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20 July 2012

Mr Nathan Petrus
Director, Pricing & Analysis
Essential Services Commission SA
GPO Box 2605
Adelaide SA 5001

Dear Nathan

ELECTRICITY STANDING CONTRACT – WHOLESALE COST INVESTIGATION

Alinta Energy appreciates the opportunity to provide a submission to the Essential Services Commission of South Australia (ESCOSA) review of the Electricity Standing Contract – Wholesale Cost Investigation (the Review).

Alinta Energy is an active investor in the energy retail, wholesale and generation markets across Australia. Alinta Energy has over 2500MW of generation facilities in Australia (and New Zealand), with retail energy customers in Western Australia, South Australia and Victoria and a commitment to growth across the National Electricity Market and is an active participant in Australian electricity derivatives markets, trading over-the-counter and Australian Stock Exchange electricity products. In South Australia specifically, Alinta Energy owns and operates the 240MW Playford B Power Station, and the 2 x 272MW Northern Power Station 1 and 2 in Port Augusta. Alinta Energy holds a retail license in South Australia and is actively growing its retail base.

Summary

The Commission announced that recent wholesale electricity market price outcomes suggest that the forward cost of wholesale electricity may now be lower than that determined in 2010. As any assessment of forward looking costs requires some level of assumptions, Alinta Energy wishes to emphasise that the potential risks of reducing the Wholesale Electricity Cost (WEC) allowance outweighs the short term benefits that a reduction in the standing price provides. A summary of the key points contained within Alinta Energy's submission are:

- That competition in the South Australian retail market is working to provide benefits to customers;
- That reopening a regulatory price determination mid-period creates uncertainty for retailers, consumers and investors;
- The impact on competition from reducing the WEC component is likely to provide a detrimental outcome to consumers in the long term, with a definite and immediate impact on 2nd tier retailers (such as Alinta Energy) and their presence in the market;
- Any examination of individual components of the cost stack needs to be balanced against the level of headroom implicit within the cost stack;
- It is premature to conclude that the current observed wholesale market prices in South Australia represent a permanent structural shift in the forward prices in the market;

Alinta Energy Retail Sales Pty Ltd • ABN 22 149 658 300
A Level 11, 20 Bridge Street, Sydney, NSW 2000 Australia
T +61 2 9372 2600 • F +61 2 9372 2610 • W alintaenergy.com.au

- That the wholesale market price is a key determinant in providing future investment signals, and that any forward looking cost estimate for the WEC needs to reflect a suitable return to a stand alone generator;
- The manner in which retailers' contract in the forward market in electricity is primarily influenced by risk and that this level of risk has remained despite the recent observed fall in head line market prices; and
- That for the period post 2013 financial year, there is very little available market liquidity in the South Australian region due to political uncertainty regarding the future of the Clean Energy Legislation.

Importance of competition

Rising electricity prices for households will always be a particularly emotive issue and inevitably it is retailers that face the scrutiny for price increases, regardless of the factors driving these price increases. That is, there are a multitude of factors contributing to rising electricity prices such as network increases and increases related to mandated green schemes, many of which are outside the control of retailers.

Alinta Energy firmly believes that competition in South Australia is working, and is providing consumers with superior outcomes for those prepared to shop around for the best offers. In the absence of a truly competitive retail market, given the sustained trajectory of some of these non-controllable inputs of a standard retailers cost stack, consumers would most likely face higher total electricity bills than they would in a competitive market. The ability to source discounted offers from a number of retailers assists customers in lessening the impact of rising energy prices.

The level of the regulated price for Standing Offers impacts primarily on the competitive nature of the market. Any short-term gain over the immediate period by substantially reducing the standing price in South Australia is likely to be significantly outweighed in the longer term by loss of competitive tension in the market. Furthermore, the uncertainty created by constant reviewal (or the perceived threat of review) of regulatory decisions tends to act as both a barrier to entry in the market and sends mixed signals to current market participants. Given that Alinta Energy itself is a relatively new player in the South Australian market, and despite the South Australian market having strategic importance to the business, it would still consider withdrawing from the market completely should it not be able to actively compete with the standing price.

For a tier 2 retailer such as Alinta Energy, the level of headroom that exists in a jurisdiction that retains price regulation is critical in guiding longer term market positioning. Alinta Energy is concerned that the debate concerning head room is not fully considered in the price setting process by Regulators. The standing price is intended to provide a safety net for those consumers who choose not to enter into a market contract with a retailer. The standing contract price should not be set at a level that minimises costs at a single point in time, which in effect is what a mid-determination review of retailer controllable costs does.

The ultimate risk from the Commission deviating from its original methodology is that the lack of available headroom may squeeze retailers already dealing with significant external cost pressures further. Alinta Energy considers that prices for standing contracts prior to the carbon cost pass through decision to be essentially within a narrow band of cost reflectivity. Following the carbon cost pass through decision (in which South Australian emission intensity was set at a below cost outcome), the level of the standing price was actually below cost reflectivity for 2nd tier retailers. Any decision to alter the wholesale component of the cost stack is likely to further remove any notion of

headroom, particularly for 2nd tier retailers that are critical to ensure a competitive retail electricity market in South Australia

Need for regulatory certainty

The regulation of retail prices has the principal benefit of providing a safety net for a portion of consumers in electricity markets that would not be considered to have effective competition. In the absence of competitive tension alone restricting retailers from raising prices above marginal cost, retail economic regulation offers a further level of protection for consumers from retailers extracting monopoly rents from the market. However, in order to encourage competitive tension to develop within a market, current and future participants need certainty as to the form and nature of economic regulation. This has been a key rationale for regulators adopting retail price paths of 3 years. The benefit of a defined price path is that it provides certainty to both consumers and retailers as to investment and consumption decisions, balanced against the need to respond to longer term structural shifts that have emerged during the pricing period at the commencement of the next determination. Alinta Energy suggests that an examination of wholesale costs occur at the commencement of the next regulatory pricing period, rather than now, when retailers have already based their 3 year investment decision on the current price path.

In addition, Alinta Energy thinks there is merit in reflecting on the precise nature of the current South Australian methodology that has been adopted in relation to retail price regulation. The Commission essentially establishes a price that reflects a market 'cap' and therefore it is reasonable if this price is above the *most* efficient forecast to achieve the benefit of encouraging competition in the market. This is a different approach to other forms of price regulation in markets less mature from a competition perspective. The level of the price cap is intended to prevent price gouging by retailers, not at a level that reflects an minimum efficient price. Alinta believes that the regulatory framework in its form should guide the Commission in its thinking

Q. 1 What approach should the Commission adopt to setting wholesale electricity purchase costs for standing contract pricing purposes and why should that approach be used?

The Commission has indicated that it considers there may be a difference between the LRMC of generation and current forward wholesale electricity prices. Alinta Energy views that current observations surrounding wholesale market prices in South Australia are cyclical in nature, and do not necessary represent a permanent shift in the observed prices from the NEM into the future. The observed wholesale prices for South Australia over the last 2 years has coincided with relatively cool summer periods, however retailers may not have entered into forward contracts that suggest that demand and prices will continue at these levels in the near future.

The real danger that emerges from adopting a return based solely upon observed market prices is that it will not accurately reflect a prudent retailer's risk strategy that it would adopt in the wholesale market. Further, the price must provide for the ability of retailers to meet a level of security equivalent to the unserved energy level measured by AEMO. This means that retailers should be allowed to buy energy to meet 1 in 10 year requirements – not an average year. Risk is the ultimate driver of a retailer's longer term contracting strategy and Alinta Energy urges the Commission to give significant weight to this issue.

Alinta Energy is of the view that the WEC component of the cost stack should ideally be based upon both of the following:

1. LRMC - representing the cost of retailers hedging for the medium to longer term through Power Purchase Agreements or through building their own plant. In SA all active retailers own generation plant.

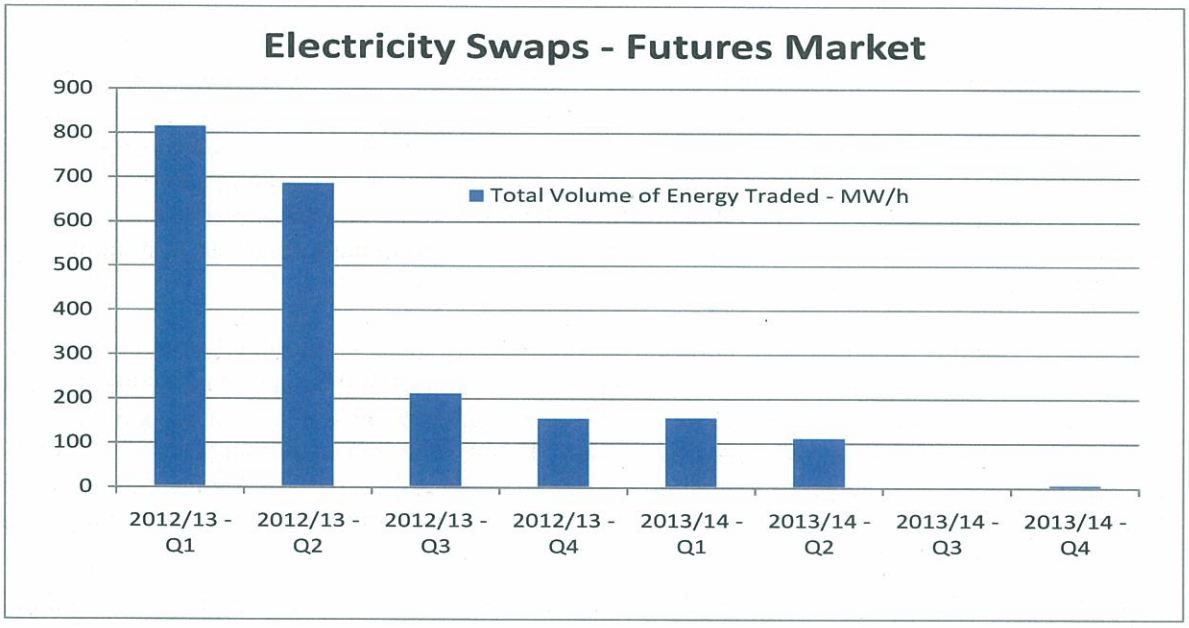
2. Market prices reflecting the short term hedging strategy for retailers that buy forward electricity contracts to meet their expected load. However, in the absence of reliable contract information the reliance on market prices should be heavily discounted.

Despite the fact that wholesale prices may deviate in the short term, over the longer term market prices provide investment signals for generators. Locking in a WEC based solely on short term fluctuations will not provide sufficient returns for new generators considering market entry and long term investment decisions. This is evidenced by the fact that Alinta Energy's own generators in SA will not be running during the winter periods as returns are too low.

Therefore taking into account the above, both market prices and LRMC are useful inputs. LRMC representing the efficient electricity costs over a period of time; and market prices reflecting the short term component. Both are relevant and must be considered. However, as discussed below, if the market for electricity contracts is not liquid, then it is not a useful representation of a retailer's costs.

***Q. 2 Is the forward market for wholesale electricity in South Australia sufficiently liquid to provide reliable forecasts of the energy purchase costs for a prudent and efficient electricity retailer with the* standing contract obligation**

As evidenced in the graph below, due to significant uncertainty regarding the future of carbon policy post the 2013 Federal election, liquidity has once again fallen significantly. This clearly shows that post the expected election in late 2013, there is virtually no trade on the Futures Market. Alinta Energy attributes this to carbon uncertainty and believes it demonstrates that forward liquidity in the South Australian Market is very limited. Based on this, Alinta Energy does not believe it would be appropriate to rely on published forward market prices in the development of the WEC.



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Q. 3 If so, should the Commission change the WEC component of standing contract prices?

As discussed in response to the previous two questions, Alinta Energy does not believe the Commission should rely on recent market data as there is inadequate liquidity and in any case no certainty that current prices will be sustained. For instance, the high incidence of wind generation in SA means that while the SRMC supply curve for SA is below other regions - and in turn is likely to have a short-run impact on contracts, possibly until supply is curtailed, long run average costs for the entire sector are higher i.e. fixed costs become more dominant and a sustainable market contract price needs to be at the higher end of LRMC expectations. Retailer's wholesale portfolio will consist of both long term and short term contracts and therefore both LRMC and market prices are an appropriate proxy for this. However, in the absence of market liquidity, market prices can not be relied upon.

Should you require any further information in relation to Alinta Energy's submission, please do not hesitate to contact me on 08 9486 3762.

Yours sincerely

M Shepherd

Michelle Shepherd
General Manager Regulatory Affairs