



18 July 2012

Essential Services Commission of South Australia  
GPO Box 2605  
Adelaide, SA 5001

Submitted by e-mail: [escosa@escosa.sa.gov.au](mailto:escosa@escosa.sa.gov.au)

Attention: Nathan Petrus

Dear Mr Petrus

**ELECTRICITY STANDING CONTRACT - WHOLESALE ELECTRICITY COST INVESTIGATION:  
DISCUSSION PAPER**

Origin Energy (Origin) welcomes the opportunity to provide the Essential Services Commission of South Australia (ESCOSA or Commission) with comments on its Discussion Paper on the Electricity Standing Contract - Wholesale Electricity Cost Investigation.

We acknowledge that the Commission has a responsibility to review the electricity market for developments that may impact upon its determination that sets the electricity standing contract price. In publishing its Discussion Paper, ESCOSA suggests that recent developments in the wholesale electricity market may indicate a change in the forward wholesale cost of electricity that could warrant reopening the existing wholesale electricity cost (WEC) component of the current standing contract price.

Origin does not consider this to be the case. There have not been any changes in circumstances that we believe indicate a material change in circumstance that would trigger a reopening of the current electricity retail determination.

We believe that the low quantity of Futures contracts traded in South Australia and the questionable nature of the implied price data included in the discussion paper reaffirm previous conclusions; there is insufficient contract data available to calculate a reliable forecast of energy purchase costs for a prudent and efficient retailer. There is not sufficient evidence, therefore, to support reopening the WEC component of the standing contract price.

The costs for a prudent and efficient retailer include a significant volume of physical generation, even in the case of a liquid wholesale contract market. The contract price in any one year does not, in isolation, provide a "long term" contract price of sufficient duration to manage efficiently a large retail business. ESCOSA's current LRMC methodology reflects this reality. The outcome is a tariff with a WEC component that is less volatile and reflects the long term commitment of industry investment.

The key for any retail pricing methodology is that it accurately captures and reflects retailer costs. Given the uniqueness of the South Australian market, ESCOSA's approach needs to recognise explicitly that physical generation is one of the more cost effective ways for a prudent retailer with substantial mass market load to manage that demand. The current LRMC approach reflects this reality.

The remainder of this submission sets out our position in more detail. Should you have any questions or wish to discuss this submission further, please contact Hannah Heath (Manager, Regulatory Policy) on [hannah.heath@originenergy.com.au](mailto:hannah.heath@originenergy.com.au).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Phil Moody', written in a cursive style.

Phil Moody  
Group Manager - Commercial, Analysis and Risk Services  
Energy Risk Management

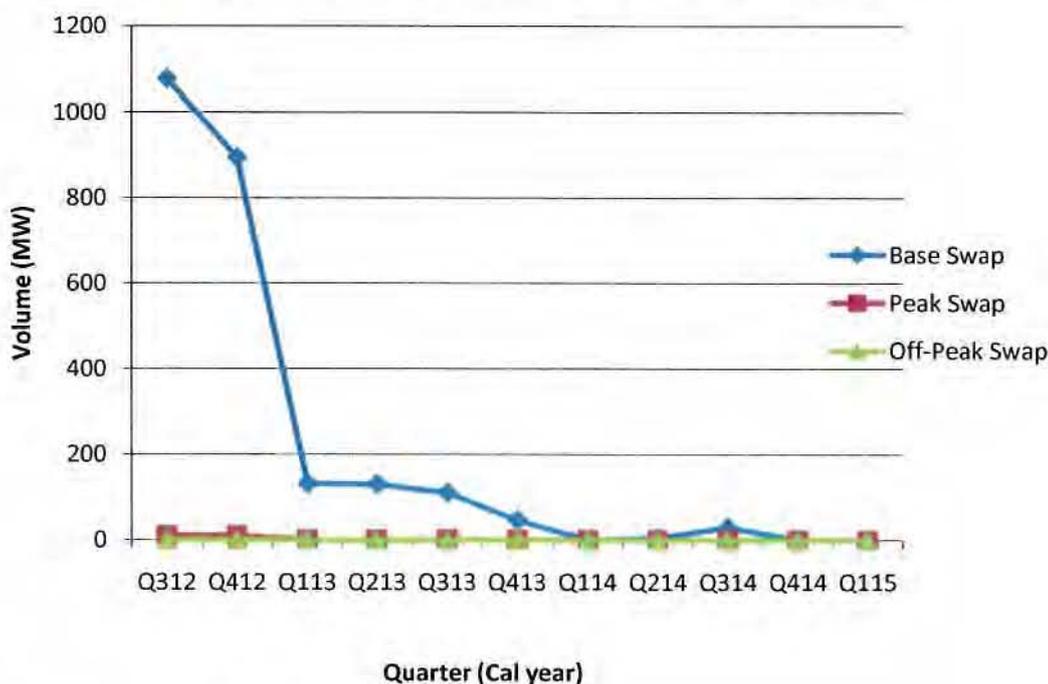
**1. Evidence does not demonstrate material change in circumstance**

Origin is not convinced that contract market liquidity for electricity derivatives in South Australia has increased as much as suggested in the Discussion Paper. As such, we do not consider there is sufficient evidence to demonstrate a material change in circumstance. This means the “special circumstances” threshold has not been established and cannot trigger a reopening of the WEC component of the current retail determination. Furthermore, the low Futures volume traded and the questionable nature of the implied Futures prices do not support a move from LRMC to a market-based methodology.

*Investigating the evidence base*

From the data we have examined, low volumes continue to be traded in South Australia through the Futures market. As highlighted in Figure 1 below, base load swap contracts are the only traded contracts, and even then, there are numerous quarters where no volume has traded through the exchange. In particular, there are very low trade volumes in Q113 and Q213 (i.e. the first and second quarter of 2013). In addition, no volumes off-peak contracts are being traded in South Australia and the only traded peak contracts have been 10 MW in each Q312 and Q412 and 1 MW in Q313. We have not observed any calendar year or financial year trades for this period either.

**Figure 1:** Volume of quarterly contracts traded through the Futures in South Australia



Source: d-cyphaTrade as at 4 July 2012

A market-based methodology would need to look forward more than a quarter in order to create an appropriate forward contract curve. In 2010, ESCOSA observed that “contracting was generally limited to that year, with little or no trading for the two

forward years after then”.<sup>1</sup> The data available today illustrates a similar scenario exists today; there are little to no volumes being traded from Q113. Counterparties appear to be limiting their trading to one, maybe two, quarters in advance. This could be for a range of reasons, but as discussed below, is likely to reflect the policy uncertainty around carbon price repeal risk.

As such, ESCOSA does not have access to a sufficiently robust data set to construct a realistic and reliable contract price. The volumes traded do not provide sufficient evidence to justify further investigation of a move away from the existing LRMC methodology. ESCOSA’s 2010 decision demonstrates the Commission understands the importance of and makes its decisions based on access to quality and robust data.

*Understanding implied Futures contract prices*

The implied Futures price data provided in Table 3 of the Discussion paper highlights that the current data cannot be relied upon as a meaningful representation of actual costs. In the ESCOSA table (replicated below), the peak load price in FY2015 is lower than the base load swap price while the off-peak load price is higher than the peak price.

This does not make sense. Base load contracts cover both the peak and off-peak periods and therefore the price of those contracts should fall somewhere between the price of the off-peak and peak contracts. Peak contract cover includes a premium compared to base load because that cover is designed to hedge against periods in the day where spot prices are higher, reflecting a higher demand profile. The counter-intuitive pricing presented for FY2015 calls into the question the validity and reliability of the data set. This highlights the difficulty around relying on this data to make a pricing determination.

**Table 1: Implied future wholesale electricity contract prices**

\$ per MWh	FY2013	FY2014	FY2015
Peak load (7am-10pm)	74.89	66.50	55.83
Base load (24hr)	56.71	56.01	62.57
Off-peak load (10pm-7am)	43.10	48.11	67.64
\$300 Caps for Jan-Mar quarter	22.65	24.35	n/a

Source: ESCOSA 2012, Discussion Paper Table 3, p.8.

As stated above, Origin is not aware of any Financial Year or Calendar Year trades being executed in South Australia for 2013, 2014 or 2015 and that the data available does not show any traded volumes beyond Q414. The Futures market prices listed for those latter years are therefore not based on actual transactions but rather are calculated by d-cyphaTrade using a formula. ESCOSA is, therefore, in a similar position to that in 2010; there is insufficient contract data available to support a market-based methodology for calculating the wholesale electricity cost.

*Policy uncertainty and its impact on price and liquidity*

Future contract prices and liquidity levels are also likely to reflect the policy uncertainty around the longevity of a carbon price. In 2010, ESCOSA acknowledged the

<sup>1</sup> ESCOSA 2012, *Electricity Standing Contract - Wholesale Cost Investigation*, Discussion Paper, 20 June 2012, p.7.

lack of certainty around whether or not a carbon price would commence during the current regulatory reset period, and if so, what form it would take. Today, the market is in a similar state of flux, but this time making assumptions around the risk of repeal of that same policy.

This uncertainty makes it increasingly difficult for ESCOSA to distinguish between the actual and speculative influences on Futures contract prices. As such, it is not only a question of whether the contract price is set at an efficient level, but whether that price accurately reflects the actual wholesale costs for retailers. The high level of policy uncertainty, low liquidity levels and counter-intuitive Futures prices suggest that this is not the case. It is therefore difficult to see how ESCOSA could confidently state that the contract data available provides a reliable base on which to determine the efficient costs of a retailer offering standing contracts in South Australia. Since the data is of a similar quality to that available in 2010, it is not sufficient to trigger a reopening of the existing Determination.

## **2. Recommended approach for determining wholesale electricity costs**

ESCOSA understands the importance of setting the WEC component of the retail tariff at a rate that represents the total costs incurred by a prudent and efficient retailer in purchasing electricity to cover standing contract customer demand. A robust and transparent process supports regulatory certainty and is crucial for supporting and promoting effective retail competition and market investment.

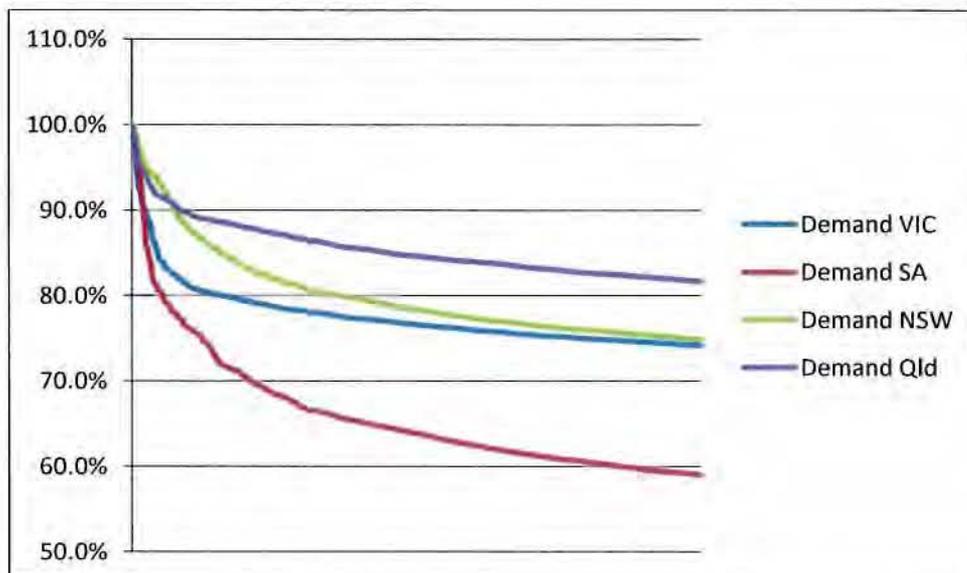
The key for any pricing methodology is that it accurately captures and reflects retailer costs. Historically, the Commission has usually estimated the WEC by considering the likely costs of a prudent and efficient NEM retailer operating under an optimum hedging strategy over the price path period.<sup>2</sup> However, in its 2010 Determination, ESCOSA acknowledged that alternate methodologies may be more appropriate, particularly when the available market data is not reliable.

While it is the smallest NEM region, South Australia has the most volatile and temperature sensitive demand. Peak load is largely related to hot summer days and air-conditioning load. This is illustrated in **Figure 2** below, which shows that the top 40 per cent of demand occurs less than 5 per cent of the time in South Australia.

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<sup>2</sup> ESCOSA 2012, Discussion Paper, p.3.

Figure 2: Load duration curve for 2011



Source: AEMO data

Note: shows the last 5 per cent of load duration curve

There is also a significant investment of wind generation in South Australia; the state has the largest concentration of wind generation in the NEM. As an intermittent supply source, this substantial generation source - over 20 per cent of installed capacity - exacerbates the variability of South Australia's spot prices.

The variability and peakiness inherent in South Australian demand means retailers face a high risk profile to meet customer demand. Retailers manage a significant volume of this risk through their hedging strategy. As noted in the Discussion Paper, there are principally three different types of hedge cover: bilateral forward contracts; financial instruments purchased on the open market (e.g. Futures exchange); and physical generation, either investment in generation plant or power purchase agreements (PPA) with generators.

Retailers with substantial mass market retail load seek to manage this demand using longer term PPAs and physical generation assets. These sources better match the longer term duration of the mass market load and provide retailers, which have significant retail demand, with price and volume certainty. This strategy is particularly relevant in South Australia for at least two reasons:

- physical generation is one of the more cost effective hedging strategies given the variable and peaky nature of demand; and
- the low level of contract liquidity makes it difficult to hedge mass market loads with any degree of certainty, both with respect to volume and price.

The costs for these retailers, with substantial market retail load, include a significant volume of physical generation, even in the case of a liquid wholesale contract market. The contract price in any one year does not, in isolation, provide a "long term" contract price of sufficient duration to manage these retail businesses efficiently. ESCOSA's current LRM methodology acknowledges this reality and delivers a tariff with a WEC component that is less volatile and reflects the long term commitment of industry investment. This is a key driver in supporting effective retail competition in

the electricity sector. The end result is an effective energy market, which provides customers with access to competitively priced electricity. This is in the long term interests of South Australian customers.

### 3. South Australian market is working

#### *Healthy level of retail competition in South Australia*

Today, the South Australian electricity retail market demonstrates a healthy level of competition. Residential (mass market) customers have choice over who supplies them power and the high rate of retail churn demonstrates they are actively seeking competitive rates. Retailers have to work hard at not only acquiring new customers but also retaining their current residential customer base. The current electricity retail tariffs are set at a level that provides an appropriate foundation for the retail market to contest for customers by offering competitively priced electricity. As ESCOSA has previously indicated, the standing contract retail price is a regulated “safety net” offer for customers who choose not to enter into market contracts.

Churn rates are a key indicator of the health of a retail energy market. They reflect the level of competition and the ability of customers to switch between competitors. The electricity churn rate in South Australia is on the rise, around 21 per cent in May 2012. This is a significant increase from a churn rate of around 14 per cent at the same time last year.<sup>3</sup>

To put this in perspective, the rolling 12-month average churn rate in Victoria is around 25 per cent.<sup>4</sup> According to the 2012 World Energy Market Rankings, Victoria continues to be the most active electricity retail market in the world. Its average churn rate has remained above 25 per cent over the past three year period, keeping it top of the rankings.<sup>5</sup> South Australia is currently ranked third in the world. **Figure 3** below shows in the increase in customer switching rates in South Australia, in the past two years in particular.

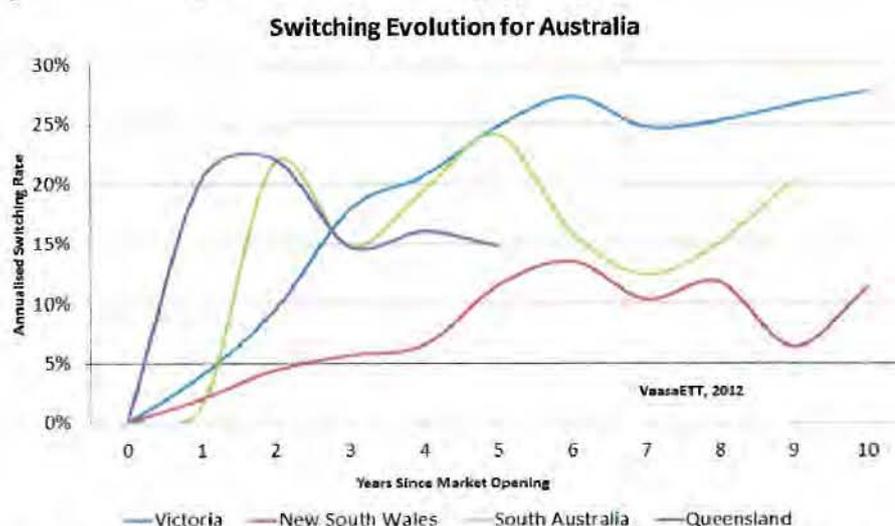
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<sup>3</sup> Credit Swisse, Equity Research Australian Utilities Update, 22 May 2012, p.3.

<sup>4</sup> Ibid.

<sup>5</sup> VaasaETT 2012, World Energy Retail Market Rankings 2012, Short Version, p.13. Available: [www.vaasaett.com](http://www.vaasaett.com)

Figure 3: Percentage of annualised switching by year post retail market start



Source: VaasaETT 2012, *World Energy Retail Market Rankings 2012, Short Version*, p. 17.

#### *Fully cost reflective and accurate tariffs support effective retail competition*

In retail markets with regulated tariffs, there is a strong connection between the level of competition and the effective level of those tariffs. In South Australia, ESCOSA has a pivotal role in determining the viability of the electricity retail market through its process of setting the regulated “safety net” tariffs. The consistent application of a robust and transparent pricing methodology provides regulatory certainty for retailers and investors alike. This encourages retail market competition, increases customer choice and promotes confidence for future investments in South Australia. ESCOSA acknowledges this, stating:

*the Commission aims to meet its primary objective by ensuring that the standing contract prices reflect the efficient costs of a retailer with the standing contract obligation in South Australia, including a reasonable profit allowance so as not to stifle competition in the retail market.<sup>6</sup>*

The level of competition in South Australia today illustrates the positive consequences that arise from setting retail tariffs that accurately and fully reflect the cost of supply.

#### *Regulatory risk and uncertainty likely to result from reopening current determination*

Reopening the existing retail determination introduces an unnecessary regulatory risk for market participants in South Australia. One of the advantages of setting a three year price path for retail tariffs is to provide the market with a degree of certainty. It is therefore important to limit reopening events to instances where there is a material change in circumstance; the start of a carbon price for example. As explained above, Origin does not consider that the evidence presented by ESCOSA triggers that materiality threshold.

As such, this Review introduces market uncertainty and could put at risk the current market balance for little gain. While Origin respects ESCOSA’s responsibility to investigate whether a material change in circumstance exists, this review is not in the long term interests of electricity customers in South Australia.

<sup>6</sup> ESCOSA 2012, Discussion Paper, p. 1.