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30 July 2004

Mr Lewis Owens
Chairman
Essential Services Commission of South Australia
GPO Box 2605
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Dear Mr Owens

INQUIRY INTO RETAIL ELECTRICITY PRICE PATH – ISSUES PAPER

AGL welcomes the opportunity to comment on the Commission's Issues paper relating to the establishment of multi-year price path for residential and small business customers. AGL understands that the Commission has released the Issues paper in accordance with the Notice of Inquiry received from the Minister and is seeking comment from interested stakeholders on the key issues the Commission proposes to address during its consideration of AGL's price proposal.

As previously agreed with the South Australian Government, AGL will provide its detailed price proposal together with supporting information to the Commission on 20 August. AGL is not seeking to address the substantive details of its price proposal in this submission but provide comment so that appropriate consideration of the issues raised by the Commission is undertaken. AGL's comments are detailed in the attached submission.

AGL supports the move to provide price stability for customers and the industry over the medium term consistent with pricing approaches in the other states. Establishing an appropriate multi-year price path is also an important step in the transition to market based prices and ensuring sufficient and timely investment in generation plant is made to meet future customer electricity demand.

Should require further clarification of any the matters covered in this submission please contact me.

Yours Sincerely,

Sean Kelly
General Manager Retail Regulation

ESCOSA ISSUES PAPER

Inquiry Into Retail Electricity Price Path

June 2004

AGL RESPONSE

EXECUTIVE SUMMARY

AGL welcomes the opportunity to comment on the Commission's Issues paper relating to the establishment of multi-year price path for residential and small business customers

AGL supports the move to provide price stability for customers and the industry over the medium term consistent with pricing approaches in the other states. Establishing a multi-year price path is also an important step in the transition to market based prices.

Establishing prices which reflect the costs and risks of supplying electricity to residential and small business customers is paramount to the Commission achieving its objectives of protecting the long term interests of consumers and ensuring a financially viable energy industry is maintained in South Australia. A viable industry is characterised by:

- A pricing level which will ensure a safe and reliable supply of electricity commensurate with the level of supply interruption that consumers are willing to bear;
- A pricing level which will cover the cost of providing the service levels that consumers desire; and
- A pricing level that provides a return to the industry participants consistent with the actual risks faced and sufficient to ensure their continued investment in the energy industry.
- A pricing level which allows retailers to manage the wholesale price risks thereby giving small customers a level of price stability over the medium term;
- A pricing level that will facilitate the appropriate level of investment in either future generation capacity in South Australia or building of generation capacity in other states coupled with sufficient interconnectors to deliver the required energy into South Australia. The Energy Supply Industry Planning Councils in its recently released planning report has identified that South Australia does not have sufficient generation capacity to meet prudent levels;
- A pricing level which will cover the costs of running existing generation plant at the times when consumers demand their energy and maintaining this plant at other times;

The establishment of a multi year price path provides the Commission with critical opportunity to bring stability into the South Australian electricity market, to provide customers with a level of comfort that electricity will be available when they wish to consume and to ensure prices paid will fairly represent the costs and risks of supplying electricity to customers over the medium to long term.

The long-term interests of SA consumers with respect to the price, quality, and reliability of electricity supply can be best served by allowing competitive markets to work. Increasing competition in the SA energy market will deliver benefits that are sustainable in the long-term.

AGL notes that the Commission has in the past "used a consultant to model both prudent retailer wholesale energy costs and the costs incurred by AGLSA using its actual contracts <u>to ensure the estimated 'prudent' cost was below the estimated 'actual' cost.</u>"

AGL is extremely concerned and cannot accept that the Commission should adopt such an approach to establishing electricity prices in South Australia. Such an approach places the long term interests of consumers at risk, is likely to result in shortfalls in investment of future generation capacity and may lead to market failure.

AGL considers that the appropriate form of regulation is an agreed price path with any proposed variation above the agreed price path having to be justified to the Commission.

1. Objectives For Retail Electricity Price Path

Summary of Commission's Discussion and Issues Raised

In considering consumers' long-term interests, the Commission proposes to establish a price path which establishes the lowest possible price consistent with:

- the costs that an efficient retailer would be expected to incur in meeting the responsibilities of standing contract supply to small customers in SA over the period;
- encouraging the development of competition among retailers for the benefit of consumers;
- encouraging ongoing, efficient investment to meet consumers' long-term requirements; and
- providing an appropriate return for an efficient declared retailer.

The Commission is seeking comment on:

The Commission seeks views from stakeholders on the objectives it has stated for establishing a retail price path. Based on the relevant legislation, are there are other factors to which it should have regard?

AGL Comments

AGL notes that the matters raised by the Independent Pricing and Regulatory Tribunal (IPART) review together with the requirements of the Commission under the Essential Services Commission Act and agrees that providing clarity of the objectives for the establishment of a multi-year year price path for standing contract customers is critical.

AGL notes that the Commission is seeking to establish a price path which has the lowest possible price that meets the four sub objectives outlined above. The objectives for the retail electricity price path could be further enhanced by:

- ensuring the costs of the declared retailer in meeting the responsibilities of supplying electricity to small customers in South Australia over the period are considered in light of the expected market conditions applying in South Australia during that time and noting the extension of the declared retailer obligations to supply all small customers who are not on market contracts or who may return from a market contract with another retailer during that period.

- Reference to efficient investment to meet consumers' long term requirements should be expanded to make reference to the reliability and security of supply together with the need to have appropriate price signals to encourage investment in future generation capacity requirements.

We understand from our reading of the paper and the Terms of Reference that the terms “prudent” and “efficient” are being used interchangeably. A common understanding of these terms will be important during the conduct of the Inquiry. The Commission in making its determination in 2002 discussed the meaning of prudent as “proceeding with care, showing sound judgement, sensible” at the time decisions are made. In this regard the consideration of costs should be on the basis of the best decisions rather than a wrong decision albeit at a lower cost.

The review of AGL’s price path proposal should be objectively assessed against the criteria established by the Commission with due regard to AGL’s supporting information.

The objectives should also make it clear that the network costs for the price path period will be a full pass through to consumers, therefore the end price to consumers will be a combination of what the Commission defines as “retailers controllable costs” and network charges. We note this is mentioned later in the Issues Paper.

2. Form of Regulation

Summary of Commission's Discussion and Issues Raised

The Commission has outlined a range of possible forms of regulation ranging from setting maximum annual revenues to setting actual price paths for each customer category. The Commission also discusses a range of general considerations covering incentive effects, regulatory risk, administrative costs and robustness.

The Commission has indicated that it will have regard to the form of regulation in other jurisdictions and the views put forward by various stakeholders.

The Commission is seeking comment on:

What form of regulation/price path formula should the Commission adopt?
What correction factors and rebalancing parameters, if required, should the Commission consider or allow?

AGL Comments

Form of Regulation

AGL considers that the form of regulation should be flexible and continue to support the rapidly developing competitive energy market.

After a slow start during the first few months of full retail contestability, 38,000 small customers (5.2%) had transferred to market contracts over a 12-month period to March 2004. A further 20,000 (2.7%) transfers were in progress bringing to cumulative total close to 8%. Monthly switching rates have also increased from 5,000 (0.7%) in January 2004 to 11,000 (1.5%) in March 2004. This shows that competition in the SA electricity market is robust and increasing.

The Commission's monitoring of the competitive market has found that awareness of ability to change retailers amongst the SA small customers is high with about two thirds indicating that they are aware that they can change retailers. Around a quarter of the customers surveyed indicated that they are quite likely to take out a new contract within the next 12 months.

The competitive market is delivering benefits to small customers, which is only likely to increase with the gas market being opened for competition. In this context, restrictive regulatory pricing arrangements in the market are not necessary and have the potential to distort the operation of the competitive market. AGL believes that while the Commission has a range of alternatives that can be considered in determining the form of regulation a less prescriptive approach based on an overall average revenue change will allow sufficient flexibility appropriate for the multi-year price path.

A range of alternate forms of regulation have been used in other states in the recent past. All are based on an understanding that greater flexibility and less intervention into prices are consistent with the development of competitive markets. Indeed, that an underlying premise is that in the longer term market forces should set retail price in preference to regulatory intervention.

In Victoria, the Government has agreed to four year price paths where the average increase in retail prices have been agreed based on expected costs and risks to be incurred. In NSW, IPART has recently approved three-year price paths for NSW gas and electricity customers. For gas customers, IPART has agreed to a CPI price path (no increase in real terms) as the appropriate form of regulation as average prices are considered to be reflective of the costs of supply. For electricity customers a substantial CPI+X approach has been adopted over the next three years as the current average prices are below cost reflective levels. Indeed IPART has acknowledged that its previous pricing determination resulted in prices that were set at below the costs of supply. In other words, electricity prices in NSW have been subsidised.

In NSW where a price variation in excess of the threshold is required in any given year during the price path then the retailers have the option to increase prices above the agreed thresholds but are required to provide a price justification to the Tribunal.

AGL considers that the appropriate form of regulation is an agreed price path with any proposed variation above the agreed price path having to be justified to the Commission.

Tariff Rebalancing

Cross subsidies in a competitive market are not sustainable. AGL notes that the Minister for Energy when advising of the Gas price increases for South Australia has accepted that the removal of cross subsidies was an inherent requirement of a competitive market.

The Commission's own analysis has shown that during the 1990's and early 2000's significant unwinding of cross subsidies was undertaken. Not withstanding this the analysis for the 2002 determination showed that cross subsidies remain between residential and small business. Cross subsidies also exist within tariff categories.

To enable individual tariffs to transition to cost reflective levels, the Commission should consider tariff rebalancing arrangements in excess of the average price threshold whilst ensuring that customers are not subject to unacceptable price shocks. Should the Commission or the government see a need to subsidise a certain class of customers these should be through transparent arrangements (eg concessions) that do not distort the operation of a competitive market.

As discussed above a threshold approach has been adopted by the Independent Pricing and Regulatory Tribunal for the NSW gas market, where the average price threshold has been set at CPI. Individual tariff can be adjusted by up to CPI+5% to allow for tariff rebalancing. Similar arrangements are in place for the NSW electricity market.

AGL is of the view that the form of regulation should allow for the rebalancing of tariffs to remove cross subsidies and that any side constraints should allow the greatest flexibility whilst avoiding unacceptable price shocks to customers.

3. Overall Approach

Summary of Commission's Discussion and Issues Raised

The Commission notes IPART's endorsement to continue to use the building block pricing methodology and advises that the Commission proposes to focus on the wholesale energy costs, retail margin and retailer operating costs components and allow a pass through of the network charges.

The Commission acknowledges the considerable uncertainty in forward estimating future wholesale energy prices and is seeking to establish a view on these costs which do not place the interests of consumers or AGL at serious risk.

The Commission is seeking comment on:

What methodology should the Commission use to obtain estimates of wholesale electricity costs for a future three-year period?

What modifications to the approach adopted by IES in estimating wholesale energy costs in the 2002 and 2003 reviews should the Commission adopt?

Are there other approaches that the Commission should consider in setting a retail price path?

AGL Comments

Prior to considering the methodology for estimating wholesale electricity costs it is worthwhile to provide comment on a prudent approach to purchasing wholesale electricity and the factors which impact South Australia's wholesale energy costs:

AGL purchases its energy requirements for the SA small customer market in accordance with its Board approved Energy Risk Management policy. Market experts have independently reviewed and have confirmed that the policy is based on industry best practice. The policy seeks to ensure that AGL purchases its energy at the best possible price while appropriately managing the various risks arising from energy supply and demand characteristics including load volatility, the potential for high pool prices (maximum of $10,000/MWh) and counterparty exposures (ie. credit risk).

Energy supply in South Australia is characterised by the following:

- Relatively high fuel costs for power generation due to the high proportion of gas-fired generation plant and gas being more expensive than coal
- Large proportion of peaking plant that is more costly to run and operate

- Generation and network assets with relatively lower utilisation factor than elsewhere in the National Electricity Market (NEM)
- Relatively high interregional and regional loss factors.

Energy demand in South Australia is characterised by a volatile load shape with the peakiest demand when compared to other NEM regions.

In AGL's view the current SA wholesale electricity costs incurred by AGL for the small customer market are at a level consistent with the fuel costs, the costs of imports, the market risks and characteristics of the SA load shape. **These costs are above what has been allowed by the Commission.**

Methodology for Wholesale Electricity Costs

AGL's experience that the commonly used methodologies for estimating future wholesale costs are based on constructing a hedge portfolio or a consideration of the Long Run Marginal Cost (LRMC) of generation. In constructing a hedge portfolio or an LRMC a number of key matters must be considered as follows:

- What is the predicted volume of customer demand over the period of the pricing determination and what is the shape of that load ie peakiness?
- What is the appropriate hedge strategy for the standing contract retailer given the dynamics of the particular market in which the retailer is operating?
- What hedge instruments will (and are available to) be purchased eg swaps, caps, etc?
- What will be the future prices for these hedge instruments?
- What is an acceptable risk based on the volatility of the customer demand?
- What allowances should be made for extreme events or defaults by counterparties?
- What adjustments must be made to the theoretical LRMC to account for losses between the actual generator locations and the end use consumer, allowances for the market realities (market does not possess perfect knowledge), allowances for the difference between existing generator plant and the mix of plant modelled.

The various Regulators have engaged a range of consultants who utilise variants of the building block approach to assess wholesale energy costs and to construct a standing contract retail price. Fundamental to establishing a price which is cost reflective and which avoids the potential risks outlined by the Commission is the recognition of the level of contracting (hedges) undertaken by retailers and the inverse relationship on pool prices.

The Commission has sought to take account of this relationship in its previous pricing determinations unlike some market commentators who draw conclusions on the cost of energy based simply on the level of pool prices.

AGL's experience is that hedge portfolio methodologies generally seek to establish a mix of swap and cap contract cover for the predicted customer load demand and profile. While each of the methodologies differ in the mix of swaps and caps they all provide for a level of hedge mismatch and other risks incurred by retailers. The extent of these allowances in part is derived from the assumptions used in modelling the quantity, type and cost of hedges. Caution should be used in utilising any specific allowance in isolation from the underlying assumptions for hedges.

The alternative approach to considering a wholesale cost is based on the long run marginal cost (LRMC) of generation. Typically LRMC analyses seek to calculate the costs of supplying the predicted demand by determining the costs of building and operating the latest available generation plant. In assessing wholesale electricity costs, the LRMC analyses do not take into account the actual costs of owning and operating the existing plant, nor the location of that plant. LRMC analyses generally assume perfect market information ie you know when and how much energy customers will consume over the next 20 years. LRMC outcomes if correctly calculated with the appropriate allowance for the market risks and the specific market characteristics can be a reasonable estimate of long run wholesale electricity prices

IES Approach

AGL has previously expressed concerns with the IES methodology particularly in relation to the underlying hedge strategy.

AGL's hedge strategy has sought to achieve the lowest available energy cost by entering into hedge contracts for a range of volumes and for sufficient duration in combination with building peaking plant both in Victoria and South Australia. AGL considers that this strategy benefited SA customers by removing continued upward pressure on wholesale electricity prices.

Adopting the IES proposed hedge strategy would see AGL only ever purchasing one year hedge contracts and not utilising the opportunity to lower the contract costs by extending the contract period for 2 or more years. Had this approach been adopted in 2001 then it is likely that the wholesale energy costs for 2003 would have been higher, as well as a strong likelihood of an upward pressure on contract price increases in subsequent years. AGL does not consider that such an approach in 2001 would have been acting prudently.

Other comments on the IES Approach are:

- AGL supports the application of the premium to the AFMA prices as a means to estimate hedge contract prices. AFMA prices are estimates of the future cost of small volume contracts and AGL's experience is that historically they have consistently been below the prices offered for large volume contracts.

  The SA market is so illiquid that AFMA prices provide no reliable guide to wholesale contract prices. AGL is not aware of any broker facilitated transactions based on AFMA over recent months. This compares to other states where broker facilitated trades occur on a daily basis.

- The pool price in South Australia reflects the level of contracting AGL has undertaken. If AGL has a large volume of contracts to cover its small customer load then generators bid a low pool price to ensure they generate to meet that contractual commitment and avoid potential financial risks. In addition, once generators have secured a large volume of contracts with AGL whom the generators know has an obligation to supply customers and must buy, generators are able to sell their remaining small volume of energy at residual prices.

- As stated above retailers incur hedge mismatch costs due to the variance between actual load and the load predicted. Hedge mismatch costs comprise the payments made on swap contracts not utilised (if demand is less than expected), the payments made for that proportion of the load covered by cap contracts being the pool purchases costs up to the cap contract price and the pool purchase costs for any load not covered by either a swap or cap contracts.

- Unless a risk allowance for other costs incurred such as supply side events, counterparty defaults, etc, the Commission will be understating the costs of supplying customers.

- The operating benchmark costs utilised by IES are below the actual costs incurred in servicing small customers and below operating costs benchmarks used in some other states

- A retail margin of 5% is at the bottom end of an acceptable range given the riskiness of the small customer market in South Australia because of the load shape and the tightness of supply and demand

- Cap prices are understated. These must be valued at a level which will meet the financial requirements of new entrant generators and encourage investment with appropriate lead time. If cap prices are set at below new entrant prices then there is the potential for extreme prices occurring when insufficient peaking plant is available.

- The increasing number of wind farms being erected will reduce the capacity usage of peaking plant and is likely to result in a higher cost per MWh used ie costs recovered over smaller volumes.

4. Actual versus Prudent Costs

Summary of Commission's Discussion and Issues Raised

The Commission in previous determinations has placed an emphasis on determining prudent costs incurred in meeting the standard contract obligations as it believed using actual costs would encourage inefficiencies. IPART has suggested greater attention be given to AGL's actual costs.

The Commission notes that a review of actual costs will require an informed judgement on the assumptions underpinning these costs. The Commission is seeking comment on:

How should the Commission, in setting a price path, treat actual and prudent costs?

AGL Comments

AGL is committed to providing its customers with electricity at reasonable prices and has always endeavoured to ensure that its prices accurately reflect the costs and risks incurred in supplying electricity. AGL adopts best practice prudent management of its wholesale energy portfolio and continually is seeking to improve the efficiency of its operations.

AGL notes that the Commission has stated that it "used a consultant to model both prudent retailer wholesale energy costs and the costs incurred by AGLSA using its actual contracts to ensure the estimated 'prudent' cost was below the estimated 'actual' cost."

AGL is extremely concerned and cannot accept that the Commission should adopt such an approach to establishing electricity prices in South Australia. Such an approach places the long term interests of consumers at risk, is likely to result in shortfalls in investment of future generation capacity and may lead to market failure.

AGL does not consider that prudent and actual costs are alternatives as AGL is confident that our costs are prudent and that we "proceed with care, show sound judgement and are sensible" at the time key business decisions are made.

AGL is strongly of the view that the multi-year price path should be based the best assessment of future actual costs with appropriate allowance for the uncertainty and risks previously discussed.

To adopt an alternative that prudent costs are different from AGL's actual costs suggests that:

- Either, AGL costs are higher than prudent costs implying AGL is not responsive to interests of its customers and that AGL can ignore the competitive pressures in the market place; or

- AGL's costs are lower than the prudent costs and customers will pay a price higher than is necessary having taken into account the costs and risks of supplying their electricity.

5. Reopeners

Summary of Commission's Discussion and Issues Raised

Establishing costs for a multi-year price path requires forecasting a number of factors. The Commission notes that there is serious risks of outcomes being significantly different to the assumptions underpinning these forecast which could impact negatively on consumers or AGL.

The Commission is seeking comment on:

What factors should be taken into account by the Commission in establishing a price path re-opening mechanism?

AGL Comments

The extent of any re-opener should be dependent on the form of regulation agreed to, the level of risk in the market place, the agreed pricing levels and allowances provided to cover an acceptable level of uncertainty.

Similar to what has been agreed with the NSW Independent Pricing and Regulatory Tribunal (IPART) for NSW gas prices AGL proposes that the appropriate form of regulation is an agreed price path with any proposed variation above the agreed price path having to be justified to the Commission.

AGL will provide specific comments on the need for, the form of and the factors that would constitute a basis for re-opening the agreed price path as part of it pricing proposal submission.

6. Failsafe or Normal prices

Summary of Commission's Discussion and Issues Raised

Prior retail price determinations by the Commission have adopted a failsafe view of standing contract prices. The Commission that an alternate view of standing contract prices being the normal price for customers. The Commission is seeking comment on:

Should the Commission regard the standing contract price for small customers:

- ***. as a "fail-safe" standard: with regard being had to the fact that market offers should be better than the standing contract price and customers seeking a better price should move to a market contract, or***

- ***. as the "standard" supply arrangement: with no regard to the price having an impact on market development.***

AGL Comments

The Commission has commented that if a "normal" view of prices were adopted then the Commission would expect a large number of customers to always remain on the standing contract regardless of the development of competition and the availability of market offers. In AGL's view this would be contrary to the Commission's legislated obligations and the specific objectives of this Inquiry to "encourage the development of competition among retailers for the benefit of consumers".

The Commission has noted the proposed changes to the Electricity Act by which the Government proposes to extend AGL's obligations as the incumbent retailer beyond 30 June 2005 to a future date to be fixed by proclamation. The proposed amendment requires AGL to continue with this obligation for an unknown and extended period of time well beyond the legislated date existing at the time AGL bought the retail business. This obligation means that AGL must continue to offer the standing contract to all small customers who are not on market contracts and must also retain the capability and be able to purchase the energy to supply customers who decide to return to the standing contract from a market contract.

AGL does not accept that pricing determinations of the Commission have established a failsafe standing contract price. Competition commenced slowly in 2003 with a large increase in market activity during 2004. A significant proportion of this market activity has resulted from the government's $50 rebate paid to customers who hold a concession card and who move to market contracts. Effectively many of these customers have remained on prices equivalent to the standing price.

7. Demand Assumptions

Summary of Commission's Discussion and Issues Raised

The Commission notes that the demand profile of small customers and the overall level of demand influence the wholesale energy price. The Commission acknowledges that the small customer demand in SA is extremely peaky with high demand on a few days and relatively low demand for the rest of the year. This usage pattern contributes to the higher average energy coist for these consumers relative to business and interstate consumers.

The Commission is seeking comment on:

How could the Commission improve its ability to estimate demand parameters?
What other approaches, such as sensitivity analysis, could the Commission use to manage this uncertainty?

AGL Comments

AGL's analysis undertaken at the time of the 2002 determination identified that South Australia has the peakiest demand in Australia. Indeed, AGL could not find an international energy market which had peaky load than South Australia.

The introduction of the seasonal tariff in January 2003 and the promotion of energy efficiency at the time has seen a reduction in the volume of energy consumed during the summer months. Not withstanding this the expected peak demand continues to grow. The Energy Supply Industry Planning Council (ESIPC) in its recent Annual Planning Report highlights this trend. Effectively peaking generation plant is still required to deliver energy but is being required less often. This likely to increase the cost of energy from these peaking plants.

The Commission correctly identifies the difficulties in forecasting the level of demand for standing contract customers. It is well accepted that weather has a significant impact on the level of demand on any given day. In addition, the numbers of customers who move to market contract, their usage pattern and the general overall growth in energy consumption will all impact on the quantity and timing of energy purchases required for standing contract customers.

ESIPC have concluded that the supply/demand balance in SA has reached a level where SA no longer has enough supply to maintain the industry-accepted reserve, or safety margin for the coming summer of 2004/05[1]. Whilst the Basslink Interconnector from Tasmania will relieve this somewhat in the following summer, the state will again fall below accepted safety margin by 2006/07. Despite the forecasts showing supply will exceed demand by 2007/08 there are currently no new committed power station projects for the future. It is critical that the Commission provides the pricing incentives for long-term investment if its legislative objective of ensuring quality and reliability of supply is to be met.

[1] South Australian Annual Planning Report, the Electricity Supply Industry Planning Council, June 2004