LUMO ENERGY

Whatever makes you shine.

Call 1300 11 5866
lumoenergy.com.au

05 November 2012

2011-2014 Electricity Standing Contract Price Determination – Wholesale Electricity Cost Investigation
Essential Services Commission of South Australia
GPO Box 2605
Adelaide SA 5001

E-mail: escosa@escosa.sa.gov.au

Dear Sir/Madam,

RE: Draft Methodology Paper Regulated Retail Electricity Prices 2012-13

I would like to thank the Essential Services Commission of South Australia, (Commission), for the opportunity to comment and provide feedback on the 2011-2014 Electricity Standing Contract Price Determination – Wholesale Electricity Cost Investigation paper.

Lumo Energy is supportive of the submission of the Energy Retailers Association Australia, (ERAA) of which Lumo Energy is a member.

The Commission states their primary objective is to:

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

It is our view that the reopening of the draft decision and the ensuing draft position is fundamentally detrimental to the long term interests of the South Australian consumers.

We dispute the Commission's claim that wholesale market conditions have materially changed allowing for the special circumstance provisions to prevail.

The Commission states that it has formed the view that the following special circumstances exist and has determined them to be so for the purposes of section 36AA (4a) of the Electricity Act:

- The relevant policy uncertainties have been resolved through the enactment of the Clean Energy Act; and
- Liquidity in the South Australian forward electricity contract market has increased since the ESCPD and following the removal of the relevant policy uncertainties, enabling a reversion to the use of the EPC-based approach for the setting of the WEC allowance for the purposes of the ESCPD[1].

The two key issues have not been resolved and a lack of liquidity and significant carbon uncertainty remains in the South Australian market.

---

[1] http://www.escosa.sa.gov.au/library/121002-WholesaleElectricityCostInvestigationReview-DraftDetermination.pdf Page 9

Market Liquidity

Liquidity in the South Australian region continues to be stifled by a lack of competition and intermediary participation due to fundamental market risks and more recently reduced local generation which has resulted in a greater reliance on interconnector flows from Victoria and subsequently further reductions in liquidity. The ongoing uncertainty around the federal government's carbon policy is also impacting traded volumes with prudent retailers unwilling to take ongoing exposure to carbon pricing through exchange traded contracts.

The expectation that all participants will operate at or below their SRMC over the longer term is flawed as can be seen by the removal of generation volume across the NEM with the current low wholesale price. With a lack of liquidity in contracts the recent changes to available generation have not been captured in published prices.

There is currently not enough liquidity in the South Australian markets to underpin the full retail customer base. The Commission cannot assume retailers will continue to enter long term off market contracts if they are taking on significant price exposure to retail tariffs set off an illiquid Exchange Traded market. The need for retailers to remain competitive, (against prices set in the contract market), will lead to short term hedging strategies and potentially a greater exposure to spot market prices. In the long term this will negatively impact wholesale market security and increase costs to retail customers.

By the government taking a clearly short term focus to pricing, investment when required will be stifled. Prudent retailers will no longer be encouraged to provide wholesale protection to vulnerable customers; rather they will be making short term, highly volatile pricing decisions.

Regulatory Certainty

A consistent approach to pricing that takes a long term market view is critical for the retention of effective competition for South Australian consumers. Electricity assets are long term investment decisions and by converting retail tariffs to an extremely short term focus the market will not adequately respond in time which will lead to very large price exposures to vulnerable consumers.

We would caution the Government on amending retail pricing policy to suit short term political motivations. Prudent market participants make long term investment decisions that underpin market security and lead to competitively priced retail contracts and should not be penalised.

Whilst the initial uncertainty around the introduction of carbon has been answered new issues have subsequently emerged and shifted focus to the potential removal or significant alteration of the carbon pricing mechanism.

A prudent retailer will not lock in a carbon inclusive price whilst the current level of uncertainty remains given it will be incurring a cost that it is unlikely it will be able to recoup. Therefore the futures prices start to trade at a discount to account for some of this risk, (which we are now seeing). If retail tariffs are then set off these prices then the Commission needs to confirm it will not conduct another special circumstance to remove the carbon cost already incurred by retailers through forward purchases.

Calculation of the WEC

In our view the Commissions basis for calculation of the WEC is flawed. In determining the appropriate contract pricing to use in its modelling, Frontier Economics has by its own admission had to override the published prices due to a lack of liquidity, clearly this is contrary to the Commissions conclusions that liquidity is now at an adequate level to set pricing off. The lack of liquidity illustrates that retailers are not using the futures market to offset the majority of their South Australian customer base and is therefore not reflective of the actual wholesale costs incurred.

From the information provided it is unclear if Frontier Economics has considered only screen based trading or additionally takes into account off market transactions which account for the majority of volume. The ASX 24 futures settlement prices are only adjusted through on screen trading, i.e. off screen “block” trades do not impact. Since 1 Jan 2012 only approximately 6% of average demand has traded through on screen for the Q1 2013 base in South Australia versus over 50% in New South Wales, therefore empirically there is a lack of liquidity and this cannot provide a good proxy for the wholesale costs of a prudent retailer.

Our recommendation is the use of a blended market and LRMC approach.

Summary

Again we draw attention to the Commissions primary objective to…*protect the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services.* The draft determination seems counterintuitive to achieving this objective.

To achieve this it is imperative for the market to maintain a Long Run Margin Cost that is truly reflective of a three year price path and allows for new entrants into the market and an independent mix of generation that compliments the current generation.

Resetting the wholesale electricity purchase costs at this time will effectively cause an unfavourable long term outcome across the market exposing current retailers, stifling innovation, disenfranchising new entrants and driving up the standing contract prices.

Lumo Energy welcomes the opportunity to participate in further discussion. Please contact Aneta Graham, General Manager Regulatory Affairs and Corporate Relations on 03 8680 6439 to discuss.

Yours sincerely,

Aneta Graham
General Manager Regulatory Affairs and Corporate Relations