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13 September 2011

Mr Bruce Layman
Director, References and Research
Economic Regulation Authority
PO Box 8469
Perth WA 6849

By Email: publicsubmissions@erawa.com.au

Dear Mr Layman,

INQUIRY INTO THE EFFICIENCY OF SYNERGY'S COSTS AND ELECTRICITY TARIFFS

Alinta Energy (Alinta) appreciates the opportunity to comment on the Economic Regulation Authority's (the Authority) issues paper concerning the efficiency of Synergy's costs and electricity tariffs.

Alinta Sales (a subsidiary of Alinta Energy) currently retail gas to around 620,000 customers in Western Australia, in addition to selling electricity to contestable customers within the SWIS. In addition, Alinta Energy has obtained a licence to retail electricity in South Australia, and has begun acquiring customers in this market. Alinta intends to expand its retail business into other National Electricity Market jurisdictions in the near future.

Alinta is supportive of the Authority, in its role as the independent regulator, conducting this inquiry and importantly establishing fully cost-reflective tariff levels for electricity consumers in WA. Alinta believes that independent regulation provides both the best outcome for both consumers and industry in the retail energy sector.

Alinta's main issues are summarised below:

- Synergy's retail operating costs need to be representative of a benchmark efficient retailer;
- The retail margin should reflect the systematic risks of a retailer operating in a competitive market;
- The Tariff Equalisation Contribution should be funded by a Community Service Obligation;
- Regulated tariffs for contestable customers should be phased out as soon as possible;
- The carbon cost allowance for Synergy provides the correct incentives for Synergy to manage its; carbon intensity;
- Assess the commercial nature of Synergy's wholesale contracts in comparison to an efficient retailer; and
- Thorough assessment of Synergy's past procurement of Renewable Energy Certificates in light of a national market for these certificates.

Each of these issues are discussed in more detail below.

Retail Operating Costs

Electricity retailers undertake a range of functions in supplying electricity to customers including billing services, handling customer inquiries, credit management, customer connections and disconnections, providing advisory services, maintaining information systems, and ensuring regulatory compliance. Traditionally, regulators have set an allowance for retail operating costs using both an analysis of a standard retailers costs, in combination with benchmarking analysis from other regulatory decisions. Generally for an entity such as Synergy, an appropriate definition of 'standard retailer' would encompass Synergy's incumbent position and its current economies of scale.

While the Terms of Reference specifically requires the Authority to consider the efficiency of Synergy's actual capital and operating expenditure, Alinta believes that the Authority runs the risk of establishing what would be considered a current cost-reflective tariff without having sufficient regard to existing regulatory benchmarks. Alinta welcomes the Authority assessing the efficiency of both the past level of operating expenditure and capital expenditure of Synergy, although sufficient weight needs to be given to a number of other regulatory decisions undertaken in regards to electricity retailers of comparable size, particularly given the amount of public information available from other decisions in jurisdictions.

Any analysis undertaken by the Authority on Synergy's actual operating costs would more than likely result in an upper and lower range depending on the determination of stand alone costs and avoided costs for the different segments of the Synergy business. Sufficient regard should be given to benchmarks from regulatory decisions previously undertaken elsewhere when selecting a point within this range.

Alinta agrees with the Authority in its conclusion that "moving towards cost-reflective tariffs is necessary to develop a competitive electricity market in Western Australia and to send appropriate price signals to customers regarding their electricity usage". However, it is critical to ensure that the cost-reflective prices set by the Authority include a sufficient retail operating cost allowance in order to further promote both competition and efficient price signals.

Retail Margin

Alinta is supportive of the Authority reviewing the margin to ensure that "the investor (the State Government) is appropriately compensated for the systematic risks associated with the electricity retail sector in the SWIS". Alinta further agrees with the Authority's objective in setting the margin to estimate profitability as if Synergy were operating in a competitive environment.

As with the establishment of retail operating costs, Alinta urges the Authority to draw upon work on the retail margin undertaken previously as part of regulatory determinations in jurisdictions elsewhere. Systematic risks refer to market wide risk factors that cannot be eliminated by investors, such as exchange risk, GDP variations or commodity price levels. Therefore, previous work undertaken by regulators for similar retail businesses operating in competitive markets provides a suitable starting point for the Authority to undertake its analysis.

Both the return, and variability in returns, of the service provider will be affected by business-specific and market-wide risk factors. The Authority notes that "in retailing to contestable and non-contestable customers, Synergy faces different risks". Alinta suggests that caution should be exercised in determining whether these risks constitute business specific risks (non-systematic risks) or market wide risk factors (systematic risks). Issues such as acquisition and retention costs when retailing to non-contestable customers should be considered within the retail operating cost component of the cost stack, not as a component of the retail margin.

Tariff Equalisation Fund

Alinta strongly believes that the Tariff Equalisation Fund should be funded from the State Government's consolidated revenue, rather than the current arrangement where SWIS network tariffs include a Tariff Equalisation Contribution (TEC) component. This approach to collecting the TEC is both non-transparent and distorts the otherwise efficient price signals that fully cost-reflective tariffs sent to customers. The Government should replace the TEC with a Community Service Obligation Payment which would remove the current distortionary impact of the TEC from Synergy's efficient tariff cost-stack.

Transition of Tariffs for Contestable Customers

Alinta supports transitioning tariffs for contestable customers (consuming over 50 MWh) to fully cost-reflective levels as soon as practical. Alinta sees no reason as to why these customers should continue to be subsidised by the State Government through the current tariff adjustment payment. Further, as competitive markets provide the best outcomes for consumers and business in the long term, the sooner these tariffs are transitioned to full cost recovery, and better reflect the true costs of electricity supply, the more business consumers will be able to benefit from a competitive market.

Carbon Tax

Alinta considers that the best mechanism to allow Synergy a portion of their cost stack dedicated to the impact of the Federal Government's Carbon Tax is to allow Synergy to recover the average carbon intensity of electricity generation in the SWIS. However, Alinta also notes that as Synergy has most likely entered into long-term electricity supply contracts with it suppliers, the opportunity for Synergy to respond to incentives may be limited in the short term. The Authority should therefore give full consideration to ensuring that any carbon allowance in Synergy's cost stack provides the appropriate incentives over time to ensure that Synergy minimises its carbon exposure in the most efficient manner.

Synergy's Wholesale Procurement

Given Synergy's current dominant position in the WA retail electricity market, Alinta supports the Authority undertaking a complete and thorough assessment of Synergy's wholesale energy procurement strategy. Alinta believes that particular attention should be directed towards the commercial aspects of the vesting contract. In particular, an examination of what would be an efficient purchasing strategy, and the commercial terms and decisions of that purchasing strategy, need to be investigated having regard to the efficient benchmark retailer model. Alinta would be particularly concerned if the current arrangements between Verve and Synergy further entrench the dominant position of each in the respective wholesale markets. The Authority needs to assess the replacement costs of generation in order to determine if the vesting contract leads to efficient pricing for the wholesale component of the cost stack.

Alinta also considers that wholesale energy procurement generally involves some level of risk, and that risk be priced by a retailer in its wholesale procurement strategy. Alinta believes that the Authority needs to investigate the nature of any contract entered into by Synergy and how risk is allocated when demand or supply exceeds minimum requirements under the contract. The key consideration for the Authority in assessing the pricing of risk is to compare the Synergy position with that of an efficient benchmark retailer.

Assessment of Synergy's Procurement of Renewable Energy Certificates

Any assessment of Synergy's past procurement processes needs to investigate if it purchased Renewable Energy Certificates (REC's) to meet its liabilities at least cost. The REC liabilities on retailers are applied at a Federal Government Level, and the opportunity for a retailer such as Synergy to purchase RECS exists within a national market. Alinta believes that the Authority should pay particular attention to Synergy's past procurement strategy and whether Synergy has minimised the cost of meeting its REC obligations given the availability of a national market for REC's. If analysis undertaken by the Authority indicates that Synergy has not procured its REC's in the most cost effective manner, then Alinta believes that this should be reflected in any cost stack allocation undertaken by the Authority related to REC liabilities.

Other Issues

As a minor point, Alinta notes that the Authority refers to contestable gas customers are those customers, typically businesses, who consume more than 180 GJ per annum. Alinta wishes to reiterate that all gas customers (including those customers who consume less than 180 GJ per annum) are currently contestable in the WA market[1]. There are no restrictions on retailers other than Synergy actively targeting any gas consumer in the WA market.

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

Yours Sincerely

M Shepherd

Michelle Shepherd
General Manager, Regulatory Affairs
Alinta Energy Pty Ltd

[1] See the Office of Energy website - http://www.energy.wa.gov.au/3/3178/64/competitive_gas_markets.pm