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Nathan Petrus
Director, Pricing & Analysis
Essential Services Commission of SA
GPO Box 2605
Adelaide, SA, 5001

Email: escosa@escosa.sa.gov.au

Dear Mr Petrus

RE: TRUenergy's response to the Electricity Standing Contract – Wholesale Electricity Cost Investigation

TRUenergy welcomes the opportunity to provide input into the Wholesale Electricity Cost (WEC) investigation for the South Australian (SA) electricity Standing Contract Price.

We support the retention of a Long Run Marginal Cost (LRMC) approach to determining the minimum wholesale electricity costs in the South Australian market to ensure that, as a minimum, the current levels of retail competition continue. A competitive retail market will deliver the best long-term outcome for all South Australians.

Our reasons for supporting this LRMC approach over a market-based approach are that our analysis shows:

- the SA electricity market isn't sufficiently liquid to obtain reliable wholesale market price data
- wholesale market prices do not accurately reflect the cost of generation that retailers face as they are affected by political uncertainty over carbon pricing; and are susceptible to gas prices and weather conditions which make it difficult to model effectively
- LRMC is a better model to use under the current market conditions as it provides a more consistent approach to estimating the cost of generation

We outline these points in further detail below.

Using a market based wholesale energy price is inappropriate as the SA market still lacks liquidity

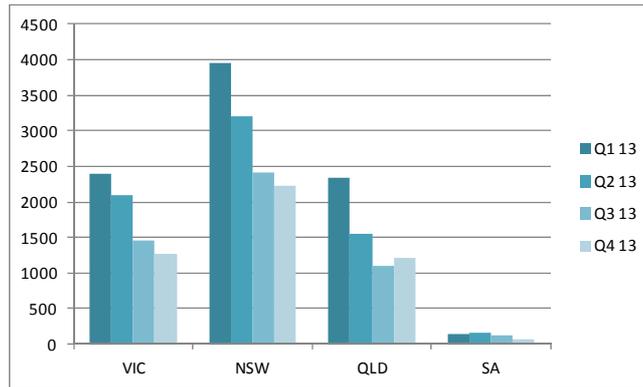
Whilst there has been some improvement in the SA electricity trading market since the last ESCOSA Contract Price Path Determination (2010 Determination),¹ analysis of d-cypha data shows that SA has lower liquidity than other states in the National Electricity Market (NEM).

One method of assessing liquidity is to examine traded volumes. In comparison with other NEM states, the traded volumes for SA have been considerably lower for many years and in the 2010-11 financial year were approximately half those of Queensland and Victoria.² More recently, an analysis of d-cypha data shows that traded volumes of Q1-4 2013 contracts in SA are typically less than 10% than those of other states.

¹ ESCOSA, *2010 Review of Retail Electricity Standing Contract Price Path – Final Inquiry Report & Final Price Determination*

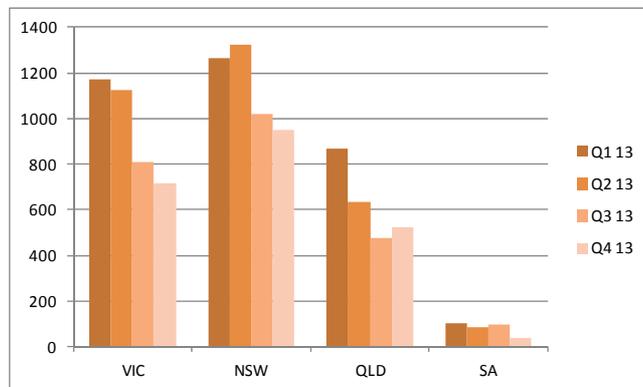
² AFMA, *2011 Australian Financial Markets Report*, pg 50

d-cypha traded volumes Q1 –Q4 2013³



Open interest in contracts predominantly reflects of the level of the hedging activity of retailers although it can include activity from other long-term speculators as well. The level of open interest in Cal13 flat contracts has a similar profile to the traded volumes data and is much lower for SA than other states.

d-cypha open interest in Cal13 flat contracts⁴



The chart above shows a similar picture to Figure 5.1 in the ESCOSA Final Price Path Determination that showed monthly peak and base data for Q3 2010 trades between Oct 2009 and May 2010.⁵ ESCOSA analysis demonstrated correctly that a contract price methodology was not acceptable at that time due to a lack of liquidity in the SA market. We believe this logic still holds.

Future prices don't fully include carbon due to political uncertainty

The implied base load futures prices outlined by ESCOSA in the discussion paper⁶ do not fully include the impacts of carbon as it remain uncertain in the context of the current political environment. Significant distortion in the pricing of financial products is expected in the early years of the carbon tax, especially with the Opposition making definitive statements about repealing the carbon tax if they win the next Federal election.

Although the discounting of carbon in futures contract prices is a smaller amount in some financial years (e.g. Fin2013), we recommend caution in using these market contracts on face value until this political issue works its way through over the next several years.

Future electricity market prices may be affected by price spikes seen recently in the gas market

The SA generation mix is heavily reliant on gas and wind, with gas prices often driving the electricity market price in SA. A key finding in AEMO's Gas Statement of Opportunities is the real prospect of increasing domestic gas prices. This expectation arises from Australia's gas sales in the medium to long-term shifting towards exports of liquid natural gas (LNG) to meet global demand.⁷ AEMO refers the Queensland Government's assessment of the likelihood of an almost threefold increase in domestic gas prices.⁸ Perhaps as an omen of

³ d-cypha, for trades between 1 Jan 2011-17 July 2012, website accessed 18th July 2012

⁴ d-cypha, website accessed 16th July 2012

⁵ ESCOSA, *2010 Review of Retail Electricity Standing Contract Price Path – Final Inquiry Report & Final Price Determination*, p66-67

⁶ ESCOSA, *Electricity Standing Contract – Wholesale Cost Investigation*, 20 June 2102, Figure 2, p8

⁷ AEMO, *2011 Gas Statement of Opportunities*, p27

⁸ Queensland Department of Employment, Economic Development and Innovation (DEEDI), *2011 Gas Market Review Queensland*, http://www.deedi.qld.gov.au/documents/energy/1-24_2011_Annual_Gas_Market_Review_Web.pdf, p ix

these anticipated higher gas prices, the Adelaide Short Term Trading Market (STTM) Hub has already experienced a recent spike in prices in the first week of July 2012 in its first peak demand period.⁹ It's not clear yet how this market will behave in future, but we see that there is a reasonable possibility of further price spikes or continued growth in prices beyond the forecasts published by AEMO.

Using a market price approach alone doesn't provide a reliable approach to calculating WEC

As outlined above, market prices won't be representative of the cost of wholesale electricity generation for several main reasons:

- the SA market still has very low levels of contract activity and remains relatively illiquid
- market prices are not yet fully inclusive of carbon
- details of long-term contract instruments (e.g. power purchase agreements) commonly used by retailers in SA are not publicly available
- market prices don't include components that properly price risk and fixed and variable costs

An allowance can be added to the modelled market price to account for some of these factors, but it is a less direct and reliable approach than using LRMC.

Another possible market price approach is to model spot market prices. However, ESCOSA also dismissed this approach on the advice of independent consulting group, Saha, due to the inherent volatility of the spot market.¹⁰ Even if reset year-to-year a spot market based mechanism would fluctuate based on weather sensitive inputs or predictions used. This would be a confusing model for both consumers and industry. We would not recommend this approach.

There are good reasons that the WEC should be no less than the Long Run Marginal Cost

ESCOSA went into the issue of LRMC at length during the 2010 Determination. There were a number of fundamental points made about the LRMC approach in this Determination.

Without reopening any debates on the detailed calculation of the LRMC used, TRUenergy agrees with ESCOSA's decision to use LRMC to calculate the minimum WEC value for the current price path period.

To re-iterate the reasons why this is still a good approach:

- An LRMC approach is a truer reflection of wholesale electricity costs faced by retailers over the long-term as it allows the recovery of fixed and variable costs associated with generation (unlike a market price approach).
- Market prices are highly dependent on weather patterns and other factors, can vary dramatically from year-to-year, and don't bear any relation to the long-term costs faced by generators.
- Modelling LRMC is a theoretical approach to determining the minimum cost to supply load under conditions that allow generators to earn an economic return on their investment.
- Using LRMC will help to encourage investment in replacement plant more so than a market price. This is relevant in the case of the Northern and Playford power stations, two of the larger and older coal fired generators in South Australia for which replacement options have been considered.¹¹
- Customers, retailers and generators all benefit from a stable floor price for WEC as this ensures that investment signals are consistent for generators, that retailers can maintain market activity and compete effectively and ensures that costs and cost fluctuations are minimised for customers in the long-term.

We believe it's important to look at market prices and LRMC when determining the wholesale energy component for the SA electricity contract price, but recommend that LRMC should not be dismissed for short-term gain during periods when market prices happen to be the lower of the two. LRMC is a more comprehensive, stable and longer term approach and provides the best minimum benchmark for the wholesale energy component of the SA Electricity Standing Contract Price.

⁹ AER, *Weekly Gas Market Report*, 1-7 July 2012, <http://www.aer.gov.au/sites/www.aer.gov.au/files/20120701-20120707%20AER%20gas%20weekly%20report.pdf>, p3

¹⁰ ESCOSA, *2010 Review of Retail Electricity Standing Contract Price Path – Final Inquiry Report & Final Price Determination*, p67

¹¹ The Advertiser, *Coal power will only switch on for summer*, 18/4/12, Miles Kemp & Cara Jenkins, <http://www.adelaidenow.com.au/coal-power-will-only-switch-on-for-summer/story-e6frea6u-1226332097185>

In conclusion

ESCOSA has made a decision for this price path period that has seen good levels of competition in the last 18 months and the entrance of a new retailer (Alinta). Altering the approach to calculating the WEC may benefit customers in the short-term, but it is very unlikely to be the best approach in the long-term.

There are other methods retailers and government can (and do) use to assist vulnerable customers. Also, retailers will frequently reduce their market offers below the level of the Standing Contract Price when this has been set at an appropriate level.¹² So continuing to use LRMC to model WEC doesn't necessarily mean that the benefits of lower wholesale market prices will not be passed on to customers.

TRUenergy understands that questions will exist for any modelled approach to determining a major component of the price that South Australians pay for electricity. We also understand the need to offer as low a price as possible whilst maintaining market efficiency. We believe that the current WEC approach that uses LRMC as a base is providing an efficient market that has long-term benefits for both customers and industry.

If you have any questions on this submission, please call me on (03) 8628 1242.

Yours sincerely



Melinda Green
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TRUenergy

¹² ESCOSA, 2010 Review of Retail Electricity Standing Contract Price Path – Final Inquiry Report & Final Price Determination, p22-23