prices need to be used. Tariff reset pricing linked to the market price in a particular month could lead to adverse or skewed outcomes in the wholesale market.

Significant uncertainty currently in the market (e.g. carbon price, industry consolidation) and the difficulty of explicitly basing the retail tariff on a spot price forecast means that the QCA cannot rely solely on an expected market price. Further, market modelling relies on a large number of assumptions (significantly more than LRMC modelling), which limits both its transparency and its consistency. In the past, this has led to the assumptions and price determinations being challenged, which further added to market uncertainty. By using a weighted cost of energy purchase cost, the impact of the weaknesses of the two individual approaches are reduced, and ensures the energy component reflects both current market conditions and the long-run, underlying cost of electricity supply in Queensland.

Environmental Costs

Stanwell recommends that all environmental costs are calculated as per the proposed methodology, with the exception of the cost of Small-scale Technology Certificates. There appears to be enough market data available to estimate the market cost of meeting Small-scale Renewable Energy Scheme obligations. Accordingly, it is important that the methodology does not incorporate inefficiencies with respect to the scheme design (i.e. incorporating the clearing price in estimating compliance costs).

It would not be consistent with the Government's stated aim of cost-reflective retail tariffs to impose pass through costs of \$40 per certificate to customers when average costs for the last 12 months to retailers were <\$30 per certificate and expectations are of continued oversupply in the market. If the market reverts to the clearing house price of \$40 per certificate, this will be passed through and therefore not leave retailers out of pocket. Incentives must be maintained for retailers to minimise costs to end use customers. Simply pricing the pass through at the penalty regardless of what costs retailers face in meeting their obligations will provide windfall gains to retailers, increasing costs to the customer and distorting wholesale and retail markets.

Conclusion

Stanwell appreciates the importance of ensuring cost-reflective retail tariffs to Queensland electricity retail customers. While there are risks and limitations to the various methodologies for estimating the market energy purchase cost, Stanwell believes its proposed methodology will provide a cost-reflective, unbiased estimate of energy purchase costs.