energy supply association of australia

Energy Retailers Association of Australia

5 November 2012

Essential Services Commission of South Australia
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2011-2014 Electricity Standing Contract Price Determination Wholesale Electricity Cost Investigation - Draft Determination

The Energy Retailers Association of Australia (ERAA) and the Energy Supply Association of Australia (esaa) (the Associations) welcome the opportunity to make a joint submission on the Essential Services Commission of South Australia's (ESCOSA) Draft Determination for the 2011-2014 Electricity Standing Contract Price Determination Wholesale Electricity Cost Investigation (the Draft Determination).

Australia's energy industry owns and operates some $120 billion in assets, employs more than 51,000 people and contributes $16.5 billion directly to the nation's Gross Domestic Product.

South Australia has undertaken significant reform over more than a decade to improve the efficiency and competitiveness of its electricity market. Until recently, ESCOSA's regulatory methodology was seen as a practical and sensible approach that could facilitate a smooth transition to retail price deregulation. ESCOSA's focus on developing a highly competitive market has led to exactly that, with less than a quarter of South Australians remaining on the regulated rate.

In this context, the Draft Determination is a backwards step and its impact on competition has been severe. One major retailer has announced that it will reduce discounts on electricity contracts and there is no appetite from rival retailers to increase their activity. The Associations are of the view that undermining a competitive market is inconsistent with ESCOSA's primary objective to "protect the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services."[1] Less competition is likely to lead to higher prices for the three quarters of customers who are on market offers.

Basis for the investigation

In the Draft Determination ESCOSA again refers to its 2010 Final Determination as containing the trigger for this review, that being that "should an event occur during

[1] Essential Services Commission Act 2002, section 6.

the next regulatory period that leads to a material change in wholesale electricity costs, a special circumstances review may be triggered."[2]

It is not clear to the Associations what event has occurred that has led to a material change in wholesale costs. There is no evidence that the Long Run Marginal Cost (LRMC) has changed materially since 2010. There is no evidence of an "event" that leads to a material change, apart from the carbon price increase on 1 July 2012, which ESCOSA has already accounted for.

It is important to note that in 2010 ESCOSA supported the use of the LRMC on the basis that it "will lead to an initial price that is representative of a long-term sustainable cost. Short term variations in wholesale costs are expected to be addressed through the RPM index calculation. In establishing a starting price, a long-term focus is therefore preferable."[3] ESCOSA in 2010 effectively said that any steady increase or decrease in the SA spot or futures price over the next few years would not be cause for an "event"; the RPM mechanism is designed to account for these.

The Associations therefore question the basis of this review.

Market Liquidity

In the context of an ultimate goal of a deregulated market with competition as the governing factor in price formation, the regulated price should be considered as a price cap. That is, it should form a backstop to the prices that will emerge through the competitive process of market offers.

In South Australia, competitive prices are what most customers pay - over three quarters of households have moved away from the standing contract and so are not directly affected by the price cap. It should not be designed to be as low as possible, as this is not consistent with supporting competitive outcomes. Inevitably, the errors endemic to setting an ex ante price cap mean that there is a risk that the cap fails to allow retailers enough revenue to cover efficiently incurred costs plus a fair margin for their business risks. This risk is especially acute when methodologies are used that are dependent on limited information.

The Associations notes that it was primarily because of the lack of liquidity in the electricity contract market that ESCOSA used an LRMC analysis to establish the WEC in its past price review of the SA regulated electricity price which took effect from 1 January 2011.

In July 2012, AGL's submission paper to Electricity Standing Contract - Wholesale Electricity Costs Discussion Paper[4] provided evidence that trading volumes and open interest in futures market continue to be problematic so that futures prices cannot be used as a reliable forecast of energy costs.

The results by AGL indicate that the number of trades and the frequency of trading in the futures market do not represent a liquid market. In 2012, as in 2010, there is little

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[2] ESCOSA, *Final Report 2010 Review of Retail Electricity Standing Contract Price*, December 2010, p.A68
[3] ESCOSA, *Final Report 2010 Review of Retail Electricity Standing Contract Price*, December 2010, p.A68
[4] AGL submission to ESCOSA, July 2012, *"Electricity Standing Contract - Wholesale Electricity Costs Discussion Paper Submission – AGL"*

or no trading for the two subsequent forward years. As a result, any reference to futures prices will be highly unreliable[5].

Preferred approach – LRMC as the floor

In the light of these considerations, the Associations continue to advocate the calculation of the wholesale energy cost (WEC) using an approach whereby the WEC should not be less than the long run marginal cost (LRMC) of electricity generation. Ultimately, wholesale prices at this level are required to bring forward new investment when required, and so such an approach is consistent with setting a price cap at an efficient level.

Both federal and state policy settings are designed to bring forward new low or zero emissions generating plant and for higher-emissions plant to ultimately be replaced. South Australia is understandably proud of its record in attracting new zero emissions electricity to the state at a greater rate than other jurisdictions. The stability and certainty of a WEC based on an LRMC floor supports this record. Conversely, an approach based purely on prevailing market data will result in greater price volatility flowing from spot and contract markets into the retail price path. This will diminish the willingness of private capital to invest in the new generation capacity that South Australia requires.

Timing of any implementation

If ESCOSA is able to reconcile this investigation with its 2010 Determination and pursues the proposed approach, the Associations believe that the timeframe the ESCOSA has suggested for its final decision is unrealistic.

We believe the adoption of a condensed consultation period for this review is inconsistent with good regulatory process, particularly given the unprecedented nature of the significant methodology change proposed mid-price path and the resulting significant impact on retail tariffs. Changing the standing contract price in July 2012, then in both January and July 2013 will add to costs for retailers and lead to confusion for customers.

Any implementation should be delayed until no earlier than July next year to allow time for the Commission to undertake a more robust consultation process. Part of the consultation process should provide retailers the ability to meet with Frontier and the Commission to discuss the new modelling approach.

In conclusion, the Associations do not believe this review is consistent with the 2010 Determination nor with ESCOSA's primary objective and therefore it should not proceed. The Associations support setting wholesale costs with reference to both market-based and long-run marginal cost (LRMC) estimates. Over the long term wholesale costs should not be lower than the LRMC to ensure long-term forward contracting does not diminish and generation investment decisions are not delayed.

However in the event that ESCOSA pursues the proposed approach, the Associations requests the Commission delay its final decision until the new year to

[5] AGL submission to ESCOSA, July 2012, *"Electricity Standing Contract - Wholesale Electricity Costs Discussion Paper Submission – AGL"*

allow for the Commission to undertake a more thorough consultation process, in time for a 1 July 2013 change.

Any questions about our submission should be addressed to either Kieran Donoghue, email kieran.donoghue@esaa.com.au telephone (03) 9205 3116 or David Lee, email dlee@eraa.com.au telephone (02) 8241 1835.

Yours sincerely

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