SUBMISSION TO THE

ECONOMIC REGULATION AUTHORITY (ERA)

REGARDING THE ERA'S DRAFT REPORT

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

MAY 2012

Executive Summary

Matter	The ERA Draft Report "Inquiry into the Efficiency of Synergy's Costs and Electricity Tariffs" (Draft Report) was issued 4 April 2012.
Context	The ERA is accepting public submissions on the Draft Report up to 2 May 2012. The ERA will issue a Final Report to the Treasurer by 1 June 2012.
Scope	Synergy provides this submission to assist the ERA's deliberations with respect to its recommendations in the Final Report.
Key issues	1. The ERA has conducted a thorough and exhaustive Inquiry against the Terms of Reference. 2. Synergy is in agreement with the majority of draft recommendations. 3. The principle issues which Synergy believes require further consideration by the ERA are: 3.1. Long Run Margin Cost (LRMC) calculations have a number of deficiencies (Section 2.1.1). 3.2. The assumption that Synergy can renegotiate existing wholesale contracts' carbon intensity to a LRMC carbon intensity is contractually not possible (Section 2.1.2). 3.3. A glide path for achieving the benchmark cost to serve should be considered (Section 2.2) . 3.4. Separate retail margins should be used for contestable tariff customers and franchise tariff customers using benchmarks margins adopted in other jurisdictions (Section 2.4.1). 3.5. The LRMC, as calculated, should not be used to set cost reflective tariff levels for 2014/15 onwards (Section 2.5.1). 3.6. Parameter changes (e.g. CPI) impacting the efficient cost reflective tariff levels should be updated yearly (Section 2.5.3).

3.7. ERA reviews its wholesale contract optimisation model to ensure all relevant contractual constraints are incorporated into the model (Section 2.5.4).

3.8. The impact of the variability of wind generation and potential Scope 2 and 3 emissions are incorporated in the calculation of carbon intensity (Section 2.5.5).

3.9. The B1 tariff should be withdrawn (Section 2.5.6).

4. A number of related issues to the above, along with some issues of lesser importance, are also discussed in this paper.

1. Background

On 11 July 2011 the Treasurer requested that the ERA undertake an inquiry in to the efficiency of Synergy's costs and electricity tariffs. The ERA has since produced a draft report entitled "Inquiry into the Efficiency of Synergy's Costs and Electricity Tariffs" (Draft Report) and has called for public comment by 2 May 2012.

Among other matters, the report recommends efficient cost reflective electricity tariffs for the financial years 2012-13 to 2015-16 inclusive. These calculations will form the basis by which Synergy will be able to recover its costs.

Synergy has prepared the attached document which generally accepts much of the ERA's findings. However, the document also highlights areas where Synergy believes the ERA's methodology and assumptions will require revision.

2. Matters for consideration

2.1 Wholesale Electricity Costs

2.1.1 Synergy believes that there are a number of deficiencies in the Long Run Margin Cost (LRMC) calculations.

In commenting on the LRMC calculation, Synergy makes reference to the Draft Report and Frontier Economics' report "LRMC of Regulated Tariffs – Final report – March 2012" (Frontier LRMC Report) released on the ERA's website.

Load Profile
In calculating the LRMC, Synergy's total load profile has been used. [1]

Synergy's total load profile is made up of both tariff and contract customers. The overall capacity factor of Synergy's total load inclusive of contract customers is higher than for tariff customers alone.[2] By using the total load profile a lower LRMC is produced than if just the tariff load profile is used. Thus the tariff customers are benefiting from Synergy's contract customers and a potential subsidy exists. The value of this "benefit" is dependent on the size and shape of the contract customers.

[1] Draft Report p 24
[2] Frontier LRMC Report p 9

A new retailer could not attain the same LRMC as calculated unless it also had other non-tariff loads which had the same capacity factor as Synergy's. The SWIS customer base with high capacity factors is however extremely shallow. This is due to the relatively low level of intensive base load industry compared to the NEM. The relatively small group of contestable customers with more efficient loads are highly sought after by all existing retailers.

The use of the total load profile appears to be in conflict with the ERA's overall approach in regard to cost reflectivity. The ERA states:

"The test for whether existing tariffs are efficient and cost reflective is whether an efficient new retailer could come into the market and sell electricity at a lesser tariff than what the existing retailer is charging. In undertaking its analysis, the Authority has kept this test in mind."[3]

To be consistent with the above statement Synergy believes only the tariff load profile should be used when calculating LRMC.

Annual Investment Path

Frontier Economics' modelling approach is to perform a new portfolio optimisation each year, thereby allowing the most efficient composition of new plant to be selected for each year's load shape.

The point is highlighted in Figure 7[4] of the Frontier LRMC Report, which shows for the Low Case that coal generation contributes to around 20% of the portfolio in 2012/13 and 2014/15. In 2015/16 coal generation drops to 0%, and in 2016/17 it rises again to around 20%.

Whilst the model aims to achieve the most efficient mix of plant, it fails to take into account the economic reality that retailers are unable to contract wholesale supplies with such price and volume resets.

Investment decisions should also be forward looking, and as such plant may be built that is not optimal in the short-term but makes sense in the longer term (e.g. as carbon prices increase gas and renewables plant become more cost competitive). Also, retailers such as Synergy are not able to re-optimise their investment decisions on an annual basis.

If LRMC is to be used Synergy recommends that the optimisation be constructed for the total review period and that yearly re-optimisations are not undertaken.

[3] Draft Report p ix
[4] Frontier LRMC Report p 21

Large scale Renewable Energy Target (LRET) Obligations

Energy retailers are required to meet the Commonwealth Government's LRET requirements. Obligations are met by the purchase of Large-scale Generation Certificates (LGCs) which are produced by renewable energy generators.

For LRMC purposes, a reasonable assumption is that the purchase of LGCs is done via long term contracting of renewable generators, and the costs of both the LGCs and the energy produced be part of the LRMC costs. This is consistent with the scheme's general intent "to encourage the additional generation of electricity from renewable sources"[5].

The modelling undertaken by Frontier Economics ignores any LRET obligation and therefore does not include any renewable generation in the efficient LRMC cost.

If LRMC is to be used Synergy recommends that the requirement to meet LRET obligations be incorporated into the LRMC modelling[6]

Cost Assumptions

Synergy's own research indicates different capital costs than those used by Frontier Economics. However it is acknowledged that their assumptions do come from a reputable source, being the Australian Energy Market Operator.

Of greater concern to Synergy is the delivered gas price assumptions, whereby the assumption has the gas price decreasing, in real dollars, from $8.25/GJ (2013/14) to $7.68/GJ (2014/15) – a decrease of 6.9%.[7] This one assumption appears to be the principle driver for the conclusion that LRMC is lower than Synergy's costs for 2014/15 and 2015/16. Synergy has provided the Authority with a separate paper on its view of the forward price for delivered gas in the SWIS.

Typically any generator committing to a new long term capital investment will require a long term fuel contract. Such fuel contracts are normally fixed price, or have market price resets in the longer term e.g. once every ten years.

If LRMC is to be used Synergy recommends that fixed fuel prices are used for the review process.

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[5] .Australian Government Clean Energy Regulator website: http://ret.cleanenergyregulator.gov.au/About-the-Schemes/lret

[6] *Note in incorporating the LRET obligations into the LRMC modelling, the full costs of the renewables need to be modelled (e.g. lower IMO capacity crediting, variability of the output and potential increased market fees for load following)*

[7] Frontier LRMC Report p 12

Reality Constraints

Synergy understands the "green fields" approach used by Frontier Economics in the LRMC modelling. However, it is considered prudent that appropriate constraints are applied to ensure the generation investment path is more realistic.

Some of the "realities" that should be considered are:

- Gas transport – the LRMC base case results show the total load being met by gas fired generation. Currently, and in the medium term, there is insufficient gas transport capacity to meet such a load.
- Gas price – a significant increase in the gas required for generation would affect normal supply / demand balance resulting in an increase in the gas price, which in itself changes the LRMC optimisation.
- Energy security – the LRMC does not take into account energy security. Considerations around the issues of energy security need to be incorporated into LRMC modelling.

If LRMC is to be used Synergy recommends that a number of reality constraints are incorporated into the modelling.

2.1.2 *The assumption that Synergy can negotiate the carbon intensity of existing arrangements to achieve LRMC carbon intensity rates ignores the reality of wholesale electricity contracts and the operations of the Wholesale Electricity Market (WEM).*

The ERA makes the following statements in the Draft Report:

"However, the full cost of carbon that is imposed on a generator is not necessarily passed on to consumers in an efficient market. The amount of carbon cost that passed on to consumers in an efficient market is the cost that applies to the marginal generator (that is, the last generator that is called upon to meet demand at any given time)."[8]

"..a coal based generator cannot always pass through the full carbon cost it incurs because in a competitive environment it may be under-priced by a less carbon intensive generator."[9]

"As outlined above, the Authority does not consider passing through the full cost of carbon to customers to be efficient. The Authority regards the carbon cost built into the LRMC calculation to be consistent with carbon cost that would be expected in a competitive market.

[8] Draft Report p 28
[9] Draft Report p 29

"The Authority recognises that it may require up to two years for Synergy to re-negotiate its contracts to ensure that only an efficient level of carbon cost is recovered in its tariffs."[10]

Synergy acknowledges that for any **new** wholesale contract the competitive procurement process would result in a generator pricing at or near the costs (including carbon) of their nearest competitor. However this principle does not apply to existing wholesale contracts.

The suggestion that LRMC or "market" carbon costs can be achieved appears to be based around a gross pool market such as the National Electricity Market (NEM). The market Synergy operates within, the WEM, is not a gross pool but a bilateral market. Therefore the initial impact of carbon in the WEM will not be subject to market forces (as in a gross pool) but to the actual contractual terms and conditions of the bilateral contracts.

Synergy's existing wholesale contracts were negotiated prior to the implementation of the current carbon scheme (the Clean Energy Act).

Contracts typically contain a "change in law" or similar clause which allows for the generator to pass through to Synergy the costs incurred by a change in law such as the carbon scheme.

The costs that can be passed through are the actual costs[11] calculated as actual carbon intensity (inclusive of scope 1 and any applicable scope 2 and 3 emissions) multiplied by the carbon price. The change in law clauses, or any other contract clause, do not allow for a setting of carbon cost to a "competitive market price". Once the mechanism for the pass through of carbon costs is agreed it will stay in force for the remainder of the contract term. The majority of Synergy's wholesale contracts have a remaining life of 10 years or more.

It is therefore inconceivable that Synergy will be able to renegotiate existing contracts to achieve a "competitive market price" for carbon within two years as recommended by the ERA.

Synergy recommends that the ERA's recommendation that Synergy achieves LRMC carbon intensity rates be removed.

[10] Draft Report p 29

[11] The generator has a requirement to take actions minimise the impact of the change in law.

2.2 Retail Operating Costs

2.2.1 Overall Synergy is in agreement with the approach adopted by the ERA in determining the allowable retail operating costs to be recovered from tariff customers.

The determination of operating costs using a benchmarking approach has a number of issues including:

- Ensuring that costs are comparative and that appropriate allowances have been made for different market structures and legislative regimes (i.e. compared with the National Electricity Market (NEM)); and
- The circulatory of basing decisions on other regulatory decisions resulting in a level of consistency amongst retailers, but not in itself implying a robust and accurate calculation. (The ERA recognised this issue when commenting on using benchmarking for retail margins).

Accepting the above issues, the overall benchmarking approach appears reasonable. However, Synergy has concern with the allowances for the costs of retaining contestable tariff customers and the glide path for reaching benchmark costs.

The Draft Report states:
"Costs associated with the acquisition and retention of contestable customers will be accounted for in Synergy's retail margin."[12]

Synergy believes that a separate and additional cost should be allowed in regard to the retention and acquisition of contestable tariff customers – a cost which is allowed for in other regulatory decisions.

Furthermore, these costs do not appear to have been considered in the determination of retail margins with the ERA recommending the same margin for both franchise and contestable customers.

The ERA has allowed Synergy to recover forecast operating costs for 2012/13 and 2013/14 and then benchmark costs ($81.50 2011/12 dollars) thereafter. Synergy proposes that the benchmark should be achieved over a two year period:

- 2014/15 - $85.14 (2011/12 dollars)
- 2015/16 - $81.50 (2011/12 dollars).

Synergy recommends:

- *A separate and additional cost allowance for the acquisition and retention of contestable customers is included in the allowable costs to be recovered; and*
- *A glide path for achievement of the benchmark costs being spread over 2 years.*

[12] Draft Report page 39

2.3 Non Controllable Costs

2.3.1 Synergy agrees with the ERA's recommendations on Non Controllable Costs and recommends that these should be reset each year with the most up-to-date forecasts.

The ERA concludes that network costs, market fees and ancillary services are outside the control of Synergy and these are allowable to be passed through to tariff customers.

The level of these costs have the ability to vary significantly from the current forecasts. In particular, the IMO and System Management are undertaking significant technology upgrades to accommodate such factors as competitive balancing, the gas bulletin board and gas statement of opportunity.

Whilst the IMO has indicated its portion of the market fees resulting from system improvements will only modestly increase in real terms, Synergy understands that the bulk of the system costs and ongoing scheduling costs will reside with System Management. This cost increase has not yet been translated into a market fee forecast.

Ancillary Services costs could also vary because of rule changes related to making the load following service linked with an expansion of intermittent generation capacity.

Synergy recommends that the allowances for the recovery of Network Charges, Market Fees and Ancillary Services Costs are reset on a yearly basis.

2.4 Retail Margin

2.4.1 Synergy believes the risks associated with contestable tariff customers are greater than for franchise tariff customers and therefore a higher margin should be assigned to contestable tariff customers.

The ERA states:

"..the Authority does not consider Synergy's contestable and non-contestable operations to have different levels of risk, and consequently does not consider it appropriate to adopt separate retail margins for contestable and non-contestable customers. The principle applied when setting regulated tariffs is to achieve the same outcome as would apply if markets were fully competitive. For this reason, the tariffs for both Synergy's contestable and non-contestable customers should reflect the levels of risk which would apply in a competitive market setting. Further, the practice of adopting multiple retail

margins is largely inconsistent with regulatory decisions in other jurisdictions."[13]

In response to the ERA's Issues Paper, Synergy proposed that a retail margin should compensate a retailer for systematic risks which include volume risk, energy purchase risk and market risk. A contestable tariff customer who has the right to churn to a competitor at anytime and without restriction has significantly more systematic risk than a franchise tariff customer.

Synergy also notes that other regulators have not had to consider the issue of differential margins for contestable and franchise customers as Full Retail Contestability (RFC) exists in all eastern state mainland states.

Synergy recommends that a contestable tariff margin be set at around the median of recent regulatory decisions (as summarised in the Draft Report) of 5%.[14]

2.4.2 *The methodology proposed for the calculation of retail margins – Cost of Acquiring and Retaining Customers (CARC) – has a level of theoretical appeal but does pose issues of verification and calculation.*

Synergy agrees the approach of determining the margin by valuing the "asset" business and applying a rate of return has merit.

The difficulty, as acknowledged by the ERA, is that the majority of the "value" of a retailer – the customer base – is an intangible asset and there is no generally agreed method for determining such valuation.

The CARC approach proposed relies on:

- The CARC estimates of other Australian regulators with the ERA selecting a rough average of these costs ($40/ per customer); and
- A long term valuation methodology using the CARC estimate to determine this intangible asset value.

Synergy has not had sufficient time to fully investigate the CARC estimates of other jurisdictions but notes these range from $28 to $49 per customer. The adoption of either of these figures would change the calculated retail margin recommended by the ERA for 2012/13 of $59.6 million by approximately 14% up or down.

The long term valuation methodology for taking the yearly CARC amount ($40/ customer) and turning it into an intangible

[13] Draft Report page 56
[14] Draft Report Table 16 page 51

asset amount (calculated by the ERA for 2012/13 of $539.9 million) has not been disclosed in the Draft Report. Synergy can therefore not comment on the applicability of this calculation.

Synergy believes that if an 'asset valuation' methodology is to be used for the calculation of margin that the "Cost of Acquiring a Business" approach as summarised on page 53 and 54 of the Draft Report be used.

2.4.3 Synergy believes the Weighted Average Cost of Capital (WACC) should be higher than that determined by the ERA.

The ERA's assessment of WACC parameters results in a WACC that is much lower than other jurisdictions. In particular, IPART's 'Changes in Regulated Electricity Retail Prices from 1 July 2011' estimates a real pre tax WACC range of 7.40% - 10.50% with a mid-point of 8.90%. In contrast the ERA has calculated a real pre tax WACC of 4.90% which falls well below IPART's lower boundary.

It is noted that the ERA's consultant, Frontier Economics, which was engaged to estimate long run marginal cost, has also sourced IPART's WACC calculation. Frontier Economics has used a real pre-tax WACC of 7.80% with a low case sensitivity of 6.50%. Again, the ERA's WACC is outside of the lower boundary.

It would appear that the ERA's detailed calculation of each parameter has resulted in too great a divergence from the bounds of industry acceptable WACC levels.

Synergy recommends that the ERA adopt an approach to calculating WACC more closely aligned to the recent decisions of IPART.

2.5 Electricity Tariffs

2.5.1 LRMC energy costs and carbon intensity, as calculated by Frontier Economics, is not appropriate for setting tariffs in 2014/15 and 2015/16.

The ERA has proposed that LRMC are used to construct tariff cost stacks for 2014/15 onwards. Synergy believes there are a number of flaws in the LRMC calculation methodology which has been detailed in Section 2.1 "Wholesale Electricity Costs".

While not having access to Frontier Economics' calculations it is Synergy's belief that if appropriate changes were made to the LRMC modelling, taking into account Synergy's comments, the resulting LRMC would be greater than Synergy's actual costs.

Additionally, Section 2.1 "Wholesale Electricity Costs" explains that the current contract arrangements in regards to the pass through of carbon means that it would be impossible for Synergy to achieve the calculated LRMC carbon intensity levels within two years.

In the section "Other Considerations" Synergy will discuss alternative methods to construct tariff costs stacks for 2014/15 onwards.

Synergy recommends that the LRMC approach is not used for determining the efficient cost reflective level for tariffs for 204/15 and 2015/16.

2.5.2 The cost of balancing should be incorporated into tariff cost stacks.

No allowance has been made within the tariff cost stacks, or any allowance in the margin, for the cost of balancing.

Balancing risk is the difference between Synergy's energy nominations, based on its forecast load, and the actual load. Synergy must make its nominations a day ahead (the scheduling day) on a half hourly basis – in effect, Synergy must make nominations for the period 24 to 48 hours in advance.

Any difference between Synergy's nominations and actual load results in Synergy either spilling (selling) into balancing market for over nominations or buying from the balancing market for any under nominations.

There are a range of factors that influence Synergy's ability to accurately forecast. The major factor is the difference between the forecast weather (estimated on the scheduling day) and the trading day's actual weather. The importance of weather accuracy is paramount given that Synergy's load, and particularly the residential load, is highly weather dependant.[15]

Historically the net cost of balancing to Synergy has been in excess of $10 million pa. With the introduction of competitive balancing within the WEM there is potential for this cost to increase. The new structure allows for a negative overnight balancing cost of up to $1,000/MWh (if Synergy over nominated it would not only pay for the energy it nominated, potentially it would also have to pay up to $1,000/MWh to the IMO).

[15] Example: The weather forecast for the day ahead used by Synergy to forecast load (provided by the Bureau of Metrology) forecasts high temperatures throughout the whole day. This would result in Synergy forecasting a high load (e.g. significant residential air conditioning). If the actual temperatures are considerably lower (e.g. the sea breeze comes in earlier than expected) then Synergy would have over nominated in these periods.

Synergy recommends that a separate cost allowance for balancing costs be incorporated into the tariff cost stacks.

2.5.3 A range of parameters changes should be made each year to re-determine the cost reflective tariff levels.

The ERA appears to be proposing that the "cost reflective tariff" levels be set for the next four years with no yearly adjustments. Synergy believes while a methodology for calculating cost reflective tariffs should be agreed in advance, the parameters used to construct the cost reflective tariffs should be updated each year and a new calculation be undertaken.

The following parameters should be updated yearly:

- CPI and labour escalation rates – both the most recent historical rates and the most recent approved forecasts should be updated. CPI impacts on Synergy's wholesale electricity costs, network costs and operating costs. Labour escalation impacts the labour component of operating costs.
- Renewable percentages – the Federal Government sets both the Small-scale Technology Percentage (STP) and Renewable Power Percentage (RPP) yearly. The most recent percentage should be used.
- Changes in non controllable costs – any changes to non controllable costs should be included in a re-calculation. Non controllable costs include network costs, market fees and ancillary services costs.
- Changes in wholesale contract pass through costs – certain wholesale contracts allow the generator to pass through to Synergy defined ancillary service and network costs. If the cost the generator incurs for these defined charges changes then the impact on Synergy's wholesale costs should be incorporated into the tariff cost stacks.
- Final negotiated carbon intensities in wholesale electricity supply agreements.
- Changes in Synergy's wholesale electricity costs (due to changes in load profiles, impact of increased PV penetration within the SWIS, contract price resets and new supply contracts commencing).
- Changes in IMO capacity due to changes in regulated price or SWIS demand.
- Changes in capacity due to changes in the regulated tariff load shape.
- Changes in forecast Balancing and STEM prices (due to the impact of the carbon tax, market surplus/shortfall, fuel supply).

Synergy recommends that the tariff cost stack calculations are updated yearly for parameter changes.

2.5.4 *The ERA's optimised wholesale dispatch model appears to not have incorporated all wholesale contractual constraints.*

To determine efficient cost reflective tariff levels for 2012/13 and 2014/15 the ERA has constructed a wholesale dispatch model. The model attempts to forecast the optimal dispatch from Synergy's existing wholesale portfolio. The output, the optimal dispatch, is then used to forecast expected wholesale costs that are incorporated into the tariff cost stacks.

The optimal dispatch calculated by the ERA is different to calculations undertaken by Synergy. The differences have been reconciled. The differences have been isolated to a number of wholesale contracts where the contract constraints have not been incorporated into the ERA's modelling. This results in the ERA forecasting the dispatch of some contracts outside of the allowances in the contracts.

Synergy has separately provided the ERA with details of the differences and the contractual constraints.

2.5.5 *ERA's approach to calculating carbon intensity should be modified.*

The ERA has used its optimal dispatch model to calculate the expected carbon intensity (and therefore carbon costs).

As discussed above, correcting the optimal dispatch model to incorporate contractual constraints will change the overall carbon intensity rate of the portfolio.

Additionally, Synergy believes the following issues need to be considered in determining carbon intensity including:

- Dispatch variability – the optimal dispatch model assumes that generation from wind generators can be perfectly forecast and optimised. In reality wind generation cannot be accurately predicted, particularly when Synergy is required to nominate a day ahead. Synergy has modelled its expected carbon intensity taking into account the variability of wind generation.
- Scope 2 and 3 emissions – the ERA has not taken into account any Scope 2 and 3 emissions incurred by generators that may contractually be passed onto Synergy. Synergy has modelled its expected carbon intensity making an allowance for some pass through of Scope 2 and 3 emissions.

Synergy has separately provided the ERA with details of Synergy's carbon intensity calculations.

Synergy recommends that allowances for the unpredictability of wind generation and potential Scope 2 and 3 emissions costs are incorporated into calculations of carbon intensity.

2.5.6 B1 retail tariff should be withdrawn.

The ERA as part of its review has identified the B1 residential tariff as a candidate for amalgamation or removal. The B1 tariff is an off-peak water heating tariff available to SWIS customers for residential water heating during a six-hour period between 11pm and 6am. The tariff was originally introduced by the State Energy Commission in the 1970s.

The ERA report also reflects Synergy's previous advice to the Authority the current method of billing the B1 tariff on a collective bill is not compliant with the *Code of Conduct for the Supply of Electricity to Small Use Customers* (Code of Conduct) with respect to a small amount of information currently not displayed on the bill. This relates to the average daily consumption and average daily cost of consumption. Synergy has received one customer complaint to date regarding the omitted information.

The ERA states in its report that the basis for examining the B1 tariff is the retail operating costs for maintaining small numbers of low consumption tariff customers is likely to outweigh the benefits to the customer group resulting in a cross-subsidisation. Synergy agrees with this finding. Further, Synergy recommends the withdrawal of the B1 tariff on the basis that:

- Synergy no longer actively promotes the B1 tariff given the existence of its SmartPower and PowerShift time of use pricing products.
- The B1 tariff is an historical legacy which requires the installation of two meters compared to current single metered time of use pricing options.
- Had the tariff not been legislated and solely within Synergy's control, a commercial decision would have been made to remove the B1 tariff a number of years previously.
- The B1 customer base is approximately 550 residential customers compared to more than 900,000 on the A1 tariff. It is not feasible to maintain a regulated tariff for a mass market retailer to such a small number of declining customers.
- Synergy estimates the cost to implement billing system changes to comply with the Code of Conduct requirements to be $110,000 and would take three months to implement. Synergy cannot commercially justify this system investment for such a small number of customers on the basis that:

- B1 customers will decline further over time;
- B1 customers are not requesting the billing information;
- system changes will only deliver minor or inconsequential benefits to B1 customers but at a significant cost; and
- resources will be diverted from initiatives which will yield greater customer benefits such as first call resolution process and system reviews.

Synergy recommends that the B1 tariff be withdrawn

3. ERA preliminary recommendations – Synergy's summarised response

1) The Authority considers Synergy's demand forecasting approach and assumptions to be appropriate and has accepted Synergy's demand forecasts for the pricing period.

   Synergy's response: Agree with recommendation.

2) The Authority considers Synergy's energy consumption forecasting process to be efficient and accepts Synergy's energy forecasts for the period 2012/13 to 2015/16.

   Synergy's response: Agree with recommendation.

3) The Authority considers Synergy's methodology and estimates for dispatching energy to be efficient.

   Synergy's response: Agree with recommendation.

4) The Authority considers that Synergy may not be able to respond immediately to the carbon price. As a result, while LRMC provides an indication of the efficient level of cost over time, it is more appropriate to adopt Synergy's actual contract costs for 2012/13 and 2013/14, followed by the LRMC approach for the following two years when determining Synergy's efficient costs. The Authority notes that:

   a) The LRMC is slightly lower than Synergy's forecast average cost of dispatch in 2012/13, mainly due to a lower carbon intensity of the new entrant generator; and
   b) From 2014/15 onwards, the LRMC is substantially below Synergy's forecast average cost of dispatch, due to both a lower energy cost and a lower carbon cost.

   Synergy's response:

   - *Agree with recommendation that Synergy's actual contract costs be used for 2012/13 and 2013/14, (after corrections are made to the ERA's dispatch optimisation model – refer to Section 2.5.4).*
   - *Strongly disagree with the recommendation that LRMC be used for 2014/15 onwards (refer to Section 2.5 above).*

5) The Authority considers Synergy's procurement of Renewable Energy Certificates (RECs) to be efficient.

   Synergy's response: Agree with recommendation.

6) The Authority has adopted the actual contract costs for Synergy in the first two years; being 2012/13 and 2013/14, followed by

the LRMC cost approach for the following two years; 2014/15 and 2015/16.

Synergy's response: Refer to comments made on Recommendation 4.

7) The Authority has adopted the actual retail operating costs for Synergy in the first two years; being 2012/13 and 2013/14, followed by $81.50 per customer (in 2011/12 dollars for the following two years; 2014/15 and 2015/16.

Synergy's response: Agree with benchmark but proposes it should be achieved by 2015/16.

8) The allowance of $81.50 per customer (in 2011/12 dollars) for retail operating costs should apply to all tariff customers, contestable and non-contestable. Additional efficient costs associated with the acquisition and retention of contestable customers is recovered through Synergy's retail margin.

Synergy's response: As no explicated allowance for acquisition and retention of contestable customers in the retail margin recommended by the ERA, then an additional allowance for this cost should be included in the allowable costs.

9) Retail operating costs are escalated by 3.375 per cent over the review period.

Synergy's response: Agrees with the escalation components being used, however these should be updated yearly.

10) Depreciation is separately accounted for in Synergy's cost, and the Authority considers that the average annual depreciation cost of $14.10 per customer, to be appropriate.

Synergy's response: Agree with recommendation.

11) The Authority recommends that the TEC be removed from Western Power's Network Charges and be funded by a CSO from the consolidated revenue.

Synergy's response: No comment. This was a recommendation made to the Government and not Synergy.

12) Synergy has little control over its ancillary services costs. The Authority therefore recommends that forecast costs for ancillary services be included in the costs to be recovered from Synergy's customers.

Synergy's response: Agree with recommendation with the figures reviewed and updated yearly.

13) As a participant in the WEM, Synergy cannot avoid market fees and has little influence on the expenditures incurred by the IMO and System Management. The Authority therefore considers it is appropriate for Synergy to recover the payment in full from its customers.

Synergy's response: Agree with recommendation with the figures reviewed and updated yearly.

14) An appropriate retail margin for Synergy for the next four years is 3.5 per cent of its total cost.

Synergy's response: Disagree with recommendation (refer to Section 2.4 above).

15) The Authority considers that there is no justification for merging any tariff categories at this stage.

Synergy's response: Agree with recommendation.

16) The Authority considers two years to be an appropriate period for Synergy to achieve the efficiency gains necessary to move to cost reflective tariffs.

Synergy's response: Agree with recommendation to achieve cost to serve benchmark operating costs (refer Section 2.2). Disagree with recommendation in regard to moving to LRMC wholesale costs (refer to Section 2.5 above).

17) The Authority recommends that Synergy take steps to reduce wholesale electricity costs and retail operating costs over this two year period.

Synergy's response: See comments for Recommendation 16 above.

18) The Authority recommends that the subsidy to Horizon Power be provided by a CSO rather than the TEC, and notes that this CSO will be partially offset as a result of moving to cost reflectivity.

Synergy's response: No comment. This was a recommendation made to the Government and not Synergy.

19) The Authority recommends that regulated tariffs be retained for all contestable customers through to 2015/16 and re-assessed at the next review.

Synergy's response: Agree with recommendations.

20) The Authority recommends that the next inquiry into the efficiency of Synergy's costs and electricity tariffs be conducted in 2014/15 rather than at the end of the four year review period,

to allow for a timely assessment of changes in Synergy's carbon cost.

Synergy's response: Agree with recommendations.

21) The Authority recommends that if there are significant changes to economic conditions, a mid-period review be undertaken.

Synergy's response: Agree, however there is a requirement for yearly updates of parameters (refer to Section 2.5.3 above).

4. Other matters

4.1 *Alternative methodologies for determining efficient cost reflective tariff levels for 2014/15 and 2015/16.*

Synergy agrees that currently the most practical approach to setting tariffs for 2012/13 and 2013/14 should be based on Synergy's actual average wholesale costs.

The setting of 2014/15 and 2015/16 tariffs using a LRMC approach is not considered the optimal methodology – Synergy has made comments on this above.

However Synergy believes that alternative approaches should be considered.

The alternative approaches would focus on calculating the true actual cost of supplying the tariff load. The approach taken for 2012/13 and 2013/14 is to use Synergy's **average** wholesale costs. The average wholesale costs are constructed using Synergy's total forecast load (tariff and contract). This approach will lead to a subsidy being applied to either the tariff or contract load over time and therefore is not recommended as a determination of efficient costs.

A fair methodology would be to calculate the actual costs of supplying the tariff load only, from existing and forecast wholesale contracts.

There are a range of methodologies for undertaking such calculations ranging from Synergy operating the two loads (tariff and contestable) completely separately (which would require significant system changes) to a range of just cost allocation methodologies such as marginal costing, incremental costing etc.

Synergy believes an alternative approach should be developed and implemented by 2014/15.

Synergy proposes that a project team, including stakeholders, be formed to:

- Identify alternative approaches and a set of agreed criteria to recommend an alternative approach.

- Detailed construction of the alternative approach including methodologies, assumptions, and data sources would be undertaken involving stakeholders.
- The output of the recommended alternative approach is used in the construction of efficient cost reflective tariff levels for 2014/15 onwards.