

Dr. Pat Walsh  
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Sent by email to [escosa@escosa.sa.gov.au](mailto:escosa@escosa.sa.gov.au)

20 July 2012

Dear Dr. Walsh,

**Re Electricity Standing Contract Wholesale Cost Investigation Discussion Paper**

Enclosed is our submission to the abovementioned review. We encourage you to consider the recommendations we have reached and would be happy to discuss this with you in person.

Should you have any enquiries regarding this matter please do not hesitate to contact me on +61 3 9617 8300.

Yours sincerely,



Stephen Orr  
Director Strategy and Regulation  
IPR-GDF SUEZ Australia



# **Submission to ESCOSA discussion paper on electricity standing contract wholesale cost investigation**

20 July 2012

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## 1 Introduction

International Power-GDF Suez Australia and Simply Energy, (IPR-GDFS), welcome the opportunity to comment on the discussion paper by ESCOSA (“the Commission”) on wholesale energy costs for electricity standing contracts.

International Power, now a wholly-owned subsidiary of GDF SUEZ, is a leading independent electricity generating company with 75,579MW gross (43,288MW net) in operation and a significant programme of 12,820MW gross (5,868MW net) projects under construction as at 31 December 2011. International Power is present in 30 countries across six regions worldwide. Together with power generation, International Power is also active in closely linked businesses including downstream LNG, gas distribution, desalination and retail.

International Power entered the Australian energy industry in 1996 and has grown to become one of the country’s largest private energy generators, with assets in Victoria, South Australia and Western Australia. The International Power portfolio also includes Simply Energy, a wholly-owned subsidiary of International Power and one of the largest second tier retailers operating in South Australia, Victoria and other National Electricity Market (NEM) regions. Simply Energy has been retailing gas and electricity to customers in South Australia since 2007.

## 2 Summary

Having reviewed the discussion paper, IPR-GDFS recommends that the Commission:

- Determine the wholesale component of the regulated electricity retail tariff as the higher of the long run marginal cost (LRMC) and the forward market contract price for wholesale electricity as calculated in each year of the regulatory price period;
- Acknowledge in its decision that regulated customers have the opportunity to seek a market offer at a lower price;
- Review its CO<sub>2</sub> pass-through decision to ensure it actually reflects the cost of CO<sub>2</sub> applicable to South Australian retail prices and does not distort wholesale prices necessary to achieve effective competition in South Australia; and
- Gives serious consideration to promoting retail price deregulation in South Australia.

Further, IPR-GDFS takes the opportunity to point out that price outcomes in the wholesale market in South Australia are currently a significant impediment to the development of a healthy electricity supply chain. This should no longer be ignored by appropriate regulators.

## 3 General

From the perspective of both its wholesale generation assets in South Australia and particularly its retail operations through Simply Energy, IPR-GDFS Australia, favours reliance on market mechanisms where the cost to consume electricity reflects the cost to produce and deliver electricity and where pricing is sustainable to attract ongoing investment that will underpin customer reliability.

The Commission’s review coincides with a period in the NEM where wholesale electricity prices have been declining in real terms notwithstanding the continuing increases in retail

prices. The rise in electricity retail prices has resulted in a focus on the cost of electricity to households and the contribution this is making to “cost of living pressures.”

As described by the Commission in the discussion paper, increases in retail prices have been heavily driven by increases in network charges and the increasing cost of a plethora of Government greenhouse policies (such as feed in tariffs, energy efficiency obligations, carbon pricing and renewable obligations). Network charges make up around 50% of a typical householder’s bill with environmental program costs making up around 10-15%.

The latest assessment of retail electricity prices by the Australian Energy Market Commission (AEMC) <sup>1</sup> indicates that wholesale generation typically represents 35% of a standing customer’s bill in South Australia. This report also highlights that prior to the introduction of a CO<sub>2</sub> price, for the period 2010/11 to 2013/14, wholesale energy costs contributed less than 24% to expected future price rises, (including a CO<sub>2</sub> price, this figure is still less than 35%).

By comparison network charges, represent over 50% of expected future price rises with and without a CO<sub>2</sub> price. For a full breakdown of the various components affecting retail price rises, Table 1 and 2 of the AEMC report have been included in an annexure to this submission.

It is important in the context of evaluating retail price caps for South Australia to recognise that while wholesale generation costs affect household electricity bills they are not the dominant driver of expected future price rises.

IPR-GDFS Australia support competitive retail and wholesale markets. Our preference is for retail markets to be fully deregulated and for wholesale markets to operate at levels that will provide a fair return to investors and also attract new investment for the future. In IPR-GDFS Australia’s own view (and, we note that of the AEMC) South Australia is more than ready for this transition.

In the absence of deregulated pricing, the mechanism for determining the wholesale contribution to the standing contract tariff must reflect not only the costs of supply, but also allow for viable competition to thrive by creating “headroom” between the regulated tariff and market offers to customers.

We suggest that it is not the job of the regulator to deliver regulated price caps that deliver the best that competition can offer. If that were the case competition would not occur. Energy prices should however gravitate to efficient levels with workable competition. Arguably the regulator should not seek an efficient level either – again no competition would occur. The desirable level of a regulated price must exceed current competitive and efficient levels to create headroom to compete.

Rather than relying on either market prices or an LRMC assessment to set the regulated retail tariff, a combination of these two approaches should be used in order to “protect the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services” consistent with the Commission’s primary objective.

In a climate of community focus on electricity costs, regulators such as ESCOSA also have an opportunity in their decisions to raise the awareness of customers who remain on

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<sup>1</sup> See AEMC Final Report, “Possible Future Retail Electricity Price Movements: 1 July 2011 to 30 June 2014”, November 2011

standing contracts that they can save money by moving to competitive market offers. We feel this is an area where ESCOSA could be more proactive.

## 4 Response to specific questions

IPR-GDFS Australia provides the following responses to the specific questions raised in the discussion paper.

### 4.1 What approach should the Commission adopt to setting wholesale electricity purchase costs for standing contract pricing purposes and why should that approach be used?

South Australia has a highly competitive retail electricity market as evidenced by one of the highest switching rates in the world. This should provide confidence to ESCOSA that regulation can and should be light-handed as competition provides customers with competitively priced electricity and more choices.

#### *Approach to setting the wholesale electricity component*

Effective competition in the South Australian electricity market – both at the wholesale and retail level – is crucial to delivering long-term benefits to customers. However, customers will not enjoy the benefits of this competition unless they participate in the competitive process by shopping around and switching to a product that offers them real savings.

Around 25% of the South Australian small customer market segment remains with AGL on the regulated standing offer price even though these customers would pay less for their electricity supply if they switched to a market offer.

The approach the Commission uses to determine the retail price path, including the wholesale energy costs (WEC), must ensure sufficient headroom in AGL's regulated retail rate to incentivise customers who remain on the standing offer to enter the competitive market. If the regulated rate is kept artificially low so that the differential between the regulated rate and market offers is small, customers already paying more than they should for their electricity will not have an incentive to find themselves a better deal.

Furthermore, failure to provide sufficient headroom may have a negative impact on retail competition as the ability of retailers to offer an attractive proposition to customers will have been removed through regulation, reducing the incentive to participate in the market.

Ultimately, the Commission's aim should be to remove customers' reliance on regulated retail tariffs by ensuring that those who remain on the regulated tariff have a strong incentive to participate in the competitive market. Perhaps somewhat ironically, this is the one mechanism that the Commission has available to it to help the 25% of customers that remain on AGL's regulated rate to reduce their electricity cost by moving to a market contract.

To achieve this objective, we believe that the Commission should calculate the LRMC and the forward market contract price of wholesale electricity for each year of the regulatory price period and select the higher of the two values when determining the price path. A precedent for this approach exists as it was used by the Independent Pricing and

Regulatory Tribunal (IPART) in the most recent determination of the regulated retail rate in New South Wales.

#### *Advantages of a hybrid approach*

While previously supporting the use of forward contract market prices (wholesale) to determine the regulated rate, IPR-GDFS Australia believes that a hybrid approach offers a number of advantages.

- The key advantage is that it ensures the regulated retail price is generally set at a level that provides for effective competition by allowing for a differential with the market offer rates available. This preserves an incentive for standing offer customers to enter the competitive market, and for competition to flourish.
- It provides a mechanism for the WEC to allow for increases in the forward contract market price. For example for situations where the supply and demand dynamics force market prices to rise above the LRMC for a time, using the higher of either the LRMC or the forward contract market price allows retailers to be able to offer tariffs which represent the true cost of hedging their load.
- Allowing headroom also minimises the risk that ESCOSA has to re-open the retail determination to allow for increases in wholesale costs.
- A hybrid approach may also offer an advantage during the regulatory determination process. The calculation of both values may provide ESCOSA with a comparator that provides insight into whether the forward contract market price and the LRMC are significantly out of line with each other to cause concern for future investment and hence reliability in South Australia. In an environment where the prospect of a repeal of the national CO<sub>2</sub> price is affecting forward market liquidity, a hybrid approach may also be beneficial.

#### 4.2 Is the forward market for wholesale electricity in South Australia sufficiently liquid to provide reliable forecasts of the energy purchase costs of a prudent and efficient electricity retailer with the standing contract obligation?

For the latest price determination period, 1 January 2011 to 30 June 2014, ESCOSA departed from its “preferred practice” of relying on market contract prices to a long run marginal cost (LRMC) approach to determine the wholesale electricity component of the standing contract tariff. At the time of this decision (2010) ESCOSA cited reduced contract liquidity in the forward wholesale contract market.

Reduced wholesale contract liquidity at the time was affected by regulatory decisions – namely uncertainty around the prospect of CO<sub>2</sub> pricing and stemming from greater vertical integration within South Australia.

The Commission has indicated that contract liquidity in South Australia has improved compared to 2010 when the last price determination was made. While liquidity may have increased, it remains at significantly low levels compared to other NEM regions.

The “on the ground” experience of IPR-GDFS Australia in South Australia in relation to a difficult environment for contract liquidity supports our recommendation for a hybrid mechanism for setting the WEC component of standing contract prices.

IPR-GDFS Australia recommends that rather than focussing on pass-through of low wholesale prices, the Commission should consider first why these prices are low and whether independent generation is viable in South Australia as a result of these wholesale price outcomes.

Given we have a market design that relies on wholesale signals for new investment, we believe the current wholesale price regime represents a threat to South Australian reliability. Indeed one generator has recently publically withdrawn some of its South Australian generation ostensibly because it is unable to obtain an adequate return from generation.

South Australia faces wholesale prices that in IPR-GDFS Australia’s view are distorted by the physical contractual positions of market participants. This should not be the case if independent new entry is sought to maintain reliability in the future.

#### 4.3 If so, should the Commission change the WEC component of standing contract prices?

In its previous price determinations, the Commission has separately used market contract prices and the LRMC approach to set the WEC. As outlined above, IPR-GDFS Australia proposes that the Commission now rely on using the greater of the LRMC price and the market contract price to set the WEC component of standing contract prices.

This is consistent with the approach that has been used by IPART. In market conditions where the forward contracts are trading at lower levels than the LRMC calculation, this approach provides sufficient head-room for retail competition to flourish. Conversely, if market contracts rise to higher levels than the calculated LRMC, this approach would ensure that retailers are not forced to offer loss making retail contracts which are below the price levels which can be effectively hedged.

In moving to this hybrid methodology, the Commission would need to update its calculation of LRMC. As part of this process, we believe it is important that the Commission update its assessment of the introduction of a price on CO<sub>2</sub> from 1 July 2012 on the wholesale price. In considering the contribution of CO<sub>2</sub> pricing to this assessment, it is essential that the intensity of the NEM be used and not simply the South Australian intensity.

The recent electricity standing contract price adjustment by the Commission (which commenced on 1 July 2012) did not allow CO<sub>2</sub> pass through at the NEM intensity. This raises a number of concerns.

Calculating an isolated theoretical LRMC for the standing customer load in South Australia does not reflect actual market dynamics. South Australia is a participant in the NEM and relies on interconnection to both meet its own demand but to also export energy. As such, retailers and generators in South Australia face CO<sub>2</sub> costs set by the NEM and not by a

theoretical generation portfolio supplying the net system load profile of the regulated customer base.

While the stand-alone approach was consistent with the approach taken by the Commission under the contract price methodology employed in previous reviews, it no longer remains valid with the introduction of CO<sub>2</sub> pricing.

A decision that understates the actual impact of CO<sub>2</sub> pricing on South Australian wholesale prices understates the WEC itself and artificially reduces the headroom so necessary for effective and sustainable competition in South Australia.

We note in this context that South Australia enjoys the benefits of both opportunities to import cheaper electricity from interstate at times and conversely to export electricity profitably into higher NEM prices when they exist.

Further, South Australia enjoys the presence of significant renewable generation within its borders. This generation supplies an interconnected NEM, not simply South Australia. Ultimately this generation exists because of subsidies paid proportionately more by consumers across Australia.

We suggest that in this context, ascribing the benefits of low emission generation to South Australia is not only inconsistent with how NEM wholesale pricing occurs, but is also not a fair reflection of the economic circumstances surrounding South Australian supply and demand.

We recommend that this anomaly be addressed as part of the Commission's review of the WEC component of standing contract prices.

## 5 Annexure

Tables taken from AEMC Final Report, "Possible Future Retail Electricity Price Movements: 1 July 2011 to 30 June 2014", November 2011, pp. 5-6.

**Table 1** The contribution of each component to possible future residential standing offer electricity price increase in the absence of a price on carbon

	National	ACT	Victoria	Tasmania	South Australia	Western Australia	Northern Territory	Queensland	NSW
<b>Total price comparison:</b>									
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)	29.01	20.47	28.87	24.82	31.47	29.43	26.12	27.36	30.27
Total c/kWh increase	6.60	4.27	6.01	4.07	7.47	5.43	2.36	6.67	7.51
Total % increase (2010/11 to 2013/14)	29.4%	26.4%	26.3%	19.6%	31.2%	22.6%	9.9%	32.2%	33.0%
<b>By component:</b>									
Transmission	7.6%	9.6%	0.1%	19.7%	12.5%	17.7%	0.0%	7.8%	7.9%
Distribution	42.4%	22.5%	19.0%	28.8%	46.3%	58.2%	36.3%	51.9%	45.7%
Wholesale	24.1%	49.9%	28.2%	35.6%	23.7%	13.5%	42.2%	27.3%	21.6%
Retail	13.2%	8.0%	34.4%	12.8%	1.7%	7.0%	1.1%	9.5%	7.3%
Feed-in tariff	3.5%	6.1%	0.9%	0.0%	7.6%	0.0%	0.0%	0.2%	7.7%
LRET	7.3%	8.0%	7.4%	7.2%	8.0%	9.6%	27.3%	6.5%	6.9%
SRES	-1.1%	-3.8%	-2.6%	-4.0%	-2.2%	-3.0%	-6.8%	-2.2%	1.9%
Energy efficiency and demand management schemes	3.1%	-0.3%	12.6%	0.0%	2.3%	0.0%	0.0%	-0.8%	1.0%
Other state based schemes	-0.3%	0.0%	0.0%	0.0%	0.0%	-3.0%	0.0%	0.0%	0.0%

**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
<b>Total price comparison:</b>									
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%
<b>By component:</b>									
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%
<b>Carbon impact (c/kWh):</b>									
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