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2012 Review of Electricity Standing Contract – Wholesale Electricity Costs: Discussion Paper

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission on the Essential Services Commission of South Australia's (ESCOSA) Discussion Paper for the 2012 Review of Electricity Standing Contract – Wholesale Electricity Costs.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 36 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ more than 51,000 people and contribute $16.5 billion directly to the nation's Gross Domestic Product.

South Australia has undertaken significant reform over more than a decade to improve the efficiency and competitiveness of its electricity market. As a founding jurisdiction of the National Electricity Market (NEM), it sources the majority of its electricity from the competitive national wholesale market and participates in the national governance framework set out in the Australian Energy Market Agreement (AEMA). Together with Victoria, South Australia has led Australia in the liberalisation of ownership of electricity supply infrastructure. Network regulation has been transferred to the independent process administered by the Australian Energy Regulator (AER) and the impending National Energy Customer Framework will transfer non-economic retail regulation to the AER as well.

Despite these commendable advancements, the process of reform is not complete. Retail price deregulation remains the key outstanding reform to ensure a sustainable competitive retail electricity market in South Australia. The current competitive dynamic of the market - 15-20 per cent of household customers switch annually, choosing between 10 licensed retailers[1] - could be undermined by a regulated price set too low.

In the context of an ultimate goal of a deregulated market with competition as the governing factor in price formation, the regulated price should be considered as a price *cap.* That is, it should form a backstop to the prices that will emerge through the competitive process of market offers. Competitive prices are in fact what most South

[1] AGL working paper no. 20, *When does retail price regulation become distortionary*, P Simshauser, June 2012

Australian customers pay - over three quarters of households have moved away from the standing contract and so are not directly affected by the price cap. It should *not* be designed to be as low as possible, as this is not consistent with supporting competitive outcomes. Inevitably, the errors endemic to setting an ex ante price cap mean that there is a risk that the cap fails to allow retailers enough revenue to cover efficiently incurred costs plus a fair margin for their business risks. This risk is especially acute when methodologies are used that are dependent on limited information. For example, the esaa notes that it was primarily because of the lack of liquidity in the electricity contract market that ESCOSA used an LRMC analysis to establish the WEC in its past price review of the SA regulated electricity price which took effect from 1 January 2011.

In the light of these considerations, the esaa continues to advocate the calculation of the wholesale energy cost (WEC) using an approach whereby the WEC should not be less than the long run marginal cost (LRMC) of electricity generation. Ultimately, wholesale prices at this level are required to bring forward new investment when required, and so such an approach is consistent with setting a price cap at an efficient level.

Both federal and state policy settings are designed to bring forward new low or zero emissions generating plant and for higher-emissions plant to ultimately be replaced. South Australia is understandably proud of its record in attracting new zero emissions electricity to the state at a greater rate than other jurisdictions. The stability and certainty of a WEC based on an LRMC floor supports this record. Conversely, an approach based purely on prevailing market data will result in greater price volatility flowing from spot and contract markets into the retail price path. This will diminish the willingness of private capital to invest in the new generation capacity that South Australia requires.

In conclusion, the esaa supports setting wholesale costs with reference to both market-based and long-run marginal cost (LRMC) estimates. Over the long term wholesale costs should not be lower than the LRMC to ensure long-term forward contracting does not diminish and generation investment decisions are not delayed.

Any questions about our submission should be addressed to Kieran Donoghue, by email to kieran.donoghue@esaa.com.au or by telephone on (03) 9205 3116.

Yours sincerely

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