

SUBMISSION TO ESCOSA'S WHOLESALE COST INVESTIGATION

Below is my submission to ESCOSA's Wholesale Costs Investigation.

My responses to the questions posed in ESCOSA's Discussion Paper are below.

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

In establishing wholesale electricity costs (WECs), ESCOSA should adopt its preferred approach of relying on market data to rather than its current long run marginal cost (LRMC) estimation approach for many reasons. Specifically, a market-based approach is superior because:

1. It is far less susceptible to gaming;
2. It avoids errors attributable to false assumptions and flawed methodology used by consultants;
3. ESCOSA's current approach is demonstrably leading to prices being far higher than the efficient level, manifestly breaching ESCOSA's primary objective;
4. The excessive prices allowed under ESCOSA's current approach do not deliver any tangible benefits to consumers;
5. The excessive prices allowed under ESCOSA's current approach are likely to inflate the general electricity price level, not just the standing contract price; and
6. A market approach can factor in changes in market dynamics far quicker than ESCOSA's current approach, thus resulting in a more efficient outcome.

These points are discussed in detail below.

Indeed, the only conceivable advantages of ESCOSA's current approach are that it provides:

1. Supernormal profits to energy providers; and
2. Revenue certainty to energy providers.

Given these "advantages" are in direct conflict with the interests of consumers under the current regime, ESCOSA must plainly choose to abandon its current approach in favour of a market-based approach in order to adhere to its primary objective:

... protect the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services.

Comparison of ESCOSA's current LRMC Estimation Approach with a Market-Based Approach

As summarised above, a market-based approach to setting WECs is superior to ESCOSA's current LRMC estimation approach for a number of reasons.

A market-based approach is far less susceptible to gaming

By relying on prices generated by a multitude of diffuse market participants, a market-based approach is inherently less predisposed to being taken advantage of by the gaming of one or a few market participants.

This is particularly important in the case of a heavily concentrated industry such as the South Australian electricity sector, which is dominated by a handful of key vertically-integrated generator-retailers (gentailers).

ESCOSA's current 'greenfields' approach to estimating LRMC is particularly susceptible to gaming by incumbent gentailers as its key output (WEC of marginal plant) is heavily dependent on the capacity factor, which is itself determined by the operating decisions of incumbent gentailers.

That is, the price that ESCOSA will "allow" the regulated entity to charge is a function of operating decisions made by that regulated entity! This is a classic regulatory gaming trap.

On this point alone, ESCOSA should have ruled out relying on the LRMC estimates of the regulated entity's (in this case, AGL SA, as the standing contract retailer) consultant.

Furthermore, by not requiring the key gentailers to provide their contract data to ESCOSA, the regulator has been successfully gamed into causing electricity prices to be higher than otherwise would have been.

It can be concluded that had ESCOSA's LRMC estimate been lower than the gentailers' average WECs, they would surely have provided their contract data to ESCOSA confidentially to substantiate this. The fact that this did not occur can only imply that the LRMC estimate is indeed higher than the key gentailers' average WECs.

Indeed, by refusing to countenance using only wholesale pool price data, ESCOSA effectively enabled the gentailers to game it into producing the highest possible WEC outcome.

A market-based approach avoids errors attributable to false assumptions and flawed methodology used by consultants

By relying on prices generated by a multitude of diffuse market participants, a market-based approach is most likely to result in an unbiased outcome reflecting all decision-makers' best estimates of future movements in costs, demand and all other relevant market variables.

Relying on actual market prices improves the probability of sending efficient pricing signals for new investment and new competitors.

By contrast, relying on one or two consultants to estimate LRMC increases the probability of a flawed, inefficient outcome, as it is reliant on far fewer views of key economic variables than a market-based approach.

ESCOSA's current approach is demonstrably leading to prices being far higher than the efficient level, manifestly breaching ESCOSA's primary objective

As a result of the gaming and/or flawed consulting output described above, ESCOSA's WEC allowance has been far higher than observed market prices (ie the pool price). Indeed, according to the Australian Energy Market Operator, the full-year volume-weighted wholesale market price for South Australia between 2003-04 and 2010-11 averaged around 60 \$/MWh, less than **two-thirds** of ESCOSA's WEC allowance!

This staggering discrepancy is damning evidence of ESCOSA's failure to achieve its primary objective.

The excessive prices allowed under ESCOSA's current approach do not deliver any tangible benefits to consumers

The excessively high WEC allowance provided for under ESCOSA's current approach may be argued to at least provide some long-run benefits for consumers if it could be showed to have brought forward some future generation investment that will at least smooth price increases over a longer period.

However, this has manifestly not been the case.

No new non-renewable generation investment has been announced or constructed since ESCOSA's price determination in December 2010.¹

Indeed, only the impending withdrawal of South Australian non-renewable generation plant appears to have been countenanced since ESCOSA's determination – admittedly, this is likely to be driven by carbon price considerations, not ESCOSA's determination.

Nonetheless, the likeliest outcome of ESCOSA's excessive WEC allowance is that the windfall gains generated by ESCOSA's decision have been pocketed by the gentailers and distributed to their shareholders in increased dividends.

Certainly they have not been passed back to South Australian electricity consumers.

The excessive prices allowed under ESCOSA's current approach are likely to inflate the general electricity price level, not just the standing contract price

ESCOSA's excessively high WEC allowance may not be as severe a problem if it only had an impact upon standing contract customers who were able to freely move onto market contracts.

However, this is not the case.

Problematically, increases in the standing contract price work to affect all electricity customers through two mechanisms:

1. Benchmarking by other retailers
2. ESCOSA's Relative Price Methodology (RPM)

Firstly, it is apparent that market offers are largely arrived at by discounting off AGL SA's standing contract price. Anecdotally, many market offers are exactly 10% or exactly 5% lower than the standing contract price, providing anecdotal evidence that market retailers use the standing contract price as a benchmark.

¹ Renewable generation benefits from significant other subsidies and regulatory measures, so it is not a reliable measure of the impact of ESCOSA's pricing regulation upon investment.

Secondly, ESCOSA's own RPM price indexation technique ensures that there is a complete circularity between the standing contract price and the average retail market price. This is because ESCOSA's RPM technique explicitly indexes the standing contract to changes in market contract prices. Thus, the standing contract price (with excessive WEC allowance) is used by retailers to set their market contract prices, which in turn dictate the next move upward in the standing contract, and so on and so on.

Superior ability of a market approach to factor in changes in market dynamics

As market prices are updated instantaneously to reflect changes in the views of market participants, they can immediately reflect updated information. This ensures that a market-based approach is likely to be both more statically- and dynamically-efficient than non-market based approaches.

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?

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

It would appear that the wholesale electricity market has become much more liquid in the last couple of years, with trading volumes projected to attain 90% of underlying demand in 2012.

Regardless of this, the wholesale market pool price reflects an acceptable proxy for the marginal cost of electricity as it reflects the price at which the marginal generator and retailer are prepared to trade electricity.

Certainly the market-traded price is deemed acceptable for use in all other industries – why should electricity retailing be any different?

Accordingly, my proposed approach to deriving a WEC cost component would be to use a market-based approach in the first instance. Ideally, this would be to use a regularly updated pool price, as this reflects what a new entrant would pay to secure energy on market.

Against this, it may be argued that relying on pool prices would subject South Australian consumers to significant fluctuations given occasional price spikes to the market price cap of 12,500 \$/MWh. This is not a sufficient reason to abandon a market-based approach, as annual volume-weighted average prices are far lower than this (less than 50 \$/MWh in 2011) and certainly lower than ESCOSA's WEC allowance.

It might also be argued that a WEC allowance that is too low will discourage future investment and lead to sharp price spikes in the future after years of cumulative underinvestment. This is a baseless concern for a number of reasons:

- 1) There has been no new non-renewable generation investment announced since ESCOSA's price determination;
- 2) All existing generation was built during times where the pool price was much lower than ESCOSA's 94 \$/MWh WEC allowance, and has since been run profitably at these lower levels – capital costs for new plant have only decreased since the current generation fleet was built;
- 3) Given the 55% increase in the standing contract price in the last two years, what sort of price spikes are we actually avoiding in the future?! The fact is that they are here now!² I, for one, am prepared to take the risks of future price spikes if it means avoiding certain annual increases of almost 30% in the present!

It might also be argued that the pool price is not an accurate indicator of the true prices paid by retailers, given they enter into hedge contracts to lay-off risk or increase cost certainty.

My response to this argument is that if retailers seek to enter into hedge contracts to achieve their own internal risk management objectives, why should South Australian consumers pay extra for this?

If gentailers have inefficiently paid excessive amounts for contracts, why should South Australian consumers pay for such imprudent decisions? The gentailers are certainly not handing consumers the windfall gains they earn when they have engaged in very clever (or lucky) hedge contracting!

And indeed, there is nothing to stop gentailers from choosing to not exercise uncommercial hedges. If a retailer has struck a hedge contract that becomes uncommercial towards the strike date, it can always purchase energy from the pool as an alternative and let its hedge go unexercised, losing only the premium it paid to establish the hedge.

If South Australian consumers are going to underwrite all of retailers' decisions, on contracting and all other cost passthroughs, then the gentailers should be receiving a commensurately lower risk-adjusted return than the 10% net margin they are receiving. A return more akin to a regulated utility or one of Australia's listed retailers (approximately 6% gross profit margin in 2011)³ would be more appropriate.

Certainly for AGL SA, the standing contract retailer, and most of the other large, vertically-integrated gentailers such arguments about the higher cost of hedging are spurious in any case. The large gentailers own their own generation, and therefore are quite capable of providing their own internal, 'natural' hedges, whereby their generation arms provide amply for their retail arms.

² While it may be argued that much of the price increases in recent years have been attributable to increasing network costs outside of ESCOSA's purview, the same rationale has been used by the AER to justify erring on the side of higher returns – that overinvestment now will avoid price spikes in future.

³ Average gross profit margin of ASX-listed large retailers (Metcash, Woolworths and Wesfarmers) in 2011.

And if the gentailers are adamant that their costs are legitimately higher than the pool price, they should be required to substantiate these by providing their contract data to ESCOSA. Otherwise, they should be forced to accept the pool price.

I would welcome the opportunity to discuss with ESCOSA any of the issues raised above.

Yours sincerely,

