



**The South Australian Council of Social Service (SACOSS)
Submission to the Essential Services Commission of SA
2012 AGL Special Circumstances Review**

9 March 2012

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Executive Summary

AGL has proposed an increase in the price ceiling of Electricity Standing Contract relative price movements for the remainder of the regulatory period to accommodate the carbon price, and an expected change in distribution prices from July 2012.

In reviewing this proposal, SACOSS acknowledges that the AGL proposal is not explicitly for a price rise but for 'room' in the determination to allow for the impact of a carbon price. In short, *if* the increase in the ceiling is approved then the standing contract price *could* rise to the new ceiling price without necessarily triggering a re-opening of the determination. Whether or not the standing contract price would rise is a different issue.

There are at least two questions that would need to be answered before approving such a change. Firstly, a threshold question exists around whether or not there is justification for any change to the ceiling under a 'Special Circumstances' review *before* the price appears.

Secondly, and subsequently, if it is accepted that there is merit in applying an increase, is AGL's methodology and result acceptable? That is, is this a fair estimate of the impact of a carbon price on supplying the standing contract?

These questions are analysed further in this submission. Overall, AGL's approach ignores the more cost reflective Relative Price Movement (RPM) approach to the movements from the 1 January 2010 opening price starting position. AGL's methodology overstates the likely impact on wholesale energy costs.

The conclusions drawn by SACOSS are that:

- The AGL methodology substantially overstates the likely impact on retailer's costs, and in addition;
- The RPM methodology should be able to effectively operate *a posteriori*¹—once the actual impact is observed.

SACOSS recommends that ESCOSA proceed with preparations for considering the impact of a carbon price on small customer electricity contracts (standing and market), and be ready to initiate a Special Circumstances Review in the event that market prices increase the RPM index to the point that the ceiling price is reached. Given that the current arrangements apply the RPM index at the start of each financial year, consideration could be given to a mid-year application in order to capture the impact of the carbon price from July 2012.

¹ The terms "*a priori*" and "*a posteriori*" have been historically used by ESCOSA and others to distinguish two different types of knowledge, justification, or argument. '*a priori* knowledge' is known independently of experience and "*a posteriori* knowledge" is proven through experience.

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Introduction

On 14 December 2010, the Essential Services Commission of SA made its Final Price Determination on the Electricity Standing Contract Price to be applied from 1 January 2011 to 30 June 2014. For the first time, the retail price path involves a 'Relative Price Movement' (RPM) methodology.

The Commission fixed an opening price which is to be varied only in relation to a numerical index based on the movement of prices in market contracts. In order to provide some containment of any potential volatility, the methodology also includes a price floor and ceiling that, if reached by the adjusted standing contract price at any point, could trigger a re-opening of the determination for an examination of the causal factors.

The determination considered a carbon price but did not include a specific amount due to the uncertainty surrounding the quantum and timing of such a price. It is now known that a carbon price will be introduced on July 1st, 2012 and that the price will be fixed for the first three years of operation.

In their letter to ESCOSA², AGL have proposed an increase in the price ceiling for the remainder of the regulatory period (the two year period July 2012 to June 2014) to accommodate the carbon price and an expected change in distribution prices from July 2012.

The AGL Proposal

AGL has proposed that the price ceiling used in the RPM model should increase by an amount equivalent to their projection of the full costs to a retailer of the imposition of a carbon price. The methodology developed by AGL estimates the increase in wholesale energy purchasing costs as well as the subsequent impacts on distribution losses and on their margin.

The results of applying the AGL methodology are given in their Table 1²:

Table 1 – Proposed change in RPM cap 2012 - 2014

	\$/MWh (\$July12)	
	1 Aug 2012 – 31 Jul 2013	1 Aug 2013 – 30 Jun 2014
Wholesale Carbon Cost	\$21.16	\$21.69
Distribution losses	\$1.72	\$1.77
Adjustment for 1 August price variation	\$2.00	-
Carbon cost allowance	\$24.88	\$23.46
Adjustment for retail margin allowance	\$2.49	\$2.34
Increase in Cap	\$27.37	\$25.80

² <http://www.escosa.sa.gov.au/library/110213-SpecialCircumstancesReviewApplication-AGL.pdf>

Should the price ceiling be increased in anticipation of a carbon price?

According to the ESCOSA website³:

“The Commission’s 2011 Standing Contract Price Determination does not include an allowance for the costs associated with the introduction of a carbon price in the predetermined floor and ceiling thresholds.

On 13 February 2012 the Commission received an application from AGL SA to re-open the Price Determination to adjust the tolerance band as a result of the introduction of a carbon price. The proposed adjustment to the tolerance band is intended to accommodate any impacts of the carbon pricing mechanism on market contract prices.”

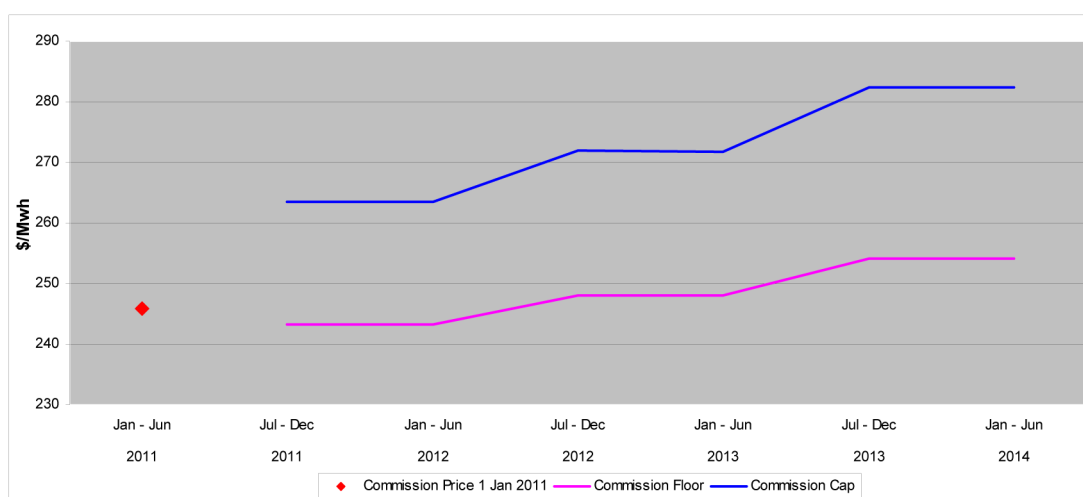
The role of the ‘tolerance band’ has been described by ESCOSA⁴:

“A key feature of the Final Price determination is that it adopts a new price setting methodology, which is intended to provide greater price flexibility and alleviate many of the difficulties in developing 3½ year cost forecasts. The Commission’s Relative Price Movement methodology involves an examination of retailer costs during 2011, such that a cost reflective price can be set on 1 January 2011. At the commencement of each financial year thereafter, the Commission will adjust the standing contract price in line with movements in market contract prices. These price movements will be made subject to prices sitting within a floor and ceiling that have been established by the Commission.”

And further (from the Determination Statement of Reasons)⁵:

“The Commission’s tolerance band, which will provide the upper and lower bound to standing contract prices, is illustrated in the figure below. The Commission’s tolerance band provides a widening spread between the floor and cap over the price path period, commencing at an 8% spread and widening to 11%. This will allow for reasonable price flexibility during the regulatory period, while also providing certainty to stakeholders over the potential limitation in price movements. The Commission’s tolerance band is illustrated below.”

Commission’s Tolerance Band



³ www.escosa.sa.gov.au/projects/171/2012-agl-special-circumstances-review.aspx accessed 24th Feb 2012

⁴ www.escosa.sa.gov.au/projects/143/2010-electricity-standing-contract-price-path-inquiry.aspx

⁵ www.escosa.sa.gov.au/library/101208-ElectricityStandingContractPrice-FinalPriceDetermination-PartA.pdf

And in discussing the tolerance band in more detail (Section 2.3.3 pages A41-42) and the upper bound in particular:

“There remains a strong possibility that certain events will occur during the next regulatory period that will impose significant additional costs on energy retailers, which will put upward pressure on electricity retail prices. The possible introduction of a CPRS [*Carbon Pollution Reduction Scheme*] or equivalent scheme is one such possibility.

While there should be sufficient flexibility to allow legitimate cost increases to be passed through to retail prices, it is incumbent on the Commission to assess the reasonableness of any major increase in electricity price, and to ensure there are no long-term deleterious effects on customers from a significant price shock.

The proposed cap for the tolerance band would provide a clear threshold beyond which any price movement could be considered out of the ordinary, or worthy of further investigation. This is not to say that the standing contract price would not be allowed to exceed the cap. If prices were to reach the cap, it is open to anyone to request a special circumstances review by the Commission, which could examine the need for prices to move beyond the cap, and for the cap itself to be reset. Such an occurrence is a distinct possibility in the next regulatory period. While the Commission recognises that a special circumstance review could be conducted even in the absence of a cap, the benefit of a cap is that it provides a clear reference point at which a re-examination of the fundamental basis of the price determination may be warranted.

Submissions to the methodology review raised concerns that the RPM approach is untested, and may lead to unintended consequences. A tolerance band provides a useful ‘safety net’ during this transition to a new form of price control.”

It is not clear from the above that a pre-emptive review and adjustment of the value of the cap—before the standing contract price reaches the cap—was what was intended. Clearly the mechanism exists for the very circumstances that will appear from 2012. However the need to increase the cap now, before the *actual* price impact is observable, should not be considered automatic.

In fact, the Commission stated (at page A42):

“ ... the Commission has formed the view that the following principles should be used in determining its parameters.

1. The tolerance band should remain fixed over the course of the next regulatory period, unless it can be demonstrated that an event has occurred that has fundamentally changed the basis of its derivation”

So while it is accepted that the legislative and regulatory conditions have been established for a carbon price to appear, the basis of the RPM approach is to allow the standing contract price to move only in relativity to observed market contracts.

AGL’s ask is somewhat counter to this.

ESCOSA seems to have alluded to this at Section 9.3 of the Final Determination⁶ which discusses the provisions for a Special Circumstances Review in relation to a carbon price:

9.3 “Special circumstances” review – reopening the determination

... [page A-115] The Commission is likely to consider the introduction of a carbon pricing scheme, should one be introduced in the next regulatory period, as a potential trigger for a special circumstances review. While the RPM index calculation is likely to substantially address the price

⁶ www.escosa.sa.gov.au/library/101208-ElectricityStandingContractPrice-FinalPriceDetermination-PartA.pdf page A-113

impacts of any such scheme, it would at least be necessary to consider whether or not the tolerance band should be adjusted to reflect these price impacts, which may be significant.

In summary, it is this 'significance' referred to above that is speculative at this stage. This leads to the question of the reasonableness of AGL's estimate and this is discussed further below.

Estimating the impact of a carbon price on supplying the standing contract load

AGL has proposed a methodology to calculate the cost to retailers that will result from the introduction of the Clean Energy Act 2011 and how this should be accounted for in the current price determination.

AGL's approach should be considered as an ambit claim.

Consideration should be given to referring them to the ACCC website⁷ for guidance on how carbon costs should be passed on to consumers.

Firstly, AGL have asserted that they anticipate "*... increases in retail operating costs for reporting and compliance obligations under the Clean Energy Act, but these costs have not been included in the calculation of the carbon cost allowance*".

AGL's compliance obligations relate to their upstream energy businesses and should in no way be attributable to the retail business. Their benevolence in not including their compliance obligations may not be as material as they suggest.

Secondly, AGL has chosen to use a NEM wide carbon intensity index as the basis for increasing the cap of the tolerance band. AGL would be aware that this is not the most accurate measure in the context of a South Australian regional price. It is arguably akin to saying that NEM average wholesale electricity costs are an efficient proxy for the wholesale cost of supplying South Australian consumers.

The AEMO Carbon Dioxide Equivalent Intensity Index (CDEII) has no status in the compliance obligations of NEM participants.

The National Greenhouse and Energy Reporting System (NGERS)⁸ provides the reporting basis for the carbon dioxide equivalent compliance obligations of electricity generators (the liable parties in the NEM context). NGERS not only receives data from the individual generators but also provides guidance on the emissions factors to apply to the electricity consumption of end users.

If ESCOSA is inclined to estimate the probable impact, it is recommended that advice be sought from the Commonwealth's Department of Climate Change and Energy Efficiency or the South Australian Department of Environment and Natural Resources (DENR, Sustainability and Climate Change) on an appropriate emissions factor to use. The NGERS Measurement Determination to be released in June 2012 (for the 2012-13 Reporting Year) will provide contemporary regional emissions intensity information. The full fuel cycle emissions intensity figures published by the

⁷ Refer to www.accc.gov.au/content/index.phtml/itemId/1017300/fromItemId/142: Australian Competition and Consumer Commission chairman Rod Sims has launched a guide for businesses on carbon price claims ... "The ACCC is launching this guide to assist business in understanding their rights and obligations when making claims about the impact of a carbon price."

⁸ www.climatechange.gov.au/government/initiatives/national-greenhouse-energy-reporting.aspx

Department are understood to be a three-year rolling average that incorporates the impact of electricity imported into (and out of) each region.

The *National Greenhouse Accounts (NGA) Factors*⁹ has been prepared by the Department of Climate Change and Energy Efficiency and is designed for use by companies and individuals to estimate greenhouse gas emissions. The NGA Factors is not published for the purposes of reporting under the *National Greenhouse and Energy Reporting Act 2007* (the NGER Act).

As a guide, the July 2011 workbook, Page 67:

Electricity emission factors for end users

These time series estimates are provided for information. Previously published estimates (see Appendix 5) have been revised for this Workbook where appropriate using emissions data in the latest state and territory greenhouse gas inventories and revised fuel consumption, interstate electricity trade and electricity transmission and distribution loss data.

**Extract from Table 39:
Scope 2 and 3 emissions factors - consumption of purchased electricity by end users**

Financial year	EF for scope 2		EF for scope 3		Full fuel cycle EF (EF for scope 2 + EF for scope 3)	
	A	B	C	D	E	F
	kg CO ₂ -e/kWh	kg CO ₂ -e/GJ	kg CO ₂ -e/kWh	kg CO ₂ -e/GJ	kg CO ₂ -e/kWh	kg CO ₂ -e/GJ
SOUTH AUSTRALIA						
1990	0.81	225	0.20	56	1.01	281
1995	0.87	241	0.19	52	1.05	292
2000	0.92	257	0.17	46	1.09	303
2005	0.89	248	0.15	42	1.04	290
2006	0.87	242	0.13	37	1.00	279
2007	0.83	231	0.13	36	0.96	267
2008	0.77	214	0.12	34	0.89	248
2009	0.72	199	0.14	38	0.85	237
Latest Estimate	0.68	190	0.13	36	0.81	226

The most relevant figures for estimating the greenhouse emissions of electricity (and the emissions attributable to the energy value chain from, for example, the extraction of gas or coal) are to be found in Column E. As can be seen this figure is a steadily declining figure (due to the increasing penetration of wind and, in part, the declining role of emissions intensive electricity imports from the VIC region), that for 2010 was 0.81 tCO₂-e/MWh.

AGL have proposed using the NEM wide CDEII figure and calculate a 1-Jul-12 price of \$22.88/MWh including losses. However, using the more appropriate estimate (which would need to be updated closer to July 1st, and can be expected to be even lower) of 0.81 tCO₂-e/MWh (which includes losses) and the starting carbon price of \$23/tonne, yields \$18.63 per MWh (almost 20% lower than that proposed by AGL).

In considering what impact this may have on the standing contract and the cap of the tolerance band it is also worth considering the anticipated extent of 'pass through' of this cost. The AEMC's

⁹ www.climatechange.gov.au/publications/greenhouse-acctg/national-greenhouse-factors.aspx

Report on Possible Future Electricity Price Movements 2011-14¹⁰ arrived at figures closer to \$10 than \$20 for the period (\$0.118/kWh for 2012/13). Their Table 2 is reproduced below (with the relevant entries highlighted).

Table 2 The contribution of each component to possible future residential standing offer electricity price increase including a price on carbon

	National	ACT	Victoria	Tasmania	South Australia	Western Australia	Northern Territory	Queensland	NSW
Total price comparison:									
2010/11 price (c/kWh)	22.41	16.19	22.86	20.75	23.99	23.99	23.76	20.69	22.75
2013/14 price (c/kWh)	30.75	22.93	30.32	25.94	32.67	31.26	27.65	29.28	32.27
Total c/kWh increase	8.34	6.74	7.46	5.19	8.68	7.26	3.89	8.59	9.51
Total % increase (2010/11 to 2013/14)	37.2%	41.6%	32.7%	25.0%	36.2%	30.3%	16.4%	41.5%	41.8%
By component:									
Transmission	6.0%	6.1%	0.1%	15.4%	10.7%	13.2%	0.0%	6.0%	6.2%
Distribution	33.6%	14.2%	15.3%	22.5%	39.9%	43.5%	22.0%	40.2%	36.1%
Wholesale	40.2%	68.5%	40.4%	50.5%	34.8%	36.7%	68.0%	44.3%	38.3%
Retail	12.1%	7.1%	31.5%	11.9%	2.7%	5.9%	1.6%	8.4%	7.1%
Feed-in tariff	2.8%	3.9%	0.7%	0.0%	6.6%	0.0%	0.0%	0.2%	6.1%
LRET	3.8%	2.7%	3.8%	2.5%	5.1%	4.9%	12.4%	3.1%	3.7%
SRES	-0.8%	-2.3%	-2.0%	-2.9%	-1.8%	-2.1%	-4.0%	-1.6%	1.6%
Energy efficiency and demand management schemes	2.5%	-0.2%	10.2%	0.0%	2.0%	0.0%	0.0%	-0.6%	0.8%
Other state based schemes	-0.2%	0.0%	0.0%	0.0%	0.0%	-2.2%	0.0%	0.0%	0.0%
Carbon impact (c/kWh):									
2012/13	1.65	2.41	1.43	1.13	1.18	1.43	1.53	1.84	1.94
2013/14	1.76	2.47	1.45	1.12	1.21	1.83	1.53	1.93	2.03

Recent modelling for ESCOSA by ACIL Tasman in relation to determining the 'fair and reasonable' contribution of retailers to the state's feed-in tariff also derived a probable price uplift from a carbon price that was much closer to the AEMC results than that of AGL.

Further, it is unclear why provision should be made for applying a 10% margin on the carbon price. It is acknowledged that the '10% of controllable costs' was set by ESCOSA in the original determination. ESCOSA should seek advice on the legitimacy of explicitly expecting a margin on the carbon price. Of course this is not relevant if the RPM approach is able to be employed as intended.

The above further reinforces the rationale for waiting until the impacts on market prices are observed before moving to increase the price ceiling as per AGL's proposal.

¹⁰ www.aemc.gov.au/Market-Reviews/Completed/Possible-Future-Retail-Electricity-Price-Movements-1-July-2011-to-30-June-2014.html

Conclusion

Overall AGL's approach and argument is more consistent with the bottom-up LRMC approach used to establish the 1 January 2010 opening price and ignores the more cost reflective RPM approach to the movements from that starting position.

In SACOSS's view AGL's methodology overstates the likely impact on wholesale energy costs, and there are indications that the impact is likely to be even further moderated by the dynamics of the wholesale market (due to such factors as the impact of compensation to generators and the fact that some sort of shadow price arguably already exists in market prices).

The need to increase the cap of the tolerance band is then best considered in the context of where the standing contract price will sit in relation to the cap at the point in time in question. In the interests of transparency (as opposed to convenience for AGL) ESCOSA should give serious consideration to continuing this current review, analysing the options, and being well prepared but to not approve a change in the cap at this point.

Instead, it is our view that consumers would be best served by waiting until the impacts on market prices are observed, and if the cap is likely to be reached implementing a change only then. If there is concern over the possibility that AGL's costs might exceed the prices they can charge, consideration could be given to a RPM 'move' at the end of the calendar year instead of waiting until the financial year.