



Wholesale Energy Cost Review - ESCoSA

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To: ESCoSA Electricity Standing Contract – Wholesale Cost Investigation

From: Uniting Communities, in partnership with UnitingCare Australia

The Problem.

South Australian households are now, most likely, facing the highest electricity prices in the world!

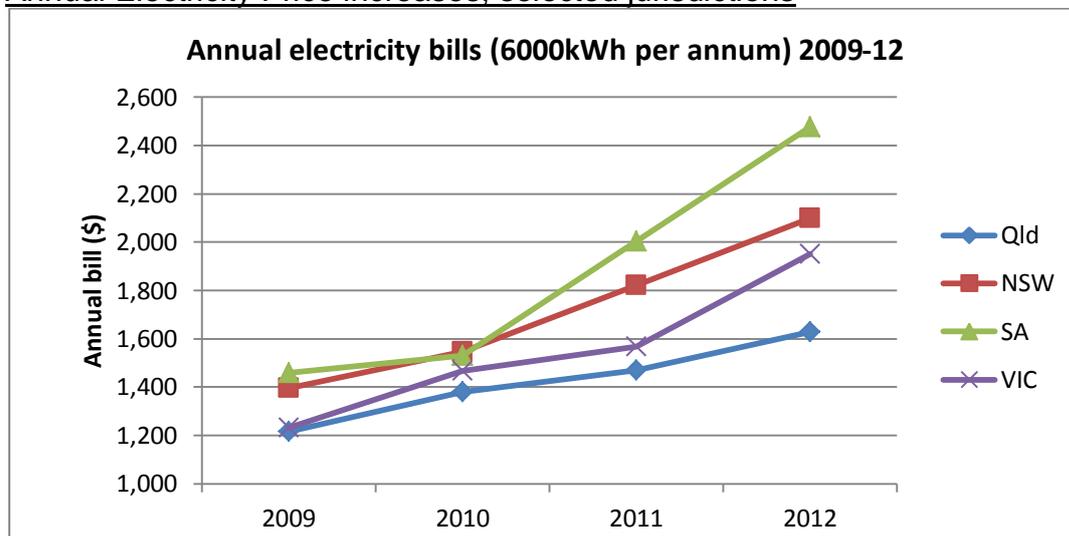
The critical questions that need to be asked are:

1. whether this is a natural consequence of a “very peaky load” and associated poor load factor across the market? and
2. whether SA consumers are paying too much?

Uniting Communities believes that these questions are central to this Wholesale Electricity Cost (WEC) review.

Electricity Prices have doubled (approximately) over the last 5 years in most Australian jurisdictions, (graph 1) exacerbating financial stress for many households in paying for this essential service, particularly lower income households, some of whom are paying over 10% of their income on energy, (graph 2).

Annual Electricity Price increases, selected jurisdictions



Graph 1, source: St Vincent de Paul Society

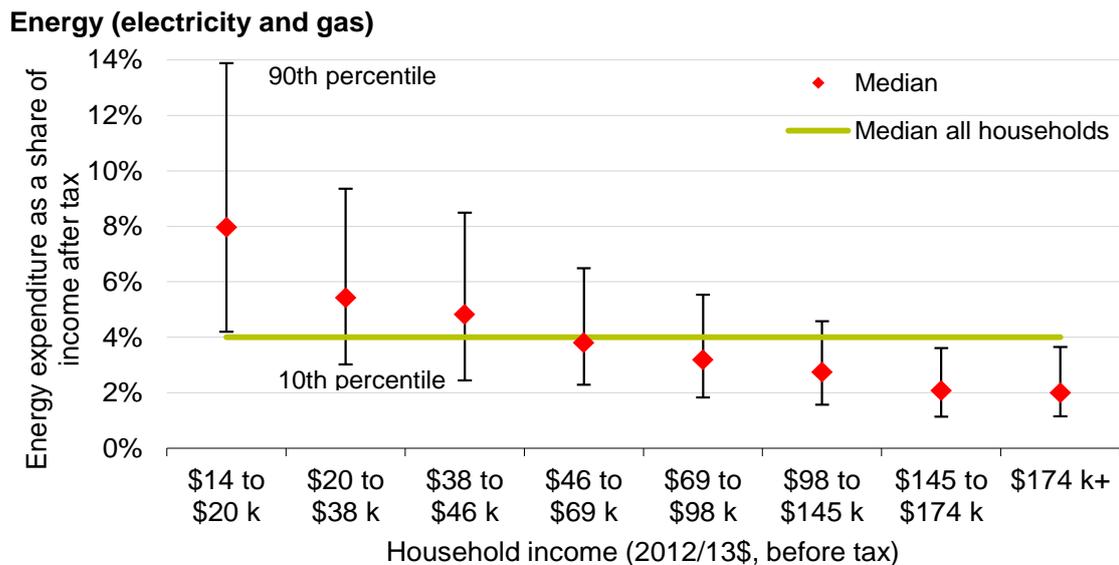
Graph 1 shows both the significant upward movement in electricity prices for most of Australia’s population over the past 3 years, and that South Australia has the highest rate of increase, even though prices were highest in SA at the start of the period graphed.

Last month, SA standing contract prices were approved to increase by another 18%.

The issue of greatest concern to Uniting Communities is what impact do these continuing and substantial price increases have on low and modest income households?

Part of the answer to this question is reflected in graph two, which has been produced by IPART to show distributional impacts of energy prices on various income households for Sydney and surrounding areas.

Energy bills as a share of disposable income, by income band (Sydney and surrounds)



Graph 2, Source: IPART

The most recent ABS Household Expenditure¹ Survey (HES) reports that average household expenditure on 'domestic fuel and power' has remained unchanged from 2003-4 to 2009-10, at 2.6% of household expenditure, prompting some to observe that energy is a minor part of household expenditure and consequently affordable for all. Median energy expenditure is 4% of household annual income. In South Australia a vast majority of energy spending is on electricity, because reticulated gas supply is limited.

The average household spending on energy is not a good indicator of spending by most households, because all households are different. Distribution measures of affordability are much more useful than statistical measures of "central tendency" (eg mean and median).

Graph 2, represented above, indicates the spread in relative household energy costs for the Sydney region. We expect that similar distribution impacts for various income classes would be very similar, but do not have this data set for SA.

Graph 2 is consistent with the experience of Uniting Communities financial counsellors, who identify significantly growing numbers of clients presenting

¹ ABS; Cat no 6530.0 - Household Expenditure Survey, Australia: Summary of Results, 2009-10

with major concerns about their capacity to pay rising energy costs. Graph 2 shows that for some very low income households, up to 14% of the household pre-tax income is spent on energy, while there are households in each of the three lowest income bands who spend over 8% of their household income on energy. Generally lower income households are lower energy use households, so a high proportion of income being spent on energy is more a function of income than energy use.

These lower income households are heavily affected by energy price rises above CPI and by price shocks in general. They are therefore the households at greatest risk of adverse impacts as a result of any use of market power, and of rising prices in general, including in energy markets.

This consumer experience is contrary to the national electricity objective (NEO): “to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to –price, quality, safety, reliability, and security of supply of electricity; and the reliability, safety and security of the national electricity system.”

We now turn to address the three questions posed by ESCoSA in their discussion paper for this WEC review

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

Taking these questions in turn

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?*

The Question of Incidence of Risk

The central question really is about who bears the risks created by uncertainty; wholesales / generators or consumers, particularly residential consumers?

Industry, rightly for them, prefer longer term price setting approaches so that they face greater certainty in returns and consequently in assessing benefits of making large, ‘lumpy’ investment decisions, eg to invest in new generation capacity.

We have some sympathy for this perspective.

We however, have much greater sympathy for the people who come to our financial counsellors, and other services, unable to meet their basic costs and “worried sick” about how they will be able to pay their next electricity and water bills.

The approach taken by the Commission in setting wholesale costs in standing contract determinations is really about making a decision about the risk trade off. In general, retailers, including ‘gentailers’ will want price setting based on long term considerations with longer term price paths. So they will argue for Long Run Marginal Cost methodology for costings, based on the costs of investing in new generation capacity for a ‘greenfields’ site, and for a 3 or more years price path period. This gives greater certainty for retailers, and generators too. Consumers on the other hand will prefer shorter run wholesale prices to be used for price determinations since longer term price increases are not as ‘locked in’ as they are with LRMC methodology. So a spot price based methodology would be preferred, with a shorter term price path.

We are satisfied that recent wholesale costs in SA have fallen well below the regulated standing contract allowed price, during the current price path period. This view is explained in response to question 2, which follows.

Preferred Approach?

We understand that there were two ‘methodologies’ involved in setting the wholesale price for the 3½ year, current price path approach

- a. Building block approach to determine the standing contract price for the first year of the price path, with subsequent price adjustments based on an RPM (Relative Price Movement) approach
- b. Application of Long Run Marginal Cost (LRMC) methodology to determine wholesale costs in applying the building block approach for the first year of the period.

Considering these approaches in turn, we consider the ‘building block’ approach to be sound regulatory practice, but we are not convinced about the use of RPM approach for subsequent years.

The regulated price is the standing contract price, and is determined independently through a building block approach. Market contracts, in general, are derived by some form of discount from the standing contract, so market contract prices are effectively dependent on standing contract prices. The RPM approach then sets standing contract prices for years after the initial year, based on movement in market contract prices, in other words, beyond year 1, the Standing contract is dependent on market contract price movements, which were based on the initial standing contract. So the RPM methodology, in essence, makes the standing contract price dependent on the standing contract price, (plus retailer adjustments), and so is a function of itself, not a function of competition. We do not consider this to be a sound

regulatory approach – standing, or default tariffs need to set as dependent on accepted independent variables.

We support the application of a building block methodology, but reject the RPM methodology as being useful.

Applying LRMC as the main method of determining wholesale prices is also fraught, in our opinion.

Long Run Marginal Cost (LRMC) is first and foremost a theoretical construct with limited practical applicability to real world essential service policy and regulation. This notion was put most eloquently by the outstanding 20th Century economist, John Maynard Keynes:

“The long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is past the ocean is flat again. - JM Keynes”

This summarises the practical dilemmas of applying a Long Run Marginal Cost approach to real world energy regulation. In dynamic markets consumers need market functions and regulation that operate in “real time”, not considerable time after the event.

LRMC can only be accurately measured after the event, and indeed, quite sometime after the event, depending on how ‘long run’ long run is. So in applying LRMC to prices to be paid by consumers in the future using a methodology that includes LRMC, the determination of values for LRMC can at best be an estimate. Given that price setters are highly unlikely to accept LRMC estimates that allow prices to be below efficient costs, plus an uncertainty premium, Long Run Marginal Costs will invariably be set higher than likely real costs. When real costs are known, in hindsight, there is virtually no scope for excess prices paid by consumers to be recovered by consumers.

LRMC based methodologies are consequently unlikely to deliver efficient costs for consumers, nor capacity for compensation for higher than necessary prices when paid by consumers.

In summary, applying LRMC methodologies for price setting means that consumers must lose, both in the short and longer terms

The methodologies for estimating long run marginal costs are relatively ineffective at providing a reasonable benchmark of consideration for shorter term considerations. This includes the inability to deal effectively with the potential or actual exercise generator market power in the market for the following reasons:

- The long timelines needed for determining long-run marginal costs.

- Long run marginal costs over time do not compare readily with spot prices averages in the shorter term.
- Abuse of market power under this approach is only observed after the event and, indeed, some time after the event, and so does not afford consumer protection.
- This methodology fails to identify market power in the short run;

LRMC approach is also based on assumed, ongoing growth in demand. A range of factors are in place that are likely to reduce total, and even peak electricity demand, for example: installed solar PV, load shifting, demand management etc. This too renders price setting based on cost of new generation capacity as redundant.

We do not regard LRMC as a sound basis for applied regulatory policy.

Which approach should be used?

Our rejection of both RPM and LRMC methodologies does not answer the salient question of “Which approach should be used?”

We answer this question by first saying that there are three tests that must be satisfied in any methodology:

1. Are prices reasonable for consumers?
2. Do prices enable a sustainable return for retailers?
3. Can prices paid by consumers go down as well as up, given favourable conditions? Or as Keynes may have asked “are prices downwards flexible?” (a question he applied to ‘sticky wages’)

In recognising the difficulties for a regulator (or anyone else) in determining prices 4 years in advance, with high precision, we recognise that this approach is flawed conceptually, particularly in highly volatile markets, like energy.

We suggest that part of a solution is to consider a regulatory process which enables direct negotiation between retailers and consumers, adding in a ‘conciliation’ option to energy price determinations. The roles of the regulator would be to:

1. assist the parties with information for negotiation,
2. establish reasonable bounds within which negotiated price(s) would occur and
3. arbitrate where the negotiators could not agree

This process requires adequate resourcing of consumer negotiators and a ‘good faith’ approach by all parties. We are aware that this sort of approach is used overseas, particularly in some North Americas jurisdictions.

We have attached as Appendix 1, some comments made about application of “Negotiated Settlements”, by Kenneth Bateman, a Board Member of the National Energy Board of Canada.

This approach has risks: asymmetrical information gives businesses an advantage over consumers, so adequate resourcing for consumer engagement is essential, and “rules of engagement” need to be clear to maintain a basis of ‘good faith’ negotiation. Any direct negotiation has potential benefits for consumers, in that they have direct communication with energy companies and capacity to negotiate. Energy companies have the advantage of direct information from their customers, and a potential for reduction in the costs for regulatory burden.

We suggest that the timing is right to start seriously exploring a form of direct negotiations between consumers and retailers on standing contract prices and conditions.

Where wholesale cost need to be established, ex ante, and without direct consumer negotiation, then a reasonable compromise is to develop a ‘basket of goods’ approach, including LRMC estimates, spot market prices, perhaps using a 2 years rolling average to remove some volatility, maybe with lesser weighting to other measures like RBA CPI estimates and / or some other established bond rate, as a proxy for cost of capital for new generation capacity.

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?*

Factors Affecting SA Wholesale Electricity Costs Determination

We are convinced that there are two relevant factors at play for SA consumers concerning wholesale costs:

- Use of generator market power to bid up prices
- Falling actual wholesale costs

UnitingCare Australia has made submissions to the current AEMC rule change process dealing with Generator Market Power, and Uniting Communities (as Uniting Care Wesley Adelaide) made submissions to the AEMC review of effectiveness of retail energy markets in SA, about 4 years ago. In each of these submissions we have expressed concern about the use of generator market power in SA to leave consumers paying more than they should. We also note the data presented to this inquiry by SACOSS through advice from CME consultants, who state on page 10 of their report:

“In other words what these charts show is that the spot market in South Australia has delivered extremely high prices despite the existence of substantial amounts of spare capacity. It follows that the extremely high prices are attributable, not to prices that reflect tight supply/demand balances, but to the exercise of market power.”

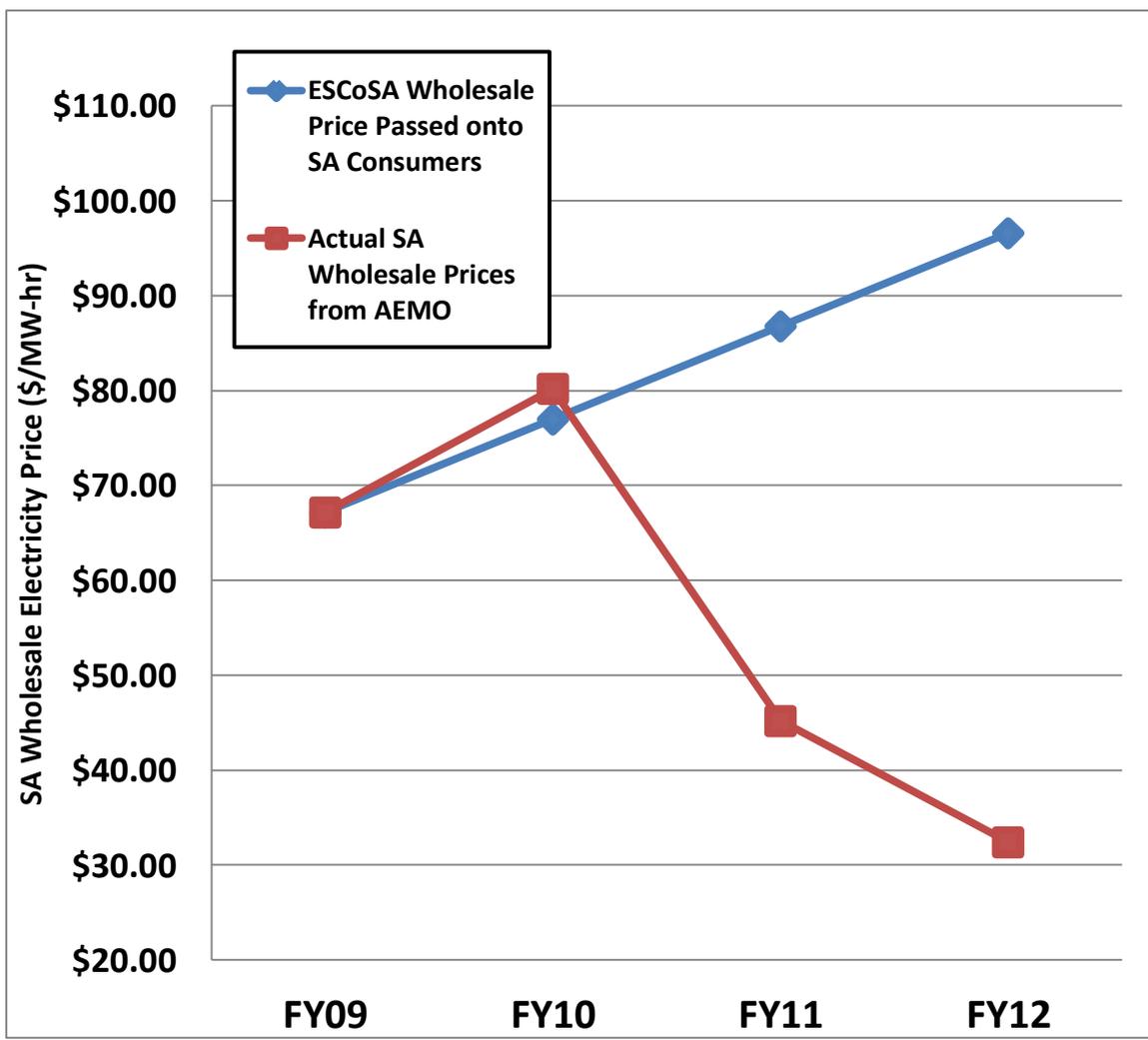
We remain very concerned about the risk of the use of generator market power in SA to push up prices paid by consumers, but recognise that this issues is currently being considered by the AEMC.

The other substantive issue is the difference between ESCoSA approved ex ante wholesale prices in the determination for the standing contact price for the current price path period, and actual, ex post prices.

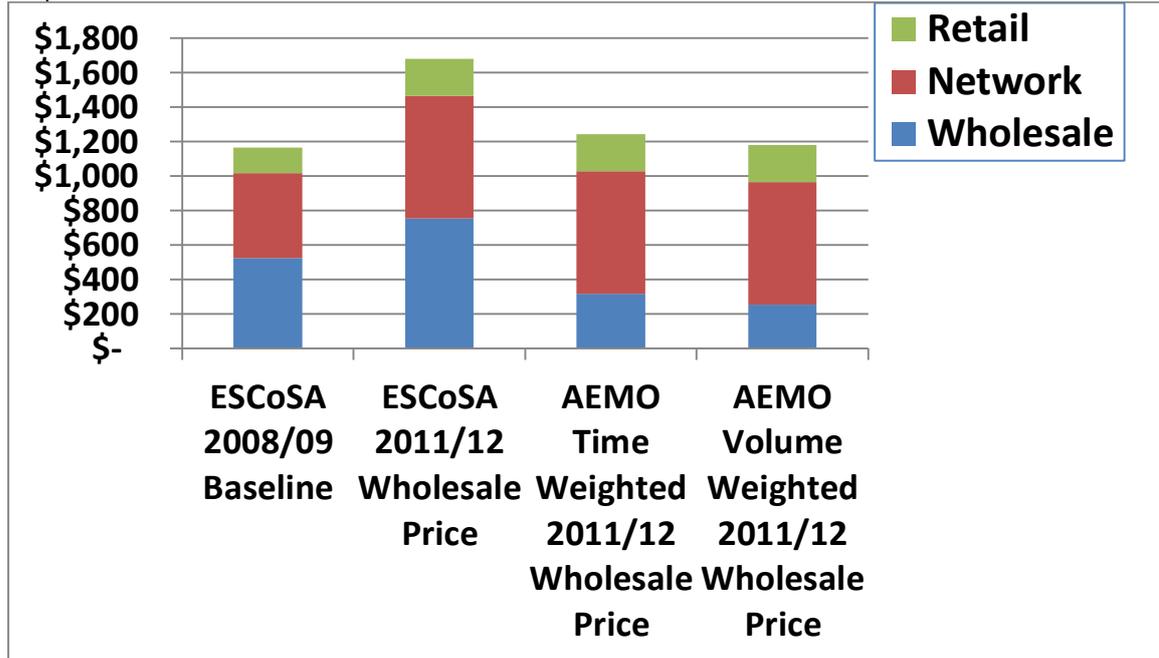
This is demonstrated in graphs 3 and 4 below. Graph 3 shows declining actual wholesale costs since the current standing contract price path commenced, plotted against regulated wholesale cost allowances. By observation, end consumers are paying higher wholesale costs than they need to.

Graph 4 shows that the main contribution to consumers 'electricity price stack' for FY 2011-12, came from high wholesale costs.

The current situation in SA is of a growing gap between actual wholesale prices, which are falling and wholesale prices approved by ESCoSA for the current retail price path.



Graph 3; Source Data from ESCoSA and AEMO



Graph 4; Source Data: ESCoSA and AEMO

In considering the question of liquidity of the forward wholesale market in SA, the overwhelming reality is that applying this approach, with a second best back of LRMC, has been to the detriment of consumers.

We suggest that the forward market is more liquid now than at the time of the standing contract price path determination, and so revising the price path to take into account more recent development is prudent. We also note the AEMO forecasts for SA capacity which suggest that there is adequate capacity in SA for the medium term future. This is coupled with likely increased attention on supply side measures, including AEMC’s Power of Choice review which is soon to be released, new Commonwealth funded energy efficiency programs and increased PV, mean that growing future demand for wholesale electricity in SA is not a ‘given’, even for peak demand. Adequate wholesale supply into the SA, in a competitive market, would lead to the expectation of an effectively liquid forward wholesale market.

SA Generation Capacity

The following summarises AEMO’s South Australian Electricity Report, suggesting the demand outlook for the next decade

*“Under the low economic growth scenario, adequate electricity generation capacity is forecast throughout the 10-year outlook period.
Under the high scenario, the LRC (Low Reserve Condition) point appears in summer 2015–16; however the reserve deficit is less than one per cent of capacity for reliability at that time. This difference grows to approximately 7% of forecast capacity for reliability by summer 2021–22.*

Under all scenarios, winter maximum demand can be met by the forecast capacity of existing generation.”

We understand this “Outlook” to say that there is adequate capacity in the SA wholesale electricity market, for at least a decade.

Basing wholesale prices for consumers today, on the LRMC of new capacity that is unlikely to be needed for considerable time, seems to be unreasonable.

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

The question here is whether ESCoSA should revise the standing contract price path, during an established price path, in the basis of significantly reduced wholesale prices?

We strongly support a revision, considering it to be in the best interest of SA consumers.

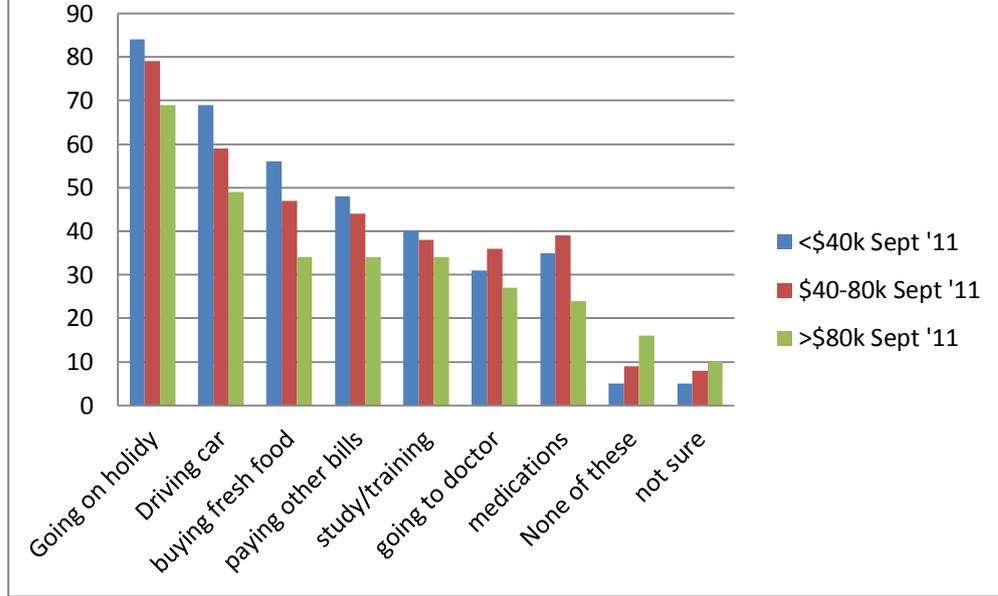
We understand the industries’ response that this situation reduces investment certainty for the industry.

We respond by saying that industry has experienced a windfall gain from (about 2½ years), which on top of rapidly growing prices for some prior of years, have had significant and adverse impacts on a large number of consumers, with about the poorest third of SA households needing to forego spending on healthy food, health, education/ training and other items, in order to meet these very high electricity costs.

We support this statement with the data in Graph 5, which is the results of an Australia wide omnibus survey, n = 1300, where consumers were asked what the impacts would be on other spending if energy prices doubled over the next 5 years (has happened for many households over the last 5 years).

The data shows that over a half of lower income households (annual income less than \$40,000) would reduce purchase of fresh food, while over a quarter of households, from low, middle and higher income ranges would reduce visits to the doctor and over a third would reduce study or training to improve employment skills.

What would you cut back on if electricity prices double over 5 years? by Income range, September 2011



Graph 5. :Source, UnitingCare Australia survey conducted by the Australia Institute

We note the following statement from the Commission:

Next Steps

Following its consideration of those submissions, the Commission will prepare a report to be released by the end of September 2012, setting out the Commission's findings.

While the Commission does not yet have any views on the outcomes of the current investigation, to provide certainty to stakeholders it notes that, to the extent that it finds cause to revisit the terms of its price determination in relation to WEC (that is, if its findings are determined to constitute "special circumstances" for the purposes of the Electricity Act), the Commission may also make a further price determination to take account of those findings. If that were to occur (which is yet to be determined), the Commission will issue a draft price determination at the time of releasing its report and finalise the price determination process in December 2012.

Uniting Communities is convinced that a review of SA standing contract prices is warranted, due to the significant change in wholesale prices, and in light too, of an 18% July 2012 price increase for consumers.

Appendix 1

We wish to highlight the comments made about an approach to essential service price setting that includes a 'negotiated settlements' approach/

Excerpt from a presentation to the 27th Annual Conference of the Canadian Administrative Tribunals, Ottawa, Ontario, 5th June 2011

By Kenneth Bateman, Board member of the National Energy Board of Canada

"More and more participants appearing before tribunals are increasingly informed, prepared and knowledgeable. They are vocal in their expectations that the tribunal process is efficient, cost effective and designed to achieve timely and practical outcomes.

As tribunal members there is an increasing responsibility and opportunity to be responsive to these expectations through continuous review and meaningful change where warranted.

Two areas touching the NEB experience is proactive steps in Stakeholder Engagement and Negotiated Settlements. Stakeholder engagement is a broad subject however time does not permit me to develop this area other than to briefly identify.

- 1. Alternative Dispute Resolution (ADR)**
- 2. Participant Funding (in facilities applications)**

ADR (Alternative Dispute Resolution)

ADR is an area receiving increasing interest and attention as a vehicle to assist disputing parties in achieving voluntary resolutions that meet their individual expectations and needs within a regulatory proceeding. One recent development at the NEB is the availability, upon request (and Board approval) that a Board Member facilitate or mediate a dispute between landowner owners and applicants.

NOTE: Participation of a Board Member in an ADR process precludes future involvement (directly or indirectly) by the assisting Board Member, should the parties fail to achieve a voluntary resolution.

Participant Funding

Improved public engagement was identified by the Board as another way to remain attuned to society's values and preferences as they evolve over time. Participant funding is one way to ensure the public has access to resources to support their timely and meaningful participation in the regulatory decisions that affect them. Public participation is an important element of an open and balanced regulatory process. It strengthens the quality and credibility of the process.

The Participant Funding Program provides some financial assistance to support the participation of individuals, including Aboriginal groups, landowners, incorporated non-industry not-for-profit organizations, or other interest groups who seek to intervene in the NEB's oral hearing process for facilities applications.

The objective of this program is to facilitate effective public participation, and consideration of public concerns and values during the NEB's hearing process. This enables the Board to make the best possible decision.

Negotiated Settlements - agreements between a pipeline and its customer that are filed with the Board to obtain resolution of toll and tariff matters without the need for a litigated proceeding.

Incentive Regulation - Incentive regulation has developed mainly through multi-year toll agreements negotiated between pipelines companies and interested parties. These settlements often includes incentives to reduce costs and provisions to share savings between the pipeline company and its shippers. In some cases, settlements have included various innovative performance mechanisms. These agreements allow both parties to share in the benefits of improved pipeline performance.

From the early 1970s to the mid 1990s, the NEB followed a more traditional regulatory approach of scrutinizing toll applications in toll hearings which involved a Line by Line examination of each element of a company's Cost of Service. This was inefficient, required extensive subjective decisions, many of which the Board agreed were of doubtful value.

In March 1994, the Board initiated the Generic Cost of Capital Hearing (RH-2-94). The aim of the hearing was to avoid annual hearings on cost of capital by developing an automatic mechanism to adjust the return on common equity. The proceeding was intended to streamline the regulatory process by removing a contentious issue from individual hearings and reduce the uncertainty in terms of a major cost item.

The Board's generic ROE formula (RH-2-94) removed this item from litigation (before the NEB) and provided a starting point for negotiations for a number of companies. It likely set a floor to the negotiation since no pipeline will accept less than the formula.

In August 1994 - Board issued revised guidelines

Removed opposition to "package deals" as long as terms agreed between the parties were no illegal or contrary to the NEB Act. If the settlement was not opposed, Board normally concluded that tolls were just and reasonable and that no hearing was required. In substance the Board required unanimous or unopposed support and no reference to contested settlements. The Board stated that: "When presented with a settlement package, the Board will either accept or reject the package in its entirety provided the Parties provided a concise statement of the resolution and the rationale for Board to assess reasonableness."

Benefits:

- Avoids contentious hearings; parties work together to find Win-Win solutions; all parties can focus on their core businesses
- Significant reduction in time and costs of hearings (see next slide)
- Cost savings may get shared based upon some pre-determined formula
- Better working relationships - Tolls Task Forces have successfully resolved issues.
- More innovative solutions are possible - e.g. Westcoast Framework for Light-handed Regulation, multi-year agreements, performance incentives such as for improved service quality, ability for parties to make tradeoffs on items that matter to them most.
- Easier to set tolls for multiple years in one agreement, i.e., 5 years for TransCanada and Enbridge, 15 years for Alliance."