



**SACOSS Submission to 2011-2014 Electricity Standing Contract
Price Determination Wholesale Electricity Cost Investigation –
Draft Determination**

October 2012

*SACOSS Submission to 2011-2014 Electricity Standing Contract Price Determination Wholesale Electricity
Cost Investigation - Draft Determination*
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Executive Summary

Because SACOSS has been extremely concerned that the recent moderating of wholesale prices for electricity was not being reflected to some degree in retail pricing, SACOSS has welcomed the decision by the Essential Services Commission of South Australia (The Commission) to conduct an investigation in to Wholesale Electricity Costs.

As the use of the Electricity Purchase Cost (EPC) approach by the Commission acknowledges the market conditions that hold in SA for the rest of the regulatory period at least, SACOSS supports the use of an EPC methodology as a fairer way of estimating the wholesale costs of a prudent and efficient retailer.

SACOSS strongly believes that there are sound reasons to revise ESCOSA's proposed allowances for headroom and compliance with the Small-scale Renewable Energy Scheme downward and that a greater reduction in the electricity standing contract price is therefore warranted. As detailed in this submission, downward revisions of the above allowances in line with the additional SACOSS proposals would result in an 8.6% reduction in the electricity standing contract price.

Notwithstanding, SACOSS welcomes the Commission's Draft Determination, the out-turn of which would be an 8.1% reduction in the electricity standing contract price. While the outcome is a good result for consumers, it is certainly not the lowest possible of the range of reasonable prices that ESCOSA could have determined.

In the first instance, SACOSS proposes that the Commission reconsider its proposal to make an allowance for headroom. If the Commission decides to proceed with an allowance, SACOSS proposes an alternative headroom allowance that is *either* 5% of the 50% PoE estimate *or*, the use of the 10% PoE estimate – but not *both* as the Commission has. The average of these is \$4.00/MWh (\$3.74 and \$4.26).

While the Commission's Draft Decision assumes an Small-scale Renewable Energy Scheme cost of \$4.65/MWh based on a small-scale technology certificate (STC) price of \$40 each, SACOSS proposes that the SRES cost to be assumed by the Commission to be set based on an STC price of \$32 and updated projections of 2013 and 2014 targets from the Clean Energy Regulator. This will yield allowances of \$6.95 for 2012/13 and \$4.23 for 2013/14

SACOSS estimates that the impact of the above proposals on the electricity standing contract price would be an overall 8.6% reduction.

SACOSS notes that softer market price signals are appropriate and efficient in the context of the level of investment required to meet forecast demand and wishes to highlight the AEMO forecasts which indicate that SA has enough capacity to meet demand until 2019-20.

While there have been reports that there is a causal link between the draft determination and halts in investment, SACOSS does not support making this link. For example, in regard to the Torrens Island Power Station, AEMO had in fact been notified of AGL Energy's decision to abandon the proposed expansion before the August 9th 2012 publishing date of the 2012 Electricity Statement of Opportunities¹ - months before the Commission's Draft Determination

¹ <http://www.aemo.com.au/Electricity/Planning/Reports/Electricity-Statement-of-Opportunities>

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Introduction

Regulation of the standing contract has major consequences for the prices that vulnerable and disadvantaged consumers pay for electricity. A key component of the Commission's price setting process is establishing Wholesale Energy Costs or an allowance for 'WEC'. This component represents around one third of the typical residential electricity bill.

Wholesale prices have declined over recent years while the regulated standing contract price has continued to rise. SACOSS notes that the correlation between wholesale market prices and retail electricity prices is not a simple one. The relationship between wholesale market prices and the costs to an electricity retailer of buying wholesale electricity also involves the costs of various financial instruments to manage the risk inherent in volatile wholesale markets.

Noting the recent decline of wholesale prices, SACOSS has undertaken detailed analysis of the determinations of WEC made by the Commission since mid-2005. This analysis has confirmed to SACOSS that there is indeed a significant relationship between wholesale and retail markets over time, as well as a relationship between the WEC Allowance and retail competition. On this basis, SACOSS has been extremely concerned that the recent moderating of wholesale prices for electricity was not being reflected to some degree in retail pricing.

SACOSS welcomed the June 2012 announcement from the Commission that there would be an investigation into current forward wholesale electricity contract prices. SACOSS considered that this investigation would examine the existing gap between wholesale prices and retail prices and ensure that electricity standing contract customers are paying no more than they should be.

SACOSS is particularly concerned about the impact of unnecessarily high prices on the significant number of standing contract customers who are on low incomes. Publicly available data confirms the view that people on low incomes are disproportionately represented in standing contract customer numbers. For example, as part of its Customer Information Requirements for the Energy Retail market in South Australia project, the Commission engaged consultancy firm Colmar Brunton to undertake a survey of energy customers in SA. The major component of the project was to survey 600 residential and 400 small business energy customers across South Australia. The findings of the survey and analysis were publicly released in late 2010².

Colmar Brunton found that of the 600 residential participants, 22% had never considered changing energy providers. According to the report, "by definition all those who have never thought about changing providers are on a standing electricity contract with AGL"³. The customers comprising this 22% are referred to here as 'non-switching' or 'sticky' customers. Of this 22% (132):

- 47% (62) were aged over 65
- 24% (31) were aged over 75
- 51% (67) were retired
- 35% (46) had annual incomes of \$25,000 and under
- 58% (76) had a high school diploma as their highest academic achievement
- 48% (63) receive the state government energy concession

The Colmar Brunton findings highlight long-held concerns that many older people and people on low incomes are disproportionately represented in numbers of standing contract customers, inclusive of those who had never considered switching.

² Colmar Brunton (2010) "Monitoring the Development of Energy Retail Competition in South Australia and Consumer Preference for Market Contract Information" at <http://www.escosa.sa.gov.au/projects/154/customer-survey-monitoring-the-development-of-energy-retail-competition-in-sa-and-consumer-preference-for-market-contract-information.aspx>

³ Colmar Brunton (2010) pg.111

The intense financial strain that people on low incomes are facing makes unnecessarily high energy bills a consequential issue. For example, the reality of what it means to live on social security incomes has been reported in a recent SACOSS Cost of Living update. As part of its work tracking cost of living pressures on low income households, SACOSS publishes quarterly updates using the Australian Bureau of Statistics' Analytical Living Cost Index⁴. The February 2011 report highlighted the reality of what it means to live on social security incomes⁵. Case Study 2 from the report shows a budget for an aged pensioner living in a retirement home. While food and utilities are not major items, there is extremely modest expenditure on most personal expenditure categories. Although individuals may differ on their priorities in this expenditure, or disagree as to what is a wise use of scarce discretionary money, it is important to recognise that even in a home where the basic food and lodging is provided, some personal expenditure is necessary to have a life as an individual and to engage in society. And even with this fairly minimal expenditure, the budget was still found to be in deficit.

Given that almost half of the 'sticky' customers surveyed by Colmar Brunton were in receipt of the state government energy concession, it is reasonable to assume that a significant number of customers on the standing contract receive some form of income support payment.

Case Study 3 from the SACOSS Cost of Living report is reproduced below. As this budget highlights, even limited expenditure still leaves the person with a fortnightly deficit of \$55.20. It can be seen that combined housing costs including utilities represent around 60% of expenditure.

Case Study 3: Budget for a Newstart Recipient (with own home)

Fortnightly Income

Source	Total
Newstart	\$498.44
Training Allowance	\$41.60
Pharm & GST Allowances	\$15.76
	\$555.80

Fortnightly Expenditure

Description	Total
Mortgage	\$228
Other House (Insurance, rates, fees)	\$60
Utilities (water, electricity, phone)	\$85
Food	\$100
Pet Food	\$30
Car (Petrol, rego, insurance)	\$73
Medication	\$5
Clothes	\$4
Haircuts/Cosmetics	\$6
Alcohol	\$20
	\$611

Nett Position: Fortnightly Deficit \$55.20

An 8.1% reduction in the electricity standing contract price on an average bill of a typical residential standing contract customer would leave the customer better off by around \$160 per annum (GST inclusive). For someone on a low income, including an income support payment, this is of very real benefit.

⁴ SACOSS Cost of Living Updates at <http://www.sacoss.org.au/costofliving/index.html>

⁵ SACOSS (2011) Cost of Living Update No. 5 at <http://www.sacoss.org.au/costofliving/index.html>

General comments

SACOSS strongly believes that there are sound reasons to revise ESCOSA's proposed allowances for headroom and compliance with the Small-scale Renewable Energy Scheme downward and that a greater reduction in the electricity standing contract price is therefore warranted. As detailed in the following sections, downward revisions of the above allowances in line with the additional SACOSS proposals would result in an 8.6% reduction in the electricity standing contract price.

Notwithstanding, SACOSS welcomes the Commission's Draft Determination, the out-turn of which would be an 8.1% reduction in the electricity standing contract price. While the outcome is a good result for consumers, it is certainly not the lowest possible of the range of reasonable prices that ESCOSA could have determined.

SACOSS has undertaken a significant amount of work on the relationship between electricity wholesale and retail costs. In July 2012, SACOSS provided a submission to the Commission's Wholesale Electricity Costs Review – Discussion Paper. This submission included two additional consultants reports, one from st.kitts.associates and one from CME. All of these reports supported the view that the WEC component of standing contract prices should be reduced.

SACOSS has commissioned st.kitts.associates to provide further advice to SACOSS. The st.kitts.associates report relates specifically to the Commission's Draft Determination with reference to key issues of relevance to the work of SACOSS and its members in advancing the interests of the market's most vulnerable consumers.

SACOSS has attached the report prepared by st.kitts.associates at Appendix 1. SACOSS supports the recommendations made and wishes to draw the Commission's attention to the full report.

In relation to the Draft Decision, of particular interest to SACOSS are the following:

- The proposed allowance for headroom
- The proposed allowance for compliance with the Small-Scale Renewable Energy Scheme (SRES)

SACOSS notes that softer market price signals are appropriate and efficient in the context of the level of investment required to meet forecast demand. As detailed in the st.kitts.associates report, the AEMO forecasts indicate that SA has enough capacity to meet demand until 2019-20.

While there have been reports that there is a causal link between the draft determination and halts in investment, SACOSS does not support making this link. In regard to the Torrens Island Power Station, AEMO had in fact been notified of the decision to abandon the proposed expansion before the August 9th 2012 publishing date of the 2012 Electricity Statement of Opportunities⁶. In line with the st.kitts.associates report, there is at best a tenuous link between halts to investment and the draft determination.

As the use of the Electricity Purchase Cost (EPC) approach by the Commission acknowledges the market conditions that hold in SA for the rest of the regulatory period at least, SACOSS supports the use of an EPC methodology as a fairer way of estimating the wholesale costs of a prudent and efficient retailer. In the case of the Commission returning to the use of a Long Run Marginal Cost approach, SACOSS considers that a *brownfield* approach would be appropriate as it better reflects contemporary market circumstances and wholesale price signals than a *greenfield* approach. However, SACOSS strongly urges the Commission to retain the use of the EPC approach as one which best emulates prices in a competitive market.

⁶ <http://www.aemo.com.au/Electricity/Planning/Reports/Electricity-Statement-of-Opportunities>

Recommendations

SACOSS proposes that the Commission review the proposed allowances relating to headroom and SRES, as detailed in the following sections.

Headroom

As discussed in the SACOSS submission to the ESCOSA WEC Review Discussion Paper, the term 'headroom' is used to describe the difference between competitive costs and what the regulated price effectively allows for. Implicitly or explicitly, this is the principal agent for encouraging competition to appear and the market to develop and function as intended.

As noted in the SACOSS submission to the Discussion Paper, one of the major issues with the use of headroom to promote or protect competition is that the headroom allowance is in fact an amount that standing contract customers have to pay above competitive prices. SACOSS welcomes the acknowledgement of this by the Commission in the Draft Determination (page 69-70):

"However, allowing headroom also has real costs: it means that standing contract customers pay prices that exceed prudent and efficient costs. This results in inefficiently low demand: some units that standing contract customers would value at more than the cost of supplying them are not consumed. That is, allowing headroom generates real efficiency costs. The equity of charging all standing contract customers more than the prudent and efficient cost in the hope that some (possibly only a few) would shift to market contracts is also open to question.

The Commission notes that allowing headroom within the standing contract price may also result in higher market contract prices. Some submissions, such as AGL's, argue that this is not that case, putting the view that, even if the standing contract price is set too high (for example, by setting an excessive headroom allowance), this would not impose costs on market contract customers.

That would be true if the retail market is highly competitive. However, it is not clear that retail market competition will prevent a high headroom allowance in the standing contract price being passed on to market contract customers."

SACOSS has previously argued that the practice of headroom allowances may be justifiable in the transition to a competitive market but 10 years on from market start this justification is very hard to sustain. SACOSS now strongly reaffirms this position. While ESCOSA has acknowledged the bluntness of the headroom approach, that this is particularly so in the context of the South Australian market and has made an explicit inclusion of a headroom component, SACOSS believes that this does not go far enough in addressing the fundamental problem with making an allowance for headroom at this stage of the market's development.

However, if the Commission does intend to proceed with provision for a headroom allowance, SACOSS strongly advises that the allowance should consider the two elements which estimate 'forecasting errors' and account for ACIL Tasman advice on the experiences in Victoria's de-regulated market not as additive but as alternative methods of estimating headroom. SACOSS proposes an alternative headroom allowance that is either 5% of the 50% PoE estimate or, the use of the 10% PoE estimate. The average of these is \$4.00/MWh (\$3.74 and \$4.26). A detailed discussion of this proposal is included in the st.kitts.associates report.

Recommendations

In the first instance, SACOSS proposes that the Commission reconsider its proposal to make an allowance for headroom. If the Commission decides to proceed with an allowance, SACOSS proposes an alternative headroom allowance that is either 5% of the 50% PoE estimate or, the use of the 10% PoE estimate. The average of these is \$4.00/MWh (\$3.74 and \$4.26).

Small-Scale Renewable Energy Scheme (SRES)

A significant component of the WEC allowance is the cost of the National Renewable Energy Target (RET) schemes. As highlighted by the st.kitts.associates report attached at Appendix 1 of this submission, the cost of the RET schemes has been contested in other jurisdictions.

While the Commission's Draft Decision assumes an SRES cost of \$4.65/MWh based on a small-scale technology certificate (STC) price of \$40 each, the cost of STCs in the market rarely exceed \$40 each and average around \$30 or less. In line with the actual cost basis used for the rest of the determination, a figure of \$30 would therefore be more reasonable. As described in the st.kitts.associates report (page 9):

The cost estimates are taken from a report by Frontier Economics for ESCOSA. The rationale used by Frontier is that (page 37):

"The cost of STCs exchanged through the STC Clearing House is fixed at \$40 (in nominal terms). While retailers may be able to purchase STCs on the open market at a discount to this \$40, any discount would reflect the benefit to the seller of the STC of receiving payment for the STC at an earlier date. In effect, the retailer would achieve the discount by taking on this holding cost itself (that is, by acquiring the STC at an earlier date)."

This rationale is somewhat inconsistent with the actual cost basis used for the rest of the determination (i.e. the EPC approach rather than the LRMC approach). The market prices for STC have rarely, if ever, exceeded \$40 each and average around \$30 or less. The idea that the discount reflects holding costs transferred to the purchaser (i.e. the electricity retailer as the liable party) is not consistent with actual market experience. In reality this willingness to accept a discount reflects the very limited confidence in the SRES market by the creators of STCs (largely Solar PV installers who have the STC assigned to them upon installing a solar system) – a market where targets are set retrospectively and remain exposed to political influence.

SACOSS notes that by accepting Frontier's comments about the cost of compliance exceeding the simple cost of certificate purchase, it would be more reasonable to consider an allowance of 80% of their recommended costs implying an STC price of \$32 ea (Frontier, Table 9, page 38): \$3.72 for 2012/13 (instead of \$4.65) and \$2.17 for 2013/14 (instead of \$2.71). However, SACOSS notes the consideration in the st.kitts.associates report of the Clean Energy Regulator's recent updated projections for the Small Scale Technology percentage (page 9):

The 19th October 2012 update increases the non-binding estimate from 7.94% (as used by Frontier and listed in Draft Determination Table 5, page 95) to 18.76% for 2013 and from 6.10% to 7.69% for 2014. Estimates for these costs, at an STC price of \$32 are for \$6.85 for 2012/13 and \$4.23 for 2013/14.

Given the need to account for these projections, SACOSS proposes that the SRES cost to be assumed by the Commission to be set at \$6.95 for 2012/13 and \$4.23 for 2013/14.

Recommendations

SACOSS proposes that the SRES cost to be assumed by the Commission to be set at \$6.95 for 2012/13 (instead of \$4.65) and \$4.23 for 2013/14 (instead of \$2.71).

Appendix

st.kitts.associates report to SACOSS on Electricity Standing Contract (2011-14) ESCOSA
Wholesale Electricity Cost Investigation – Draft Determination

ELECTRICITY STANDING CONTRACT (2011-14)

ESCOSA WHOLESALE ELECTRICITY COST INVESTIGATION – DRAFT DETERMINATION

SOUTH AUSTRALIAN COUNCIL OF SOCIAL SERVICE

A report to SACOSS on:

- ESCOSA's Determination of Special Circumstances and Draft Standing Contract (Further Variation) Price Determination (October 2012).
- Key issues for SACOSS
- Recommendations

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October 31st, 2012

PREFACE

SACOSS has sought a brief report on ESCOSA's Draft Determination¹ to reduce the *Wholesale Energy Cost* component of the electricity standing contract. The report is to identify key issues of relevance to the work of SACOSS and its members in advancing the interests of the market's most vulnerable consumers.

The WEC component is currently \$12.6c/kWh out of an average 33.5c/kWh (37%) for supply under the standing contract. The reduction proposed in the Draft Determination would reduce this to 9.96c/kWh out of 30.8c/kWh (32%). At around one-third of electricity bills, this is a key driver of household costs.

The WEC Allowance applies directly to the regulated price paid by standing contract customers (approximately one-quarter of households and around one-third of small business). For market contract customers, the WEC represents the costs borne by their retailer from buying electricity in the wholesale markets, hedging risks and complying with the requirements of a number of management and policy initiatives (such as Market Operation Fees, Ancillary Services fees, Renewable Energy, Energy Efficiency and Greenhouse programs).

Retailers only have control over some of the costs of supplying electricity. Up to half of the average bill relates to the costs of the networks that deliver electricity to homes. Retailer controlled costs include the costs of their own operations (call centres, billing systems, marketing, IT infrastructure etc) plus the costs of buying electricity and managing risks in the market. The ability of retailers to compete against each other is a central element of liberalised energy markets. Competitive forces can contain costs and drive innovation for the long term benefit of consumers. Robust competition can be expected to seek out efficiencies and opportunities to add value in all aspects of the cost structures for retailers.

In the transition from monopoly provision (pre-2003) to open competition the standing contract provides a number of consumer protection roles. The oversight and analysis provided by the regulatory processes aids transparency in the market. The contract provides a safety-net of almost universal access to electricity for households. However, in order to deliver a competitive market that can one-day substitute for the need to set prices, the prices that are set must remain above those that the competitive part of the market are delivering.

At this point in time, at the conclusion of the first 10 years of competitive electricity supply to households, the transition has almost stagnated. The standing contract has retained an almost static number of households since the 2008-9 financial year. The structure of the market has also solidified into a dominant configuration of four vertically integrated businesses that dominate the retail and wholesale (generation) markets.

Coincidentally, this period of stagnation has followed soon after the findings of the AEMC's 2008 Review of Competition in the SA Energy Markets that competition was workable and that price regulation should be wound back. There is also reason to believe that the presence of the standing contract is a barrier to intensifying competition.

This is a conundrum for all stakeholders and provides an important context for considering the ESCOSA Draft Determination.

¹ The Draft Determination and accompanying consultant reports are available from <http://www.escosa.sa.gov.au/projects/178/electricity-standing-contract-wholesale-electricity-costs.aspx>

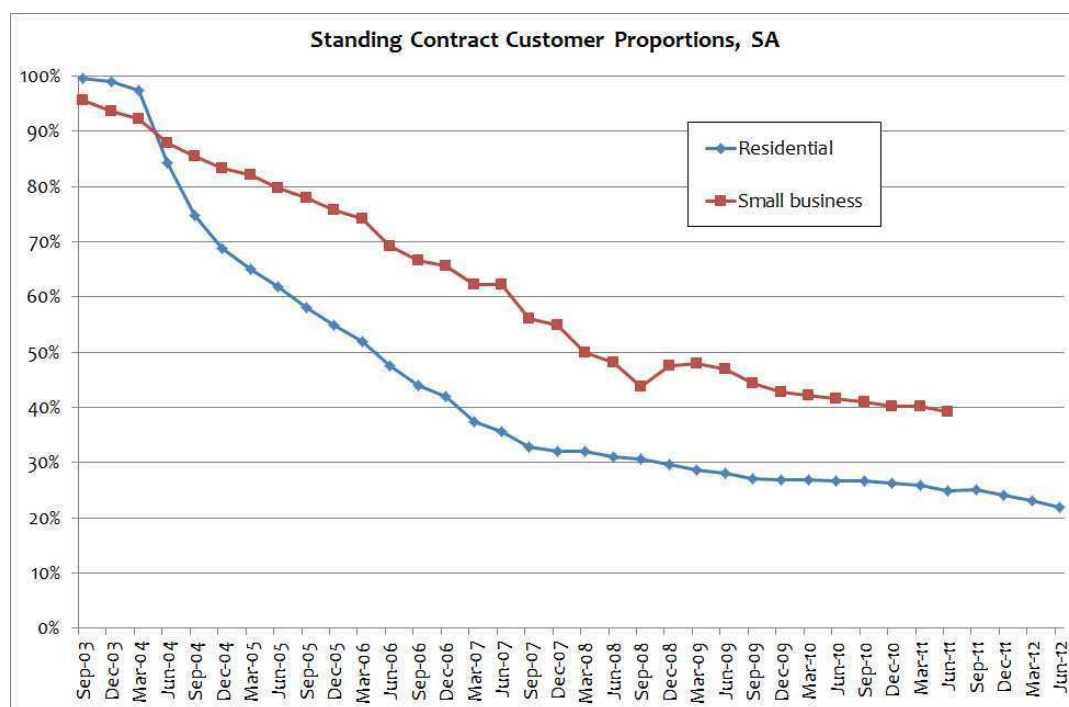
BACKGROUND

SACOSS has conducted a significant amount of work on this subject and made a comprehensive submission to the ESCOSA Discussion Paper in July 2012². That submission included accompanying reports from Mr Bruce Mountain (CME) and Mr Andrew Nance (st.kitts.associates).

In early October, the Commission announced their draft decision was to institute a reduction in the Wholesale Electricity Cost (WEC) component of the standing electricity cost by around 20% that would lower the overall standing contract price by around 8%.

ESCOSA has been responsible for electricity retail price regulation since the commencement of contestability for small customers. In the 10 years³ since, this is the first occurrence of a standing contract price reduction.

According to ESCOSA⁴, as at June 30 2012, around 22% of Residential customers remained on the standing contract. There are around 750,000 residential customers, so around 165,000 households would receive the reduction directly.



The implications for the balance of customers on *Market Contracts* (as opposed to the *standing contract*) are dependent on the nature of these contracts and the positions taken by the Electricity Retailers. The vast majority of market contracts have been, and continue to be, marketed as a % discount from the standing contract price.

Of the 78% not on the standing contract, AGL (and Powerdirect) has 31%, Origin Energy 18%, TRUenergy 12%, Simply Energy 10% and the smaller retailers a combined 8% (as at June 30, 2012).

² Available from <http://www.sacoss.org.au/publications/index.html>

³ Full Retail Contestability (FRC) for the tranche of customers consuming less than 160MWh per annum (households, small business and community facilities) commenced on January 1st, 2003.

⁴ ESCOSA Quarterly statistical updates, Energy Retail Market <http://www.escosa.sa.gov.au/electricity-overview/market-information/quarterly-statistical-updates.aspx>

SUMMARY

1. The Essential Services Commission of South Australia (ESCOSA) Draft Determination comprises a number of separate decisions that relate to the methodologies employed and end-results for a number of the discrete elements of the standing electricity contract for small consumers.
2. The out-turn of these decisions is an expectation that the standing contract price (inclusive of network and other charges) should be reduced by an estimated 8.1%.
3. The draft determination is, in a relative sense, a good result for consumers. However it is certainly not the lowest possible of the range of reasonable prices that ESCOSA could have determined.
4. The Commission has decided to revert to more of a market-based methodology for estimating the WEC allowance – the Electricity Purchase Cost (EPC) approach. This change from the Long Run Marginal Cost (LRMC) basis used at the start of this current regulatory period is a significant change that is likely to attract much industry comment.
5. ESCOSA has gone to some length in explaining its reasons for the change in methodology. ESCOSA is of the view that the EPC approach best emulates prices in a competitive market and that this is their intention. The economics of the rationale will no doubt be contested by electricity retailers.
6. It is important to note that the contemporary electricity market environment in South Australia (and across the NEM) is somewhat different to historical settings. The softening of demand and the consequent lack of immediate need for investment in new capacity is a contributing factor to the appropriateness of a lowering of prices.
7. Both the EPC and LRMC are estimates based on a series of assumptions and cannot be known with any precision. Each is best represented by a range of values that, as illustrated herein, may well overlap under some plausible scenarios.
8. Further, ESCOSA has decided to, for what is believed to be the first time, make an explicit allowance for *headroom*. The earlier SACOSS submission (and accompanying paper by st.kitts.associates) talked to this directly. The added transparency of being explicit about this component should be welcomed.
9. The *headroom* provision makes explicit an allowance for preserving competition in the market and adds to other conservative estimates of retailer hedging costs and Renewable Energy Target compliance costs by ESCOSA's consultants. ESCOSA have also determined to not reduce the dollar figure for the profit margin allowance of 10% in the original decision. Combined, this means that retailers and consumers can be confident that the proposed WEC allowance is certainly above the actual costs of an efficient retailer. An alternative headroom allowance is proposed that will still allow for competition but at a lower cost.
10. The assessment of the compliance costs of the Small-scale Renewable Energy Scheme (SRES) is contested. A case exists for the use of a certificate cost that is less than the nominal \$40 used by ESCOSA's consultants. Since the Draft Determination was released, the Clean Energy Regulator has increased the estimated target for 2013 (from 7.94% to 18.76%). An alternative costing based on a more accurate certificate cost and an increased obligation has been proposed.

RECOMMENDATIONS

11. It is recommended that SACOSS submit to ESCOSA that there is some room to lower the WEC allowance further in respect of

- a. The allowance for compliance with the Small-Scale Renewable Energy Scheme (SRES); and,
- b. The headroom allowance

ESCOSA's Table 2 (Draft Determination Page 74) has been reproduced below with an alternative summary (right hand column) that reflects updated SRES compliance costs and a revised headroom allowance.

WEC component	ESCPD 2010	Current WEC allowance	Draft Determination	Alternative
LRMC	93.93	93.93	-	
Carbon Price	-	13.97	-	
EPC	-	-	74.88	74.88
Headroom	-	-	8.00	4.00
Line losses	8.50	8.50	7.38	7.38
AEMO fees	0.39	0.39	0.39	0.39
Ancillary service charges	0.41	0.41	0.45	0.45
LRET	3.66	3.66	3.91	3.91
SRES	6.00	6.00	4.65	6.85
Total WEC	112.89	126.86	99.67	97.86

12. The overall result, while still on the high side, can be considered a reasonable estimate of efficient costs and, to the extent that the preservation of current levels of competition (as measured by customer switching rates) is desirable, in the longer term interests of consumers. Assuming that the annual revenue allowance is \$335.27/MWh (Draft Determination page 76), the alternative described above would constitute a \$29/MWh reduction or an average 8.6%.
13. If ESCOSA chooses to revert to an LRMC methodology at some point in the future, then SACOSS must continue to push for use of a *brownfield* method that acknowledges the reality of existing generation and customer diversity (as opposed to the stand-alone or *greenfield* approach used to date).
14. This draft determination and (alternative elements proposed) should be considered as reasonable to address the immediate issues only. The longer-term issues of the role of the standing contract and the development of effective competition have not been addressed by the Commission and this should be acknowledged by SACOSS. The end of 2012 concludes the first decade of the use of competitive markets to supply electricity to small consumers in South Australia. The bigger question of *where to from here?* remains unresolved.

METHODOLOGY AND ELECTRICITY PURCHASE COST ESTIMATES

15. The Commission has decided to revert to more of a market-based methodology for estimating the WEC allowance – the Electricity Purchase Cost (EPC) approach. This change from the Long Run Marginal Cost (LRMC) basis used at the start of this current regulatory period is a significant change that is likely to attract much industry comment. In the simplest of terms, the EPC is more representative of shorter-term actual costs whereas the LRMC is a more theoretical but longer term indication of expected costs.
16. ESCOSA has gone to some length in explaining its reasons for the change in methodology (Draft Price Determination Part A, Section 2.4, pages 22-50). ESCOSA is of the view that the EPC approach best emulates prices in a competitive market and that this is in the long term interests of consumers (for example p25, p33, p35). The economics of the rationale will no doubt be contested by electricity retailers.
17. AGL has consistently argued for a price regulation methodology based on 'LRMC as a floor'⁵:

“As ESCOSA has stated, the role of [the] standing contract price is to provide a safety net, not to provide the lowest possible energy price. It should facilitate retail competition, which will promote economic efficiency and is in the best long term interest of consumers. The 'LRMC as a floor' approach is entirely consistent with this role.”

18. ESCOSA (and its consultants ACIL Tasman) however have rejected this approach as not being in the consumer interest (Draft Determination page 36) due to the inconsistency between such an approach and the workings of competitive markets.
19. In criticising the Draft Determination, AGL have recently made public statements that⁶:

AGL will also suspend any further investment in power generation, including renewable energy, in South Australia as a result of ESCOSA's draft decision ... “*ESCOSA has effectively put up a sign saying do not invest in South Australian power generation just as the QCA has done in Queensland.*”

20. However, as noted by ESCOSA (Draft Determination p33-34), the most recent energy and peak demand forecasts from AEMO (South Australian Electricity Report, August 2012) show a softening of demand and hence the need for wholesale prices to signal the deferral of investment in new generation. In particular (page 34):

“Having regard to AEMO's statements, the Commission concludes that investment in the competitive wholesale market is responding to market price signals, which helps protect the long-term interests of consumers.”

21. Further, it has been reported that part of AGL Energy's response is to abandon the proposed expansion (announced November 2009)⁷ of Torrens Island Power Station (TIPS). Presumably this is because of the expansion being AGL's only publicly announced non-wind project in SA. It should be noted that AEMO had already been advised of this before the August 9th 2012 publishing date of

⁵ For example, see AGL submission to the Issues Paper, page 2 at <http://www.escosa.sa.gov.au/library/120718-ElectricityStandingContractWEC-DiscussionPaperSubmission-AGL.pdf>

⁶ AGL's Managing Director, Michael Fraser quoted in AGL's 2013 Earnings Guidance (tabled as part of the AGL Energy AGM October 2012) available from <http://www.agl.com.au/about/ASXandMedia/Pages/2013EarningsGuidance.aspx>

⁷ <http://www.abc.net.au/news/2009-11-06/agl-plans-torrens-island-expansion/1132522>

the 2012 Electricity Statement of Opportunities⁸ (at least 2-months prior to the release of ESCOSA's Draft Determination):

"AEMO has been advised that AGL Energy's 750 MW OCGT Torrens Island C proposal, publicly announced in 2011, is now inactive or unlikely to proceed". (page 3-22)

Recent work for the Australian Energy Market Commission (AEMC) by the Competition Economics Group – as part of inquiries related to the consideration of the Generator Market Power Rule Change Proposal – also raised doubt to the sincerity of the original proposal:

"For example, the planned major expansion of its Torrens Island Power Station was announced in November 2009 with AGL hoping "to begin construction in about two years". The AEMO noted in June 2011 that the expansion is subject to market demand and is "expected within the next 2-3 years" [reference to the 2011 ESOO, p38]. While market factors may have led to the delay, it is also possible that the intention of announcing the planned expansion well before any actual construction may have been directed at discouraging other players from making large investments in South Australia."

In summary, the causal link between the draft determination and to investment halts may be best be considered to be part of what Gavin Dufty refers to as "the *theatre* of price setting".

22. Rather than debating the merits of the alternative methodologies, it is important to acknowledge that both the EPC and LRMC can only ever be estimates based on a series of assumptions and cannot be known with any precision. Each is best represented by a range of values that, as discussed below, may well overlap under some plausible scenarios.
23. Part B of the Draft Determination outlines the Commissions reasoning and separates the findings into component parts. Sections 3.1 to 3.3 of the report outline the recommendations of consultants on the appropriate EPC estimates for SA. ESCOSA has selected a conservative approach that delivers an estimate for 2012-13 of between \$72.70/MWh (90% probability of exceedence, PoE) and \$79.14/MWh (10% PoE) with a central estimate of \$74.88 (50% PoE).
24. The Frontier Economics Methodology assumes the benchmark *prudent and efficient retailer* would take the most conservative risk position (i.e. the most risk averse and hence most expensive hedge position) which according to ESCOSA (p60 and 61):

"... will, if anything, over-estimate the EPC of a prudent and efficient retailer"

25. Given the uncertainties involved and this inherent upward bias, there is a basis for accepting the proposed central estimate (the 50% PoE) as a reasonably sound basis for the addition of moderate headroom and other costs in order to propose the WEC.
26. Frontier Economics has also made an estimate of the LRMC of serving the standing contract load of just under \$88/MWh (Chapter 4). While this exceeds the EPC estimate (of just under \$83 with headroom) it is noted that Frontier use a *greenfield* approach to estimating LRMC that SACOSS has criticised as unrepresentative in the past. This was the same approach used by AGL and their consultants ACIL Tasman for the original determination (2010)⁹. The AGL modelling arrived at a somewhat different result though.

⁸ <http://www.aemo.com.au/Electricity/Planning/Reports/Electricity-Statement-of-Opportunities>

⁹ <http://www.escosa.sa.gov.au/projects/143/2010-electricity-standing-contract-price-path-inquiry.aspx#stage-list=0>

27. SACOSS should also note that the submission to the Issues Paper by Macquarie Generation made specific comments about the range of options in determining LRMC and that *greenfield* “... invariably results in LRMC estimates at the upper end of forecasts, particularly if it based on a ‘peaky’ customer load.” Further, a *brownfield* approach “... generally results in lower LRMC estimates, particularly for small load increments where there is an excess of existing capacity.” Clearly, the South Australian small customer load can be considered as “peaky” and that the SA market, based on AEMO’s statements has an “excess of existing capacity” – implying that the greenfield LRMC estimate is going to be biased upwards in this market context.
28. Frontier’s LRMC estimate uses a somewhat arbitrary 15% capacity margin (ie the model builds capacity to meet 115% of peak demand in a given year). This is inconsistent with the reserve margins determined by AEMO¹⁰ for the combined SA/VIC region which has historically been less than 3% of the regional Maximum Demand forecasts due to the ability to share reserves across the interconnectors – something a greenfield approach ignores. Taking this in to account and the other uncertainties associated with estimating LRMC (such as the cost of capital and gas prices), the EPC approach would appear to deliver something that would overlap with the range of reasonable LRMC estimates (albeit at the lower end of this range).
29. In summary, the use of an EPC methodology is considered to be a fairer way of estimating the wholesale costs of a prudent and efficient retailer since it acknowledges the market conditions that hold in SA for at least the rest of the regulatory period. However, if ESCOSA chooses to use an LRMC approach at some point in the future, then a brownfield approach is more appropriate since, again, it reflects the contemporary market circumstances and wholesale price signals. ESCOSA have resisted the use of a brownfield approach previously (see SACOSS submission to Issues Paper page 9) as being too difficult¹¹.

HEADROOM

30. Section 3.4 discusses the matter of “*headroom*”: the difference between the standing contract price and the actual costs likely to be incurred by the retailer. The rationale for headroom lies in the preservation of a margin in order to *promote* or *protect* competition. However, this approach does have implications for standing contract customers, as acknowledged in the Draft Determination (page 69-70):

“However, allowing headroom also has real costs: it means that standing contract customers pay prices that exceed prudent and efficient costs. This results in inefficiently low demand: some units that standing contract customers would value at more than the cost of supplying them are not consumed. That is, allowing headroom generates real efficiency costs. The equity of charging all standing contract customers more than the prudent and efficient cost in the hope that some (possibly only a few) would shift to market contracts is also open to question.

The Commission notes that allowing headroom within the standing contract price may also result in higher market contract prices. Some submissions, such as AGL’s, argue that this is not that case, putting the view that, even if the standing contract price is set too high (for

¹⁰ AEMO translates the Reliability Standard into a required safety margin of surplus generation capacity that can be applied operationally. By convention, this margin is referred to as a MRL and is expressed relative to a region’s 10% POE maximum demand projection, including any DSP. MRLs calculated by ROAM Consulting for AEMO (2010 <http://www.aemo.com.au/Electricity/Market-Operations/Reserve-Management/Regional-Minimum-Reserve-Levels>) illustrate combined SA/VIC MRLs of less than 400MW for 2010-12 compared to 10% PoE MD of more than 14,000MW – implying a proportion of less than 3%.

¹¹ <http://www.escosa.sa.gov.au/library/101208-ElectricityStandingContractPrice-FinalPriceDetermination-PartA.pdf> page A-71

example, by setting an excessive headroom allowance), this would not impose costs on market contract customers.

That would be true if the retail market is highly competitive. However, it is not clear that retail market competition will prevent a high headroom allowance in the standing contract price being passed on to market contract customers.”

31. SACOSS has argued that the practice of headroom allowances may be justifiable in the transition to a competitive market but, 10 years on from market start this justification is very hard to sustain – and largely for the reasons outlined by ESCOSA above – and the presence of the *sticky customer* cohort acknowledged by ESCOSA on page 71.
32. ESCOSA have decided to retain a headroom allowance despite this but have at least been explicit about its value. The Draft Determination includes a headroom allowance of 5% of the central EPC estimate (ie 5% of the 50% PoE figure of \$74.88) which equates to \$3.74 and add this to the difference between the 50% PoE estimate and the 10% PoE estimate. In essence it is the same as 104.7% of the 10% PoE estimate of the EPC costs or 110.7% of the 50% PoE estimate.
33. The headroom allowance includes a 5% figure that has been applied on the basis of market data from Victoria (provided by consultants ACIL Tasman) which indicated that switching required minimum discounts of between 3% and 7% of the total price. Given that the other retailer controllable costs retain an implicit headroom allowance¹² (and are not being included in the scope of this review), ESCOSA decided a 5% allowance on the EPC component was reasonable.
34. The explicit inclusion of a headroom component represents an advance on the transparency of the price setting process. Further, ESCOSA has acknowledged the bluntness of the headroom approach and that this is particularly so in the context of the South Australian market. It is clear that it contributes to the inefficiencies inherent in a market that appears to be almost stuck between workable competition and price regulation. The references to renowned regulation academic Prof George Yarrow (page 70) only reinforce this.
35. For SACOSS, this continues to be an unresolved situation. It is known that some of those remaining on the standing contract would meet a definition of vulnerable and these attributes of vulnerability may be why they have not engaged with the market and remain on the standing contract. These households will continue to pay more than efficient prices as a result. However, the extent of this will be reduced by the Draft Determination. A longer term, more structural solution will be required to address this issue and falls outside the scope of ESCOSA’s current considerations.
36. In the meantime, SACOSS needs to form an opinion on what constitutes a reasonable headroom allowance. ESCOSA have arrived at an estimate of \$8.00/MWh on top of the central estimate of EPC (of \$74.88/MWh). As described above, this allowance is based on adding two amounts derived from an estimate of ‘forecasting errors’ and ACIL Tasman advice on the experiences in Victoria’s de-regulated market. There is a case to be made that a more appropriate approach would be to consider these elements not as additive but as alternative methods of estimating headroom. In this regard, SACOSS should consider advancing an alternative headroom allowance that is either 5% of the 50% PoE estimate or, the use of the 10% PoE estimate. The average of these is \$4.00/MWh (\$3.74 and \$4.26).

¹² See Draft Determination page 72

OTHER ELEMENTS

37. The other components of the WEC allowance are explained in Appendix A to the Draft Report. These are line losses (declared by AEMO as 8% for 2012/13 and applicable to all retailers), AEMO fees and Ancillary Services charges (\$0.84/MWh and applicable to all retailers) and the cost of the National Renewable Energy Target (RET) schemes. The values chosen for the AEMO and Ancillary Services fees are uncontroversial, small and apply equally to all retailers.
38. The cost of the RET schemes is a matter that has been contested in other jurisdictions. In particular, it has been suggested that the cost of compliance with the Small-scale Renewable Energy Scheme (SRES) is at a material discount to the notional \$40 per STC (small-scale technology certificate). The Draft decision assumes an SRES cost of \$4.65/MWh based on an STC price of \$40 each.
39. The cost estimates are taken from a report by Frontier Economics¹³ for ESCOSA. The rationale used by Frontier is that (page 37):
- “The cost of STCs exchanged through the STC Clearing House is fixed at \$40 (in nominal terms). While retailers may be able to purchase STCs on the open market at a discount to this \$40, any discount would reflect the benefit to the seller of the STC of receiving payment for the STC at an earlier date. In effect, the retailer would achieve the discount by taking on this holding cost itself (that is, by acquiring the STC at an earlier date).”*
40. This rationale is somewhat inconsistent with the *actual* cost basis used for the rest of the determination (ie the EPC approach rather than the LRMC approach). The market prices for STC have rarely, if ever, exceeded \$40 each and average around \$30 or less¹⁴. The idea that the discount reflects holding costs transferred to the purchaser (ie the electricity retailer as the liable party) is not consistent with actual market experience. In reality this willingness to accept a discount reflects the very limited confidence in the SRES market by the creators of STCs (largely Solar PV installers who have the STC assigned to them upon installing a solar system) – a market where targets are set retrospectively and remain exposed to political influence.
41. In summary, a figure of \$30 would be more reasonable. Accepting Frontier’s comments about the cost of compliance exceeding the simple cost of certificate purchase, an allowance of 80% of their recommended costs (Frontier, Table 9, page 38) may be considered more reasonable – that is an implied STC price of \$32. This would deliver \$3.72 for 2012/13 (instead of \$4.65) and \$2.17 for 2013/14 (instead of \$2.71).
42. However, the Clean Energy Regulator has very recently announced updated projections for the Small Scale Technology percentage (STP)¹⁵. The 19th October 2012 update increases the non-binding estimate from 7.94% (as used by Frontier and listed in Draft Determination Table 5, page 95) to 18.76% for 2013 and from 6.10% to 7.69% for 2014. Estimates for these costs, at an STC price of \$32 are for \$6.85 for 2012/13 and \$4.23 for 2013/14.

¹³ “Wholesale energy cost estimates for 2012/13 and 2013/14 A DRAFT REPORT PREPARED FOR ESCOSA October 2012” available from http://www.escosa.sa.gov.au/library/120928-WholesaleElectricityCostEstimates_2012-14-FrontierReport.pdf

¹⁴ For example, refer to data published by the REC Agents Association at <http://www.recagents.asn.au/wp-content/uploads/2012/09/Research-Note-No-2-STC-scheme-and-cost-Sept-2012-Final.pdf> page 4: “Based on the above analysis the real cost of the STC scheme is probably closer to \$30 per STC on a cumulative basis.”

¹⁵ <http://ret.cleanenergyregulator.gov.au/For-Industry/Liable-Entities/Small-scale-Technology-Percentage/stp>

SOFTENING DEMAND

43. It is important to acknowledge market supply-demand conditions when considering appropriate costs of purchasing energy for the small customer load. Chapter 6 of AEMO's National Electricity Forecasting Report (NEFR) 2012 presents the most recent projections of energy and peak demand for South Australia. The report highlighted the softening of demand in the region. AEMO's 2012 Electricity Statement of Opportunities (ESOO) showed that SA has enough capacity to meet demand until around 2019-20, and even then that this was in the order of a few MW (out of a Maximum Demand of less than 3,500MW).
44. Figure 1, below, illustrates the annualised energy consumption of the small customer load (the Net System Load Profile) since the introduction of FRC. The chart represents a rolling total consumption of the 12-month period preceding each day from January 1st 2004 until the 31st December 2011. The decline in total consumption from late 2010 is quite evident. Total small customer numbers over this period however have continued to rise (based on ESCOSA Annual Performance Report data).
45. Figure 2, illustrates the contrasting performance of maximum demand for the NSLP. As shown, the maximum of the summer of 2009 has not been exceeded and cumulative maximum demand has close to stabilised despite increases in customer numbers and falling energy consumption.
46. The implications of Figures 1 and 2 and the forecasts of AEMO are that the existing supply infrastructure appears capable of meeting contemporary demand. This supports the view of ESCOSA and its consultants that softer market price signals are appropriate and efficient for the level of investment required (Section 2.4.3.2 pages 32-35).

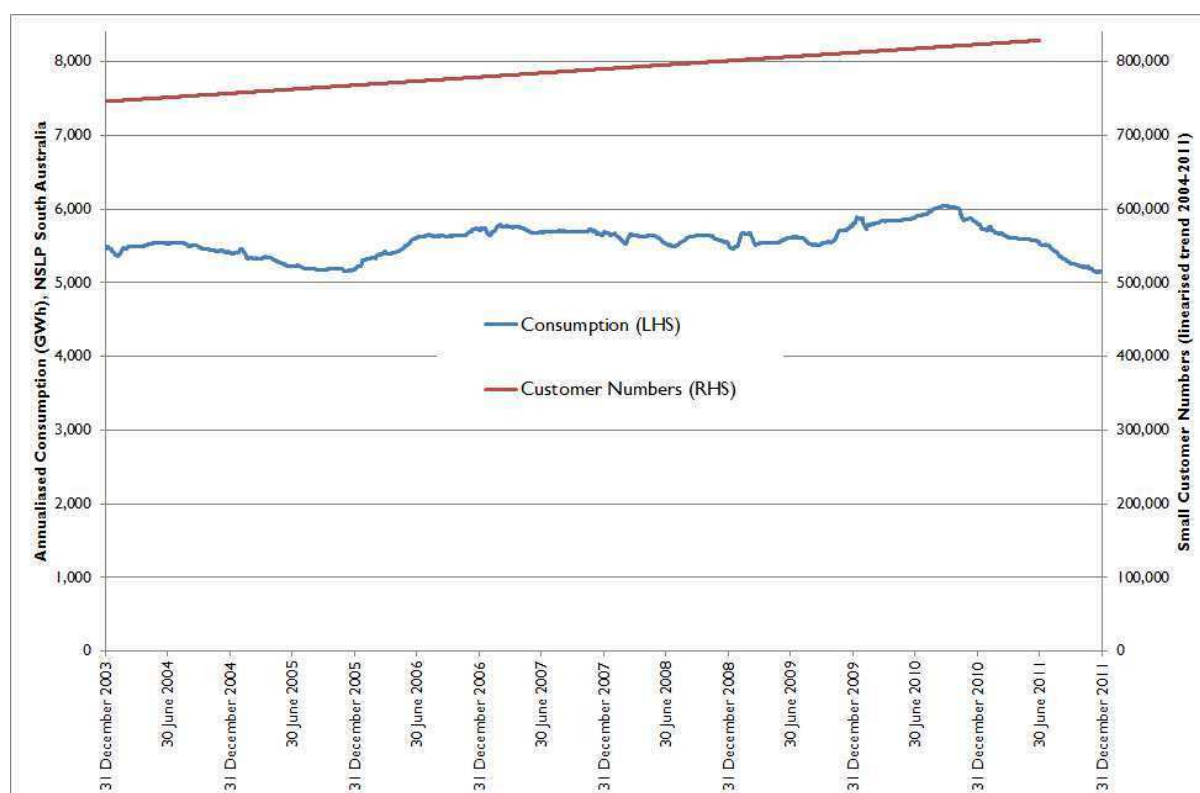


Figure 1: Annualised small customer aggregate consumption and customer numbers 2004-2011 (Source AEMO, ESCOSA)

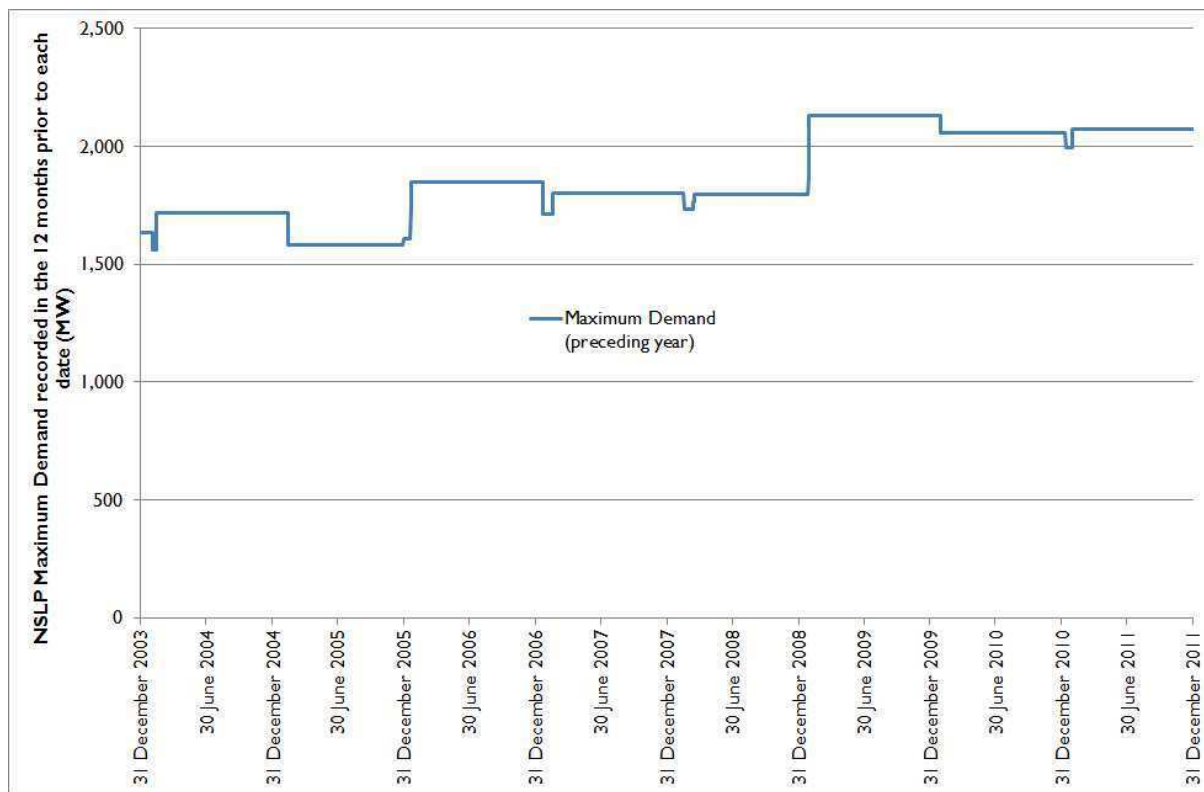


Figure 2: Trend in small customer aggregate maximum demand 2004-11 (as recorded in the year prior to each date)