PROPOSAL

For

Retail Electricity Prices for Standing Contract Customers for January 2005 – June 2008

August 2004

Public Version

EMBARGOED to 5pm Sunday 22 August 2004

EXECUTIVE SUMMARY

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

Prices which reflect the costs and risks of supplying electricity to residential and small business customers are paramount to achieving the objectives of protecting the long term interests of consumers and ensuring that a financially viable energy industry is maintained in South Australia.

The level of information sought by the Essential Services Commission of South Australia (the Commission) means that the Inquiry into AGL's price proposal will be the most comprehensive and exhaustive review in any jurisdiction in Australia. AGL is providing the Commission with independently audited financial statements, tax returns, accounting information, operating costs and a review of historical results for 2003. AGL's wholesale costs are also being independently audited and will be provided to the Commission.

AGL has proposed a three and half year price path commencing 1 January 2005 that we consider will:

- ensure a safe and reliable supply of electricity commensurate with the level of supply interruption that consumers are willing to bear;
- cover the cost of providing the service levels that consumers desire;
- allow AGL to manage the wholesale price risks thereby giving small customers a level of price stability over the medium term;
- provide a return to AGL consistent with the actual risks faced and sufficient to ensure our continued investment in the energy industry in SA;
- cover the costs of generators running their existing SA generation plant at the times when consumers demand their energy and the costs of maintaining this plant;
- enable a stable South Australian electricity market to continue to develop; and
- provide customers with a level of comfort that electricity will be available when they wish to consume and is based on the fair and reasonable costs reflecting the risks of supplying electricity to customers over the medium to long term.

In finalising AGL's price proposal we have undertaken a comprehensive analysis of wholesale and operating costs and the prices proposed reflect the costs of supplying electricity to those customers on standing contracts.

AGL proposes that retail electricity prices for residential and small business customers on standing contracts be varied as follows:

Period	January - June 2005	July 2005 - June 2006	July 2006 - June 2007	July 2007 - June 2008
Retail Price Change (%)	CPI	1.3%	CPI	CPI

Under AGL's proposed prices small customers will see stable electricity prices with increases in line with inflation over the price path period. In determining our proposed retail price path we have used the existing network charges.

The Commission is currently undertaking a review to determine the network charges to apply to customers from 1 July 2005 and subsequent years. The final price impact on customers will be as a result of the combined effect of the retail and network components. To the extent that the Commission determines a lower network charge then the final retail price to customers will be lower than outlined in this submission. That is, whatever change is determined for network prices will be passed through to consumers. The Commission has advised that a draft determination on the network charges is expected in November 2004.

AGL understands and agrees that all changes to network charges that occur for the period 1 January 2005 to 30 June 2008 should be fully passed through to customers.

AGL believes this price path proposal will help strike the appropriate balance between protecting consumer interests and ensuring a financially viable electricity industry is maintained in South Australia

Contents

1 Scope of the Price Proposal

The South Australian Government has introduced legislation into the Parliament to enable standing prices for residential and small business customers to:

- move from an annual (or more frequent) price setting process to a price path approach covering multiple years;
- require the process to be initiated by a proposal from AGL; and
- provide for a period of at least six months for a review of AGL South Australia Pty Ltd's (AGL) proposal by the Essential Services Commission of South Australia (The Commission)

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. AGL has agreed with the Government to submit this price proposal for consideration and review by the Commission, in anticipation of the legislative changes being adopted.

This price proposal covers the standing contract prices for residential and small business customers consuming less than 160MWh per annum who have not entered into a market contract.

The price proposal covers the period 1 January 2005 to 30 June 2008 (price path).

2 Background

The Commission's Terms of Reference

In considering consumers' long-term interests, the Commission is seeking to establish a price path that 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 in its Issues Paper has used the terms "prudent" and "efficient" retailer 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.

AGL's Responsibilities as the Declared Retailer

Section 36AA of the Electricity Act provides that a declared retailer is, on request, legally bound to sell electricity to small customers at a standing contract price and under standing contract terms and conditions. The Commission sets out these terms and conditions in the Energy Retail Code.

AGL South Australia Pty Ltd (AGL) is the only declared retailer in South Australia pursuant to the Electricity Act. As a declared retailer AGL must:

- supply electricity to any small customer who was a standing customer at 1 January 2003 at the standing price;
- supply electricity to any small customer who decides to return from a market contract to the standing contract;
- pay the network charges to ETSA Utilities for all energy consumed irrespective of whether the customer pays their bill; and
- meet the service standards established under the retail code.

The Commission's Information Request

The Commission as part of the Inquiry issued a request for information on 29 June 2004 to AGL South Australia Pty Ltd (AGL) under Part 5 of the Essential Services Commission Act 2002. This request has sought AGL's price proposal and a range of information to support the Commission's consideration of that price proposal.

The Commission's Inquiry is the most comprehensive and exhaustive review of pricing submissions AGL has experienced nationally. The Commission is seeking and AGL is providing on a commercially confidential basis the following information:

1. The demand forecasts for each year of the price path by consumer group and tariff, on which the submission has been based, together with information on historical actual demand.

2. The proposed prices and price path for AGL's controllable costs for the major small consumer tariffs.

3. The wholesale electricity costs for each year of this period, and where appropriate, broken down into tariffs, consumer groups or seasons.

4. The retail operating costs per consumer for each year of this period, and where appropriate, broken down into tariffs and consumer groups

5. The retail margin to be applied for each year of this period, and where appropriate, broken down into tariffs and consumer groups.

6. A detailed justification and explanation of the costs and margins used in items 2 to 5 above, including reasons for shifts from historical trends, audited historical operating costs and cost estimates of wholesale electricity contracts, and the assumptions underpinning these costs (including the cost allocation methodology used).

7. An indication of total revenue and costs for each year of the price path, for each major customer category and tariff.

8. A proposed form of regulation and its compliance with that form of regulation.

9. Any other information that will assist the Commission comply.

3 South Australian Electricity Market

The South Australian electricity market is an integral part of the National Electricity Market (NEM) in Australia. The physical, wholesale and retail markets are the key components that make up the NEM and can be differentiated as follows:

- The physical market relates to the actual flow of electricity from the generation plant through the transmission and distribution networks to the customers. When a customer uses electricity (eg by turning on a TV) the flow of electricity occurs instantaneously.

- The wholesale market relates to the payment for the electricity produced by the generators and sold by retailers. Generators sell their electricity into the NEM pool and retailers are required to pay for the amount of energy their customers consume. The price at which the electricity is traded is called the "pool" price. As the pool price can fluctuate between -$1,000 and $10,000 per MWh, generators and retailers enter into bilateral contracts (hedges) to minimise the financial risk to both parties from fluctuating pool prices.

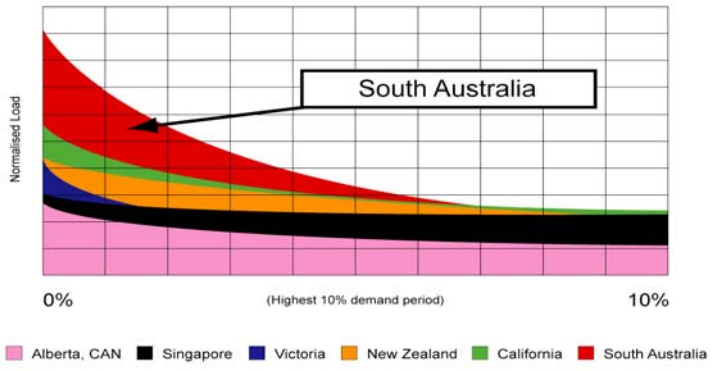
- The retail market relates to the relationship between retailers and customers and is characterised by contracts that specify price, terms and conditions. At the commencement of Full Retail Contestability (FRC) in South Australia the majority of residential and small business customers were automatically covered by the standing contract and price approved by the Commission. Customers have the choice to move away from the standing contract to a market offer with AGL or another retailer.

AGL South Australia Pty Ltd (AGL) is the declared retailer in South Australia for electricity. AGL operates in the wholesale and retail markets. It purchases the energy that SA customers use, from the NEM pool, and hedges that price with contracts generally purchased from the generators.

Characteristics of the South Australian Electricity Market

The South Australian Electricity Market is characterised by the peakiest demand in the National Electricity Market. Indeed research AGL undertook in 2002 indicated the South Australian consumer demand is one of the peakiest loads in the western world.

Graph 1: Shape of SA Customer Demand



Other characteristics of the South Australian Market that have a direct impact on the costs of electricity in this state include:

- Limitations on availability of fuel supply and the higher costs of available fuel supply – a high proportion of generation in SA is fuelled by gas as a result of limited and poor quality coal supply. Gas is a more expensive fuel than coal and as a result the costs of supplying electricity in SA are higher than in other states. In addition, limited infrastructure to deliver gas to the site of generation in SA has meant that additional infrastructure has been required in order to improve the reliability of fuel supply and hence reduce the risks of generating electricity. The capital cost of this infrastructure must be recovered over time.

- SA has a relatively small electricity consumption and is a region of the NEM interconnected to only one state. This being the case frequent, but short lived, events of high pool prices occur resulting from NEMMCO's requirement to maintain a secure and reliable system. This increases the risk and costs to generators and retailers alike in the SA region.

- The peakiness of SA electricity consumption means that a significant proportion of generation plant operates for only a small portion of time each year. In 2002/03 some 41% of generation was used for less than 4% of the time. This means that the costs of such plant are required to be recovered over a smaller volume of energy produced.

- Electricity demand in SA is highly dependent upon weather conditions. Extreme weather conditions, whilst occurring infrequently, can be very costly to retailers whose customer demand remains exposed to the pool price. The cost of this exposure is asymmetric to the cost of hedging this potential demand.

- SA is a net importer of electricity from Victoria. As such the price in SA is frequently higher than the Victorian price by at least the effect of loss factors which are very high (at times in excess of 10%) across both the Heywood and Murraylink interconnectors. Indeed, the Murraylink interconnector often operates to supply electricity to the north of Victoria, even where the SA pool price is higher than Victoria. This further increases the pool price in SA as South Australian generators are supplying this demand.

4 Overview of Price Proposal

AGL has proposed a form of regulation that is flexible and that is suitable to the nature of the risks existing in the purchasing and supplying electricity to small customers.

AGL's price proposal is based on an average revenue approach with any proposed variation above the agreed price path having to be justified to the Commission.

AGL also proposes that remaining cross subsidies be removed within acceptable constraints.

Summary of Proposed Price Path

AGL's proposed price path provides price certainty for standing contract customers and is outlined in Table One.

Table One

Period	January - June 2005	July 2005 - June 2006	July 2006 - June 2007	July 2007 - June 2008
Retail Price Change %	CPI	1.3%	CPI	CPI

AGL has considered a range of alternative price paths. Our proposed price path balances the desire to provide stable, cost reflective prices to customers with the commercial imperatives facing AGL.

The Commission's Approach to Considering AGL's Price Proposal

The Commission has indicated that it determining retail prices it will continue to use the building block pricing methodology that focuses on the wholesale energy costs, network costs, retail margin and retailer operating costs components. The Independent Pricing and Regulatory Tribunal (IPART) supported this approach in their review of the Commission's methodology.

The Commission has acknowledged that there is considerable uncertainty in estimating future wholesale energy prices and is seeking to establish an appropriate level of these costs which do not place the interests of consumers or AGL at serious risk. The Commission proposes to adopt a comprehensive approach to assessing appropriate wholesale electricity costs for small customers including:

- a review of AGL's actual costs and AGL's contracts for future years;
- an assessment of the long run marginal costs of supply; and
- modelling of future wholesale electricity prices.

The Commission will also be undertaking a detailed analysis of AGL's operating costs and margins. The Commission has also advised it will allow a full pass through of the network charges to determine the final price to customers.

5 Basis for the Proposal

AGL's standing contract prices for small customers protects customers from the risks associated with their peaky and volatile demand and fluctuating energy prices which can increase dramatically up to $10,000 per MWh compared to the retail energy price component charged to customers of approximately $75 per MWh. The revenue also covers AGL's costs in providing services to regulated standards.

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 is continually is seeking to improve the efficiency of its operations.

AGL's price proposal has been based on AGL's expected costs for the period 1 January 2005 to 30 June 2008. In determining these costs AGL has given consideration to:

1. the projected customer demand for standing contract customers;

2. the number of customers expected to move to market contracts either with AGL or with other retailers;

3. the wholesale electricity costs based on a prudent approach to managing the risk, existing and future hedge contracts, projected pool prices, the risks associated with volatile demand, market fees and charges and the costs of delivering the energy to the customers premise;

4. the retail operating costs associated with supplying electricity to customers and providing services to the standards specified in the regulations and codes; and

5. an appropriate retail margin.

The Commission is currently undertaking a review to determine the network charges to apply to customers from 1 July 2005 and subsequent years. In considering the retail price impact of the above items AGL has used existing network charges. The final price impact on customers will be the combined effect of the retail and network components. To the extent that the Commission determines a lower network charge then the final retail price to customers will be lower than outlined in this submission. The Commission has advised that a draft determination on the network charges is expected in November 2004 and that these network charges will be fully passed through to customers.

The following sections detail AGL's consideration of each of items 1-5 above.

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

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 on the best assessment of future actual costs with appropriate allowance for the uncertainty and risks.

6 Standing Contract Customer Numbers and Demand

ESIPC Forecasts of Demand

The Electricity Supply Industry Planning Council (ESIPC) is a government body established primarily to provide expert, independent advice to the South Australian Government and the Essential Services Commission of South Australia in relation to the state of the electricity supply industry in South Australia. Amongst other things ESIPC are to:

- develop overall electricity load forecasts;
- review and report on the performance of the South Australian power system;
- advise on matters relating to the future capacity and reliability; and
- publish an annual review of the performance, future capacity and reliability of the South Australian power system.

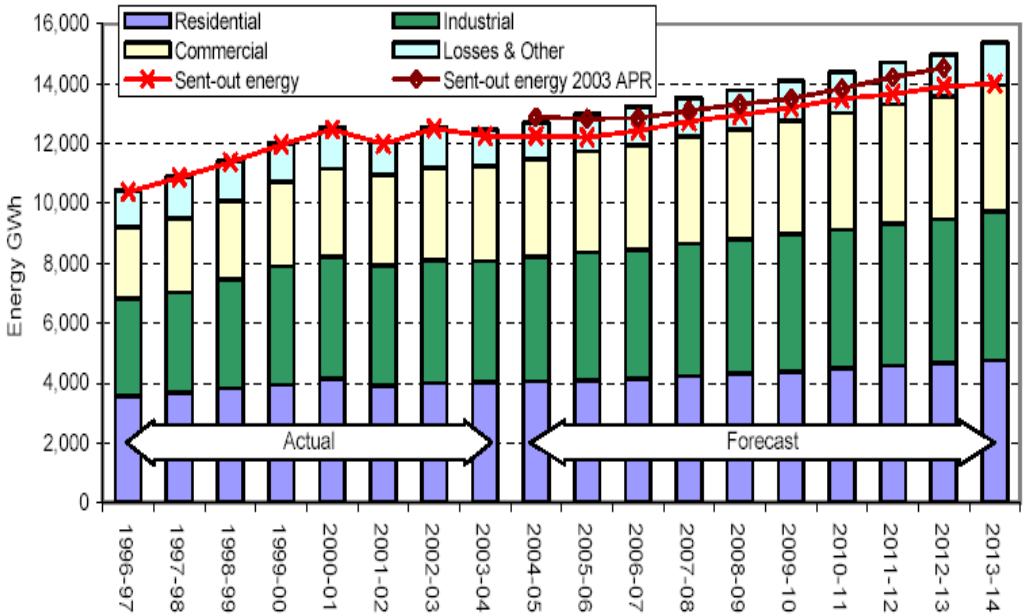
ESIPC recently released its Annual Planning Report 2004 with forecasts of consumer demand for the next 10 years. In this report ESIPC has identified the following key projections for SA electricity demand:

- total customer sales of electricity are forecast to grow by an average of 2.1% per annum over the next ten years compared to an average annual growth rate over the last ten years of 3%. At the same time, peak demand continues to grow at an average of 2.8% per year. The ongoing growth in the peak demand expected under extreme conditions drives the need for future capacity.

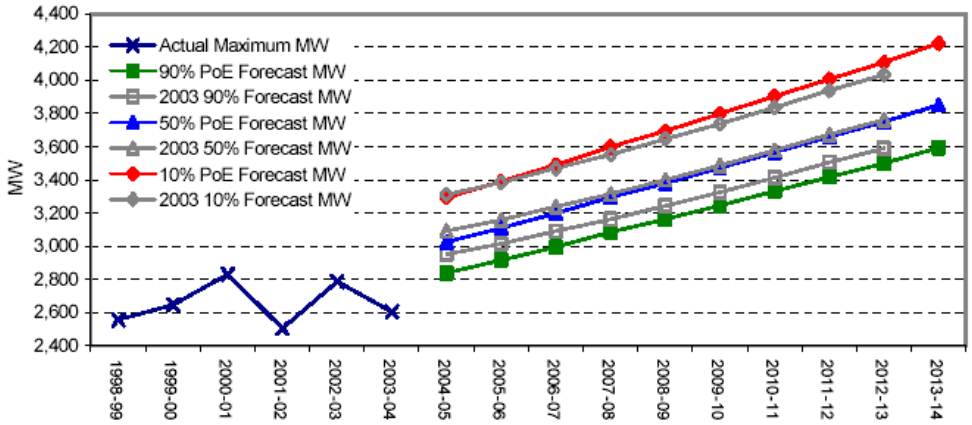
- the stronger growth in peak demand compared to the modest average growth in net energy consumption rates indicates a deterioration in the South Australian load shape with a higher peak to average energy ratio.

These demand forecasts are detailed in Graphs 3 and 4 below.

Graph3: ESIPC Demand Forecast



Graph 4: ESIPC Maximum Demand Forecast



The above information from ESIPC relates to the total South Australian electricity market. There is a need to establish the projected customer demand for residential and small business customers who remain on the standing contract.

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 that had a more peakier load than South Australia.

The introduction of the seasonal tariff in January 2003 and the promotion of energy efficiency at the time have seen a reduction in the volume of energy consumed during the summer months. Not withstanding this the expected peak demand continues to grow. The graphs above highlight that the peak demand is expected to grow at a faster rate than the annual energy consumption. This trend leads to a lower utilisation rate of not only existing generation assets, but also assets that will be required in the future to meet peak demand growth and maintain reserve levels.

There exists an inverse relationship between utilisation rates of generation assets and energy prices, that is, as utilisation rates decrease, energy prices required for recovery of costs increases. This is due to the fact that the high fixed costs associated with generation infrastructure can be recovered over a lower quantity of generation output.

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/Victoria has reached a level where SA/Victoria no longer has enough supply to maintain the industry-accepted reserve, or safety margin for the coming summer of 2004/05. 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.

Customer Demand for Standing Contract Customers

To establish the projected customer demand from standing contract customers for each of the years of the price path AGL has used customer numbers at 30 June 2004, and assessed a range of factors that impact on customer numbers and demand characteristics. These factors include:

- average volume growth per annum;
- average peak load – with and without hot water;
- average hot water load – MWh pa;
- household growth pa and AGL's expected share;
- percentage of customers likely to move to another retailer and their consumption pattern;
- percentage of customers on market contracts expected to return to standing contract in subsequent years; and

- percentage of customers moving to retention contracts and their consumption pattern;

Full details of AGL's assessment of these factors have been provided to the Commission on a confidential basis.

7 Wholesale Electricity Costs

Overview of the Wholesale Electricity Market

The Commission in its numerous reports has described the operation of the National Electricity Market. Characteristics of the wholesale market operation include:

- the NEM is currently comprised of five separate market regions (Qld, NSW, Snowy, Victoria and SA);
- prices are set in each region, by determining the market clearing price for each region every five minutes of every day;
- a generator can change its bid on how much energy it wishes to produce at a given price up to five minutes before the electricity is required to be produced;
- interconnectors allow for the flow of electricity between regions where the price in one region is less than another (after allowing for the electricity lost over the interconnector). However, due to the role of MurrayLink in supplying electricity to northern Victoria this is not always the case in respect of this interconnector;
- the South Australian contract market is unusual, because of the limited number of generators and AGL as the only declared retailer. AGL's action in contracting the output of generators has a direct impact on the pool price and therefore the forward value of small volume contracts. If AGL were to not hedge customer demand, therefore leaving the generators exposed to the pool price, the generators would need to recover their costs of operation (including fixed costs) from the spot market. This would result in a higher pool price that would reflect the costs of generation. The lower prices in 2003 for 2004 supply were a result of the high level of contracting in 2001/02. If this had not occurred, the contract prices in 2003 for 2004 supply would have been much higher.
- retailers are required by best practice corporate governance to operate under sound risk management policies. The extent and timing of a retailer's hedge contracts will reflect the requirements of these policies.
- AGL's declared retailer responsibilities require it to supply all small consumers and to satisfy their electricity demands. This leaves AGL with little flexibility in negotiating contracts with generators. The longer AGL delays contracting to meet its obligations, the more bargaining power provided to generators to insist on higher prices and longer contracts. AGL's statutory obligation to supply encourages us to contract well in advance of when energy is required.

- 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). The utilisation rate of generation assets in SA is 29.1% compared to the generation assets in NSW and Victoria, which have utilisation rates of greater than 60%; and
  - relatively high interregional and regional loss factors.

AGL's Approach to Wholesale Risk Management

AGL purchases its energy requirements for the SA small customer market in accordance with its Board approved Wholesale 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).

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 in prior price determinations.

Wholesale Electricity Contracts

AGL's electricity contract portfolio for South Australia includes peak and off-peak swap contracts, demand triggered peak swap contracts, cap contracts and other sophisticated products designed to follow a variable and uncertain load and which are priced referenced to the regional reference node.

The purchase volume in some contracts is uncertain until the day before the energy is used. In others, the contract is triggered by the NEMMCO day-ahead forecast and the contract quantity varies with the level of total South Australian demand. These complications make modelling of the estimated wholesale price over price path period extremely difficult.

AGL's wholesale electricity costs for calendar year 2003 and our projected wholesale electricity costs for the period January 2005 to 30 June 2008 have been provided to the Commission on a confidential basis.

AGL's wholesale costs are currently being independently audited and the results of these independent audits will be provided to the Commission when completed. AGL has provided the Commission with full access to our wholesale electricity contracts.

Wholesale Electricity Risk Allowance

AGL is exposed to a number of risks resulting from purchasing electricity and our obligation to supply customers. These risks include weather risks, pool price risks, allowance for market events (eg supply side events) and NEMMCO directions.

No allowance has been made for any additional cost that may arise for Reserve Trader arrangements that are currently being considered.

Market Fees and Charges

Market fees and charges comprise NEMMCO participant fees, ancillary charges, renewable energy levy and bank guarantee fees.

Electricity Cost at the Customers Meter

There are energy losses occurring during the transmission and distribution of energy to end users. For 2004/05, line losses of 8.12% for the SA mass market have been calculated based on the NEMMCO published loss factors for transmission and distribution.

Alternative Approaches to Determining Wholesale Electricity Cost Benchmarks

AGL's experience is that the commonly used methodologies for estimating future wholesale costs benchmarks are based on constructing a hedge portfolio (using various contracting assumptions) or a consideration of the Long Run Marginal Cost (LRMC) of generation.

In constructing a hedge portfolio or an LRMC benchmark 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 pattern of that consumption, namely, what is the peak demand as compared to the average demand ie peakiness of the load?
- 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, such as, swaps, caps or others and in what proportions should they assumed to be contracted?
- what will be the future prices for these hedge instruments with reference to the quantity of contracts required and the relative market liquidity?
- what is an acceptable allowance for the volatility of the customer demand and how are the inevitable inaccuracies in demand forecasting accounted for?
- what allowances should be made for unforeseen or unpredictable events or events of defaults by counterparties?
- what adjustments must be made to the theoretical LRMC to account for losses between the actual generator locations and the regional reference node?

- what allowances should be made for the market uncertainties (as the market does not possess perfect knowledge)?
- what allowances for the difference between existing generator plant and the mix of plant modelled in an LRMC benchmark?

The various State 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 with 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 historical 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 consumption and demand profile. While each of the methodologies differ in the mix of swaps and caps they all provide for a level of mismatch between contract quantities and demand and some allowance for other risks incurred by retailers. The extent of these allowances in part is derived from the assumptions used in modelling the quantity, type relative proportions and cost of hedges. Caution should be applied in utilising any specific allowance in isolation from the underlying assumptions that are inherent and peculiar to the particular model.

An alternative approach to considering a wholesale cost is a methodology 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 the timing and amount of energy consumption over the next 20 years are known precisely. LRMC studies tend to assume that generation capacity can be installed in small increments (1MW). 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

The Commission is undertaking an LRMC analysis. AGL is supplying all necessary information to the Commission to assist with the completion of this work.

8 Common Misconceptions Regarding AGL's Wholesale Costs

Misconception1: Pool Prices reflect the cost of energy to AGL

Public comments have often inferred that the wholesale cost of electricity to AGL is represented by pool prices. This inference is totally incorrect.

In reality, the pool price in South Australia largely reflects the level of hedge contracting that AGL has undertaken. If AGL has a large volume of contracts to cover its residential and small business customer load then generators bid a low pool price to ensure they generate electricity to meet that contractual commitment and avoid potential financial risks.

AGL only pays the pool price for the energy we purchase to the extent we have residual customer demand that has not been hedged. This is likely only to occur when customer demand is high, which is also the occasions when the pool price is likely to be high. For the majority of energy purchases AGL's cost of energy is the energy price contracted with generators.

Misconception 2: AFMA Prices Reflect AGL's Hedge Contract Prices

AFMA prices are a survey of estimates of the future cost of small volume contracts (10MW) based on responses from a small number of market participants. AFMA quoted prices only reflect a perception from market participants as to what the price should be and are not available to retailers to contract at. AFMA discards the high and low response in calculating their estimate. Contributors to the AFMA electricity price survey have no obligation to transact at these prices.

AGL's experience is that historically AFMA survey prices have consistently been below the prices offered for large volume contracts. The Commission in its own discussions with AFMA officials and with generators concluded that AFMA prices are below large volume hedge contract prices.

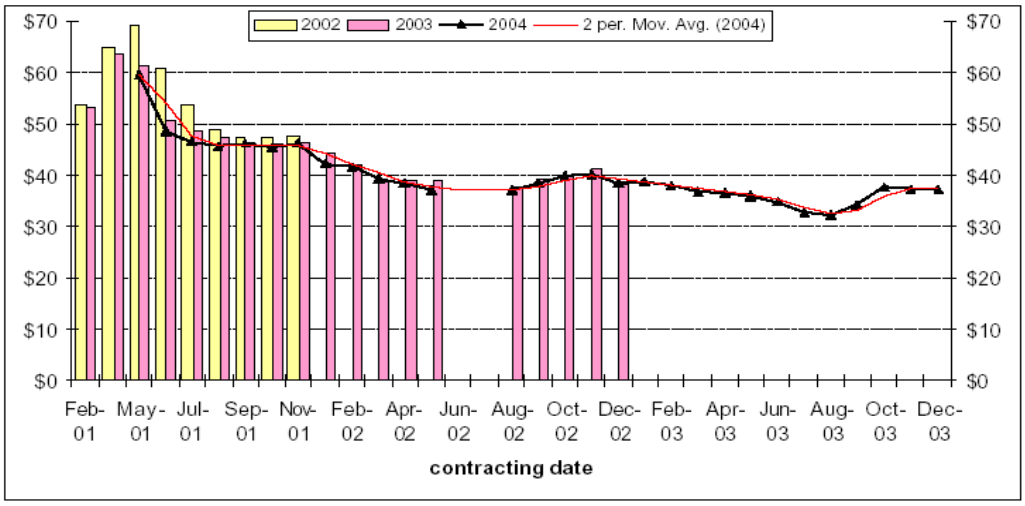
There are a number of other sources of information regarding contract prices for small volumes, namely, broker prepared information and a report produced by the Sydney Futures Exchange (D-Cypha). Whilst these sources may be reliable for detailing information on contract prices for small volumes, it should be noted that AGL is only aware of a maximum of 65MW reported as being traded through any of these mediums for any given annual period since October 2003. This represents less than 3% of peak demand in SA.

The South Australian market is so illiquid that true price transparency cannot be attained and there is no publicly available information which can provide a reliable guide to AGL's wholesale contract prices.

Misconception3: Retailers such as AGL should always be able to negotiate lower prices

AGL is obligated to supply the small customers market and must buy energy. AGL's contracting has a significant and inverse effect on pool prices and forward contracts prices. Once generators have secured a large volume of contracts with AGL they are able to sell their remaining small volume of energy at residual (lower) prices. This effect is reflected in the analysis of swap contract electricity prices undertaken by IPART (refer graph below). IPART concluded that " it would not have been possible for AGL to 'capture' the benefit of the expected price reduction through a changed purchase pattern because that change would have affected price expectations in the market". During the latter half of 2001 contract prices for future years had levelled out. When AGL substantially contracted load (by November 2001) a resultant fall in contract prices followed as illustrated in Graph 5.

Graph 5



Misconception 4: Retailers Incur Limited Risk When Contracted

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. In addition, AGL is exposed to any variations that occur in forecasting customer consumption, that is, AGL may have purchased more or less contracts than required compared to the actual demand of customers.

Retailers also incur other costs when supply side events occur for example the failure of the Moomba gas field to supply contracted gas requirements in the early months of 2004, counterparty defaults, etc.

Misconception 5: Cap contract prices are too high and should only reflect the value they return from the pool price

The market prices for cap contracts reflect the value of generation capacity required to cover demand beyond the base load generation. These must be valued at a level that 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, thus increasing the likelihood of blackouts. If cap prices only reflected their value according to outcomes in the pool price, insufficient peaking capacity would have been constructed in recent years to meet forecast peak demand growth.

The increasing number of wind farms being erected will reduce the capacity usage of intermediate and peaking plant and is likely to result in a higher unit cost as fixed costs are recovered over a reduced volume of output.

Misconception 6: AGL only allocates high cost contracts to the residential and small business customers (those using less than 160MWh per annum).

AGL negotiates the best possible price for the wholesale energy purchased for the regulated tariff customer segment.

AGL's highest priced contracts in the SA region were purchased to cover the risks relating to the energy being sold to large electricity customers (>160MWh pa) at the time of the cessation of the grace period tariff in June 2001. AGL entered into back to back contractual arrangements for these large customers.

AGL enters into separate energy contracts for the residential and small business customer segment.

AGL confirms that there have been no switching of contracts between market segments and no grace period contracts have been included in AGL's wholesale costs for the regulated small customer market.

Misconception 7: AGL has been profiteering in the SA market

Combining the misconception about AGL's wholesale costs and the large increases in prices in January 2003 has resulted in some views that AGL is profiteering from the SA residential and small business market.

AGL seeks to recover the costs of supplying electricity and making an appropriate return from each market segment it supplies in SA. The Commission made an assessment that the appropriate retail margin for standing contract customers is 5%.

The Commission, however, established wholesale benchmark costs below the actual costs for AGL.

AGL is not recovering sufficiently from the wholesale cost component of the regulated tariff to cover its wholesale costs for this customer segment and is earning a return below that allowed by the Commission.

The Commission has full access to AGL's financial records to verify these facts.

9 Network Costs

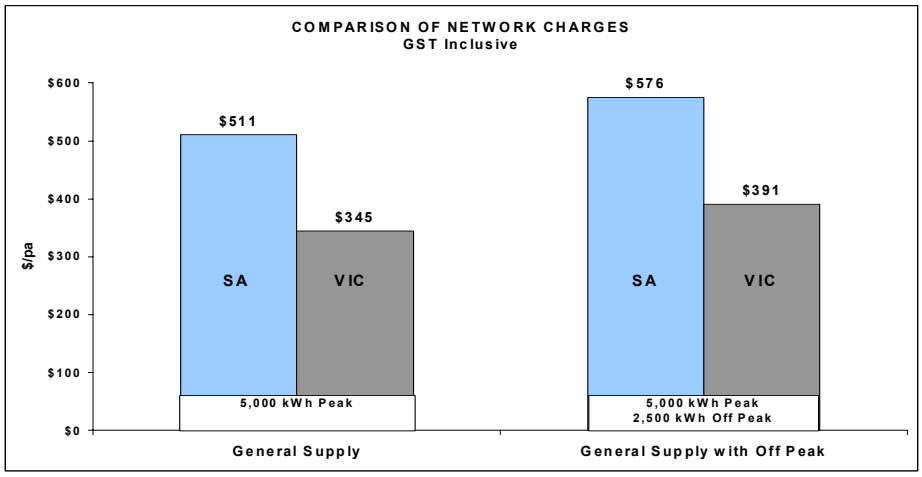
Under the terms of the Commission's inquiry AGL has been requested to submit a price path based on the retailers' controllable costs. These costs exclude the network charges from ETSA Utilities.

In determining the final price for customers AGL's proposed price path will need to be combined with the network prices determined by the Commission for ETSA Utilities for 1 July 2005 and subsequent periods. Ultimately the bridging price determined by the Commission will also need to give consideration to any potential changes to the network tariffs at 1 January 2005.

South Australian electricity prices are based on three major cost components - wholesale electricity costs, network costs and retail costs. In South Australia, network charges account for 48% of the total price of electricity. In Victoria network costs comprise only 39% of electricity prices for small customers. For the average residential customer, network charges in SA are $511 per annum compared to a residential customer consuming the same amount of electricity in Victoria of $345 per annum.

South Australian network charges for the average residential customer are some 48% higher than for a similar customer in Victoria

Graph 6: Comparison of Network Charges



ETSA Utilities has outlined a number of reasons for the higher network charges including the geographical spread of customers leading to a lower density of customers per kilometre of network.

The rate of return and the valuation of ETSA's network assets are also key determinants in the level of ETSA's network charges.

10 Retail Operating Costs

AGL Service Standard Obligations

AGL as the declared retailer has the obligation to supply all customers who wish to be on the standard contract price and terms. AGL must also comply with the Energy Retail Code that establishes a number of service standards and operational requirements. Examples include:

- eighty-five percent of all customer calls must be answered in 30 seconds;
- appointments must be kept with agreed timeframes;
- standards for the response to correspondence;
- the issuing of reminder notices and disconnection warning notices to customer who fail to meet their payment obligations which extend the credit risks to retailers;
- the provision of instalment plans and alternative payment arrangements; and
- processing of Government rebates on electricity bills for concession card holders.

AGL also provides a range of energy efficiency advice and services to assist customers to manage their energy consumption and to lower their energy bills.

Increasing Customer Service Requirements

AGL has experienced increased demands and expectations from customers, introduced new systems and processes for handling meter data and other transactions with the distributor on behalf of customers, established new programs to help customers manage their energy consumption, implemented assistance programs for customers in financial hardship and administered government initiated programs.

AGL continues to increase our employment of South Australians with an additional people being engaged over the last few years to meet increasing customer expectations.

AGL's Operating Costs for Calender Year 2003

The Commission has requested AGL to provide the operating costs relating to the standing contract customers for the calendar year 2003. These costs are currently being independently audited and will be provided to the Commission on completion of the independent audit.

AGL's Projected Operating Costs

In establishing the operating costs for residential and small business customers on standing contracts we have undertaken an intensive analysis of our operating costs ensuring that:

- only costs incurred in AGLSA that are costs relevant to customers consuming less than 160MWh are taken into account. Costs relating to providing services to commercial and industrial customers and to customers in other jurisdictions have been excluded;
- costs incurred in other AGL entities that relate to SA small customers are taken into account; and
- marketing costs not related to standing contract customers have also been excluded.

AGL's projected operating costs for 2005 are higher than those incurred in 2003 as a result of a number of cost changes that have occurred since 2003. In projecting costs for the price path period we have escalated costs based on the underlying cost drivers for each cost category. Examples of cost changes include:

- development of the business to business system with ETSA Utilities ($6 million cost);
- requirement to provide ETSA Utilities with service orders to perform tasks previously under the direct control of AGL;
- Additional work resulting from customer enquiries relating to meter reading which is no longer under the direct control of AGL; and
- increased numbers of telephone contacts from customers with the average duration of calls increasing to meet customers' information and transaction requirements.

The cost per customer is derived from the projected net operating costs divided by the the number of customers remaining on standing contract prices.

Competition in the SA electricity market is robust with increasing numbers of customers moving to market contracts. 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 level of customer churn has an adverse impact on the costs of providing services to standing contract customers. AGL's operating costs comprise both fixed and variable costs. Some fixed costs can be varied over the medium to longer term. As customer numbers decrease the operating cost per customer increases

AGL must also continue to maintain sufficient capability to meet our ongoing legislative obligations as the declared retailer. A significant proportion of the current 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 moved to market contracts with prices equivalent to the standing price and no termination fees. These customers could readily return to standing contract arrangements at any time.

AGL's projected operating costs used for the price path period have been provided to the Commission on a confidential basis.

11 Retail Margin

The retail margin represents the earnings of the retailer and is established to cover interest payments, business risks, tax liabilities, market risks, sponsorships and providing a return to shareholders who have invested in the company.

A fair margin would have regard to the risks inherent in retailing electricity as the standing contract retailer.

AGL strongly considers that the appropriate margin based on the level of risk in the South Australian market and reflecting AGL's continuing obligation to supply would require a retail margin at the upper end of the 5-10% range. AGL has also taken into account stakeholder views on the level of earnings by energy retailers in proposing a retail margin.

AGL notes that the Commission has previously considered in consultation with external parties involved in evaluating firms' financial performances the basis for calculating margins. The advice indicated that margins are always calculated on the basis of a firm's total costs without the removal of any components in determining a reasonable margin. If a component of the bill were removed then the retail margin allowed must increase to ensure an appropriate aggregate margin.

Details of AGL's proposed margin and a comparison to the allowed margins in Victoria have been provided to the Commission on a confidential basis. AGL's proposed a retail margin is consistent with previous determinations by the Commission.

12 Price Proposal

Price Proposal

AGL's proposed price path balances the desire to provide stable prices to customers with the commercial imperatives facing AGL and is outlined in Table Three.

Table Three: AGL Proposed Price Path

Period	January - June 2005	July 2005 - June 2006	July 2006 - June 2007	July 2007 - June 2008
Retail Price Change %	CPI	1.3%	CPI	CPI

In determining our proposed retail price path we have used the existing network charges. AGL understands and agrees that all changes to network charges that occur for the period 1 January 2005 to 30 June 2008 should be fully passed through to customers.

Price path arrangements approved in NSW and Victoria have generally been characterised by prices that:

- address the fundamental cost structure of the industry;
- recognise the increases occurring in wholesale costs and operating costs;
- provide a return to the retailer on a % margin on sales basis;
- allow for the timely removal of cross subsidies with appropriate control to avoid price shocks.

AGL's proposed price path is consistent with these principles.

If significant events occur that increase the costs of supplying electricity to small customers then AGL must have the option to alter the agreed price path subject to the Commission being satisfied that such changes are justified

AGL also proposes that should there be any change to taxes (eg changes to GST rate) and market related charges (eg industry levy for national regulator) or new charges introduced (eg reserve trader) then these should be passed through to the retail price.

Prices for Customer Categories

Currently standing contract prices exist for residential general light and power, residential controlled load (hot water), charities, business general, business time of use and farms.

AGL has not at this time submitted individual prices for these specific customer categories but will do so when greater clarity exists on the acceptance of AGL's proposed price path.

A key consideration in establishing specific prices for the price path period will be the treatment of cross subsidies. 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 in electricity prices 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, AGL considers that tariff rebalancing arrangements in excess of the average price threshold should exist 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.

AGL proposes that individual tariffs be allowed to be adjusted by up to CPI+5% to enable tariff rebalancing and the smooth transition to cost reflective prices within the overall agreed price path. This means that an increase in individual tariffs above the average price increase will be offset by a corresponding decrease in other tariffs such that overall prices will increase by the agreed price path. This approach has been adopted in both the NSW and Victorian energy markets.

13 Commission's Information Request

The Commission as part of the Inquiry issued a request for information on 29 June 2004 to AGL South Australia Pty Ltd (AGL) under Part 5 of the Essential Services Commission Act 2002. This request has sought AGL's price proposal and a range of information to support the Commission's consideration of that price proposal.

The level of information sought by the Essential Services Commission of South Australia (the Commission) means that the Inquiry into AGL's price proposal will be the most comprehensive and exhaustive review in any jurisdiction in Australia.

Details of the requested information are outlined in section 2 above.

This Public Version of AGL's Proposal is provided in response to that request.

A Confidential Version of AGL's proposal has also been forwarded to the Commission. This confidential version provides further details of AGL's wholesale and operating costs that cannot be disclosed for commercial reasons.

AGL is also providing the Commission with independently audited financial statements, tax returns, accounting information, operating costs and a review of historical results for 2003. AGL's wholesale costs are also being independently audited and will be provided to the Commission.