International Power
GDF SUEZ

Dr Paul Kerin
Essential Services Commission of South Australia
GPO Box 2605
Adelaide SA 5001

5 November 2012

RE: 2011-2014 ELECTRICITY STANDING CONTRACT – WHOLESALE ELECTRICITY COST INVESTIGATION

Dear Dr Kerin

Thank you for the opportunity to comment further on the Essential Services Commission of South Australia’s (ESCOSA’s) draft determination on the Wholesale Energy Cost (WEC) component used to determine the regulated standing offer rate.

This submission from GDF SUEZ Energy Australia (GDFSEA) reflects the views of this business as both a generator and a significant retailer (Simply Energy) servicing South Australia.

GDFSEA is both disappointed with the draft determination and gravely concerned that, if left unvaried; it will severely curtail retail competition in South Australia and deliver an outcome that is not in the long term interests of South Australian energy customers.

Should you have any enquiries regarding this matter please do not hesitate to contact Dianne Shields +61 3 8807 1132 or Greg Hannan +61 3 9617 8405.

Yours sincerely,

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GDF SUEZ Energy Australia (GDFSEA) submission to 2011-2014 electricity standing contract wholesale electricity cost investigation

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1 Executive summary

GDFSEA urges ESCOSA to reconsider the approach that it is taking to the review of the wholesale electricity cost (WEC) component of the South Australian standing offer.

While the draft determination may provide a degree of short-term benefit to some customers at the expense of most retailers in South Australia, it will be to the long term detriment of all South Australian customers as retailer entry is discouraged and other retailers exit the market.

Market churn in Queensland dropped from 20% to 13% in response to the Queensland Competition Authority's decision to reduce the wholesale component of the regulated retail price by $5 per MWh (by comparison, ESCOSA is proposing a $27 per MWh reduction).

GDFSEA suggests that continuation of the Draft determination places the same risk on the South Australian market.

In summary, our concerns with the draft determination are as follows:

- The underlying approach used by ESCOSA is not appropriate for the setting of what is in effect a "safety net" price from a regulatory strategy perspective. The approach adopted in the draft determination attempts to simulate the outcomes from retail competition in a circumstance where both wholesale and retail competition is already present. We suggest that the "standard" regulatory framework of attempting to simulate competitive outcomes typically applied to regulated monopoly businesses such as transmission and distribution companies, and is not appropriate in a "safety net" case.
- Put another way, ESCOSA should not be trying to set an efficient purchase cost for wholesale energy in a way that treats AGL as a regulated monopoly. AGL is already subject to competition and significant threat of new entry.
- Flaws in the assumptions and modelling that has been used by ESCOSA and Frontier Economics regarding the actual state of the South Australian wholesale electricity market. In particular, reports about contract liquidity are in direct contradiction to our experience of operating in both the retail and generation sectors in South Australia. We are happy to provide confidential evidence to the contrary (confirming poor liquidity), given our continuing difficulty at the practical level finding liquidity to hedge generation assets in South Australia.

We suggest ESCOSA should be setting a wholesale energy cost that acts as a "safety net" that protects those customers who are disinclined, or not sufficiently informed, to switch to a more competitive market offer, while at the same time providing the headroom that encourages competition from a broad panel of retail alternatives.

In order to do this, we argue ESCOSA's approach should aim to set a ceiling for the WEC below which retailers can compete to develop the best wholesale purchase strategy. This is why we recommended earlier that the wholesale component of the regulated electricity retail tariff be set as the higher of the long run marginal cost (LRMC) and the forward market contract price for wholesale electricity as calculated in each year of the regulatory price period.

2 Response to previous consultation

In our earlier submissions, GDFSEA encouraged ESCOSA to give serious consideration to recommending that retail pricing be deregulated. It is disappointing that this opportunity has been dismissed in the draft determination.

Therefore GDFSEA takes this opportunity to reinforce the key elements of its formal response to the ESCOSA's consultation, dated 20 July 2012.

In the submission we recommended that ESCOSA:

- Determine the wholesale component of the regulated electricity retail tariff as the higher of the long run marginal cost (LRMC) and the forward market contract price for wholesale electricity as calculated in each year of the regulatory price period;
- Acknowledge in its decision that regulated customers have the opportunity to seek a market offer at a lower price; and
- Gives serious consideration to promoting retail price deregulation in South Australia.

GDFSEA also took the opportunity to point out that price outcomes in the wholesale market in South Australia are currently a significant impediment to the development of a healthy electricity supply chain. GDFSEA believes this should no longer be ignored by the relevant regulators.

3 Concerns regarding ESCOSA's approach

GDFSEA does not believe that ESCOSA is adopting the correct approach for this review.

ESCOSA is attempting to simulate the outcomes from the competitive process by attempting to estimate the price that a prudent and efficient retailer would pay for wholesale energy given the current state of the South Australian wholesale market.

This is an approach that is normally adopted for regulating the monopoly distribution and transmission elements of the industry — not the competitive retail market.

As a former regulator in that space, ESCOSA is aware that the framework used to regulate distribution and transmission seeks to create incentives that mimic the competitive market because these companies do not face any competition.

In the absence of that competitive framework, distribution and transmission companies do not face the consequences of any poor investment or purchasing decisions that they may make. Their franchised customer base protects them from these consequences because a monopoly can simply raise its prices to recover from its mistakes. The incentive framework aims to shift the risk of poor decision making away from the customer and back on to the distribution or transmission company.

This is not the case with the competitive retail market. Retailers will wear the consequences of poor purchasing or investment decisions. Any attempt to pass these through to their customers will cause customers to switch retailers.

The consequences of ESCOSA applying a monopoly framework to a competitive market are that:

1. It makes entry for new retailers harder. New entrants sell much smaller loads than established retailers and will have a higher wholesale cost of energy than established retailers. The headroom for competition is not about the level of the discount offered by established retailers. Providing headroom is about providing enough ceiling space in the regulated price to allow for new entry. We suggest ESCOSA has not considered this dynamic.

2. It ignores the fact that the wholesale market is dynamic. While South Australian wholesale energy spot prices may be lower now than they have been in recent years, they are just as susceptible to sharp increases in the future as they were in 2007. ESCOSA's wholesale price determination does not allow sufficiently for unanticipated increases in the wholesale price for electricity. Even in the regulation of monopolies, regulators recognise the need for conservatism and provide plenty of headroom in price paths to allow for unanticipated changes in circumstances.

3. It ignores the fact that different retailers have different wholesale purchasing strategies and that these strategies evolve over time. Setting a wholesale energy prices too low detracts from innovation because it reduces the incentives that retailers have to try out more innovative wholesale purchasing approaches.

3.1 Short run versus the long run costs

GDFSEA strongly disagrees with ESCOSA's view that in setting the WEC it is the short run (next 18 months) that is of relevance.

ESCOSA should be using a measure commensurate with the long run costs because the regulated retail price set for the next 18 months provides a price signal for future investment in the South Australian electricity market at both the generation and retail level.

The price signal set over the next 18 months will affect investment decisions well beyond that time period because of the long lead times required for making investment decisions in the generation and retail sector.

Setting a WEC that does not reflect the LRMC means that an inefficient price signal is set in the market. For example, if regulated wholesale energy prices are set below LRMC, incorrect pricing signals may deter efficient investment in generation assets and will deter efficient retail entry into the South Australian market.

In this context, we suggest that the long-run cost of wholesale energy strikes the balance between:

- Avoiding monopoly rents by setting a price that would reflect the value of a new increment of generation into South Australia;
- Avoiding providing competitive prices to customer that have shown no inclination to participate in the competitive process, while ensuring those unable to do so are not overcharged; and
- Providing competitive headroom to encourage vigorous retail competition.

3.2 Assumptions and methodology

We believe that the assumptions and modelling that have been used by ESCOSA and Frontier Economics are incorrect and misrepresent the actual state of the South Australian wholesale electricity market. Forward contract price data has been incorrectly utilised as well as flawed methodologies which will incorrectly value the electricity purchase cost (EPC) methodology.

The price data utilised to calculate the three separate forward curves is not representative of hedge costs achievable by a prudent retailer. The quoted prices for electricity financial instruments on the ASX24 exchange (D-cypha published) do not always represent actual market transactions undertaken on an arms-length basis.

A reasonable proportion of transactions undertaken on the ASX24 are associated with 'exchange for physical' and 'block' trades, which do not represent actual, market transactions on an arms-length basis. They are deemed by the ASX24 to be prior negotiated, off-market trades and as such are not considered in its methodology for determining the daily settlement prices. These represent approximately 50% of all transactions conducted during FY11/12 on the ASX24 for South Australian based products. These facts bring into questions the use of ASX24 settlement prices and how they are used in any EPC methodology.

In approaching pricing to serve a standing contract load a prudent and efficient retailer would not only assess the current price of hedging contracts to serve that load but would consider the volatility of the current price, current liquidity management risk and the variability of total customer volume in a highly competitive environment. These are real costs to a retailer and Frontier's mark-to-market approach does not address these at all.

In summary, we believe the methodology used by Frontier is inadequate and unrepresentative, and we recommend further consultation with those directly involved in hedging retail demands to assist the ESCOSA in its final determination.

3.3 Outcomes of ESCOSA's decision

GDFSEA is very concerned about the outcomes of ESCOSA's draft determination.

By basing the wholesale price on short-term market prices, limited in their representation (see above), ESCOSA is effectively giving the benefit of switching to standing offer customers without them having to switch retailers. This severely damages competition as it reduces any incentive customers have to switch and may actually encourage customers to shift from a market offer back to the standing offer.

We suggest the experience in Queensland is instructive for South Australia. The decision of the Queensland regulator on the wholesale cost of energy has resulted in a reduction in the number of second tier retailers operating in that market and, prima facie, a reduction in retail competition for consumers in that State. Between 2007-08 and 2011-12, the market share held by second tier retailers in Queensland fell from around 10% to around 5% as regulatory pricing decisions removed incentives for second tiers to participate in that market. Retailer churn also fell from around 20% to 13%. This impact has been outside of the decision by the Queensland Government to freeze Tariff 11 rates.

With the draft decision, ESCOSA is risking undoing much of what has been achieved in South Australia since the commencement of full retail contestability. This is disappointing because it is not in the long term interests of customers.

The draft determination is also increasing the regulatory risk associated with doing business in South Australia. ESCOSA's assertion that returning to a previously used methodology midway through a price path does not create regulatory uncertainty is not correct.

Retailers require certainty over the long term that the capital that they have invested will generate a level of return that is worth the risk involved. The draft decision acts directly against this certainty. The risk is further exacerbated by the fact that there is now only two months' notice of a substantial change in methodology.

Further, the ESCOSA has not been consistent in its setting of the WEC and is not providing certainty or confidence that its regulatory rulings are consistently applied. ESCOSA's preferred EPC-based approach (marked-to-market) is not consistent with any previously adopted methodology.

In previous reviews ESCOSA has adopted a rolling average for its EPC-based approach. The proposed change in methodology will not only deliver a different value outcome but it also introduces a new uncertainty to a prudent and efficient retailer and undervalues the volatility component of a retailers energy cost. GDFSEA cannot see any "logical" reasoning for this change.