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5 November 2012

Mr Nathan Petrus
Director, Pricing and Analysis
Essential Services Commission of South Australia
GPO Box 2605
Adelaide SA 5001

Dear Nathan

2011 – 2014 ELECTRICITY STANDING CONTRACT PRICE DETERMINATION - WHOLESALE ELECTRICITY COSTS INVESTIGATION

Alinta Energy is an active investor in the energy retail, wholesale and generation markets across Australia and is a significant participant in the South Australian market. The purpose of the attached submission is to outline Alinta Energy's key concerns, including the likely market consequences, of the Essential Services Commission of South Australia's (**the Commission**) Draft Decision (**the Draft Decision**).

While Alinta Energy remains of the view that consultation has been inadequate, and that the case for a "special circumstances" re-opening is tenuous, the focus of this submission is on the impact on competition and the short-comings in the analysis to date.

The Draft Decision would see the Standing Contract price fall by 8.1% from 1 January 2012 which if implemented Alinta Energy believes would result in an unsustainable long-term electricity retail market and a significant decline in competition in the South Australian market. Alinta Energy holds this view not as an established incumbent but as a new entrant who had envisaged targeting an increased market share.

Alinta Energy looks forward to your consideration of the attached submission and to further discussion on this matter.

Yours sincerely

M Shepherd

Michelle Shepherd
General Manager Regulatory and Government Affairs

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Alinta Energy's Submission

The Essential Services Commission of South Australia Review: *2011 – 2014 Electricity Standing Contract Price Determination - Wholesale Electricity Costs Investigation*

Executive Summary

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 licence in South Australia and is actively growing its retail base, recently launching a substantial marketing campaign aimed at attracting customers.

Alinta Energy is concerned about the Draft Decision which, if implemented, would see the Standing Contract price fall by 8.1% from 1 January 2012. Alinta Energy is of the view that the Commission has failed to fully appreciate the likely decline in competition in the SA retail market that will ensue and that ultimately consumers are likely to be worse off.

In addition to its concerns about the impact on competition, Alinta Energy maintains a number of concerns about the consultation process and has previously raised those with the Commission.

Alinta Energy is requesting that the Commission provide further attention to the issues at hand and allow for additional discussions with industry prior to arriving at any definitive conclusions. To allow this to occur, Alinta Energy seeks a delay in the Commission's Final Decision until the new year, with any new tariffs to take effect on 1 July 2013.

Alinta Energy's main concerns with the Draft Decision are:

- Cyclical variances in the observed wholesale electricity market price does not in itself warrant a "special circumstances" re-opening of the price path and in any case liquidity has not returned to the SA market rendering this Draft Decision unfounded;
- The ultimate impact of the Commission's Draft Decision will be to reduce the competitiveness of the South Australian retail electricity market. The Commission's decision is primarily intended to provide for a short-term gain, while ignoring the longer term cost of supply issues;
- While the Commission pays much attention to the concept of headroom in its Draft Decision, the Commission could afford to apply a higher headroom margin in its analysis with little risk of damaging consumers in the long run. Alinta Energy would like to see the Commission recognise that competition in itself will have the greatest impact on reducing electricity prices in South Australia over the next few years;
- In calculating the Wholesale Energy Cost (**WEC**), the Commission has relied almost solely on observed market prices while ignoring the reality that retailers take a portfolio approach to their energy purchasing – using a combination of short and long-term contracts/underwriting of generation;
- The WEC model does not adequately account for the risks/cost of extreme demand or supply events;

- The reliance on marked to market wholesale contract prices in the WEC model will import the volatility from the wholesale market into the retail market - the very thing retailers try to protect customers from; and
- The consultation process undertaken by the Commission has been lacking, particularly given the impact this review will have on market participants. This is directly contrary to the Commission's previous messages around accountability and transparency.

Each of these points is expanded upon in further detail below.

1. The Special Circumstance Re-opening of the Price Path

1.1. An improvement in liquidity is not a 'special circumstance'

Alinta Energy does not believe that in itself, an improvement in liquidity in the wholesale electricity market warrants a Special Circumstance reopening of the price path.

The Commission needs to consider carefully what constitutes a 'special circumstance', that effectively re-opens a previously determined price path, due to the uncertainty it creates both within the market and for those parties that interact with the market.

The electricity industry and its supply chain (as with most regulated industries) is characterised by long lived assets with extensive pay-back periods. In order to ensure that investment occurs along the supply chain in a timely manner in regulated industries, regulators have tended to balance the need for certainty with the flexibility to respond to external circumstances. This has generally resulted in regulators adopting a 3 – 5 year price path before price re-opening. Alinta Energy believes that:

- The change in liquidity alluded to does not warrant a special circumstances review, this is not an endogenous factor causing price shock, it is a normal component of the National Electricity Market; and
- The Commission's willingness to re-open the price path before the completion of the scheduled 3 ½ year price path signals to retailers and investors that the Commission could intervene at any opportunity in the market. The existence of this type of regulatory risk and a lack of price certainty greatly deters current (and potential) investors and is likely to delay future investment in the electricity retail market, particularly in South Australia.

However, even if it could be argued that the presence of liquidity is a special circumstance, Alinta Energy maintains its view that liquidity has not returned in the South Australian market.

1.2. Liquidity has not returned to the SA electricity market

In its Draft Determination, the Commission indicates that it supports a move to an Energy Purchase Cost (**EPC**) based approach as;

> *"liquidity in the South Australian forward electricity contract market has increased since the ESCPD and following the removal of policy uncertainties, enabling a reversion to the use of the EPC-based approach for the setting of the WEC allowance for the purposes of the ESCPD."* [1]

[1] "2011-2014 Electricity Standing Contract Price Determination. Wholesale Electricity Cost Investigation" ESCOSA, October 2012, p9

At page 47, the Commission cites a chart derived from d-Cypha and AFMA data which purport to show that liquidity in the combined ET and OTC markets have increased considerably. It is Alinta Energy's view that this in itself does not demonstrate that the South Australian market for derivative contracts is liquid. Increases in liquidity are not the same as sufficient liquidity. In response to the Commission's analysis, Alinta Energy would make the following observations:

- Due to the risk of exposure to pool prices participants will require their positions to be substantially hedged. Evidence of trading is not evidence of liquidity but merely that participants view pool exposure more risky than holding contracts and thus are willing to pay the high transaction costs;
- Over time increased trading has been a response to increased competition. As more retailers enter the market they will trade with one another rather than rely solely on internal generation;
- Liquidity in a trading market requires the ability to transact quickly without exerting a material effect on prices. While the Commission provides evidence of volumes traded it provides no discussion on how volumes influence price. There is no analysis of bid/ask spreads nor is there discussion of the time and cost of individual transactions. In order to show that there is sufficient market liquidity with respect to tariff customers the Commission needs to demonstrate that the hedging position utilised (assumed in the additional data provided) can be transacted quickly without materially impacting prices.

Although the Commission has based its decision on moving to an EPC method of pricing on liquidity in the South Australian market, it is Alinta Energy's view that the Commission has failed to demonstrate there is sufficient liquidity and in fact has failed to address salient issues required in measuring liquidity.

In fact, Frontier Economic's own findings in its report make clear that liquidity has not returned. This is demonstrated by its need to model some market prices due to a thinly traded market. As stated by the Commission:

> *"As of 16 August 2012 the d-cyphaTrade peak and off-peak swap prices for 2013/14 were thinly traded. For Q2 peak contracts there was no traded volume and what appears to be a default value for price. This default value implied that the forward curve was inverted. That is, off-peak prices were greater than peak prices. Using an inverted forward curve for 2013/14 would not yield a sensible wholesale energy cost result. To resolve this issue, Frontier has used the price of base swaps in 2013/14 and the relative premium between peak/off-peak and base prices in 2012/13 to infer peak and off-peak prices for 2013/14."*[2]

The use of modelled market prices due to illiquidity is incongruous with the assertion that liquidity has returned to the market.

2. Impact on Competition

2.1. The Commission's Draft Decision will be to consumers' long term detriment

Alinta Energy firmly believes that the Commission's decision is short-sighted and will distort the operation of a competitive electricity supply chain. The longer term impacts to the development and fostering of a competitive market may very well be irreparable. Not only does the Commission's decision erode profitability to damage already committed business strategies in the retail market, it

[2] Frontier Economics "Wholesale Energy Cost Estimates For 2012/13 and 2013/14: A Draft Report Prepared for ESCOSA", October 2012, p.22.

sends a signal to the electricity market that the Commission is willing to intervene to artificially suppress prices to provide short term and populist gains.

The Commission states "*the EPC based approach provides cost estimates that are consistent with the costs on which prices are set in competitive retail markets*"[3]. It is Alinta Energy's view that it is not the Commission's task to set prices for tariff customers equivalent to those prevailing under competitive market conditions, but as stated in section 6 of the ESC Act, the Commission should:

> "*have as its primary objective protection of the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services; and (i) promote competitive and fair market conduct...and (iii) facilitate entry into relevant markets*".

A price determination which promotes competition and new entry is not one which seeks to mimic the prices of a competitive market. In trying to mimic competitive prices, the Commission has set a price which is too low, which will have a negative impact on competition in the market which will be to the detriment of South Australian consumers in the long term.

2.2. Retailers will revise their competitive offers

Alinta Energy has only recently initiated a large marketing campaign in the South Australia residential market, and underlying this campaign is a highly competitive offering. Alinta Energy's principal objective of its increased marketing presence in South Australia, combined with the offering of its most competitive offer yet, is to increase its market share while increasing brand loyalty. In turn this propagates further market competition, clearly an objective the Commission would wish to encourage.

Prior to the Commission's decision, Alinta Energy did not envisage positive returns in the South Australian market for its retail business in the near term. The cost of acquiring customers, combined with the margins on offering a product that will induce customers to switch retailers, meant that Alinta Energy was prepared to incur short-term low to zero margin returns in exchange for the opportunity to become a significant energy retailer in the South Australian market and grow its load to a reasonably profitable level. The Commission's Draft Decision is extremely detrimental to Alinta Energy's growth plans in the South Australian market as not only does it erode the financial viability of Alinta Energy's current expansion in the immediate future, it places serious doubt over the ability for Alinta Energy to earn a positive return on its retail and hence generation investment. As is the stated case of other retailers operating in South Australia, Alinta Energy is re-evaluating its retail strategy in South Australia.

Alinta Energy also notes with interest the recent comments from the incumbent retailer, AGL, in regards to the Commission's Draft Decision resulting in it withdrawing marketing activities from the South Australian market. It sends a clear signal as to the projected state of the market when the incumbent substantially reduces its effort in a retail market in regards to gaining customers. Alinta Energy notes with concern that after the effort in electricity market reform over the past 20 years, the South Australian market may end up stagnant from a competition perspective. The Commission's decision is a major backward step on the path to reform envisaged 20 years ago.

3. The headroom allowance is inadequate

The Commission's discussion around headroom raises some interesting questions. Headroom as a concept in regulatory decisions is an often debated point, and it is clear that there is no consensus

[3] ESCOSA, October 2012, p29

view as to how, or at what level, headroom is incorporated into regulatory decisions. Alinta Energy's view on headroom is that competition will always provide superior outcomes to unwarranted regulatory interference and that if headroom is set too high it will be mitigated as competitive tension increases within the margin. However, the consequence of too little or no headroom is two fold:

- The opportunity to offer price discounts by all retailers is diminished; and
- It discourages new entrants and tier two retailers actively engaging in the market, ultimately entrenching the incumbent position in the market.

The Commission admits in its Draft Decision that "*underestimating the Electricity Purchase Cost may reduce competition*" in addition to making reference to the 'promote competition' and 'protect competition' rationale for the calculation of the appropriate level of headroom. The Commission has relied upon some analysis undertaken by ACIL Tasman to determine a 'reasonable' level of discounting.

Alinta Energy's own internal analysis of the ACIL Tasman discount table has found that the list of market offers with discounts relative to the standing offer is not comprehensive. Of key concern is the oversight of Origin and TRU Energy market offers available to customers at the time of ACIL Tasman's analysis. TRU Energy had in fact offered 18.5% discount to customers willing to switch retailers under the One Big Switch campaign, and that Origin was in fact offering a 15% discount on usage to prospective customers. Nearly all other retailers identified by ACIL Tasman were offering discounts in excess of 10% discount to entice customers to switch retailers.

Alinta Energy strongly disagrees (and is well placed to comment on this aspect of ACIL Tasman's work) that 3% – 7% discounting is enough to induce a customer to switch retailers. Alinta Energy's own experience is that this level of discounting in relation to the Standing Contract price is significantly below what is required to increase one's market share. It is widely acknowledged that 10%+ discounts provide sufficient incentive for customers to switch.

Alinta Energy encourages the Commission to reconsider the level of headroom allowed for in its final decision.

4. Wholesale Energy Cost Component

4.1. Summary of concerns

Alinta Energy has a number of concerns with Frontier Economic's model and it's applicability to the calculation of the WEC. In summary these concerns are:

- Frontier Economic's model applies wholesale market contracts purchased at a single point in time as the primary input into its model. However, these are not the only instruments used by a prudent retailer to buy energy, and therefore do not reflect a retailer's wholesale energy cost. Retailers establish a portfolio of wholesale market contracts over a period of time and will invest in generation, directly or through Power Purchase Agreements (PPAs), to build a portfolio of wholesale energy supply contracts to effectively manage their load and price risks;
- The model does not adequately account for the risks/cost of extreme demand or supply events; and
- The reliance on marked to market wholesale contract prices will import the volatility from the wholesale market into the retail market - the very thing retailers try to protect customers from.

Each of these issues are discussed further below.

4.2. Background to how a retailer manages their wholesale energy cost

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 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 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 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.

4.3. The WEC model does not reflect the behaviour of a prudent retailer

Alinta Energy is very concerned that the WEC model does not factor in the portfolio approach described above and simply (and incorrectly) assumes retailers hedge their entire load at a point in time using prevailing market prices available on that day.

As discussed above, a prudent retailer will layer in contracts over a period of time to match its load, including for its known load which it will look to underwrite generation plant through PPAs or direct investment.

Therefore to determine a retailer's WEC the Frontier Economics' model should apply the following prices for an appropriate portion of its load:

- Published forward contract prices using a 2-3 year rolling hedge strategy; and
- Long Run Marginal Cost of generation representative of longer term PPA contract or the cost of directly investing in plant.

The WEC model fails to reflect this prudent strategy and therefore fails to reflect an appropriate WEC allowance.

4.4. **The risk of an extreme event is not captured**

As discussed above, retailers hedge their price and load risk by:

- Taking a portfolio approach to its contracting (described in the previous section); and
- Contracting to a 1 in 20 year demand/price year; or ensuring it has liquid capital on hand to fund any volume exposure to an extreme price period.

Frontier Economic's model does not appear to reflect a strategy to contract to an extreme event given:

- the only load scenarios it applies is to a maximum of a 10POE (ie: 1 in 10 year); and
- there is no account for the capital required to have on hand to manage the exposure to such an event.

It's important the risk associated with this WEC methodology includes an appropriate risk margin. By not taking into account either a more extreme year, or the cost of the capital to have on hand, the model does not reflect the costs/risks incurred by a prudent retailer.

Alinta Energy acknowledges the Commission has maintained the dollar Retail Operating Margin (**ROM**) allowance from the original price determination, and it could be argued by not reducing the ROM in-line with the lower WEC, that this additional amount of $1/MWh allows for an additional risk allowance. However, as the Commission states in its own Draft Report the reason for maintaining the dollar ROM appears unrelated to risk and is a result of the following:

- the current review is limited to the WEC;
- operating costs have not changed with the decision and therefore no change in ROM is required; and
- it's not appropriate to adjust the ROM during a price path.

While Alinta Energy does not necessarily agree with the above statements made by the Commission, it is clear that the maintenance of the ROM is not there to ensure the residual risk resulting for the change in WEC methodology is factored into the price. This should therefore be dealt with explicitly in the Commission's decision.

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4.5. Using marked to market contract prices will import volatility into the retail price

The reliance on marked to market wholesale contract prices will import the volatility from the wholesale market into the retail market. This is because the WEC will be determined by the applicable contract price published on the day the Frontier Economics' model is run.

Contract prices fluctuate considerably from one year to the next. Prudent retailers who hedge over a period of time using a combination of market contracts and PPAs (or direct investment in generation) will protect their customers from this volatility. The Commission's approach does not.

5. Small-scale Renewable Energy Scheme

Since the Commission published its Draft Decision, the Clean Energy Regulator has published an up-dated Small Scale Technology Percentage (**STP**) for 2013. The revised STP is 18.76%, which is considerably higher than the Commission's assumed STP of 7.94%. Alinta Energy requests that this revised non-binding STP be used in the Commission's final decision.

6. The Commission's Consultation Process

Alinta Energy is disappointed with the Commission's consultation process. Alinta Energy believes that the Commission has not followed best practice consultation in regards to the time made available for consultation and the nature of the information made available for the industry to review. Given the magnitude and impact of the Commission's Decision, it would seem imperative that the Commission demonstrate a high level of accountability and transparency when undertaking a Special Circumstances Review. Alinta Energy notes in particular that:

- The consultation process has not allowed for meaningful input from interested stakeholders on all aspects, including not allowing specific consultation on the *methodology* to be used to calculate the Energy Purchase Cost prior to the Draft Decision;
- The consultation time frame was short, given the significance of the review and the potential impact this type of review could have on market participants, and ultimately end use consumers and
- There is a need for further information in relation to the work undertaken by the Commission's consultant - Frontier Economics. However, the Commission has not allowed for a public forum or private meeting with Frontier Economics despite being requested to do so.

The 5 week time frame for interested Stakeholders to assess the Frontier Economics' model is not sufficient, and is a significantly shorter time than all other retail pricing determinations Alinta Energy has been involved in. Further, the Frontier Economics modelling and all assumptions have not been reviewed in any manner independent from the consultant or the Commission. Alinta Energy notes that it is critical that both the industry, and ideally an organisation with an in-depth knowledge of the industry, be able to liaise and review the work, particularly given the level of obvious contention regarding the assumptions and outcomes from this work.