



# INQUIRY INTO RETAIL ELECTRICITY PRICE PATH DRAFT FINAL REPORT

**November 2004**

**ELECTRICITY**



## REQUEST FOR SUBMISSIONS

The Essential Services Commission of SA (the Commission) invites written submissions from interested parties in relation to the draft conclusions reached in this report. Written comments should be provided by **11 February 2005**. It is highly desirable for an electronic copy of the submission to accompany any written submission.

It is Commission policy to make all submissions publicly available via its website ([www.escosa.sa.gov.au](http://www.escosa.sa.gov.au)), except where a submission either wholly or partly contains confidential or commercially sensitive information provided on a confidential basis and appropriate prior notice has been given.

The Commission may also exercise its discretion not to exhibit any submission based on their length or content (for example containing material that is defamatory, offensive or in breach of any law).

The Commission intends to finalise this Inquiry in March 2005.

Responses to this draft report should be directed to:

### **Inquiry into Retail Electricity Price Path: Draft Final Report**

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### ***Public Information about ESCOSA's activities***

Information about the role and activities of the Commission, including copies of latest reports and submissions, can be found on the ESCOSA website at [www.escosa.sa.gov.au](http://www.escosa.sa.gov.au).



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## GLOSSARY OF TERMS

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ACCC	Australian Competition and Consumer Commission
ACG	Allen Consulting Group
AFMA	Australian Financial Markets Association
AGL	AGL South Australia Pty Ltd
CCGT	Combined Cycle Gas Turbine
CPI	Consumer Price Index
DUOS	Distribution Use of System
EBITDA	Earnings before interest, tax, depreciation and amortization
EPO	Electricity Pricing Order
ESCV	Essential Services Commission (Victoria)
ESIPC	Electricity Supply Industry Planning Council
ESCOSA	Essential Services Commission of SA
ETEF	Electricity Trading Equalisation Fund (NSW)
ETSA	ETSA Utilities
FRC	Full Retail Competition or Full Retail Contestability
GJ	Gigajoule
GST	Goods and Services Tax
IES	Intelligent Energy Systems Pty Ltd
IPART	Independent Pricing and Regulatory Tribunal (NSW)
IT	Information Technology
kW	Kilowatt
LRMC	Long Run Marginal Cost
MWh	Megawatt Hour
NECA	National Electricity Code Administrator Ltd
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company Ltd
NPV	Net Present Value
NSW	New South Wales
OCGT	Open Cycle Gas Turbine
Q1, Q2, Q3, Q4	Quarter 1, Quarter 2, Quarter 3, Quarter 4
QLD	Queensland
REC	Renewable Energy Certificates
ROC	Retail Operating Costs
SA	South Australia
SAIIR	South Australian Independent Industry Regulator
SRMC	Short Run Marginal Cost
TOR	Terms of Reference
TUOS	Transmission Use of System
WEC	Wholesale Energy Cost



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# **PART A: INQUIRY APPROACH**

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# 1 SUMMARY

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This report presents the draft findings of the Commission's inquiry into the electricity standing contract price path proposal submitted by AGL SA on 20 August 2004.

The Commission received a Notice of Inquiry from the Minister for Energy, Hon P Conlon MP, on 26 May 2004. The Notice, under Part 7 of the *Essential Services Commission Act 2002*, required the Commission 'to investigate the standing contract price proposal that will apply to small customers from 1 July 2005 for a period of no less than three years.'

The Commission has, in evaluating the AGL SA proposal, considered each of the factors nominated in the Terms of Reference, including those factors specified in the *Essential Services Commission Act 2002* (ESC Act) and the *Electricity Act 1996*.

The Commission has examined, and made conclusions about, the prudent costs for the three key components of AGL SA's controllable costs (namely, the wholesale energy cost, the retailer operating cost, and the retail margin). These costs, when converted into a pricing structure, are in this report referred to collectively as the "retailer tariffs". The other components which make up the price charged to customers for standing contract supply (namely, network charges and GST) are in addition to the retailer tariffs.

The prudent wholesale energy costs have been estimated for each quarter of the three year period from 1 January 2005. The prudent retail operating costs have been estimated for the base year and escalated thereafter at two percent in excess of inflation. A retail margin has been set as a fixed percentage of these two cost components (energy and operating costs). The Commission has evaluated AGL SA's price path proposal against these prudent costs.

The Commission has given consideration to how AGL SA's current standing contract tariffs should be adjusted to reflect these prudent costs, and what controls should be put in place to protect individual consumers from any re-balancing of price components within tariff structures.

The Commission has also given consideration to the possible grounds on which the price path should be varied or revoked, and what changes in costs should be passed through to the standing contract prices.

## 1.1 Observations

The Commission, in reviewing prudent costs for operating as the standing contract retailer in the SA market, has observed the two key factors that cause higher costs in SA are the energy costs and the network charges: both are influenced by the extremely peaky nature of energy demand in this State (related to the high use of air conditioners). The Commission recognizes the importance of measures to manage demand for energy for air-conditioning, and emphasizes the need for a concerted effort to make consumers aware of the cost implications of this demand and to inform consumers on the options to



manage their energy requirements more effectively. Electricity prices will always be higher in SA than other States until such time as consumers are able to manage their demand for electricity better at times of peak demand, associated with summer air cooling.

In a separate determination, the Commission is addressing this matter through special funding of ETSA Utilities to commence a pilot program of demand management to manage consumer demand in the peak summer demand period. However, the Commission emphasizes that additional measures are needed if the wholesale electricity costs are to be reduced to levels more in line with costs interstate. Without a strong commitment by consumers, the electricity industry and government to such programs, SA electricity costs will remain at a level well above interstate costs.

## **1.2 Preliminary Conclusions**

As a result of this Inquiry, the Commission has decided to:

- ▲ Issue a draft Price Determination with the release of this Draft Final Report, with the intention of releasing a final Price Determination in mid-December 2004 to take effect from 1 January 2005;
- ▲ Set a retail electricity price path for the AGL SA component of the standing contract prices (called the retailer tariffs) for the 3 year period to 31 December 2007;
- ▲ Require AGL SA to pass through the actual network charges of ETSA Utilities, and any changes in those charges when they occur (such that the standing contract prices will equal the sum of the AGL SA tariffs and the ETSA Utilities tariffs, plus GST);
- ▲ Set AGL SA's retailer tariffs for the 6 month period commencing 1 January 2005 at 2.5% above current levels, with increases in the 2004-05 average retailer tariff cap (\$91.51 per MWh) of [CPI minus 1.05%] to apply from each 1 July thereafter (but the CPIs for the first and last regulatory years are for 9 month periods);
- ▲ Apply the price control as an average retailer tariff cap for the combined total of standing contract tariffs, based on forecasts of customer numbers and consumptions in May each year;
- ▲ Impose a side-constraint on each tariff such that no residential customer can receive an increase in the retailer tariff (for the same level of consumption) of more than CPI plus four percent in any regulatory year commencing 1 July; and no small business customer can receive an increase in the retailer tariff of more than CPI plus four percent or \$40 per annum, whichever is the greater;
- ▲ Provide for cost pass-through arrangements to apply in limited circumstances where certain of AGL SA's exogenous costs are altered significantly from those applying at the time of this Inquiry;
- ▲ Provide for AGL SA to open new tariffs, and to close existing tariffs, at the start of any regulatory year commencing 1 July, with appropriate review by the Commission and protection of consumer interests;

- ▲ Provide for the price path escalation factors to be revised in the event that the Commission, in its Final Report, changes the prudent cost components relative to those determined in this draft, and also arising from the “special circumstances” provisions in the Electricity Act.

In determining this price path for retailer tariffs, the Commission has determined that the prudent controllable costs of AGL SA, and consumer demand parameters, should be assumed to be at the following levels for each quarter over the price path period (all prices are in March 2005 dollars):

YEAR	QUARTER	STANDING CONTRACT CONSUMERS	AVERAGE CONSUMPTION (MWH/QTR)	WEC (\$ PER MWH) (REAL \$ MAR 05, EXCL GST)	ROC (\$ PER CUSTOMER) (REAL \$ MAR 05, EXCL GST)	RETAIL MARGIN (% OF WEC + ROC)
2005	Jan-Mar	603,691	1.90	92.03	84.41	10.0
	Apr-Jun	575,747	1.90	59.50	84.83	10.0
	Jul-Sep	549,350	1.81	61.86	85.25	10.0
	Oct-Dec	530,714	1.81	63.79	85.67	10.0
2006	Jan-Mar	512,078	1.92	98.11	86.10	10.0
	Apr-Jun	493,442	1.92	63.43	86.53	10.0
	Jul-Sep	477,956	1.81	59.79	86.96	10.0
	Oct-Dec	464,046	1.81	61.67	87.39	10.0
2007	Jan-Mar	450,135	1.92	92.37	87.82	10.0
	Apr-Jun	436,224	1.92	61.70	88.26	10.0
	Jul-Sep	423,901	1.80	60.35	88.70	10.0
	Oct-Dec	412,373	1.80	62.92	89.14	10.0

The Commission has developed a price path which smoothes the actual cost path and delivers to AGL SA the same net present value of revenue over the price path period as for prudent costs. In determining the NPV of prudent costs over the 3 year period, the Commission has used the above quarterly estimates of WEC, ROC, customer numbers and consumption, discounted at a real rate of return of 10.0%.

The Commission has undertaken a comprehensive evaluation of input costs using consultants, stakeholder comments and access to AGL SA’s actual costs (assisted by their auditor). The Commission is seeking further comment on the draft findings reported in this draft Inquiry Report, and will review those comments in reaching its final conclusions for incorporation in the Final Report (to be released in March 2005). If, as a result of that further consultation, the Commission revises its conclusions on input costs as reported above, it will use the Price Path Variation Event provisions of the Price Determination to adjust the price path cap escalation factors to apply from 1 July 2005 (so



as to ensure AGL SA receives the NPV of the revised prudent costs over the price path period).

The Commission has, as a result of its investigations, replaced the increases in AGL SA's tariffs included in AGL SA's proposal with the increases set out in the following Table:

Increase Commencement Date ->	1 January 2005	1 July 2005	1 July 2006	1 July 2007
AGL SA retailer tariff change requested (approximate)#	2 x CPI (5.0%)	2.6%	2 x CPI	2 x CPI
Commission determined increase	2.5%	CPI *- 1.05%	CPI**-1.05%	CPI ***- 1.05%

# AGL SA's proposal was for CPI increases applied to the standing contract price (ie including network charges). As network charges are approximately half of standing contract charges, the Commission has for illustrative purposes in the above table, doubled the increase to reflect the increase proposed by AGL SA for its retailer tariff component of total costs.

\* CPI is for 9 months ending 31 March 2005.

\*\* CPI is for 12 months ending 31 March 2006.

\*\*\* CPI is for 9 months ending 31 December 2006.

The Commission received a number of submissions from community organisations commenting on the impact of high electricity prices on vulnerable customers. The Commission is also concerned at these impacts, although it has concluded it is not possible to address such impacts via tariff structures. It also recognizes that there are many complex issues at play, which it has been unable to consider in this inquiry. Accordingly, the Commission has decided to undertake a comprehensive review with its Consumer Advisory Committee of the impact of current prices and concession provisions on vulnerable customers (including the use of disconnections) to see if it is necessary to modify Commission regulatory instruments (such as the Retail Code) or decisions (such as in this inquiry) to achieve better outcomes for vulnerable customers.

The Commission intends to commence this work in December 2004.

## 2 BACKGROUND TO INQUIRY

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### 2.1 *Competition and Retail Pricing*

On 1 January 2003, the South Australian retail electricity market became fully contestable. From that time, there were no longer any direct legal or regulatory impediments to prevent a licensed electricity retailer seeking to sell electricity to any South Australian customer.

However, effective competition takes time to evolve, and transitional regulation of retail tariffs has been required to protect vulnerable customers and ensure small consumers have access to a basic standard of service at a reasonable price. In virtually every electricity market where competition has been developed in the retail sector, regulatory or government control of prices has applied for a period of time until the competitive market is functioning properly.

The South Australian *Electricity Act 1996* was amended in late 2002 to insert special provisions relating to the retail prices charged to small electricity customers (those who consume less than 160 Megawatt-hours (MWhs) per year). In particular, Section 36AA of the *Electricity Act 1996* required AGL SA to publish its *standing contract price* for small customers by notice published in the Gazette and a newspaper circulating generally in the State, where:

- ▲ the standing contract price was fixed by the notice with effect from the end of the period of 3 months from the date of publication of the notice; and
- ▲ the notice contained a statement of justification for the price; and
- ▲ the Commission did not, within the period of 3 months, make a price determination under the *Electricity Act 1996* that had the effect of fixing AGL SA's price.

The Commission undertook an Inquiry in the second half of 2002, and issued a determination setting standing contract prices to apply from 1 January 2003.

Twelve months later, the Commission reviewed these prices based on the then current costs, and in its *Final Report 2004 Electricity Standing Contract Prices*<sup>1</sup> which was released on 31 December 2003, decided to allow the prices to remain at their existing level for 2004. Although network charges increased on 1 January 2004, they were offset by a reduction in wholesale electricity prices identified by the Commission.

### 2.2 *IPART Review of Methodology*

Following the release of the Commission's report, the South Australian Premier asked IPART 'to undertake a review of the methodology used by the Essential Services Commission of SA to consider a determination of 2004 prices'. IPART was not asked to review the level of prices, simply the methodology.

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<sup>1</sup> <http://www.escosa.sa.gov.au/resources/documents/031231-R-2004ElecStandingContractPrice-FinalReport.pdf>



In late March 2004, the South Australian Government released IPART's report *South Australian 2004 Electricity Standing Contract Price: Review of ESCOSA Methodology*.<sup>2</sup>

This report made a number of recommendations, which the South Australian Government indicated it would adopt. The present Inquiry is in response to the recommendations contained in IPART's report and to subsequent legislative change.

IPART's recommendations are briefly summarised as follows:

- ▲ **clarity of process** – legislative amendments or administrative guidance should be introduced to clarify the appropriate process irrespective of whether prices and costs are rising, static or falling;
- ▲ **length and frequency of reviews** – a medium-term price path should be set which may provide for annual adjustments subject to compliance checks;
- ▲ **role of the regulator** – legislative change or administrative guidance should be introduced to (1) require the medium-term price review to be commenced by a submission from the utility; and (2) ensure that ESCOSA can conduct annual compliance checks on price changes within the medium-term price path;
- ▲ **stakeholder input** – at least six months should be allowed for a medium-term price review, allowing full stakeholder input;
- ▲ **resources and quality control** – ESCOSA should (1) take on additional resources; and (2) draw further on the ideas and resources of other stakeholders before committing to a position;
- ▲ **clarity of objectives for regulation of standing contracts** – greater clarity should be brought to the objectives for regulation of standing contracts in future reviews. The use of data/estimates under alternative approaches should also be employed;
- ▲ **building block approach** – the use of a building block approach is endorsed as the primary approach, supported by benchmarking against competitive prices and margins in South Australia and elsewhere where possible;
- ▲ **options for assessing wholesale energy costs** – despite the difficulties and uncertainties involved, future reviews should estimate actual contract costs attributable to standing contract customers. This provides an alternative estimate of wholesale electricity costs;
- ▲ **IES methodology for assessing benchmark incumbent costs** – the notional prudent price should be estimated using a similar methodology at the next review but with earlier data verification against actual contract data;
- ▲ **assessing retail costs** – actual costs could be used as a cross-check against benchmarks, although the uncertainties and limitations involved should be recognised;

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<sup>2</sup> <http://www.escosa.sa.gov.au/resources/documents/040330-R-IPARTReportSAGovt.pdf>



- ▲ **assessing retail margins** – benchmarking should provide the reference point but the method of specifying these margins (as a percentage or dollar amount) should be examined further. Market-specific risks reflected in the wholesale cost should be identified or excluded from the retail margin;
- ▲ **allowance for headroom** – proposed medium-term review should adopt a clear and consistent position on the issue. This is a policy issue on which government may wish to provide direction.

One of the recommendations made by IPART was that the Commission should set a medium-term price path for standing offer tariffs, with provision for annual adjustments within limits subject to a compliance review, rather than reviewing these tariffs on an annual basis. The primary reasons for reaching this conclusion were that:

- ▲ the legislative provision for a three month review of proposed tariffs was insufficient for a ground-up review of prices with adequate stakeholder consultation;
- ▲ annual reviews are excessively costly and burdensome: a medium-term price path would reduce regulatory costs; and
- ▲ a medium-term price path would increase certainty for customers, AGL SA and competing retailers.

## 2.3 Legislative Changes

In July 2004, the South Australian Parliament passed the *Statutes Amendment (Electricity and Gas) Act 2004* which, inter alia, amended the provisions of Section 36AA of the *Electricity Act 1996* to incorporate the proposed standing contract price path arrangements.

The new provisions of Section 36AA are as follows:

- 4a *The following provisions apply in relation to the fixing by the Commission of a standing contract price for an entity for the purposes of this section:*
- (a) *the Commission may fix the price by a determination of a kind referred to in section 35A(1)(a);*
  - (b) *a determination must provide for the expiry of the determination at the end of a period of not less than 3 years specified in the determination;*
  - (c) *a determination may provide for prices that vary at specified times according to a formula specified in the determination;*
  - (d) *unless the Commission determines that special circumstances exist*
    - (i) *a determination may not be made to take effect before the expiry date of the last preceding determination made by the Commission in accordance with this subsection;*
    - (ii) *a determination may only be made if the entity has made a submission to the Commission stating the price that the entity proposes be fixed by the Commission as the entity's standing contract price, and the entity's justification for the price, not less than 6 months and not more than 9 months before the making of the determination;*



- (ii) *the Commission must, before making a determination, have conducted an inquiry under part 7 of the Essential Services Commission Act 2002 into the question of the appropriate price to be fixed as the standing contract price;*
- (e) *a submission under paragraph (d) must comply with any requirements as to the form and content of such submissions imposed by the Commission by written notice served on the entity.*

Clauses 36AA(4a) (a) to (c) were proclaimed to operate from 19 August 2004, while clauses (d) and (e) have been proclaimed to operate from 1 July 2005: accordingly, clauses (d) and (e) are not relevant to the current Inquiry.

The Commission, in its June 2004 Issues Paper<sup>3</sup>, outlined to AGL SA the information it required in AGL SA's submission, in accordance with its power to seek information under Part 5 of the ESC Act.

AGL SA submitted its price path proposal to the Commission on 20 August 2004. There were two submissions: a public version which was placed on the Commission's website on 23 August<sup>4</sup>, and a Commercial-in-Confidence version, submitted under Part 5 of the ESC Act as it included commercially sensitive material.

## **2.4 Details of the Inquiry**

The Terms of Reference (TOR) of the Inquiry, as specified by the Minister for Energy in the Notice of Referral dated 26 May 2004, require the Commission to undertake a number of tasks (the Terms of Reference are provided in full in Appendix 1).

In summary, the Commission is required to:

*... investigate the standing contract price proposal ("the Proposal") that will apply to small customers from 1 July 2005 for a period of no less than three years.*

*In assessing the proposal, the Commission's evaluation will be limited to reviewing the electricity entity's prudent controllable costs, which, together with the relevant network tariffs, comprise the final standing contract prices charge to small customers. There should be no provision for specific headroom allowed in the prudent controllable costs determined by the Commission.*

*In determining whether the electricity entity's controllable costs are justified as the prudent costs incurred in supplying small customers, in addition to the requirements of Parts 2 and 3 of the Act, the Commission is to have regard to:*

- *the electricity entity's justification for its proposed charges, presented as part of the proposal;*
- *the wholesale electricity contracts and hedging strategies that would be utilised by a prudent electricity entity in providing the standing contracts to each of the residential and business customer classes in South Australia;*

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<sup>3</sup> <http://www.escosa.sa.gov.au/resources/documents/040625-R-ElecPricInqIssuesPaper.pdf>

<sup>4</sup> <http://www.escosa.sa.gov.au/resources/documents/040823-R-AGLStandingContractPriceProposal.pdf>

- *the electricity entity's actual underlying wholesale electricity contracts, hedging strategies and other arrangements for securing electricity supply for South Australia, as well as the method for allocating these costs between large and small customers and within the small customer class;*
- *the retail operating costs that would be incurred by a prudent electricity entity in delivering the range and standard of services that are required of the electricity entity in providing standing contract services to South Australian small customers;*
- *the electricity entity's actual operating costs in providing standing contract services to South Australian small customers, and the method of allocating its costs between the different customer classes;*
- *the electricity entity's proposed margin on standing contract sales, and its actual margin achieved in recent years, and whether these are reasonable having regard to the entity's investment in the business, the risks of standing contract retailing in South Australia, and the equivalence with standing contract retailer margins interstate without Government risk management schemes;*
- *any cross-subsidies between, and within, business and residential small customer classes, and whether these cross-subsidies are justified to prevent a disproportionate price impact on any small customer group;*
- *the prices charged and costs incurred in providing comparable services in other States and Territories of Australia, and whether the reasons for any differences can be justified; and*
- *any other factors the Commission considers relevant.*

The TOR require the Commission to also have regard to the requirements of Parts 2 and 3 of the ESC Act.

The general factors specified in Part 2 of the ESC Act are as follows:

- 6(1) *In performing the Commission's functions, the Commission must-*
- (a) *have as its primary objective protection of the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services; and*
  - (b) *at the same time, have regard to the need to-*
    - (i) *promote competitive and fair market conduct; and*
    - (ii) *prevent misuse of monopoly or market power; and*
    - (iii) *facilitate entry into relevant markets; and*
    - (iv) *promote economic efficiency; and*
    - (v) *ensure consumers benefit from competition and efficiency; and*
    - (vi) *facilitate maintenance of the financial viability of regulated industries and the incentive for long term investment; and*
    - (vii) *promote consistency in regulation with other jurisdictions.*

The factors specified in Part 3 of the ESC Act are as follows:

- 25(4) *In making a price determination, the Commission must (in addition to having regard to the general factors specified in Part 2) have regard to:*



- (a) the particular circumstances of the regulated industry and the goods and services for which the determination is being made;*
- (b) the costs of making, producing or supplying the goods or services;*
- (c) the costs of complying with laws or regulatory requirements;*
- (d) the return on assets in the regulated industry;*
- (e) any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries;*
- (f) the financial implications of the determination;*
- (g) any factors specified by a relevant industry regulation Act or by regulation under this Act;*
- (h) any other factors the Commission considers relevant.*

Section 25(5) states that, in making a Price Determination under the Act, the Commission must ensure that:

- (a) wherever possible, the costs of regulation do not exceed the benefits; and
- (b) the decision takes into account and clearly articulates any trade-off between costs and service standards.

Section 25(6) states that all of the Part 2 and 3 factors are subject to the provisions of the relevant industry regulation Act for that industry (in this case, the Electricity Act 1996).

Section 6A(4) of the Electricity Act states that the Commission must (in addition to having regard to factors specified in the Electricity Act and the Essential Services Commission Act) have regard to the provisions of the National Electricity Code and the need to avoid duplication of, or inconsistency with, regulatory requirements under the Code.

Section 3 of the Electricity Act states that the objects are:

- (a) to promote efficiency and competition in the electricity supply industry; and
- (b) to promote the establishment and maintenance of a safe and efficient system of electricity generation, transmission, distribution and supply; and
- (c) to establish and enforce proper standards of safety, reliability and quality in the electricity supply industry; and
- (d) to establish and enforce proper safety and technical standards for electrical installations; and
- (e) to protect the interests of consumers of electricity.

Apart from the above, there are no factors specified in the Electricity Act relating to price determinations that the Commission is required to have regard to.

The above Electricity Act factors do not conflict in any way with the factors set out in Parts 2 and 3 of the Act, and hence the potential restriction in Section 25(6) of the Act (that is, that the Part 2 and Part 3 factors are subject to the Electricity Act provisions) is not relevant.

## 2.5 Process of the Inquiry

The process for holding the Inquiry was set out in the Notice of Referral, and is also governed by the provisions of Part 7 of the ESC Act.

A notice was published in the Advertiser on 28 May 2004 with the full Terms of Reference of the Inquiry and details on how to make a submission.

A Paper entitled "*Inquiry into Retail Electricity Price Path: Issues Paper*"<sup>5</sup> was released by the Commission on 25 June 2004. In response, the Commission received 9 submissions, from AGL SA, Origin Energy (Origin), TXU, International Power Australia Pty Ltd (IPA), the Conservation Council of South Australia Inc (CCSA), the Energy Retailers Association of Australia (ERAA) and Business SA. The submissions are available on the Commission's website.<sup>6</sup>

On 20 August 2004, AGL SA submitted a price path proposal for the period to 30 June 2008, as requested in the Issues Paper. A public version of AGL SA's price path proposal was placed on the Commission's website.<sup>7</sup>

The Notice from the Minister also required the Commission to release a Discussion Paper following the receipt of AGL SA's price path proposal.

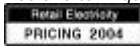
A paper entitled "*Inquiry into Retail Electricity Price Path: Discussion Paper*"<sup>8</sup> was released on 14 September 2004. In response, the Commission received 11 submissions from AGL SA, EnergyAustralia, the Minister for Energy, Energy Consumers Council, Energy Retailers Association of Australia, ETSA Utilities, NRG Flinders, Origin Energy, SA Council of Social Service, TXU and UnitingCare Wesley.

On 20 October 2004, the Commission held a Public Hearing at the Hilton Adelaide. Approximately 24 people attended, and four parties presented to the Commission.

The TOR required the Commission to release a draft decision (and Price Determination if applicable) to the Minister and AGL SA for comment at least one week prior to public release of the draft decision. Further, the public draft decision was to be released no later than 30 November 2004 and was to include provision for a bridging price for the period to 30 June 2005.

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<sup>5</sup> <http://www.escosa.sa.gov.au/resources/documents/040625-R-ElecPricingIssuesPaper.pdf>

<sup>6</sup> Submissions to *Inquiry into Retail Electricity Price Path: Issues Paper*, can be accessed via the "Retail Electricity Pricing 2004" icon  on the ESCOSA Home page ([www.escosa.sa.gov.au](http://www.escosa.sa.gov.au))

<sup>7</sup> AGL SA's Price Path Proposal: <http://www.escosa.sa.gov.au/resources/documents/040823-R-AGLStandingContractPriceProposal.pdf>

<sup>8</sup> [http://www.escosa.sa.gov.au/resources/documents/040914-ElecRetailPricePathInq\\_DiscPaper.pdf](http://www.escosa.sa.gov.au/resources/documents/040914-ElecRetailPricePathInq_DiscPaper.pdf)



A Final Report (and Price Determination if applicable) is to be submitted to the Minister and AGL SA no later than 31 March 2005, and to the public no later than 7 days thereafter.

The ESC Act requires the Minister to table the report in Parliament within twelve sitting days of receipt by the Minister (or made publicly available within 28 days if Parliament is not sitting).

### 3 AGL SA'S PRICE PATH PROPOSAL

The Executive Summary of the public version of AGL SA's price path proposal is provided in Appendix 2. This section provides a summary of the proposal.

A confidential version of the proposal was provided to the Commission but cannot be released because it contains commercially sensitive material. The Commission is limited under Part 5 of the ESC Act from releasing such information.

#### 3.1 Overview

AGL SA proposed that retail electricity prices for residential and small business consumers on standing contracts be varied as follows:

PERIOD	JANUARY TO JUNE 2005	JULY 2005 TO JUNE 2006	JULY 2006 TO JUNE 2007	JULY 2007 TO JUNE 2008
RETAIL PRICE CHANGE (%)	CPI	1.3	CPI	CPI

AGL SA advised that this proposed price path for the total retail price (that is, retailer controllable costs and network charges) is based on current network charges and that any change in these charges would be passed on to consumers. Given that network charges represent almost half of total retail price for standing contract consumers, AGL SA's proposal sought almost double CPI increases to its own controllable costs over the period.

Assuming a CPI of 2.5% per annum over the period, the AGL SA proposal sought approximately the following increases in its controllable costs (ie excluding network charges):

INCREASE COMMENCEMENT DATE	1 JANUARY 2005	1 JULY 2005	1 JULY 2006	1 JULY 2007
AGL CONTROLLABLE COSTS CHANGE	5 %	2.6 %	5 %	5 %

AGL SA's proposal was based on a building block approach. The rationale for the price path is discussed in the following sections.

#### 3.2 Form of Regulation

AGL SA proposed a form of regulation with the following characteristics:

- ▲ prices would be set for a period of three years, excluding the half year of transition from January to June 2005;



- ▲ prices would be set according to a constraint on AGL SA's average revenue; thus the retail price change figures in the table above refer to changes in AGL SA's average revenue per MWh of sales on standing contracts;
- ▲ individual tariffs would be permitted to increase by a greater extent, CPI+5%, to allow for the unwinding of existing cross subsidies between business and residential consumers and cross subsidies within tariffs;
- ▲ should AGL SA wish to increase prices above the price path, it would be required to justify such an increase to the Commission;
- ▲ changes in taxes, market related changes (such as an industry levy for the national regulator) or new charges introduced (such as reserve trader charges) would be treated as passthrough items.

### **3.3 Wholesale Energy Costs**

AGL SA did not provide its estimate of wholesale energy costs in the public version of its submission, though it provided this estimate to the Commission on a confidential basis. This estimate was based on:

- ▲ AGL SA's view that 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;
  - a large proportion of peaking plant that is more costly to run and operate;
  - generation and network assets with a relatively lower utilisation factor than elsewhere in the National Electricity Market (NEM); and
  - relatively high interregional and regional loss factors.
- ▲ AGL SA's view that the current wholesale electricity costs it incurs 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 and that these costs are above what has been allowed by the Commission in prior Price Determinations;
- ▲ AGL SA's view that there is an inverse relationship between the level of contracts undertaken by retailers and pool prices;
- ▲ AGL SA's hedging approach;
- ▲ risk allowances for weather, pool prices, market events (such as supply side events) and National Electricity Market Management Company (NEMMCO) directions;
- ▲ an allowance for NEMMCO participant fees, ancillary charges, renewable energy levy and bank guarantee fees; and
- ▲ 2004/05 line losses of 8.12%, based on NEMMCO published loss factors for transmission and distribution.



AGL SA also provided comment on what, in its view, were a number of 'common misconceptions' regarding its wholesale costs, including:

- ▲ that pool prices reflect the cost of energy to retailers – AGL SA's view is that pool prices largely reflect the level of hedge contracting AGL SA has undertaken;
- ▲ that the Australian Financial Managers Association (AFMA) prices reflect AGL SA's hedge contract prices – in AGL SA's view these prices reflect only a perception from a few market participants as to what the price should be and are not available for retailers to contract at. In AGL SA's view, there is no publicly available information which can provide a reliable guide to AGL SA's wholesale contract prices;
- ▲ that retailers incur limited risk when contracted – AGL SA is of the view that retailers incur hedge mismatch costs and the risk of supply side events, such as the failure of the Moomba gas field to supply in the early months of 2004, counterparty defaults, etc; and
- ▲ that cap contracts should only reflect the value they return from the pool prices – AGL SA is of the view that if this were the case, insufficient peaking capacity would have been constructed in recent years to meet forecast peak demand growth. AGL SA believes that the increasing number of wind farms is likely to result in a higher unit cost for caps as fixed costs must be recovered over a reduced volume of output.

### **3.4 Retail Operating Costs**

AGL SA did not provide its estimate of retail operating costs in the public version of its submission, though it provided this estimate to the Commission on a confidential basis. AGL SA outlined its regulatory obligations and other services<sup>9</sup> that it currently provides to its customer base. It asserted that in the future, both the number of services provided and the level of service will increase.

AGL SA provided confidential information on actual operating costs relating to standing contract customers for the calendar year 2003 and projected operating costs for the period 2005 to 2008. AGL SA's cost per customer has been derived from the projected net operating costs divided by the total small customer number. The estimate was based on AGL SA assurances that:

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

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<sup>9</sup> Such as administering the Government rebate, which is not a regulatory obligation.



### **3.5 Retail Operating Margin**

AGL SA stated that it considered the appropriate margin based on the level of risk in the South Australian market and reflecting its continuing obligation to supply would require a retail margin at the upper end of the 5-10 per cent range. Although AGL SA did not include its proposed retail margin in the public version of its proposal, it stated that it has based its proposal on a margin consistent with previous determinations by the Commission (ie 5 percent).

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# **PART B: INQUIRY CONSIDERATIONS**

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## 4 OBJECTIVES

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As outlined in Section 2.4, the Commission is required to have regard to a large number of factors in undertaking this Inquiry. The IPART Report (Section 5.1) emphasised the importance of providing clarity of the objectives for price regulation of standing contracts, at the commencement of an Inquiry.

The Commission discussed the interplay of the various factors in its Issues Paper, and proposed an objective that met the legal obligations in the ESC Act and Electricity Act.

The Commission confirmed that the key objective in the establishment of an electricity retail price path is the protection of the long-term interests of consumers. However, the Commission indicated it would have regard to all of the factors it was required to, and would attempt to ensure that all objectives were achieved.

Specifically, the Commission proposed the following statement of its objective in setting the retail electricity price path.

### Objective For Retail Electricity Price Path

In considering consumers' long-term interests, the Commission will 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 South Australia 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.

### 4.1 Submissions

The Commission received a number of comments on this statement in responses to the Issues Paper. Submissions were, for the most part, supportive of the stated objective.<sup>10</sup>

AGL SA believed that the objective should clearly state that network costs for the price path period will be a full pass-through to consumers and suggested the objective could be enhanced by:<sup>11</sup>

- ▲ *“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*

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<sup>10</sup> Origin, TXU, IPRA, NRG Flinders and AGL SA were all generally supportive.

<sup>11</sup> AGL SA Submission, 30 July 2004, page 3



*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."*

Both TXU and NRG Flinders stated that the establishment of effective competition was the most important objective. Origin agreed that emphasis should be placed on this objective and stated that the increasingly competitive market was largely due to the Commission's pro-competitive stance in its 2003 and 2004 retail Price Determinations.<sup>12</sup>

Business SA commented:<sup>13</sup>

*"All of the objectives contained in the Issues Paper concentrate on the supply side of the electricity market. Since electricity is a commodity that can not be stored, much of the efficiency must be gained from the demand side of the market."*

ERAA pointed to a position taken by UK regulator Ofgem when stating:<sup>14</sup>

*"There appears to be a suggestion that there is a "trade-off" between the primary objective of protecting the long-term interests of consumers and subsidiary objectives of promoting competition, providing incentives for long-term investment and ensuring the financial viability of regulated industries etc..."*

*The ERAA believes that the primary and subsidiary objectives outlined in the ESC Act are not a matter of trade-offs but rather a means to deliver on the primary objective. In other words the Commission must achieve the subsidiary objectives in order to achieve its primary objective."*

CCSA commented that it does not believe the case has been made that competition and 'benefit for consumers' have a causal relationship, and that the objective does not state what an 'appropriate' return for an efficient declared retailer is. CCSA also believes that there should be an investigation into the allocative equity of the structural form of the standing contract tariff and attached a paper to its submission in order to stimulate discussion on the subject.<sup>15</sup>

While the Discussion Paper did not specifically raise again the issue of the overall objective for the retail electricity price path, a number of submissions contained comments on this subject (Section 5 presents a more detailed summary of stakeholder comments on the Discussion Paper).

EnergyAustralia, one of the new entrant retailers offering market contracts in South Australia to small consumers, argued that the over-riding objective should be to encourage further competition. It stated that new entrant retailers incur higher costs than

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<sup>12</sup> Origin Energy Submission, 30 July 2004, page 1

<sup>13</sup> Business SA Submission, 27 July 2004, page 2

<sup>14</sup> ERAA Submission, 2 August 2004, page 6

<sup>15</sup> Conservation Council of South Australia Submission, 30 July 2004

the incumbent retailer. It proposed that the price path should be set for a “fail safe” and pro-competition purpose, not for the lowest possible prices an incumbent monopoly can deliver.

Similarly, the Energy Retailers Association (ERA) argued that the price path must meet the key objectives of promoting competition and encouraging long term investment. While the ERA supported the balanced analysis of issues in the Discussion Paper, it was concerned that the analysis did not give sufficient recognition of the state of development of competition in the market (and the discipline associated with that). It argued against adopting a “lowest common denominator” approach in setting cost components, and urged the Commission to set prices at a level to support the continuing development of a competitive market. To address implications for vulnerable consumers, the ERA urged the development of targeted programs based on a shared responsibility between the industry, government, relief agencies and consumers.

On the other hand, the two consumer group submissions highlighted the impact on vulnerable consumers of the current high prices and any future continuation of removal of cross-subsidies. They urged the Commission to base prices on the lowest possible costs, and to manage the removal of cross-subsidies in a way which causes the least harm to these consumers.

The SACOSS-WREAG and UnitingCare Wesley submissions recognised, however, that vulnerable consumers can be high consumers of electricity and it is not appropriate to build in cross-subsidies from large to small consumers: this may discriminate against those most in need (especially the ill and aged forced to use large amounts of electricity in their own homes).

Accordingly, while supporting the Commission’s proposed objective of a price path which establishes “the lowest possible price consistent with other objectives”, the consumer groups were also supportive of a joint approach by retailers, government and community service organisations to develop measures to protect vulnerable customers. The Commission will comment on the SACOSS-WREAG and UnitingCare Wesley proposals later in this report.

The Minister for Energy stated that the Government was extremely conscious of the need to ensure that the standing contract price charged to small customers is as low as possible, and is fully justified with the interests of small customers in mind. The Minister supported the adoption of a price path that is transparent and simple.

## **4.2 Commission Comment**

The Commission notes the general support for its statement of objectives, and observes that many of the comments relate to interpretation of the individual components in that statement.



The Commission was quite deliberate in its preparation of the statement to emphasise “development of competition for the benefit of consumers”: it does not see competition as an end in itself.

Similarly, it believes the price should be set at a level which encourages efficient investment in generation, networks and retailing, but again emphasises its purpose is to meet consumers’ long-term requirements: it does not seek investment as an end in itself.

The Commission accepts that this statement does not specifically address demand management issues. It is, of course, giving attention to those matters in its electricity distribution price review, and has committed to provide funding to ETSA Utilities for a program of demand management initiatives. Costs and benefits from such a program will be reflected in network charges, and are therefore not directly relevant to the task of setting the retail price path.

The Commission will address the allocative implications of tariff structures later in this report.

Having considered the submissions, the Commission endorses its Objective as previously outlined.

This requires the Commission to look beyond the short-term objective of the lowest possible price, and consider as well how the decision on price might impact on investment, quality and reliability of supply in the longer term (over the next few years or more).

If the Commission was to set prices below the cost of supply, then AGL SA would make a loss and retailers might elect to withdraw from the market. If AGL SA operated at a loss, it may not be able to pay NEMMCO and the generators for energy, nor ETSA for network charges: this would ultimately have a negative impact on security and reliability of supply.

In summary, therefore, the Commission will interpret the ‘consumer long-term interest’ as the lowest possible price commensurate with ensuring a number of other objectives:

- ▲ meeting the costs that an efficient retailer would incur in complying with the standing contract supply obligations;
- ▲ providing a return that reflects those costs and a return on the funds invested in the retail business appropriate to the risk; and
- ▲ encouraging efficient investment to ensure consumers’ long-term requirements are met.



## 5 DISCUSSION PAPER AND STAKEHOLDER COMMENTS

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The Terms of Reference of the Inquiry required the Commission to release a Discussion Paper following receipt of AGL SA's price path proposal. As reported, the AGL SA proposal was received on 20 August, and the Commission released its Discussion Paper in early September 2004: comments were sought from stakeholders by 15 October, and a public forum was held on 20 October 2004.

Preparation of the Discussion Paper was assisted by stakeholder comments on the earlier Issues Paper: these comments were considered in the Discussion Paper and will not be further reviewed here (the submissions are available on the Commission's website<sup>16</sup>).

The Discussion Paper was accompanied by two reports from advisors to the Commission: a study estimating the long run marginal cost of electricity for the standing contract small consumer market, undertaken by ESIPC; and a report on the scenario-based approach to estimating wholesale energy costs prepared by the Allen Consulting Group (ACG).

The Commission sought comment on AGL SA's proposal, the Discussion Paper and the two consultant reports. In all, submissions were received from 11 organisations:

- ▲ AGL SA (public and confidential submissions)
- ▲ EnergyAustralia (confidential)
- ▲ Energy Consumers Council
- ▲ Energy Retailers Association of Australia
- ▲ ETSA Utilities
- ▲ Minister for Energy
- ▲ NRG Flinders
- ▲ Origin Energy
- ▲ SA Council of Social Service/Western Region Energy Action Group
- ▲ TXU
- ▲ UnitingCare Australia

Copies of these submissions (other than the confidential ones) are available on the Commission's website<sup>17</sup>.

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<sup>16</sup> Submissions to the *Inquiry into Retail Electricity Price Path Issues Paper – June 2004* can be accessed via the "Retail Electricity Pricing 2004" icon on the ESCOSA website homepage ([www.escosa.sa.gov.au](http://www.escosa.sa.gov.au))

<sup>17</sup> Submissions to the *Inquiry into Retail Electricity Price Path Discussion Paper – September 2004* can be accessed via the "Retail Electricity Price 2004" icon on the ESCOSA website homepage ([www.escosa.sa.gov.au](http://www.escosa.sa.gov.au))



Four stakeholders presented at the public forum on 20 October (AGL SA, SACOSS-WREAG, TXU and WesleyCare Uniting Adelaide); this allowed the Commission to ask questions and gain further insight into the issues raised.

AGL SA officers met with the Commission on 20 October to discuss their confidential submission.

The Commission has given detailed consideration to the submissions in forming its views in this Inquiry. This section summarises the key points made by stakeholders in responding to the Discussion Paper. The structure follows that adopted in the Discussion Paper of September 2004.

## **5.1 Form of Regulation**

The Discussion Paper raised a number of issues relating to the form of regulation to be applied, and sought comment on options available. These are set out below.

### **5.1.1 Timing of Price Determination**

The Commission sought views on whether it should issue a final determination in December 2004 (covering the period 1 January 2005 to 30 June 2008) or in March 2005 (covering the period 1 July 2005 to 30 June 2008), reflecting the time needed to allow for adequate consultation on this report.

AGL SA argued strongly for a December 2004 determination, as this allowed any adjustment to prices to commence at the appropriate time (and avoided catch-up problems with a delayed commencement). AGL SA claimed that the Commission could revoke a determination and replace it in the period before 1 July 2005, if subsequent consultation required further changes.

ETSA Utilities, on the other hand, considered that the determination should be delayed until March 2005 to provide adequate time for consultation on the draft and to allow for a single adjustment to retail and network charges commencing on 1 July 2005.

The Minister for Energy supported a determination late in 2004 for the full period, with some adjustment mechanism to incorporate any necessary adjustment arising from consultation on the draft report.

Origin expressed surprise at the legislative issue preventing a 6 month bridging price, but urged for a solution to be found to allow prices to be adjusted from 1 January 2005.

TXU proposed that the determination be delayed to allow adequate consultation, and that prices from 1 July 2005 be adjusted to compensate for any under/over recovery.

## 5.1.2 Instrument of Control

The Commission raised a number of issues concerning how the price path control might be applied, such as to individual tariffs, or a basket of tariffs, or total revenue, or cost components.

AGL SA argued that a number of principles gave guidance to the appropriate form of control: these included cost-reflective tariffs, elimination of cross-subsidies, and direct pass-through of all network tariff components. AGL SA's preference was for a less prescriptive approach that allowed tariffs to be moved to cost reflective levels over the period of the price path, with limited controls on individual charges and tariffs.

AGL SA stated that the form of regulation "should be light-handed and simple", and referred to the approaches in NSW and Victoria. In particular, it proposed controls on overall revenue from tariffs as a whole, rather than individual tariff controls. It proposed that the load weighted average revenue across all tariffs be used to calculate the average increase in prices. It proposed an allowable increase equal to CPI for standing contract tariffs, with a side constraint that an annual bill must not increase by more than CPI+5% or \$40 (whichever is the greater).

EnergyAustralia supported a 3 year CPI based price path with an average revenue cap expressed in dollars per MWh. Cross-subsidies should continue to be unwound, such that no tariff controls were necessary.

The ECC was supportive of the need to remove cross-subsidies, but conscious of the need to maintain electricity at affordable prices, and encouraged the Commission to give particular consideration to actions which impacted on low income consumers. It suggested there may be the potential to develop tariffs which consider the need for a basic supply of electricity to all consumers at reasonable costs (and which encourage demand side measures such as time-of-use or multi-part tariffs).

The ERAA believed the price path control should operate at a high level, such as average price per MWh. Tariffs needed to be cost reflective, and controls on supply charges or energy charges were inappropriate.

ETSA Utilities observed that the AGL SA proposal to escalate standing contract tariffs at CPI was potentially misleading, as it included network charges. It proposed that only the AGL SA controllable costs (independent of network charges) should be included in the price path, and allowable changes should apply to those costs.

ETSA Utilities noted that AGL SA's costs for standing contract customers will vary as customer churn occurs (and depending on whether they go to other retailers or AGL SA). Ideally, any revenue control would recognise the different cost



components and charges as customers churn. It proposed a CPI related control for the main cost components, with other charges as pass-throughs.

The Minister for Energy did not support AGL SA's proposal for a side-constraint of CPI plus 5%, and considered that any rebalancing should be restricted to a maximum of no more than CPI.

NRG Flinders argued, as a general principle, that it is preferable to adopt the most straightforward and intuitive approach, which is an average revenue per MWh price path. It also supported a side constraint to enable rebalancing of individual tariffs.

Origin also proposed that the price path control should be at a high level, on either an average revenue or a weighted average tariff basis. It stated that retailers should be able to recover fixed costs from customers, such that the supply charge should be cost reflective. Origin noted that AGL SA's proposal for a CPI+5% cap on movement in individual tariffs seemed reasonable.

TXU noted that network charges should be passed through as incurred, and the non-network charges should be escalated in accordance with a CPI based price path. AGL SA should be free to re-balance tariffs towards cost reflectivity subject to a tariff category limit of 5%.

### 5.1.3 Conditions for Reopening

AGL SA proposed that the price path be reopened in special circumstances, such as:

- ▲ large force majeure events;
- ▲ events leading to significant changes in wholesale energy costs;
- ▲ significant changes to market structures or retailer obligations;
- ▲ significant changes to consumption levels of standing contract customers.

AGL SA stated that benefits from a price path depend on having only a limited number of circumstances where reopening can occur. Accordingly, it argued that a margin should be included in the base price to compensate for the risk of smaller adverse events which do not justify a reopening.

The ERAA likewise believed the price path should only be reopened under special circumstances (such as events which impact on wholesale energy costs). It also supported the inclusion of a risk premium in the base price to cover minor deviations. In the event of a re-opening application, it believed the Commission should restrict its review to the implications of that event and not extend to a review of unrelated events.

NRG Flinders argued it is essential to allow for reopening of the price path in the event of unforeseen and material increases in wholesale energy costs (it argued

against reopening in the event of a fall in such costs). AGL SA should be the only party to trigger a reopening.

The Minister for Energy supported an adjustment mechanism to accommodate any changes in cost components in the final report from those used in the price determination.

Origin supported a reopening in the event of significant changes in the wholesale energy costs or consumption levels, and also argued the margin should have a component to cover the costs of lesser events. In the event of a re-opening review, it should be limited to the particular event and not a comprehensive review. Only AGL SA should be entitled to seek a reopening review at any time.

TXU argued that, if the Commission adopted its approach of basing wholesale energy costs on the LRMC, the need for reopening events would be significantly reduced and limited only to significant unforeseen events.

#### 5.1.4 Pass-through Items

AGL SA believed that costs beyond its control should be identified and treated as pass-through items (with retail costs being adjusted by the full cost of these items). The list of pass-through items proposed by AGL SA covered:

- ▲ network charges;
- ▲ changes in taxes;
- ▲ market related charges (including AER levies);
- ▲ new charges such as reserve trader;
- ▲ changes to regulatory structures, obligations and service standards (including greenhouse and carbon emissions, administration of government schemes).

The ERAA proposed that costs that are currently not quantifiable but are possible in future should be treated as pass-through items, and endorsed the general list above.

NRG Flinders also endorsed the list of pass-through events in the Discussion Paper, noting the inclusion of network charges, tax events, market related charges and new charges. However, NRG Flinders suggested it was appropriate to include specific reference to carbon tax or greenhouse abatement charges, and to material market force majeure events.

Origin supported the proposed list.



## **5.2 Cost Components**

The Discussion Paper examined in some detail issues associated with three key components of the standing contract price that are attributable to a retailer: wholesale energy cost, retailer operating costs, and retailer margin. Stakeholder comments on these issues are reported below.

### **5.2.1 Wholesale Energy Costs (WEC)**

Determining the WEC for each year of the price path is a major challenge, and accordingly the Commission has sought assistance from expert consultants and consulted widely on its methodology and conclusions. This section outlines stakeholder comments on the methodology and conclusions described in the Discussion Paper and the two accompanying consultant reports. Following sections will outline the Commission's response to these comments and any changes to the methodology as a result.

The Commission has previously indicated there is no single correct approach to estimating the future wholesale energy cost, as such costs are dependent on a range of factors including the weather, contract design, market behaviours and outcomes, customer demands and practices, interstate activities, and contract prices. Costs in one year are not necessarily a guide to the following year's costs. Projecting forward over a three year price path is unreliable and challenging.

The Commission has sought to obtain information from a variety of sources, and to have regard to each of these approaches in determining a credible wholesale energy cost. These different sources have included actual contract costs, market reported contract prices, historical costs, long run marginal cost estimates, large employer energy contract prices, and modelling calculations based on risk managing the standing contract demand.

In the present Inquiry, the Commission proposed a modified approach which attempted to integrate as many of these approaches as possible into a scenario model of possible futures, and to develop a contracting strategy to minimise the risk to the retailer of differences from the base assumptions of consumer demands and market outcomes (pool prices).

The new approach was documented in the ACG report released with the Discussion Paper, and is again outlined in the ACG final report accompanying this Inquiry Report (modified following feedback on the earlier version).

The underlying presumption in the ACG analysis is that a prudent retailer would create a portfolio of swaps and cap contracts that minimises the risks associated with the variability of customer demand and pool price. As inputs, ACG required estimates of small customer demand and the demand profile for each year of the price path, and also costs of swap and cap contracts (covering AGL SA actual and

forecast future costs). The ACG model creates a portfolio of hedge contracts that minimises the risk associated with the scenario variations of customer demand and pool price. The Commission sought stakeholder comment on the model and the input assumptions, including the 5 scenarios.

The Commission also presented an analysis by the ESIPC of the long run marginal cost (LRMC) of supply for standing contract customers.

EnergyAustralia noted that the LRMC approach had been adopted by IPART in its NSW retail price determinations, and the prudent retailer modelling approach had been followed in Victoria. It noted the role of ETEF in NSW as a means of reducing risk to retailers associated with use of LRMC. Nevertheless, it proposed that the Commission should take a combined view of both methods, as one presents the view of likely costs in the near term and the other presents a retrospective view. It suggested more emphasis should be placed on the LRMC benchmark.

The Minister for Energy highlighted the documented reductions in wholesale pool prices and contract prices over recent years, and expected that the contract option selected to determine prudent controllable costs would take these reductions into account.

TXU was also of the view that the LRMC approach was preferable. It stated that this approach takes a longer term view on the average wholesale revenue required over time to efficiently fund the generation sector, and this avoids the need for frequent retail price reviews. The TXU submission set out in some detail the approach that should be followed in setting the LRMC based on new entrant generation technologies.

TXU reviewed the ESIPC report and concluded that (subject to several points of detail) it provided “a reasonable way forward in principle on assessing the long run cost of meeting small customer demand in SA.” The points of detail were:

- ▲ the base case cost of equity at 11.8% is below the level required by private sector investors for a high risk investment in merchant generation;
- ▲ the cost of gas assumed by ESIPC is too low, and below publicly reported costs for Victorian gas delivered via SEA Gas pipeline;
- ▲ fuel supply and price assumptions for OCGT plant are not credible, and the \$4/GJ assumption has ignored the cost of secondary fuel capability.

TXU expressed serious concerns with the ACG approach, primarily because it attempted to forecast short-term wholesale contract price movements over the 3 year period, and the majority of the scenarios proposed by ACG were not considered prudent. TXU commented that it was difficult to analyse the ACG methodology because insufficient detail was provided in the report, and this lack of



transparency was a concern. It urged the Commission to subject all of its actual inputs to public scrutiny.

TXU's other concerns included:

- ▲ the use of historical pool prices rather than forward looking estimates;
- ▲ lack of adjustment to VoLL values in historical prices;
- ▲ uncertainty about the load profiles used;
- ▲ impact of customer churn on load factor and demand;
- ▲ assumptions about the level of contracting assumed (90% POE being too risky);
- ▲ ACG scenarios over-emphasise low cost outcomes;
- ▲ highest weightings should be given to scenarios that have the highest impact on wholesale energy cost;
- ▲ use of an assumed quarterly contracting basis, as generators negotiate for annual contracts;
- ▲ contract prices appear lower than recent market levels;
- ▲ cap contract prices should trend upwards, not remain constant, as supply/demand tighten;
- ▲ the quantity of 'options' available in the market is very small and not appropriate for the Case B assumptions;
- ▲ large customer contract prices are not relevant in considering contract prices for AGL SA.

In summary, TXU urged the Commission not to use the scenario modelling approach and instead to refine the LRMC methodology as outlined in its submission. The ESIPC approach was a good starting point, and with an appropriate allowance for hedge mismatch would produce a credible wholesale energy cost.

NRG Flinders commented that forward contract prices incorporated in the ACG analysis were derived from market data in August, and SA forward contract prices have risen by \$1 per MWh since that time. It also noted that the 12 month rolling average pool price for SA had now risen above \$40 per MWh, the highest for many years. It therefore recommended that the modelling be updated to reflect current prices.

NRG Flinders also raised a number of issues:

- ▲ use of simple swaps and caps oversimplifies the position;
- ▲ use of historic pool prices in forecasting over a 4 year timeframe was problematic, given the tightening of supply and demand;



- ▲ costs are based at the regional reference node, and generator transmission losses not included in the analysis;
- ▲ limited emphasis on new entrant pricing, with only one scenario including this;
- ▲ no scenario considered the possibility of new entrant pricing being exceeded for a period: new entrant prices are an average, not a ceiling, and will be exceeded until new capacity commences operation.

NRG Flinders believed that the approach placed undue emphasis on historic prices, and needed to be reconsidered such that other factors were given greater weighting to balance the analysis (such as future pool price expectations). NRG Flinders observed that the model had produced a flat to declining wholesale energy cost outlook over the regulatory period, and that at an intuitive level, this contradicted the upward sloping forward contract curve and the growing peakiness of small customer demand.

With regard to the ESIPC report, NRG Flinders noted that a number of key variables appeared low:

- ▲ equity beta of 1.0 should be higher for a generator;
- ▲ cost of equity at 13% should be 15 to 20%;
- ▲ cost of gas is below market prices;
- ▲ model assumes a new entrant generator locates at the regional reference node;
- ▲ no allowance for the deteriorating load profile.

NRG Flinders observed that ESIPC had presented a base case with sensitivity analysis of the impact of key variables. It suggested it would be preferable to rely on a weighted average figure reflective of the cost impact of all scenarios, rather than just the base case.

Origin expressed concern at the use of only 5 scenarios by ACG, and stated that a more appropriate industry standard approach would be to model thousands of scenarios. It therefore considered the ACG approach was unrealistic, in that it did not capture the full range of risks that retailers have to manage.

Origin supported ACG's approach of combining AGL SA's pre-existing hedge position with an estimate of the cost to hedge the load not yet covered, and recognised that this impacted primarily on 2007/08 prices. Accordingly, it supported use of a new entrant LRMC price for those new contracts, being consistent with signals for new capacity.

However, Origin disputed ESIPC's assumptions in calculating the LRMC, and in particular:

- ▲ gas price assumptions are too low;



- ▲ rate of return assumptions are not justified and appear low;
- ▲ the analysis makes no allowance for other market risks such as price risk, fuel supply risk and transmission failure risks;
- ▲ project life assumptions are too long.

Origin also believed assumptions by ACG concerning AFMA contract prices and the cost of RECs underestimated the true costs.

AGL SA provided a public submission (on which most of the following comments are based), and also appeared before the Commission to present a confidential submission addressing the reports by ESIPC and ACG. In addition, AGL SA officers spent many days with officers of the Commission and ACG reviewing the scenario model and input assumptions. This is reflected in the revised modelling outlined later in this report and in ACG's final report released with this Inquiry report. The following comments summarise AGL SA's views as represented in its public submission.

AGL SA stated that aspects of both the ACG modelling and the LRMC estimates needed to be reconsidered as they understated AGL SA's wholesale electricity costs. It noted that it had provided full details of its contracts to the Commission, and ACG had confirmed that its contract purchases had been prudent and efficient.

AGL SA did not believe that the scenario approach adopted by ACG is appropriate for deriving its wholesale energy costs. Its assessment of the ACG model has resulted in its having serious concerns with the process, as the model has significant shortcomings in the manner in which it reflects the complex inter-relationships between the factors impacting on WEC (namely, customer load profile, spot market prices, weather conditions, terms of hedging contracts, proportion of load uncontracted, supply/demand balance, strategies adopted by generators in bidding and contracting, and customer churn).

In summary, AGL SA noted the following concerns with the ACG model:

- ▲ the scenarios do not adequately address the complex inter-relationships between AGL SA contract position, demand and subsequent pool prices;
- ▲ it ignores generators' bidding behaviours when the market is over or under contracted;
- ▲ it uses averaged historic pool prices in all scenarios, so there is no diversity in pool price outcomes;
- ▲ even though it uses AGL SA contracts, it does not take account of contract structures, and modelling on a quarterly basis causes a significant averaging impact;
- ▲ the modelling results in over-contracting, which lies outside appropriate risk management guidelines and produces unrealistic speculative gains;

- ▲ weighting of scenarios is confusing, and should be based on the likelihood of occurrence;
- ▲ prices of swaps, caps and REC are below current market rates and ignore some costs.

AGL SA proposed that its own modelling, which is comprehensive and sophisticated, should form the basis of the Commission's determination.

AGL SA indicated its support for using LRMC as an approximation of medium to long term WEC if the estimates are adjusted for market risks, current market structure and market realities; however, it did not believe the ESIPC estimates did this. In particular:

- ▲ fixed capital costs are too low;
- ▲ plant size is 50% larger than the existing largest unit, resulting in an increase in reserve margin charges;
- ▲ pass-through costs of fuel and opex are low;
- ▲ financing costs are too low for a project that assumes merchant risk not underwritten by a power purchasing agreement;
- ▲ inadequate allowance for fuel transportation costs.

AGL SA stated it is easy to demonstrate that the fuel cost assumptions are incorrect for both CCGT and OCGT units, and that the financial assumptions are not commercially realistic. It indicated that a more credible LRMC is reflected in Curve 8 which has a 3.5% higher fuel cost and higher financing assumptions. Allowing for a larger reserve margin and location away from the regional reference node, AGL SA argued that the LRMC increases from the \$60.34/MWh in the base case to over \$70 (excluding network losses).

AGL SA also commented on its historical WEC for 2003, based on audited information provided to the Commission. It indicated that the costs were above the benchmark of \$71 per MWh allowed by the Commission for that year.

## 5.2.2 Retail Operating Costs (ROC)

In the Discussion Paper, the Commission explained that the allowance for ROC was intended to cover the retailer's costs associated with:

- ▲ billing and revenue collection;
- ▲ operating a telephone call centre;
- ▲ providing advice and assistance to consumers;
- ▲ fulfilling obligations of the standing contract retailer;
- ▲ corporate overheads.



The Commission indicated it had set ROC in the past by reference to allowances made by regulators in other jurisdictions (\$82 per customer applying in 2004). However, the Terms of Reference of the Inquiry required it to examine AGL SA's actual operating costs, although it preferred to use a benchmark for setting prices.

AGL SA in its submission on the Discussion Paper stated that the Commission should adopt a benchmark at least equal to AGL SA's actual costs. It claimed that the detailed costs it had provided to the Commission accurately reflected the service standard obligations, consumer expectations, costs of new systems and processes associated with the new metering arrangements, new programs to help vulnerable customers and administration of government subsidy schemes.

AGL SA argued that standalone retailers did not have access to shared services that retailers stapled to a distribution business could access. It also noted that service standards in the SA Energy Retail Code are higher than interstate, and are increasing.

AGL SA drew comparison to the \$92 per customer allowance in the current Victorian price path arrangements. It emphasised the additional costs it incurs as the sole standing contract retailer compared to the Victorian situation, and the need to recover its fixed costs from a declining customer base as consumers switch to other retailers.

AGL SA disagreed with the Commission's treatment of bad debts, arguing they should be part of the operating costs and not the retail margin.

EnergyAustralia stated that, in setting the operating cost, the over-riding objective should be to encourage further competition. It stated that the ROC for a new entrant retailer was higher than for the incumbent, as they are required to develop systems, process and legal compliance procedures for each new market. These costs are not sunk or incremental to the existing business, and need to be recovered from the specific market.

EnergyAustralia noted that operating costs for AGL SA will increase, because of the unique situation of one incumbent retailer facing a net loss of customers without the possibility of inter-retailer churns. It stated that the risk of setting the benchmark ROC on the basis of a prudent retailer's costs was it would endanger the viability of the business and undermine the momentum of development of a competitive market.

The ECCC considered that a standalone retailer should have the same opportunities to achieve efficiencies as a stapled retailer (eg by negotiating arrangements with the distributor). The ECC urged the Commission to assess retailers' actual costs rather than rely on benchmarks from interstate; and these should focus on the costs that an efficiently operated retailer would incur.

The ERAA, on the other hand, believed that a standalone retailer would incur higher costs than retailers who can share fixed costs with their stapled distribution businesses. It proposed that the ROC benchmark should be based on the actual costs of the retailer and be tested against benchmarks used in other jurisdictions (and specifically Victoria, given the stapled arrangements and similar ownership structure). Adjustments to future ROC benchmarks should take into account the drivers to increases in costs and scope for efficiency improvements.

Origin believed there should be some opportunity for cost sharing in stapled retailer/distribution businesses, but believed cost benchmarks did not necessarily reflect this. It believed that the Victorian regulatory environment was most relevant to South Australia, and noted the level allowed in the 2004-07 Victorian price path agreement. It believed the Commission's \$82 per customer benchmark is below the actual cost. In terms of escalation, Origin noted that the dominant cost is wages, and these escalate at a faster rate than inflation, so CPI escalation should allow for productivity gains.

TXU supported benchmarking as the basis for ROC, as this was in keeping with a light-handed regulatory approach. It recommended adoption of the Victorian benchmark used in the recent multi-year price path agreement. Escalation should have regard to changes in underlying labour costs.

### 5.2.3 Retail Margin

The Discussion Paper stated that the retail margin is intended to compensate and reward retailers for their investment in the business and the risks they assume in order to provide retail services. The current margin of 5% of costs (pre-GST) is intended to provide retailers with funds to cover:

- ▲ a return on funds invested;
- ▲ depreciation and amortisation allowance;
- ▲ bad debts;
- ▲ income tax payable.

The Commission proposed to continue with a measure based on total costs (currently 5% of retailer costs plus network charges).

AGL SA, in its submission, strongly supported the margin being expressed as a % of sales, as this was consistent with the approach adopted in other jurisdictions.

AGL SA believed that the appropriate level of margin in South Australia was 5 to 10%, but adopted a 5% level in its proposed price path. It highlighted that discussion on the margin level assumed that the Commission had made a realistic assessment of its WEC and ROC; if these were set below its actual costs, then the margin would be eroded below the level it considered necessary. Any setting of WEC and ROC benchmarks below costs incurred by AGL SA "would be



tantamount to setting a retail margin below 5%". It indicated this was evidenced by the outcomes for the standing contract market in 2003, as provided in its audited accounts to the Commission.

AGL SA was critical of the Commission's approach to determining a retail margin by a return on investment approach. It nevertheless commented as follows on such an approach:

- ▲ the asset base should include working capital, intangible assets and tangible assets;
- ▲ valuing intangible assets should be based on future income, but this presents a circular valuation;
- ▲ the WACC for a retail business would be at the upper end of the 8.1 to 11.1% real pre-tax range used by the Commission, based on a retailer's debt/equity ratio, higher cash flow volatility, and NEMMCO prudential requirement impact on borrowing capacity;
- ▲ bad debts should be included in operating costs and not retail margin.

AGL SA concluded that a preliminary analysis based on an ROI approach would result in a retail margin of 5 to 10% of sales.

The ECC urged the Commission to adopt a flat retail margin rather than a percentage of total costs. It suggested a fixed charge to AGL SA to cover the bad debts it incurs on ETSA Utilities' behalf. The ECC did not believe AGL SA should receive a greater margin because it is the sole standing contract retailer. It also believed intangible assets should be ignored in determining a retail margin.

The ERAA supported the adoption of a retail margin benchmark as a % of sales revenue, as this was consistent with past practice and other jurisdictions, and it is a better reflection of retailer risk. Based on UK experience, it suggested that a margin of at least 8% was necessary to support competition: this was similar to the current margins allowed in Victoria.

The ERAA was critical of the Commission's analysis of margins based on an ROI approach, and in particular noted the:

- ▲ difficulty in determining a value of a retail business;
- ▲ role of the purchase price in intangible asset value;
- ▲ difficulty in setting an appropriate rate of return.

The ERAA believed that the ROI approach to setting retail margins is untested in the Australian context and urged the Commission to continue with its margin on sales revenue approach. It also recommended bad debts be treated with operating costs and not in the margin.

The Minister for Energy saw no justification for an increase in retail margin, and opposed the inclusion of the purchase price of the retail business in the estimation of justified margin, as this would be “double dipping”.

Origin noted that the Commission’s approach in deriving working capital requirements appeared plausible, but recommended the Commission check this with AGL SA.

Origin supported the incorporation of the purchase price in intangible assets, but highlighted the difficulty of benchmarking a price when the Commission’s information demonstrated prices paid in Victoria were significantly higher.

Origin supported use of a retailer rate of return centred on a benchmark return for new entrant generator, but had made previous comments that the ESIPC assumptions were too low. It also commented on the treatment of bad debts, indicating it did not matter where they were allocated as long as they were allowed for.

Origin believed that the 5% on sales margin represents the minimum commercially viable net margin for standing contract supply. To the extent that a price path places greater risks on AGL SA, as compared to an annual price review, the Commission should consider adopting a net margin between 6 and 7%.

TXU supported a light-handed approach to setting the retail margin, based on benchmarking. It supported retention of the measure as a % of total costs. In terms of the ROI approach by the Commission, it noted:

- ▲ working capital needed to take account of high demand/high price period cash flows;
- ▲ an appropriate return on investment was above the level set by the Commission;
- ▲ it did not support this approach.

TXU believed that the appropriate benchmark was the 6 to 7% range applying in the Victorian market. A move to lower margins would question the viability of ongoing investment and competition in the South Australian retail sector.

### **5.3 Commission Comment**

The Commission does not intend to address in this Section each point raised by stakeholders in their submissions. However, the following sections will outline the Commission’s conclusions having considered the submissions and the work undertaken by Commission staff and consultants.





## 6 KEY ASSUMPTIONS

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In undertaking this Inquiry, and in forecasting costs for the next three years, it has been necessary for the Commission to investigate and come to conclusions regarding a number of key underpinning assumptions that have a significant impact on the cost estimates, and it has also had to investigate and come to conclusions on the cost components themselves. This has been necessary so as to form an independent view on the cost components in AGL SA's proposal.

The Commission's investigations of AGL SA's price path proposal, in relation to the underpinning assumptions and the cost components, have been informed by advice and analysis from specialist consultants and auditors, representations and submissions from and discussions with AGL SA, representations and submissions from stakeholders and interested parties, and work undertaken by the Commission's own staff.

This section 6, and sections 7, 8 and 9, set out the Commission's investigations, analysis and conclusions.

### 6.1 *Customer Numbers*

Key underlying factors are the number of standing contract consumers (by tariff), their consumption, and their consumption profile (in terms of peak to average), for each of the next three years. There must naturally be a high degree of uncertainty about such assumptions.

The Commission has a reasonably reliable estimate of the number of small customers (ie those consuming less than 160 MWh/a and to whom the Energy Retail Code applies). It is also able, with a reasonable degree of accuracy, to allocate those small customers to the different tariff categories such as residential, residential controlled load, low voltage business etc.

The growth in customer numbers each year is reasonably consistent for each tariff category, and hence the Commission can be confident of the forward estimates of small customer numbers. For example, the ESIPC forecast assumes a 1.2% pa growth in residential consumers, in line with previous experience.

However, the Inquiry is directed towards small consumers on standing contracts and excludes those who have moved to market contracts (with other retailers or with AGL SA).

To estimate the number of standing contract customers, therefore, requires the Commission to project "customer churn" rates for each tariff category. At the end of September 2004, approximately 29% of small customers had moved to market contracts; this churn had been achieved over the previous 21 months (and primarily in the last 10 months). The rate of churn is expected to taper off as the market becomes more established. There is little relevant information from other markets to provide guidance as to how the churn rate will move over the coming years: the Commission (with help from



ESIPC and AGL SA) has been required to make an estimate of the number of consumers on standing contracts for each quarter out to the end of 2007.

It should be noted that, in reviewing and forecasting AGL SA's operating costs, the Commission has used estimates of AGL SA's small customer numbers (ie covering standing contract and its market contract customers) as its customer services (eg telephone inquiries, billing etc) are provided to both categories and not just standing contract customers.

## 6.2 Customer Consumption

With respect to forecasting annual consumption of standing contract customers, there are at least four key impacts to consider:

- ▲ weather impacts, reflecting the impact of mild or extreme conditions on the level of consumption;
- ▲ price impacts, reflecting the short and long term effect on consumption of the large price increases in 2003;
- ▲ growth impacts, having regard to the traditional growth in consumption associated with the addition of new equipment and appliances; and
- ▲ churn impacts, reflecting the possibility that consumers moving to market contracts have a different average consumption from the average standing contract customer.

There is very limited information available to the Commission on these impacts that is of much assistance in forecasting future consumption of standing contract customers. The ESIPC forecasts prepared for the Commission in September 2004<sup>18</sup> address the first three items, and estimate average sales per customer as follows (these cover all small customers, not just standing contract customers):

TARIFF CATEGORY	AVERAGE SALES PER SMALL CUSTOMER (MWH/A)			
	2004/05	2005/06	2006/07	2007/08
Residential	4.755	4.750	4.770	4.802
Controlled Load	2.653	2.647	2.627	2.613
LV Business single rate	10.5	10.4	10.4	10.3
LV Business two rate	53.4	53.6	53.8	53.9

It can be seen that ESIPC is forecasting only very small changes in average consumption per small customer over the price path period.

<sup>18</sup> Sales Forecasts by Tariff Category for SA's Electricity Distribution Network for the Period 2005/06 to 2009/10, ESIPC, 14 September 2004

The Commission has used the following assumptions in considering the total allowable revenue for standing contract customers over each year of the price path:

YEAR	QUARTER	AVERAGE CONSUMPTION (MWH/Q)	AVERAGE NUMBER OF CUSTOMERS
2005	Jan – Mar	1.90	603,691
	Apr – Jun	1.90	575,747
	Jul- Sep	1.81	549,350
	Oct – Dec	1.81	530,714
2006	Jan – Mar	1.92	512,078
	Apr – Jun	1.92	493,442
	Jul – Sep	1.81	477,956
	Oct – Dec	1.81	464,046
2007	Jan – Mar	1.92	450,135
	Apr – Jun	1.92	436,224
	Jul – Sep	1.80	423,901
	Oct - Dec	1.80	412,373

As indicated in the table, the Commission has chosen to assume an average consumption of approximately 7.4 MWh per annum for standing contract customers throughout the price path period. This is the average consumption used by AGL SA in its 2003 estimates provided to the Commission in the last price review, reflecting average consumption of all small customers.

It has been suggested by AGL SA that consumers moving to market contracts are likely to be the larger consumers, and those remaining are likely to be below average consumption consumers. However, the Commission is aware that in 2004, many of those moving to market contracts were indeed below average consumption consumers, and information collected by the Commission on sales to standing contract and market contract customers in 2003-04 showed that average consumption did not reduce. In the absence of any information to the contrary, the Commission has decided to retain an average consumption of approximately 7.4 MWh per annum for standing contract customers, for its analysis of average revenue caps.

### **6.3 Load Profile**

Assumptions about the load profile of standing contract customers are needed for the task of estimating the wholesale energy cost. The peakier the load, larger amounts of more expensive peaking generation plant are required, and the more uncertain is the amount of contract cover necessary to meet the load (and hence costs are higher).



The Commission has relied on two sources of information on the load profile for standing contract customers: the ESIPC (using data from ETSA Utilities and its own research) and AGL SA (using information on its standing contract customer base). Both sets of information require modification over the price path period to account for changes in the standing contract customer characteristics. The evidence supports a continuing deterioration in the load factor (that is, the load becoming more peaky) over the period, and this has been reflected in the assumptions used.

There are differences, however, between the two sources on the actual levels of demand throughout the period, and these differences can only partly be explained by use of different base years and load probabilities (eg 2001/02 was a very hot year with record demands, whereas 2002/03 was a mild year: so different forecasts will result if either of these years is used as base. Further, ESIPC produces 10, 50 and 90 POE (probability of exceedence) forecasts, and it is open to dispute as to which is the most credible to use in setting a contract purchasing strategy).

ESIPC used its load profile to estimate a LRMC of energy, and these new entrant costs were used by ACG, the Commission's consultants in determining WEC, in considering upper bounds for new contracts for the 2007/08 year.

The Commission's consultants, in estimating the wholesale electricity cost, used both ESIPC and AGL SA demand profile forecasts to construct a number of different scenarios for possible future supply. AGL SA uses its own demand profile to develop its contract purchasing strategy.

The Commission's approach to estimating the future wholesale energy cost by using a number of different scenarios and developing a contracting strategy which minimises the risks of errors in the demand and pool price forecasts, is believed to be an appropriate procedure for managing the uncertainty concerning load profile forecasts.

## 7 WHOLESALE ENERGY COST

The cost component with the greatest impact on standing contract prices (apart from network charges) is the wholesale energy cost – the cost that AGL SA incurs in purchasing electricity from the national market to meet standing contract customer demands. The Commission has therefore devoted considerable resources to ensuring it is able to have confidence in the costs it determines as the basis of the price path.

### 7.1 Current Provision

Electricity Industry Guideline No 10 sets out the current approved cost components for determining the standing contract prices. Schedule 1 details the justifiable wholesale energy cost for the period from 1 January 2004.

**Schedule 1: Maximum Justifiable Wholesale Energy Cost (\$/MWh)**

YEAR 2004	\$/MWh		VOLUME WEIGHTED AVERAGE
	OFF-PEAK	PEAK	
Q1	49.5	127.4	87.6
Q2	49.6	79.4	63.8
Q3	49.4	80.9	65.1
Q4	47.6	63.8	55.4
Average			68.5

The volume weighted average price of \$68.50 per MWh for 2004 was a reduction from the \$71.00 determined to apply in 2003.

While AGL SA's standing contract tariffs for residential and small business customers have a "summer surcharge" which applies to the second step of consumption (> 300 kWh and >7500kWh per quarter for residential and business consumers respectively) during the first quarter period, the surcharge does not fully recover the higher Q1 energy costs, such that a portion of the higher costs is recovered over the remaining three quarters of the year.

### 7.2 AGL SA's Proposal

The public proposal submitted by AGL SA in August 2004 did not include details of the actual wholesale electricity costs claimed by AGL SA for the price path.

The AGL SA Confidential proposal included details of AGL SA's estimate of costs for the bridging period (January to June 2005) and each year of the three year price path. Unfortunately, because AGL SA has claimed confidentiality for these numbers, the Commission is unable to report them.



However, the Commission can report that the numbers for WEC estimated by AGL SA are all higher than the current value of \$68.50 per MWh set by the Commission in December 2003, and in most cases by a significant degree. The prices do fall in each year over the period, but even in 2007 and 2008 are above the currently approved WEC.

AGL SA provided details of all of its contracts, and an audit report on its actual 2003 WEC, in support of its proposed costs.

### **7.3 Submissions**

As reported in section 5.2.1, the Commission received 11 submissions on the Discussion Paper and consultant reports, addressing the estimation of WEC.

A number of submissions stated that it was not possible to comment on the AGL SA proposed WEC, as insufficient details were provided due to the commercially confidential restriction applied.

The main comments received from stakeholders addressed the approach and assumptions used by the Commission's consultants, ACG and ESIPC. A number of industry participants commented that key assumptions underestimated the true costs of factors such as gas price, equipment costs, cost of capital, and contract prices. Others were critical of the scenarios adopted by ACG in developing the risk minimised WEC.

The submissions were reviewed by the Commission and its consultants, and adjustments were made to the assumptions where appropriate. In particular, the Commission decided to modify the following:

- ▲ structure of the five scenarios;
- ▲ cost of gas for both OCGT and CCGT;
- ▲ forward swap contract prices; and
- ▲ use of historical pool prices in modelling.

### **7.4 Commission's Considerations**

In its 2002 and 2003 price investigations, the Commission used a specialist consultant (IES) to assist it in determining the WEC. IES had been used by NSW and Victorian regulators to advise on wholesale energy costs in those jurisdictions for retail price determinations since 2001.

For the current Inquiry, the Commission decided to adopt a different approach to determining the wholesale energy cost from that used by IES. The IES approach essentially developed a most likely scenario and used best estimates of input costs to determine the average price, to which allowances for hedge mismatch and other risks were added. Whilst IES considered a large number of different scenarios (representing different input costs), essentially it modelled one outcome and added costs for uncertainty.

The approach adopted in the current Inquiry was developed by ACG for the Commission, and is outlined in its reports which have been released by the Commission. Essentially, the ACG approach is to develop a number (5) of alternative scenarios about future market outcomes, and to determine a contracting strategy which minimises the risks to the retailer of differences in actual outcomes concerning the level of demand and spot market prices. In other words, assuming these 5 scenarios describe potential outcomes (with some different probabilities of occurrence), the approach identifies the optimal contracting strategy to minimise the financial impact on the retailer of variations in load and market outcomes from its contracting assumptions.

It is not the intention of the Commission to outline in detail here the analysis undertaken by ACG: that is available in the two reports released by the Commission on the ACG work. However, a brief description of the work and its underlying analysis is provided here so as to illustrate the overall approach.

This approach was adopted because the Terms of Reference of the Inquiry specifically required the Commission to have regard to AGL SA's actual costs of wholesale energy, as well as the costs incurred by a prudent retailer. Such a requirement has caused the Commission to gather details on AGL SA's actual contracts, and (subject to confirming that these contracts were prudent), incorporating these actual costs into the wholesale energy price determination.

In previous inquiries into wholesale energy prices, the Commission primarily relied on determining prudent retailer costs and checked a sample of AGL SA's actual contracts to provide comfort about its overall conclusions. In this Inquiry, the Commission has incorporated AGL SA's actual contract costs into its pricing decision.

The Commission's consultants (ACG) have examined all of AGL SA's contracts for the period 2005 to 2008, and considered them against contracts being written by other retailers at the time AGL SA entered into these contracts. ACG has advised the Commission that the prices achieved by AGL SA were in line with market expectations, and concluded that the contracts represented prudent and efficient contracting behaviour by AGL SA.

For the record, the Commission (based on ACG analysis) has estimated, in October 2004, that the costs of swap and cap contracts for supply in the years 2006-07 and 2007-08 are as follows (it should be noted that AGL SA is essentially fully contracted for supply to standing contract customers in the first half of 2005 and 2005-06, and the Commission's estimates of WEC for those periods have not needed assumptions about the cost of future swap and peak contracts as it has been able to use AGL SA's actual contract costs):



WEC MODELLING	ACG ASSUMPTIONS RE FUTURE CONTRACT PRICES	
YEAR	PRICE (\$/MWh)	
	SWAP	CAP
2006/07	42.25	9.50
2007/08	43.00	9.50

These costs are not dissimilar to those reported by larger business consumers to the Commission and current AFMA prices. However, it is important to recognise the significant impact AGL SA does have on the South Australian market, and how market prices for other retailers are influenced by the extent to which AGL SA is contracted or not.

Given AGL SA's dominance in the market, its level of contracting impacts on the South Australian market in two ways. First, if AGL SA is highly contracted with local generators, then the generators will bid into the market in a way to protect their contracted position: that is, they will bid at a low price to ensure they are called upon by NEMMCO to generate, and hence avoid exposure to high market pool prices if contracted but not generating (ie pool prices bear an inverse relationship to the level of contracting – and in SA, particularly the level of AGL SA contracting). Second, if a generator has contracted significant quantities of its output at a price which meets its longer term objectives (ie gives a return on its capital as well as its operating costs), then it is more inclined to enter into additional contracts for smaller quantities at prices less than its long run marginal cost.

The above situations mean it is not possible to judge AGL SA's actual contract prices against spot market prices and prices for small contract quantities: the relationship is a lot more complex.

Obviously, AGL SA will not enter into contracts with generators if the price is too high. However, if AGL SA is significantly under-contracted, it faces the risk of high pool prices. Hence, there is pressure on it to secure contract cover at a price that is reasonable relative to a generator's long run costs.

The ACG approach has been to develop price scenarios of possible futures, based on possible outcomes concerning demand levels, pool prices and linkages between these parameters.

As indicated previously, the level of demand is quite variable and unpredictable, and yet AGL SA must enter into hedging arrangements to minimise the cost impact of its exposure to this variable load. It must decide such questions as whether it should over - or under – contract; and what contracting strategy minimizes the cost impacts of actual loads being different from the most likely loads?



Further, it is necessary to consider the linkages between demand level and pool price: are they perfectly correlated such that high prices only occur wherever demand is high, or do high prices occur on other occasions and if so, can these be predicted in advance? Evidence suggests that, whilst there is some correlation between high demand and high prices, it is not perfect, and retailers must protect against unforeseen events that result in high pool prices.

In the September 2004 Discussion Paper and accompanying ACG report, the 5 scenarios were described and were stated to represent a credible range of possible events, having regard to those which might have a significant impact on AGL SA's exposure (eg a 2000/01 type summer with very high temperatures and air-conditioning demand).

Comments were received from a number of stakeholders on the credibility of these scenarios. AGL SA claimed only one of the scenarios in the first ACG report (Number 2) was credible, and that its risk management policy would not allow it to contract on the basis of the other scenarios. TXU similarly stated that the scenarios were not credible, and NRG Flinders observed that only one scenario considered new entrant pricing. However, as reported in section 5.2.1, the main criticism was the use of historic pool prices rather than a forward-looking estimate, given the tightening of supply and demand.

ACG reviewed the comments received from stakeholders and held discussions with AGL SA and the Commission to consider what changes, if any, should be made to the scenarios and other assumptions. These changes have been reflected in its final report to the Commission, a copy of which is released with this report.

The 5 scenarios adopted by ACG for its analysis in its final report were modified from those in its earlier analysis, and are as follows:

1. AGL SA base case load forecast and AGL SA forecast pool prices.
2. AGL SA load forecast with historical pool prices, perfectly synchronised with customer load, so pool prices are highest when load is highest, and lowest when load is lowest.
3. ESIPC load forecast for medium economic growth and 50% POE, and adjusted for customer switching and other factors. AGL SA forecast pool prices adjusted to have the same synchronisation as for scenario 1.
4. ESIPC load forecast for low economic growth and 90% POE, and adjusted for customer switching and other factors. AGL SA forecast pool prices adjusted to have the same synchronisation as for scenario 1.
5. ESIPC load forecast for high economic growth and 10% POE, and adjusted for customer switching and other factors. AGL SA forecast pool prices adjusted to have the same synchronisation as for scenario 1.



ACG also updated the information on other cost inputs as appropriate, based on stakeholder feedback. The analysis was undertaken for three different cases covering future energy contract prices:

Case A: based on current market prices;

Case B: based on current options prices applied to half of the new contract requirements.

Case C: based on new entrant prices provided by ESIPC.

As reported previously, these prices were applied only to the currently uncontracted requirements of AGL SA to meet future optimal contracting levels as determined by the ACG model: this primarily related to 2007/08, as AGL SA is already highly contracted for its 2005/06 and 2006/07 requirements.

In determining WEC for the price path, it has been necessary for the Commission to select one of these Cases as the most credible for AGL SA's future contracting experience. The Commission considers that it is unlikely that prices will reach the new entrant level in the next 2 or 3 years. Capacity is currently available, and a retailer could lock in future prices at the options price, even though this market is not particularly liquid. Accordingly, the Commission has elected to use Case B as the basis for determining the WEC.

#### **7.4.1 ACG Model Results**

ACG in its final report has determined WECs for the three years 2005-06 to 2007-08 approximately \$5 per MWh higher than in its initial report. This resulted primarily from the changed scenario analysis, the use of forward-looking pool prices rather than historical prices, and from a change in the contracting strategy to avoid over-contracting and false surpluses.

A comparison of ACG's estimates with the costs submitted by AGL SA shows a difference of approximately \$2.1 per MWh over the three year period. ACG advises the Commission that its estimates are very similar to AGL SA's estimates, but the latter adds a further margin to cover for unexpected events and risks not identified in the scenario modelling approach. ACG has advised the Commission that it does not believe that this additional margin is appropriate, and that the WECs calculated in the model are a fair reflection of the most likely WEC. The Commission therefore proposes to use the ACG model estimates for WEC for the price path period.

However, the ACG scenario model had some difficulty accommodating the 6 month bridging period January to June 2005. This period includes the high cost Q1 contracts, and it is difficult to model the allocation of cap costs across the shorter period. Further, the scenario modelling was restricted to use of only 2 scenarios, as data was unavailable for the 6 month period for the remaining 3 scenarios. Accordingly, ACG advised the Commission :

*"We have concerns, however, about the precision of our results for this period, given the absence of a full range of scenarios in the estimation process. Given these concerns, and the similarity of our estimates with those presented by AGL, we recommend that the Commission adopt AGL's estimate for the January to June 2005 period".<sup>19</sup>*

AGL SA's estimate of WEC for the period January to June 2005 was a little over \$78 per MWh, which adjusting for the \$2.1 margin applied by AGL SA, would result in a WEC of approximately \$76 per MWh.

As indicated in Section 7.1, the current price determination for 2004 supply has an average WEC of \$87.6 for Q1 and \$63.8 for Q2, an average of \$75.7 per MWh. The Commission is not aware of any significant changes in the NEM in the period since it made its December 2003 determination which would suggest that this estimate would not apply equally in early 2005 as it did in early 2004 (indeed, in its December 2003 determination, the Commission observed that contract prices were declining and that prices in 2005 could be reduced as the high cost 2001 contracts disappeared).

Accordingly, the Commission believes that a WEC of \$76.0 per MWh should apply for the period January to June 2005 (expressed in December 2004 prices).

## 7.5 Summary

The Commission has decided that the following average wholesale energy costs are the most credible estimates for supply to standing contract customers over the price path period, based on its own evaluation of the January to June 2005 costs and the advice from ACG on the following three year period (expressed below in financial year terms, in December 2004 prices).

	JAN – JUN 2005	2005-06	2006-07	2007-08
WHOLESALE ENERGY COST (\$ PER MWH)	76.00	71.64	68.73	67.55

The Commission also requested ACG to provide the WEC estimates by quarter, using the Commission's estimates for the period January to June 2005 and ACG's estimates for the remaining period. These numbers (reported below in March 2005 prices) were used to determine the NPV of the standing contract controllable costs for the three year period from 1 January 2005.

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<sup>19</sup> Allen Consulting Group "Supplementary Report Energy Wholesale Price Study" Nov 2004, page 18.



YEAR	PERIOD	WHOLESALE ENERGY COST (\$ PER MWH) MAR 05 PRICES
2005	Jan – Mar	92.03
	Apr – Jun	59.50
	Jul – Sep	61.86
	Oct – Dec	63.79
2006	Jan – Mar	98.11
	Apr – Jun	63.43
	Jul – Sep	59.79
	Oct – Dec	61.67
2007	Jan – Mar	92.37
	Apr – Jun	61.70
	Jul – Sep	60.35
	Oct - Dec	62.92

Accordingly, the Commission will revise the numbers provided by AGL SA in its proposal, and use instead the estimates reported above.

## 8 RETAIL OPERATING COST (ROC)

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A retailer incurs operating costs in providing services to standing contract customers such as billing, revenue collection, telephone inquiries, information, and other retail code obligations. These costs have generally been treated by regulators as a cost per customer per annum.

### 8.1 Current Provision

The Commission has extensively reviewed ROC benchmarks from interstate jurisdictions in setting the operating cost allowance for the 2003 and 2004 standing contract tariffs<sup>20</sup>. Those reviews resulted in the Commission setting an ROC of \$80 per customer in 2003 and \$82 per customer in 2004.

### 8.2 AGL SA's Proposal

AGL SA's projected operating costs for the price path period were provided to the Commission on a confidential basis, and are therefore unable to be reported.

However, for the record, AGL SA's proposed ROC are above the current \$82 per customer allowance, and are proposed to escalate at a rate greater than CPI.

### 8.3 Submissions

Submissions on the AGL SA proposal and the Commission's Discussion Paper presented no new evidence, but referred to benchmark allowances in other jurisdictions (see section 5.2.2 for a summary of submissions).

ECC stated that it believed the ROC allowance should be reduced to levels currently applying in NSW, and industry participants drew attention to the notional allowances underpinning the Victorian price path agreements. These values cover a range of approximately \$70 to 92 per customer per year.

AGL SA, in its confidential submissions to the Commission and through its provision of comprehensive audited accounts on operating costs in 2002/03 and 2003/04 (and its budget for 2004/05) did make available new information on its operating costs that provided an alternative approach to the use of benchmarks. Unfortunately, the information provided is commercially confidential and cannot be disclosed in this report.

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<sup>20</sup> See ESCOSA "2004 Electricity Standing Contract Price: Final Report", Dec 2003 (<http://www.escosa.sa.gov.au/resources/documents/031231-R-2004ElecStandingContractPrice-FinalReport.pdf>) and "Inquiry into Electricity Standing Contract Prices: Final Report and Determination", Oct 2002 (<http://www.escosa.sa.gov.au/resources/documents/FinalReport-InquiryElecStandingContractPrices.pdf>)



## **8.4 Commission's Considerations**

The Terms of Reference of the Inquiry required the Commission to have regard to the ROC that would be incurred by a prudent retailer in delivering the range and standard of services required for standing contracts, as well as AGL SA's actual operating costs in delivering these services.

Accordingly, the Commission required AGL SA to provide it with access to its accounts for 2002/03 and 2003/04, from which it created operating costs for calendar year 2003. The Commission arranged with AGL SA for its auditors, Deloitte, to undertake an "Agreed Upon Procedures" audit of the information to confirm that the costs were in accordance with the audited financial statements and that costs had been allocated correctly in accordance with AGL SA's cost allocation procedures.

The Commission reviewed this information to confirm its support for the allocation basis for key cost components (ie that the basis was not inappropriate) and, specifically to review:

- ▲ allocation between standing contract customers and other customers;
- ▲ allocations of costs and revenues between AGL SA and other AGL businesses;
- ▲ allocation of AGL corporate costs between AGL subsidiary businesses.

The operating costs included bad debts, but allowances for depreciation and amortisation were removed (and considered as part of the margin EBITDA).

The 2003 operating costs included special provisions for IT expenditure for the introduction of FRC, revenues/costs associated with work undertaken for ETSA Utilities, and charges for IT project cost over-runs: these were either removed by the Commission or adjusted to a normal expected level of expenditure. The level of bad debt provision was reduced to a more realistic level in line with earlier year expenditures.

In 2003, the number of standing contract customers was almost equal to the number of small customers (consuming below 160MWh/a), as very little market churn had occurred. Therefore, AGL SA's operating costs were divided by the number of small customers to derive a ROC per customer.

This exercise resulted in the Commission concluding an average retail operating cost of \$84 per customer, compared to the \$80 allowed in the December 2002 Price Determination for 2003 standing contract supply (and \$82 for 2004 supply).

The process of examining AGL SA's actual operating costs has demonstrated to the Commission the difficulty of determining with any great accuracy the efficient operating costs of a retail business. The process involved numerous (and arbitrary) decisions regarding the allocation of costs between AGL and other related businesses including AGL SA, and then between standing contract and other customers. It involved judgement as to whether some costs were legitimate (such as marketing expenses) and whether other costs were appropriate and ongoing (such as many of the costs associated with

commencement of FRC, installation of new billing systems, and development of B2B systems for communication with ETSA Utilities and other retailers). Such a process inevitably results in some uncertainty about the efficient and prudent costs of operating as a retailer.

The regulatory regime requires the Commission to have regard to the promotion of efficiency and the provision of incentives to businesses to reduce costs. Use of benchmarks based on reference to other similar businesses' costs is more in keeping with this approach than attempting to determine an individual firm's actual costs (and then building them into the price).

What the review of AGL SA's actual operating costs has shown is that the benchmark adopted in 2003 of \$80 per consumer is similar to the cost estimated through the audit review. The accuracy of the cost allocation is not such as to justify a replacement of the benchmark number with the audit value.

The Commission believes there are reasons why the 2003 estimate could overstate the ongoing operating cost, as there were many one-off FRC and price related events in that year that potentially inflated AGL SA's costs (including the costs of answering consumer queries about price rises and FRC matters in general): these events are not likely to continue into the next three years of the price path.

On the other hand, as customers leave AGL SA for other retailers, the average cost per customer will rise given that some proportion of the operating costs is fixed (at least in the short to medium term). Nevertheless, with the commencement of full retail competition in the gas market in SA from July 2004, it is also likely that AGL SA will be able to use its electricity operations to provide similar services in the gas market, so reversing some of the dis-economies of scale arising from the declining share of the electricity market.

Given the Commission's estimates of customer churn, the average operating cost per customer remaining with AGL SA is likely to increase over the period, offset to some degree by the increasing number of AGL SA consumers on market contracts for electricity and gas (being served by the same operating personnel). Therefore, the Commission has decided to escalate the ROC by a 2 percent margin above CPI from the December 2004 base, for each year of the price path.

## **8.5 Conclusion**

The Commission believes that maintaining the benchmark approach to setting retail operating cost provides AGL SA with a strong incentive to manage these costs going forward. Adjusting the June 2004 ROC of \$82 per customer by CPI gives a December 2004 ROC of approximately \$84 per customer, and the Commission believes (for the reasons set out above) that a CPI plus two percent increase thereafter would be appropriate for future costs.

This allowance is below the level proposed by AGL SA.





## 9 RETAIL MARGIN

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The retail margin is the increment above a retailer's actual costs to cover return on capital, depreciation, amortisation, taxes and profit.

### 9.1 *Current Provision*

In its previous determinations, the Commission has applied a benchmark margin of 5% of total sales (including network charges as well as the retailer's own costs). This margin was chosen from a range of benchmark returns allowed by other regulators (generally covering the range 3% to 5%).

The level of margin, and the application as a % of sales, has been criticised as rewarding AGL SA for the higher network charges in SA, and for being at the top end of the benchmark range.

### 9.2 *AGL SA's Proposal*

Details of AGL SA's proposed margin and a comparison to the allowed margins in Victoria were provided to the Commission on a confidential basis, and therefore cannot be reported here.

Nevertheless, for the record, it can be reported that AGL SA believes that a margin higher than the current provision is justified.

However, AGL SA's proposed margin is consistent with the Commission's previous determination.

### 9.3 *Submissions*

As reported in section 5.2.3, submissions to the Discussion Paper presented a range of views. The ECC stated that the margin should be a fixed amount, and lower than the current allowance. The Minister for Energy could see no justification for an increase from present levels. Retailers and generators, on the other hand, referred to experience in the UK and Victoria to argue that a margin of 7 to 10% was necessary to cover a retailer's risks and give an appropriate return in the competitive market.

Retailers in particular referred to the margins endorsed by the Victorian Government in setting the electricity price path arrangements in late 2003, where margins up to 9% are allowed before triggering a price path reopening.

### 9.4 *Commission's Considerations*

The Commission indicated in its Discussion Paper that margins chosen by regulators have no theoretical basis, and were somewhat arbitrary in their application. It therefore sought to examine whether it was possible to quantify the necessary margin by undertaking a return on investment analysis. The analysis sought to identify the capital in



the business (primarily working capital due to timing differences in payments to NEMMCO, generators, the distributor and operating costs from the receipt of revenue from consumers), the relevant WACC or return on capital, the appropriate depreciation/amortisation allowance, and the provision for bad debts.

Industry participants were critical of the approach and argued strongly that the benchmark approach was preferred. They were also critical of the inclusion of bad debts (and depreciation) in the margin rather than in operating costs.

Other respondents recognised that the approach was useful in attempting to explain what the margin is intended to cover, and to provide some basis for quantifying what that margin should be.

The Commission remains attracted to the attempt of quantifying the margin by calculating a prudent EBITDA (earnings before interest, tax, depreciation and amortisation). It accepts the view that bad debts should be included in operating costs and not EBITDA (see section 8.4).

The Commission has reviewed the numbers included in the Discussion Paper, on the basis of feedback from stakeholders on its earlier assumptions. Changes include:

- ▲ modifying the timing of cash flows to more accurately reflect payments to ETSA Utilities;
- ▲ revising the real, pre-tax WACC to reflect better the risk of retailing (having regard to proposed arrangements regarding pass-throughs and reopening events, which remove many risks from the retailer);
- ▲ accepting the value of intangible assets associated with the purchase of the franchise customer base;
- ▲ accepting the AGL SA provisions for depreciation and amortisation.

The revised calculation for EBITDA is as follows:

	VALUE RANGE (\$M)	
Working Capital	100	125
Intangible Assets	138	167
Tangible Assets	7	8
Interstate Allocation of Assets to AGL SA	10	20
Total Investment	255	320
WACC (real, pre-tax)	8%	10%
Return on Investment	20.4	32
Depreciation	3	4
Total Margin	23.4	36
% of (WEC+ROC)	8%	13%

The mid-point of this range is approximately 10%. This is broadly in line with the Commission's 2003 and 2004 allowance of 5% of total costs, given the network charges represent around 50% of total costs. This calculation gives the Commission some comfort that its benchmark derived number is appropriate for AGL SA's operations as standing contract retailer.

The Commission estimates that such a margin would provide to AGL SA an amount of approximately \$52 per consumer in 2005. In Victoria, where the margin is reportedly 7 to 9 percent of total sales, the margin is estimated to be approximately \$70 to \$80 per customer per year, slightly above the upper range of margins in the above table.

While the Commission recognises the importance of benchmarking against interstate margins, it believes that the margin it is setting is appropriate for the price path period given the risk protection measures it is proposing to implement. Setting the margin at this level also provides a strong incentive for AGL SA to continue to implement efficiencies in its operations.

## **9.5 Conclusion**

The Commission will use a retail margin of 10% of wholesale electricity costs and retailer operating costs as the basis for setting the price path.

This is a different basis to AGL SA's proposal, and is set at a level below that which was proposed by AGL SA.



## **10 FACTORS CONSIDERED BY THE COMMISSION**

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Section 2.4 outlined the factors the Commission is required to have regard to in undertaking this Inquiry. This Section comments on the consideration given by the Commission to each factor.

### **10.1 Essential Services Commission Act 2002 Part 2 Factors**

#### **10.1.1 Section 6(1)(a): Protection of consumer long-term interest**

The Commission's analysis has determined the prudent level of costs that AGL SA would be expected to incur in meeting its standing contract retailer obligations. It has comprehensively reviewed AGL SA's costs, and independently determined the costs that a prudent retailer would be expected to incur. It has set a fair return based on AGL SA's investment in the business and the risks it faces.

Consumers' long-term interests are protected by ensuring the prices charged are based on efficient and prudent costs, while maintaining the financial viability of the retailer and encouraging its continued investment in the industry. The Commission has sought to ensure that this balance of consumer and AGL SA interests is achieved through its pricing decision.

#### **10.1.2 Section 6(1)(b)(i): Promote competitive and fair market conduct**

The Commission has sought to encourage competition between retailers as one way of protecting consumers' long-term interests. In setting the wholesale electricity price (the major component of AGL SA's controllable costs) the Commission has incorporated AGL SA's actual contract costs for swap and cap contracts, many of which were entered into in 2001 and 2002 when market prices were higher than in recent years.

The Commission's consultant advised it that these higher prices were prudent, in that they were seen to be market rates at that time and the market did not expect prices to fall (as they subsequently did). These higher prices from earlier years' contracting have increased the allowable wholesale electricity cost relative to a level based on more recent contracting (during 2003 and 2004).

Accordingly, a retailer purchasing contracts in recent years to supply market contract customers should be able to secure a wholesale electricity price below that allowed for in the standing contract price.

Even without a specific allowance for headroom (which the Commission has not provided for in this report), there should be sufficient margin to encourage ongoing competition between retailers and an ability to offer prices below the standing contract price.



The Commission believes that its decision will promote competitive and fair market conduct by retailers.

### **10.1.3 Section 6(1)(b)(ii): Prevent misuse of monopoly or market power**

Although AGL SA no longer has a monopoly in the sale of electricity to small customers, it continues to serve over 80% of such customers in South Australia and therefore clearly continues to have market power. Many consumers will remain on the standing contract supply, no matter what potential there is to achieve savings by transferring to a market contract.

The Commission therefore needs to ensure that its Price Determination prevents AGL SA from abusing this situation. The prices set must attempt to replicate a truly competitive market and ensure AGL SA's prices are at a level which provides an appropriate risk adjusted return (and no more).

The Commission's decision, based as it is on AGL SA's actual costs and the costs of a prudent retailer with its responsibilities, should ensure that the potential for abuse of market power is minimised.

### **10.1.4 Section 6(1)(b)(iii): Facilitate entry into markets**

For the reasons set out in 10.1.2 above concerning wholesale energy prices, the Commission's decision should provide an opportunity for other retailers to join the market and offer competitive prices to consumers.

### **10.1.5 Section (1)(b)(iv): Promote economic efficiency**

The Commission has considered interstate benchmarks in determining prudent costs for a retailer, and this gives some guide as to efficient costs. The wholesale energy cost has been determined in a model which optimises contract cover so as to minimise risk, and this is considered to produce an economically efficient outcome.

### **10.1.6 Section 6(1)(b)(v): Ensure consumers benefit from competition and efficiency**

The Commission has determined the efficient costs of operating as the standing contract retailer. While it has had regard to AGL SA's actual operating costs, it has used them primarily to check that its prudent and efficient cost estimates are credible. For wholesale energy costs, the Commission has had regard to AGL SA's actual contract costs in setting prudent prices for the period.

Accordingly, benefits arising from competition and efficient practices have been passed through to consumers in the standing contract price.

Further, as mentioned in 10.1.2 above, the standing contract prices also provide an opportunity for retailers to offer market contracts to consumers at even lower prices: the existence of strong competition between retailers should also lead to benefits to those consumers who take up the opportunity to switch.

#### **10.1.7 Section 6(1)(b)(vi): Facilitate maintenance of financial viability and incentive for long-term investment**

The Commission has undertaken a comprehensive evaluation of the investment of funds by AGL SA in the standing contract retail business, and considered the risk-adjusted return appropriate for such an investment. The retail margin set by the Commission provides for a return which supports the investment and other costs incurred by the retailer.

Further, the other cost components (wholesale energy cost and retailer operating costs) have been set at a level reflecting retailer risks and operating costs.

The Commission's decision should therefore provide an appropriate return to an efficient retailer, and support further investment in generation, network and retailing businesses. This will facilitate the ongoing financial viability of the industry, and protect consumers' long-term interests.

#### **10.1.8 Section 6(1)(b)(viii): Promote consistency in regulation**

The arrangements for a price path set by the Commission are unique to South Australia, given the price path is applied to a privately owned business. In NSW, the regulator sets prices for the government-owned retailers over a period of some years, but the NSW government has other arrangements to manage the impact on retailers (such as the ETEF arrangement between generators and retailers). In Victoria, the price path is negotiated between the retailers and the government, and the regulator is not involved.

It is therefore difficult for the Commission to promote consistency when the legal and administrative arrangements are so different.

Nevertheless, the Commission has had regard to cost benchmarks from other jurisdictions, and sought to be consistent with decisions of other regulators where they are appropriate for South Australia.

### **10.2 Essential Services Commission Act 2002 Part 3 Factors**

#### **10.2.1 Section 25(4)(a): Particular circumstances of regulated industry and goods being regulated**

The Commission has specifically focussed its evaluation on the provision of standing contract services in the South Australian electricity market. Further, it has had regard to AGL SA's specific circumstances and costs.



### **10.2.2 Section 25(4)(b): Costs of supplying the services**

The Commission has, through this Inquiry, sought to obtain specific information on the costs to AGL SA of providing standing contract services.

It has (with the assistance of consultants and AGL SA's auditor) reviewed historical costs and projections, and modelled future wholesale energy costs based on actual contract prices.

Through other work, the Commission has sought to obtain information on the costs of operating as a standing contract retailer, including by a review of benchmark costs from other jurisdictions.

While it is difficult to estimate future costs when the actual future costs depend on such factors as the weather, NEM outcomes and the behaviour of other market participants, the Commission has used expert advice and modelled a number of different scenarios in producing its best estimate of the future costs of supply. Further, the Commission released reports and discussion papers that outlined its assumptions and approach, and sought comment on them from stakeholders (including AGL SA).

The Commission has considered these comments in reaching its decision. It believes that its conclusions have significant regard to the actual costs of providing standing contract supply.

### **10.2.3 Section 25(4)(c): Cost of complying with laws and regulations**

The Commission has included in its estimate of the wholesale electricity cost the costs of market participation and environmental change. The retailer operating costs also include a provision for legal and regulatory compliance.

### **10.2.4 Section 25(4)(d): Return on assets in the regulated industry**

The Commission, in determining the appropriate retail margin, has reviewed the return on assets that an investor might expect for investing funds in the retail industry. While there was limited information available on a benchmark return for retailing, the Commission's decision has included consideration of this factor.

### **10.2.5 Section 25(4)(e): Relevant interstate benchmarks**

The Commission has considered the equivalent of standing contract prices in interstate jurisdictions, particularly Victoria and NSW. It has also had regard to the different components of prices in these jurisdictions, and confirmed reasons for differences with South Australian costs.

The Commission believes that the interstate benchmarks confirm the credibility of its own decision on input costs and standing contract prices.



### **10.2.6 Section 25(4)(f): Financial implications**

In setting the relevant cost components for determining the standing contract prices, the Commission has had regard to AGL SA's costs and the financial implications of this decision on its viability (see 10.1.7 above).

The Commission has also had regard to the financial implications for consumers, and has sought to protect consumers' interests with respect to price (see 10.1.1 above).

The decision seeks to balance the financial implications between the interests of consumers and the retailer.

### **10.2.7 Section 25(4)(g): Factors specified by Act or Regulation**

As indicated previously in 2.4, there are a number of other factors specified in the Electricity Act including consistency with the National Electricity Code; promoting efficiency and competition; promoting the establishment and maintenance of an efficient system of electricity generation and supply; establishing proper standards of reliability and quality of supply; and protecting the interests of consumers.

These additional factors have already been covered in the previous discussion. There is potentially the added requirement to consider the establishment of efficient and reliable systems of generation and supply; but the Commission believes that this decision provides the necessary funding and price signals to support investment in generation, network and retail operations.

In basing its decision on an assessment of efficient costs, the Commission is ensuring the maintenance of a safe and reliable electricity industry and protecting the interests of consumers.

### **10.2.8 Section 25(5)(a): Costs and benefits of regulation**

The Commission does not believe there would be any significant costs of regulation imposed on AGL SA as a result of this decision. AGL SA will need to substitute new prices for the existing ones, but that should be a reasonably straight forward matter through the computer system. There are no major ongoing or compliance costs associated with the decision, apart from those required by law.

### **10.2.9 Section 25(5)(b): Articulate trade-off between costs and standards**

With regard to the trade-off between costs and service standards, the Commission has been keen to ensure that AGL SA's existing service standards (as spelt out in the Retail Code) are maintained, and have not been reduced as part of this decision. The allowance of the base \$84 per customer for retail operating costs increasing at two percent above CPI, and the 10% retail margin, should ensure that service standards can be maintained at current levels. The Commission will continue to monitor and report on AGL SA's performance in this regard.



## **10.3 Terms of Reference of Inquiry**

### **10.3.1 TOR 3.1: Investigate the standing contract price proposal**

On 20 August 2004, AGL SA made a submission to the Commission proposing a price path for standing contract prices for the period to 30 June 2008. The Commission was required to investigate this proposal, which was provided to the Commission by AGL SA in response to the initial information request set out in the Issues Paper.

The Commission has investigated this proposal and reviewed the basis of costs identified by AGL SA using consultants, auditors and its own resources. These independent reviews have assisted the Commission investigate the basis of the proposal to ascertain if it was justified.

### **10.3.2 TOR 3.2: Restricted to prudent controllable costs**

The Commission's assessment was limited to reviewing AGL SA's prudent controllable costs, namely the wholesale energy cost, the operating costs and the retail margin. The TOR instructed that no allowance should be made for headroom.

This Inquiry has only considered the three components of retailer controllable costs. In addition, it has not made any provision for headroom.

### **10.3.3 TOR 3.4.1: AGL SA's justification**

The AGL SA submission of 20 August 2004 included a confidential document providing greater detail in support of the proposal (compared to the public version of the submission).

The Commission has also sought additional information from AGL SA on various aspects of its submission.

Commission staff and consultants have met with AGL SA on a number of occasions, to better understand its justification for the proposed prices.

### **10.3.4 TOR 3.4.2: Prudent retailer energy contracts**

The Commission engaged consultants to assist it:

- ▲ review AGL SA's existing contracts for supply over 2005 to 2008, to determine if they were prudent;
- ▲ determine what a prudent retailer's hedging and contracting strategy would be;
- ▲ estimate what future quantities of swap and cap contracts would be required, and what prudent prices would apply.

The conclusions from this evaluation were used as input assumptions into a model to estimate the prudent wholesale energy cost for each year of the price path.

### **10.3.5 TOR 3.4.3: AGL SA's contracts and hedging strategy**

Consultants and Commission staff reviewed AGL SA's existing contracts that relate to electricity supply from 2005-08, and considered them in the context of AGL SA's overall hedging strategy and risk management policy.

It also reviewed actual contracts and outcomes for 2003, and how those costs could be allocated between large and small customers (and ultimately standing contract customers). The Commission was assisted by AGL SA's auditors, Deloitte, in ensuring audited cost numbers were available for this work.

The existing contracts for supply over the period 2005-08 were incorporated into a scenario model to provide estimates of the optimal contract quantities and wholesale energy price, to minimise the risk to the retailer of different demand levels and market outcomes. AGL SA's existing contracts played an important role in this analysis.

### **10.3.6 TOR 3.4.4: Prudent retail operating costs**

The Commission reviewed allowances in recent regulatory and government pricing decisions for retail operating costs, and sought comment from stakeholders on the appropriateness of these benchmark allowances. Possible reasons for differences from interstate retail allowances were considered, including economies of scale, relationship to distributors, and different roles and responsibilities.

### **10.3.7 TOR 3.4.5: AGL SA's actual operating costs**

With the assistance of independent auditors, the Commission examined AGL SA's financial accounts and reviewed cost allocations between businesses and consumer groups. This exercise was undertaken for calendar year 2003, and was extended to include a review of 2004-05 budgeted expenditure and forecast expenditure for 2005-06.

While allocation of costs is very dependent on assumptions about cost drivers, this exercise enabled the Commission to consider actual costs incurred within the South Australian retail business, and to be able to compare these with benchmarked operating costs from other States.

### **10.3.8 TOR 3.4.6: AGL SA's proposed margin**

AGL SA's submission argued that an appropriate margin for an electricity retailer was in the range 7 to 10% of total costs (including network charges), but based its price path proposal on the margin the Commission had previously adopted of 5% of total costs.



The Commission examined the actual margin achieved in 2003 (the first year of standing contract supply), although this required many assumptions about cost allocation and cost drivers.

Separately, the Commission derived a margin from first principles, having regard to AGL SA's investment in the retail business, the required working capital, the appropriate return on investment, the relevant amortisation and depreciation, and the level of bad debts. The Commission sought stakeholder comment on the assumptions it had used, and incorporated these into a final view on the justifiable level of retail margin based on its assessment of the funds invested, the risk of that investment and the margins achieved by Victorian retailers.

### **10.3.9 TOR 3.4.7: Cross-subsidies**

The Commission has compared estimates of revenue at different levels of consumption with estimated costs of supply for different tariff classes, in order to identify cross-subsidies between and within tariff types.

### **10.3.10 TOR 3.4.8: Interstate prices**

The Commission compared prices at various levels of consumption under different tariff types, with interstate prices for the same levels of consumption and customer type.

In NSW, Victoria and South Australia, it is possible to obtain published tariff schedules for the equivalent of standing contract supply for each retailer (as set by the regulator or Minister) and also the network charges (as set by the regulator). It is therefore possible not only to compare total prices payable at different consumption levels, but also the network charges and the retailer controllable costs.

The Commission has compared the retailer controllable costs (covering wholesale energy costs, retail operating cost, retailer margin) for each retailer in NSW, Victoria and South Australia. It has then considered the possible reasons for any differences and whether these can be justified.

## **10.4 Summary**

The Terms of Reference of the Inquiry required the Commission to consider all of the above factors in "reviewing AGL SA's prudent controllable costs." This Section has sought to outline briefly how the Commission has considered each factor, and the approach it has taken to ensure it complied with the Terms of Reference.

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# **PART C: APPLICATION METHODOLOGY**

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## 11 PRICE PATH AND CONTROLLABLE COSTS

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The Terms of Reference for this Inquiry restricted the Commission to a consideration of the retailer controllable costs: that is, those components of the standing contract tariffs charged to small customers excluding the network charges and GST.

Network charges are set by the Commission in a separate and quite distinct process. The Commission is currently undertaking the electricity distribution price review, a process which will set ETSA Utilities' network charges (or DUOS) for the period 1 July 2005 to 30 June 2010. Charges for use of the ElectraNet transmission network (TUOS) for the period 1 July 2003 to 30 June 2008 have already been set by the ACCC. Accordingly, the network charges (TUOS and DUOS) applicable to standing contact customers for the period of the price path will be fixed independently of this review.

It should be noted that both TUOS and DUOS charges are in the form CPI-X, with additional adjustments each June for service incentive scheme payments and other adjustments; the CPI is based on the previous 12 months ending 31 March. Hence, whilst the price path formula is fixed, the actual price is not able to be determined until late May or early June each year. This makes it difficult to factor in the network charge at this time, and to incorporate it in a price path formula.

Further the retailer has no ability to manage or control these network charges (at least in the medium term): they are not a controllable cost of the retailer.

It is for these reasons that this Inquiry limited the Commission to a consideration of the retailer's "controllable costs". These costs are the wholesale electricity cost, the retailer operating costs and the retailer margin – costs that a retailer is able to influence through its own business skills and practices.

The difficulty for the Commission arises when it seeks to set a price path for the standing contract price seen by the consumer; that is, for the total of network charges and retailer controllable costs. It is extremely difficult, if not impossible, to combine these components into a simple, single price control mechanism when each is separately controlled.

Accordingly, the Commission believes it is best to treat the two elements separately, and to combine them in June each year to produce the price schedule seen by standing contract customers.

Therefore, this Inquiry has focussed specifically on how to apply a price control process to the retailer controllable cost component of standing contract prices. It will assume that the other components (that is, network charges and GST) will be added to the allowable controllable costs to produce the standing contract tariffs.

Treating network charges as a pass-through was supported by all stakeholders commenting on the Issues Paper. Under the South Australian legislative scheme, network charges are levied directly against customers under their connection and supply



contracts with ETSA Utilities; AGL SA's (and other retailers') role is to collect those charges on ETSA Utilities' behalf as an agent. This is done through a straight incorporation of those network charges into retail tariffs. It was accepted by all stakeholders that, as these costs cannot be controlled by the retailer, any changes in network charges (positive or negative) must flow through directly into customer tariffs.

The Commission believes that it is therefore appropriate to limit its price path controls to the retailer controllable costs. Network charges should be passed through directly into standing contract prices, and any changes in network charges should be passed through by an adjustment to standing contract prices, whenever they occur.

### ***11.1 Price Path Period***

In the Discussion Paper (Section 3.4.2), the Commission commented on the appropriate period for the price path. Previous submissions on the Issues Paper had varied from 4 years down to an annual review; AGL SA's proposal had been for 3 years from 1 July 2005, with a six month bridging price from 1 January 2005.

The Commission indicated in the Discussion Paper that it would adopt AGL SA's proposed period, extending to 30 June 2008. It suggested it would do this by issuing a Determination in December 2004 for the period January to June 2005, and another Determination in March 2005 for the 3 year period commencing 1 July 2005.

The Commission received legal advice that indicated it could not issue a Price Determination in December 2004 covering a 6 month period: Section 36AA(4a)(b) of the Electricity Act requires any determination to be for a period of at least 3 years.

On this basis, the Commission has decided that it will make a determination in December 2004 to change prices from January 2005, but covering the three year period to 31 December 2007. It will provide in the Determination for a "price path variation event" to allow the average price cap escalation factors to be adjusted if the underlying cost components are changed in the Final Report from those proposed in this draft report, if the change would have a material effect on the average price cap.



## 12 FORM OF REGULATION FOR RETAILER CONTROLLABLE COSTS

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In the Issues Paper, the Commission identified a number of options for the form of regulation it could apply to the retailer controllable cost components. These were:

- ▲ setting the maximum annual revenue or price that AGL SA could earn from standing contract customers for each year of the period, and allowing AGL SA to collect that revenue or achieve that price from the various customer categories as it saw fit (or within additional constraints specific to customer categories);
- ▲ setting the actual price that can be charged to each customer or tariff category over each year of the price path; or
- ▲ setting a starting price for each customer or tariff category, then having a formula for annual adjustments (such as a CPI-X adjustment or other measure).

These options would be considered in addition to cost pass-throughs for certain events (such as tax or fee changes applicable only to the electricity industry, or a regulated change in services to be provided by the standing contract retailer), and revoking and replacing the price path determination if special circumstances arise. The Commission's approach to revoking the determination will be discussed in Section 13.

The Commission has identified the prudent and efficient retailer controllable costs that AGL SA should be entitled to recover over the price path period. These costs can be recovered by setting tariffs that smooth the changes across the years, but result in the same collection of total revenue as if the tariffs were set exactly to recover the costs in each period. The net present value of both streams (ie of costs and tariff revenues) must be the same. The Commission will henceforth refer to these tariffs that provide the same NPV of revenue to AGL SA as the NPV of the controllable costs, as the 'retailer tariffs'.

This Section therefore focuses only on the form of regulation for the retailer tariffs. The Commission indicated in the Issues Paper that, in choosing the appropriate form of regulation for these tariffs, it would have regard to the form of regulation in other jurisdictions, the views put forward by stakeholders, and the ease of administration and compliance with the proposed form of regulation.

### **12.1 Stakeholder Comments**

In general, most stakeholders argued for a "light handed" form of regulation that did not involve the Commission in frequent re-visits to the price path. Whilst stakeholders were not specific about what they considered were "light handed" characteristics, the implications were that they should be at the broad level of detail and not involve the Commission in detailed review of individual tariffs throughout the period. In other words, "light handed" was seen to be an approach whereby the Commission would set the



allowable price path and simply monitor its application: the price path would be re-opened in only very limited circumstances.

The Commission summarised in its Discussion Paper the stakeholder submissions it had received on this matter as raised in the Issues Paper (see in particular page 17 and following in the Discussion Paper).

The Discussion Paper also sought comment on a number of key issues relating to the form of regulation, including:

- ▲ to what measure should the price path control be applied?;
- ▲ whether it was necessary to control supply charges and energy charges within a tariff;
- ▲ what degree of flexibility should AGL SA be allowed to change average prices between tariffs;
- ▲ the method for achieving compliance with the price path.

The Commission received a number of submissions addressing these issues, and they have been summarised in section 5.

## **12.2 Discussion**

Section 25(3) of the Act says that the Commission may regulate prices, conditions relating to prices, or price-fixing factors in any manner the Commission considers appropriate; it also includes a list of possible approaches to fixing a price.

The Commission has given consideration to the most effective form of price control for the retailer controllable cost components of the standing contract price path.

At the present time, there are nine different tariffs covering supply to small customers under standing contract terms and conditions. Options available to the Commission therefore include the application of a price control to:

- ▲ each tariff individually;
- ▲ the total of all tariffs combined;
- ▲ a weighted basket of individual tariffs;
- ▲ selected (key) tariffs.

Other possibilities, such as providing guidelines or pricing principles to AGL SA and price monitoring, are considered to be too general and light-handed (and therefore inappropriate) for this stage of development of the competitive market.

The Commission, as previously reported, has identified the justified level for wholesale energy cost, retail operating cost and retail margin for each year (and indeed, every quarter of each year) of the price path to December 2007. In addition, the Commission has estimated the average number of consumers and level of demand (MWh) for each of

the above periods, based on ESIPC forecasts and AGL SA assumptions regarding customer churn.

As a result of this work, the Commission has produced justified price components, for each period of the price path (on a constant pricing basis):

- ▲ wholesale energy cost;
- ▲ retail operating cost;
- ▲ retail margin;
- ▲ average revenue per MWh for standing contract customers in total.

The Commission has considered how suitable this information is for application of a price control to the different options above (individual tariffs, total revenue, weighted basket of tariffs). The relative advantages of each option are discussed below.

## **12.3 Price Control Options**

### **12.3.1 Cost components and individual tariffs**

One possible approach available to the Commission is to specify the allowable cost components for each year (ie wholesale energy cost, retail operating cost, margin) and to require AGL SA to present its proposed retail tariffs to the Commission each May for approval (to apply from the following 1 July). The ETSA Utilities network charges would be approved in the same timeframe, allowing the final standing contract tariffs to be approved by mid June for a 1 July commencement.

The advantage of this approach is that it would allow more reliable estimates of customer numbers and average consumption to be used each year, and it also would allow some changes between individual tariffs to be considered.

The disadvantage is that it does not provide the same clarity of actual prices out for the three years that some other options provide.

### **12.3.2 Average price cap applied to total standing contract revenue**

This approach would apply the Commission determined average price cap (\$/MWh) to the total net retailer revenue and sales from all standing contract tariffs combined.

AGL SA would need to submit to the Commission in May each year its projected standing contract customer numbers and consumption by tariff, and its proposed tariffs for recovery of its controllable costs, and demonstrate that the total revenue divided by the total sales was no more than the average price cap set by the Commission for that year.



ETSA Utilities' network charges would need to be added to obtain the standing contract tariffs, and these could be approved by the Commission in mid June for a July commencement.

The main advantage of this approach is that the price path is quite visible and easy to comprehend for the retailer's tariffs for standing contract supply.

The disadvantages are that it could potentially lead to significant changes in individual tariffs (although these could be restricted by side constraints applying to individual tariffs or consumer impacts), and it is potentially more sensitive to the accuracy of the Commission's estimates in this Inquiry of customer numbers and consumptions.

### **12.3.3 Average price escalation applied to individual tariffs**

In this approach, the percentage change in the average price each year determined by the Commission in this Inquiry would be applied to the individual retailer tariffs: that is, the individual components of each existing tariff would be allowed to change by the set percentage for each year.

Again, AGL SA would be required to present to the Commission each May its proposed charges for each customer group, based on the common escalation factor as set by the Commission based on this Inquiry. These charges would be added to ETSA Utilities' network charges for the following year, to obtain the approved standing contract tariffs.

For simplicity, it is probable that both the AGL SA supply charge and energy charges would be escalated by the same factor. Alternatively, it might be possible to consider different changes for these components, provided that AGL SA could demonstrate that the increase in the overall average price would not exceed the approved escalation.

The advantage of this approach is its simplicity for consumers, given it is a straightforward adjustment to existing prices. It also provides for greater clarity of the price path for each tariff.

The main disadvantage is its inflexibility, in that all tariffs move at exactly the same rate: there is no ability to adjust prices differentially across tariffs. It is also potentially sensitive to the accuracy of the Commission's estimates in this Inquiry of customer numbers and consumption.

All of the above options suffer from the risk that the Commission's underlying assumptions in estimating the future component costs turn out to be unreliable. In particular, assumptions about the number of customers on each tariff, the average consumption per tariff, and the average wholesale electricity cost, would appear to be of some significance.

The Commission gave extensive consideration to which factors might be covered in re-opening arrangements to allow variation of certain values within the price control, and what magnitude of change in the assumptions (or what event causing the change) should act as a trigger for a review.

However, the main purpose of a price path is to provide certainty (to AGL SA and consumers) of standing contract prices over the period: hence it is not desirable for a re-opening to be frequent or for small changes, as that would undermine the intent of the arrangement. The Commission has therefore decided not to make provision for such re-opening events in the price determination.

Nevertheless, major or unexpected events that have a significant impact on costs and margins, should be a basis for a review and potential revision. This is considered further in Section 13.

## **12.4 Preferred Price Control System**

Having considered the relative merits of the different approaches, the Commission has determined to apply an average price cap to the combined total of the retailer (standing contract) tariffs (Option (ii) above), in conjunction with tight side-constraints on individual tariff changes. This will provide AGL SA with some flexibility in adjusting tariffs over the three years to reduce cross-subsidies across and within customer classes, but will prevent major step-changes in prices to individual consumers.

The price control system will be as follows:

- ▲ There will be four separate “regulatory periods” covering the price path period:
  - The initial regulatory period covering 1 January 2005 to 30 June 2005
  - Two regulatory periods covering the financial years 2005-06 and 2006-07
  - The closing regulatory period covering 1 July 2007 to 31 December 2007.
- ▲ the Commission will set in its December 2004 Price Determination the actual retailer tariff components of the standing contract tariffs for supply to small customers for the 6 months period from 1 January 2005,
- ▲ the Commission will also set a base value for the average retailer price cap for the retailer tariff component of the combined standing contract tariffs (exclusive of GST), and a CPI minus X adjustment to apply from 1 July 2005 and each year thereafter;
- ▲ in May each year (2005, 2006 and 2007), AGL SA will be required to submit to the Commission information on the forecast number of standing contract customers and total consumption for each standing contract tariff for the following regulatory period, and demonstrate:
  - that the total revenue (from the “retailer tariffs” component of the standing contract tariffs) divided by total consumption, is no more than the allowed average retailer price cap ;



- that the charge at any level of consumption for each “retailer tariff” :
  - ▶ for residential and off-peak controlled load customers, is no more than (CPI plus four percent) above the charge applying at the time; and
  - ▶ for all other customer types, is no more than the greater of (CPI plus four percent) above or \$40 more than the charge applying at that time;
- ▲ the Commission will review both the AGL SA proposed charges, and the ETSA Utilities network charges, and confirm the new prices (GST exclusive) for each standing contract tariff category, to apply from 1 July each year (in 2005, 2006 and 2007) ;
- ▲ AGL SA will then be required to publish the final standing contract tariffs (GST exclusive and inclusive) before 30 June each year.

This price control system, with its associated tariff control side constraints, will be set out in a Price Determination. The system will make provision for AGL SA to close existing tariffs, and open new ones, at the start of each regulatory period commencing 1 July, with appropriate review by the Commission and protection of consumers’ interests.

### ***12.5 Pass-through Events***

The Commission has concluded that there should be only four events that would result in an automatic pass-through of net additional costs to the approved retailer tariffs, and ultimately to standing contract prices. The relevant pass-through events would be:

- ▲ a change in taxes event, affecting only the electricity industry;
- ▲ a regulatory reset event, which imposes different obligations on AGL SA as standing contract retailer
- ▲ a reserve trader event, where NEMMCO imposes charges on retailers for reserve trader activities, and
- ▲ a NEMMCO direction event, where it directs a party to take an action which results in the imposition of a cost on the retailer.

In addition, as previously indicated, changes in network charges will be treated as a pass-through for standing contract prices.

### ***12.6 Price Path Variation Event***

The Commission intends to make a Price Determination in December 2004 (commencing on 1 January 2005 for the three year period 2005 to 2007), based on the conclusions in this draft report. Accordingly, in setting the values of the average retail price cap and escalation factors in the Determination, it will not have concluded its Inquiry and had the opportunity to review its draft conclusions based on stakeholder feedback. The Commission may change its prudent cost components (and hence the average retail price cap and escalation factors) in its Final Report from those on which the Price Determination is based.

Therefore, it will be necessary to provide for a Price Path Variation Event, to allow the Commission to revise its average price cap escalation factor (CPI minus X) in the event it changes the prudent cost components from those in this report, where such changes would have a material impact on the escalation factor.

## ***12.7 Implications of Price Control System***

Choosing this particular form of price control has implications for the Commission (in its setting of average retailer price caps) and for AGL SA in preparing its annual retailer tariffs.

The Commission has estimated the most likely costs for each of the components (wholesale energy and retail operating costs) for each period of the price path. These costs are a reasonable assessment of actual and prudent costs (at least as reasonable as could be expected for an ex ante estimation), although there is no guarantee they will be achieved.

In addition to the uncertainty associated with changes to the key input assumptions in the Final Report, there are other uncertainties relating to:

- ▲ any new levies, taxes, charges or responsibilities placed on AGL SA (and it is proposed these will be treated as a pass-through); and
- ▲ the impact of unexpected events or special circumstances (and it is proposed these be dealt with under the new “special circumstances” provisions in Section 36AA of the Electricity Act – see discussion in the next section).

The benefits to the Commission of choosing this form of price control are that it will provide a clear guide (to consumers, AGL SA and other retailers) to the price path for retailer tariffs for the next three years; the cost pass-through events and special circumstance events have only a small chance of occurring and yet provide some protection to consumers and retailers if things are significantly different from the Commission’s conclusions in this Inquiry.

If such events do not occur, then the role of the Commission is simply to ensure every May/June that AGL SA’s proposed retailer tariffs from the following 1 July comply with the Determination: it is as light-handed a form of regulation as is possible in the circumstances.

The benefits to consumers from this arrangement are that they can have a clear view out three years as to the price to be paid to the standing contract retailer (a similar view will apply to the price to be paid to ETSA Utilities once that decision is made by the Commission), and this should allow the consumer to make an informed choice of retailer for market contracts extending beyond one year. Further, the average retailer price cap system allows the consumer to easily understand the general direction of prices over the price path period: it is a reasonably simple concept to explain.



In addition, the individual tariff side constraints will provide some comfort to residential consumers that they will not experience an increase in price (at the same level of consumption) of greater than CPI plus four percent in any year (or approximately 6.5%), offset by any reduction in the network component of the standing contract price). For small businesses, the maximum increase in any year will be the greater of CPI plus four percent or \$40.

The advantage to AGL SA from the proposed price control system is that it can undertake some re-balancing of tariffs to move towards greater cost reflectivity and to gradually remove any remaining cross-subsidies (although these cross-subsidies will not be fully removed during the three year period). The administrative implications of the proposed approach are minimal, and only require AGL SA to submit proposed retailer tariffs and report compliance with the Price Determination in May each year: it will not have to participate in a lengthy price review process that has been undertaken in 2002, 2003 and 2004. Finally, knowing the allowed costs as set by the Commission, AGL SA is able to seek further efficiencies and economies below these costs, in the full knowledge that it can retain these benefits until the next price review in 2007.

Other retailers benefit from the certainty of a clear price path out to end 2007, and the knowledge of the target price they need to achieve if they are to attract small customers to their market contracts. This greater certainty should encourage retailers to participate more actively in the small customer retail market.

The Commission believes that the proposed approach gives the greatest certainty to consumers and retailers about future prices, whilst achieving a reasonably non-intrusive regulatory role. The opportunities for varying the price path have been kept to the minimum necessary to provide appropriate protection to AGL SA and consumers against unforeseen events impacting on the Commission's conclusions in this Inquiry and the design of the price path.



## 13 SPECIAL CIRCUMSTANCES AND PRICE PATH RE-OPENING

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As indicated in the previous Section, the Price Determination should provide for limited opportunities for re-opening the price path. Small changes can be accommodated via pass-throughs, where an amount is added to or subtracted from the maximum average price set by the price path (but the underlying price path arrangements remain unchanged).

However, there may be some situations where the impact of an unexpected event is so great as to undermine the whole basis of the price path as determined through the Inquiry. Fundamental changes in the market, or the cost of events that far outweigh the costs as determined in the Inquiry, may justify the Commission revisiting the analysis and deciding to revoke the price path and replace it with a more appropriate path for the future. However, the Commission would wish to restrict the opportunities for such a process to those matters of material impact, and not to allow re-opening whenever there are small changes in costs or assumptions.

In adopting this limited approach, the Commission has had regard to section 36AA(4a)(d) of the Electricity Act, which will come into operation from 1 July 2005. That section permits the Commission to make a new determination if “special circumstances” are determined to exist. Section 26(8) of the ESC Act also provides that a price determination may be varied or revoked by a subsequent determination of the Commission.

The Commission considers that “special circumstances” will generally be events of a magnitude such as to disturb the fundamental basis of an existing Price Determination so much as to require a new determination to be made. The Commission, AGL SA or any other interested party should have the ability under the Electricity Act to ask the Commission to consider whether special circumstances have arisen such that the determination should be reviewed and possibly replaced.

The Commission has not, therefore, sought to displace the operation of the Electricity Act through this Price Determination by providing for additional grounds to re-open the price path determination. The Electricity Act provides grounds for reviewing the determination if special circumstances arise, and the Commission is satisfied that this is sufficient. The Commission expects that if an unexpected event occurs which can be shown to have a material impact on the credibility of the average price cap, a review would be initiated to determine if the event was unable to be predicted, planned for or reasonably insured against, and whether it had a material impact on AGL SA’s prudent costs, such that the average price cap was no longer credible. If this was the case, the Commission would proceed immediately to undertake an inquiry and to vary or revoke the determination.



## 14 AGL SA REVENUE AND PRICE PATH

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The Commission has in the previous sections set out its analysis of the information presented to it on the three key areas of cost: wholesale energy cost, retail operating cost and retail margin. In all three areas, it has come to different views on costs than those presented by AGL SA.

It should be noted that the role of the Commission in this Inquiry and in making a price determination is not simply to have regard to actual costs or to AGL SA's commercial interest. While these are factors it is required to have regard to (and has), it is also required to consider other factors such as efficient costs and consumers' interests. In replacing AGL SA's proposed costs with its own, the Commission is simply undertaking its duty of balancing the different objectives and factors set out in the legislation and Terms of Reference of the Inquiry. It is seeking to ensure that AGL SA recovers sufficient revenue to cover efficient costs, that it provides incentive to AGL SA to secure further economies and efficiencies, and that consumers receive the benefits of competition through lower prices and improved service over the long term.

The Commission has, on the basis of information provided by AGL SA, stakeholders and consultants, determined that there is justification for increasing the retailer component costs used to set the standing contract prices from the currently approved levels. The Commission needs to manage the move to the new retailer price levels in a way that has least impact on consumers and yet protects AGL SA's interests.

The Commission has modelled AGL SA's costs and necessary revenue associated with the prudent costs determined by the Commission in this Inquiry. Based on the estimated standing contract customer numbers for each quarter of the price path, an average consumption of approximately 7.4 MWh/a and the component costs as outlined in the previous sections, the Commission has determined the Net Present Value (NPV) of the quarterly costs stream (in December 2004 dollars, using a 10% real discount rate) over the three year period from 1 January 2005 to 31 December 2007.

The Commission has also developed an alternative set of retailer tariff adjustments, giving a smoother transition to the price path tariffs, but with the same NPV as above. To achieve this NPV, the alternative **adjustments to retailer tariffs** for standing contract customers have been determined as:

- ▲ Increase of 2.5% from current levels on 1 January 2005
- ▲ Average price cap increase of CPI minus 1.05 percent from 1 July 2005 (where CPI is the 9 months March quarter 2005 to June quarter 2004 increase), applied to the 2004-05 base average price cap of \$91.51 per MWh;
- ▲ Average price cap increase of CPI minus 1.05 percent from 1 July 2006 (where CPI is the full 12 months increase of March quarter 2006 to March quarter 2005)
- ▲ Average price cap increase of CPI minus 1.05 percent from 1 July 2007 (where CPI is the 9 months increase of December quarter 2006 to March quarter 2006).



In a separate investigation, the Commission has been reviewing the justified network charges of ETSA Utilities, which will flow through directly into standing contract charges for small customers. Its draft determination in that regard will be handed down at the same time as this draft Inquiry Report. Without pre-empting that draft determination, the Commission can report that its draft position is that network charges to small consumers will be reduced, commencing 1 July 2005 and increasing at below CPI for the following 5 years.

Combining the retailer tariff changes with the changes expected in the network charges, should result in the following approximate **changes in standing contract prices** for small residential and business consumers:

- ▲ an increase of about 1.2% in January 2005,
- ▲ a reduction of about 2.5% in July 2005, and
- ▲ increases of about 1.2% below CPI each July thereafter, until the price path concludes in December 2007.

The Commission believes such a price path fairly balances the interests of AGL SA and consumers, and provides a clear guidance to the market about the direction of standing contract prices for the next three years.

## 15 CUSTOMER IMPACT

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The terms of reference of the Inquiry require the Commission to have regard to:

- ▲ Any cross-subsidies between, and within, business and residential small customer classes, and whether these cross-subsidies are justified to prevent a disproportionate price impact on any small customer group; and
- ▲ The prices charged and costs incurred in providing comparable services in other States and Territories of Australia, and whether the reasons for any differences can be justified.

In the Commission's Discussion Paper of September 2004, Section 4.5 presented a comparison of small customer residential and business tariffs at selected average levels of consumption. The Commission concluded, for tariffs applicable at that time:

- ▲ SA and Victorian tariffs are higher than NSW, in both the network charges and retailer controllable cost components;
- ▲ SA standing contract tariffs are higher than equivalent Victorian tariffs, primarily due to the higher network charges; and
- ▲ Retailer controllable costs (covering WEC, ROC and margin) are similar in SA and Victoria.

The Commission has decided to increase the allowable retailer tariffs for each of the three years of the price path (initially by 2.5% and then by escalating the base average price cap of \$91.51 per MWh by CPI minus 1.05 percent every 1 July thereafter), reflecting the Commission's decisions regarding the prudent costs of the individual components (WEC, ROC and margin) over the period.

As foreshadowed, the Commission's proposed determination for small customer network charges over the same period is for an initial reduction in July 2005, followed by increases less than inflation in July 2006 and July 2007 (and subsequent years).

The combined impact of these proposed tariff changes is likely to be a reduction in overall standing contract prices in July 2005 (and a higher proportion of retailer controllable costs in the standing contract price), and increases below CPI in July 2006 and July 2007 (and a further increase in the proportion attributable to retailer controllable costs).

It is the Commission's understanding that the equivalent standing contract tariffs in Victoria are to increase from 1 January 2005 by an amount less than CPI (on average)<sup>21</sup>. Similarly, Victorian network charges are to increase from 1 July 2005 by an amount less

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<sup>21</sup> The average annual tariff adjustment on 1 January 2005 in Victoria is CPI - 1.5% for TXU, CPI - 1.3% for Origin/Powercor, CPI - 0.5% for Origin/Citipower, CPI - 1.5% for AGL, and CPI - 0.5% for AGL/Pulse. See [www.doi.vic.gov.au/DOI/Internet/Energy.nsf](http://www.doi.vic.gov.au/DOI/Internet/Energy.nsf) "Energy Prices 2004 to 2007". Increases of CPI - 0.5% apply from 1 January 2006, except for AGL where it is CPI - 0.9%.



than CPI (on average)<sup>22</sup>, such that it could be expected that the retailer controllable cost allowances in Victoria will also increase by an amount less than CPI.

This preliminary analysis would suggest that the retailer controllable cost allowance would increase slightly in SA relative to the allowance in Victoria, over the 3 year period. The SA network charges for small customers will decrease, relative to a small increase in Victoria.

However, it is difficult to confirm this assessment as the component parts will change each 6 months (in both SA and Victoria) during 2005. The Commission will repeat the analysis at various intervals, and particularly in June 2005, to allow an accurate comparison of retailer controllable costs between SA and Victoria.

Nevertheless, the conclusions in the September Discussion Paper reported above are still likely to be applicable for tariffs in the first half of 2005, despite the 2.5% increase in retailer tariffs allowed by the Commission. The retailer controllable costs allowed under the SA and Victorian price controls remain broadly similar, with the higher WEC in SA offset to some degree by the lower margin and operating cost allowed. The Commission believes that the slightly higher retailer charges in South Australia are reflective of the costs of operating in the local market, and that the small increment is justified by its consideration of the input costs.

The Commission emphasises that the two main reasons why standing contract prices for small customers are higher in SA than in Victoria are the higher wholesale energy charges and the higher network charges. To some extent, these higher charges reflect the specific nature of the industry in this State, with high cost fuels used for generating electricity and an extensive and dispersed network with low customer density. The most significant factor, however, is the peaky load whereby the peak demand requirement on the system is many times the average load, resulting in much capacity sitting unutilised for much of the year (but requiring a return on capital and maintenance expenditure).

Lower retail prices depend on actions to reduce the peakiness of demand, and the Commission is providing funds to ETSA Utilities in the next regulatory period to commence a number of trials of demand management initiatives that in time may help reduce the impact of the peak demand on costs. In the meantime, the high costs will be passed through to consumers, and the Commission needs to ensure it minimizes the harmful impact on vulnerable consumers.

### **15.1 Individual Tariff Assessment**

In its Final Report in October 2002 into standing contract tariffs, the Commission undertook an examination of cross-subsidies between and within the various standing contract tariffs. This showed that there was some cross-subsidy from business and residential tariffs to off-peak and farm tariffs. Further, within the business and residential tariffs, there were cross-subsidies from larger to smaller consumers.

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<sup>22</sup> New network charges are to be set by ESC Victoria commencing 1 July 2006.

As the Commission is proposing to increase AGL SA's retailer tariffs by a straight 2.5% on 1 January 2005 (and to allow no tariff restructuring until 1 July 2005), and as the network charges from ETSA Utilities will also not change until July 2005, it is likely that these cross-subsidies will be unaffected in the first 6 months of the price path.

However, from 1 July 2005, the network tariffs are expected to be restructured to reduce the charges at lower consumption levels (either by introducing a two step tariff where the charge for the first block of consumption is lower than for the second block, or by removal of the supply charge). Such a change would be expected to either reduce or eliminate the previous cross-subsidy that was previously identified for consumers with low levels of consumption. It may also reduce the size of the margin above costs for the larger consumers, and reduce the incentive for other retailers to "cherry pick" the higher margin customers.

The actual network tariffs are still being developed at this time, and will not be completed until the time of the final report in March 2005. Further, any changes that AGL SA may wish to implement as part of tariff restructuring to apply from 1 July 2005 are also unable to be considered at this time.

The Commission will therefore undertake a more detailed analysis of the impact on individual customers and tariffs in its final report, when the additional information is available.

## **15.2 Vulnerable Customers**

Submissions to the Issues and Discussion Papers by SACOSS-WREAG and UnitingCare Wesley (and presentations by these parties to the Commission's Forum) raised concern at the impact of the higher prices since January 2003 on low income, vulnerable customers. These groups recommended that the Commission give regard to tariff design such that these vulnerable customers were assisted in some way to secure a basic supply of electricity to meet their requirements, and made some suggestions about the design of "socially responsible tariffs".

The Commission referred to these matters in its Discussion Paper, and highlighted the difficulty of addressing these requirements via tariffs (pointing out that not all vulnerable customers had low consumption, and indeed many - such as the elderly, sick and large families - had large consumption). Both parties agreed that such matters needed to be addressed across a range of different approaches, and offered to work with the Commission to explore the impacts on vulnerable customers in more detail, and to consider the design of better concession and emergency support packages. The Commission has separately advised the Minister of the need for a review of concessions and support packages for vulnerable customers.

The Commission has not been able as part of this Inquiry to address the concerns of consumer groups about the impacts of high electricity prices on these consumers. However, the Commission is intending to undertake in early 2005 a major review, with the



assistance of the Consumer Advisory Committee, of customer disconnections: it has already commenced a preliminary review of the 2003-04 experience with the assistance of consultants. This review will provide the opportunity for a thorough examination of payment issues and the impacts on vulnerable customers of an inability to meet their electricity charges. The Commission believes that such a review presents an opportunity for the community, retailers and government to examine the underlying issues and to develop innovative solutions that may better address the needs of such consumers.

The projected reduction in prices in July 2005 and the restructuring of tariffs to reduce charges for the first block of consumption and for off-peak water heating, will go some way to assisting certain consumer types (especially those who have low consumption). However, such changes will not provide much assistance to those vulnerable customers who have high consumption levels (perhaps associated with being at home and requiring on-going air-conditioning, heating or other equipment).

The Commission therefore welcomes the offer of those bodies from the social service sector to work with the Commission in 2005 to examine these issues and to help identify possible improvements in concessions, advisory and tariff arrangements that will allow assistance to be better targeted to the most vulnerable customers. The Commission will commence this work in conjunction with the Consumer Advisory Committee in December 2004, following the release of this draft inquiry report.



## 16 CONCLUSION

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The Commission has undertaken this Inquiry into AGL SA's proposed standing contract price path in accordance with the Terms of Reference: these also required it to have regard to the factors in Parts 2 and 3 of the Essential Services Commission Act 2002. How the Commission considered each of these factors has been outlined in section 11 of this Report.

The Commission released an Issues Paper and a Discussion Paper as part of this Inquiry; it also held a public forum. Through these means, it has obtained valuable input from stakeholders and informed itself on key issues relevant to the Inquiry. Further, the Commission engaged expert consultants to assist it in specific areas of inquiry, and also met with AGL SA officers to better understand the costs associated with the role of standing contract retailer in South Australia.

The Commission has clearly stated its objective in setting standing contract prices over the period of the price path, and believes that this properly reflects the priorities and factors it is required to have regard to in carrying out this role.

This Report, and the various papers and reports released by the Commission during the Inquiry, outline the key analysis, inputs and conclusions undertaken and drawn during the Inquiry. The Commission acknowledges the difficulties in determining retailer prices over the next three years, and appreciates the valuable contributions from stakeholders and consultants in undertaking this analysis. Ultimately, however, the Commission has considered the available information and the factors it is required to have regard to, and it has made its conclusions based on these inputs.

The Commission has firstly concluded that this Inquiry will only consider "retailer controllable costs" – namely, the wholesale energy cost, the retailer operating costs, and the retailer margin.

Secondly, it has concluded that (for practical reasons primarily) it will set the allowable retailer margin as a percentage of the wholesale energy cost plus retailer operating costs; it will not in future (as it has in the past) include the network charges in these base costs on which the margin will be applied.

Thirdly, the Inquiry has considered the hedging strategies that a prudent retailer would adopt in supplying standing contract customers, and has estimated the wholesale energy cost in meeting that obligation in a way that minimizes the risk to the retailer. It has derived an average annual cost to meet this obligation.

Fourthly, it has considered operating costs associated with the provision of services to standing contract customers, and expressed that as an average cost per customer. This was particularly informed by an audit of AGL SA's actual operating costs in meeting standing contract customer obligations, and by benchmark costs determined in previous investigations.



Finally, the Commission has given consideration to how it could apply a price control system to standing contract tariffs which incorporated the above costs and which minimized the regulatory intrusion into the market whilst protecting consumer interests. The proposed price control system can be summarised as follows:

- ▲ The standing contract prices (for each tariff) will comprise three parts:
  - AGL SA retailer tariffs, covering retailer controllable costs; plus
  - Network charges, covering TUOS and DUOS; plus
  - Cost pass-through amounts.
- ▲ AGL SA retailer tariffs will be set in accordance with a Price Determination, based on the Commission's determined controllable cost components, which will set an annual average retailer price cap for the combined standing contract tariff categories, plus individual tariff side-constraints.
- ▲ AGL SA will be required to submit to the Commission each May its proposed retailer tariffs and demonstrate compliance with the overall average retailer price cap and the individual tariff side-constraints (including the compliance of any proposed opening of new tariffs or closing of existing tariffs).
- ▲ There will be provision for a "price path variation event" following the conclusion of this Inquiry, to allow the cost components and hence the average price cap escalation factors to be altered if the Commission alters its findings in the Final Report.
- ▲ There will be provision for specified cost pass-throughs to the retailer tariffs.
- ▲ There will be limited opportunities for variation or replacement of the determination, to the extent provided for by the "special circumstances" test of the Electricity Act.
- ▲ Network tariffs (determined in accordance with the Electricity Distribution Price Determination) will be added to the AGL SA retailer tariffs to form the standing contract tariffs (exclusive of GST, which will be separately added).
- ▲ Retailer tariffs and the corresponding standing contract tariffs will be set in June each year and apply for the following financial year; they will only be altered during a financial year if a pass-through (either for network charges or retailer tariffs) is approved.
- ▲ The price control system will cease to apply from 31 December 2007, unless replaced with a further Price Determination by the Commission.

The Commission was required to consider whether to implement a "bridging price" for the period 1 January to 30 June 2005, and this has required some particular consideration given the obligation in the Electricity Act 1996 for any Price Determination to be for a period of at least 3 years. The Commission has decided to make a Price Determination in December 2004 for the 3 year period from 1 January 2005. Legal advice confirms that the proposed approach complies with the legislative obligations in all regards.

The above comments reflect the complexity of establishing a price path control system for the next three years, and the need for some flexibility in putting the system in place. However, once established, it is the intention of the Commission to minimise the number of changes and to provide the maximum possible certainty to consumers, AGL SA and other retailers about standing contract prices through to December 2007.

The Commission has undertaken a difficult task in conducting this Inquiry, but has sought to develop a price control system that meets all of the objectives set out in the Terms of Reference of the Inquiry.

The Commission will, separate to this Report, prepare a draft Price Determination that outlines in a formal document the price control system it has described in this Report. The Determination is the legally compliant document that will formally establish the standing contract price path regime, and must demonstrate its compliance with the Electricity Act 1996 and the Essential Services Commission Act 2002. This Inquiry has assisted in informing the Commission on relevant factors for that draft Price Determination.

The Commission welcomes comments on the draft Determination over the next two weeks, prior to it being finalised in mid December 2004, and on this draft report prior to it being finalised in March 2005.



## APPENDIX 1

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### Essential Services Commission Act 2002

#### NOTICE OF REFERENCE UNDER PART 7

#### Standing Contract Prices of AGL from 2005

### 1. BACKGROUND

- 1.1 Pursuant to Part 7 of the *Essential Services Commission Act 2002* (“**the Act**”) an industry Minister may, by written notice, refer any matter relating to a regulated industry to the Essential Services Commission (“**the Commission**”) for the Commission to conduct an inquiry into that matter.
- 1.2 By virtue of section 14D of the *Electricity Act 1996*, the electricity industry is a regulated industry for the purposes of Part 7 of the Act.
- 1.3 The Hon Patrick Conlon, Minister for Energy (“**the Minister**”) is the Minister administering the *Electricity Act 1996*.
- 1.4 Pursuant to section 36AA of the *Electricity Act 1996* the Governor may declare an electricity entity to be subject to section 36AA of the *Electricity Act 1996*.
- 1.5 By proclamation in the Gazette, edition of 12 September 2002 (p.3384), AGL South Australia Pty Ltd ACN 091 105 092 (“**the electricity entity**”) is a declared electricity entity pursuant to section 36AA of the *Electricity Act 1996*.
- 1.6 The Government has announced a legislative amendment process in response to the recommendations of the Report by the Independent Pricing and Regulatory Tribunal (IPART) of March 2004. These changes will be pursued whilst the price inquiry to which these terms of reference apply is in progress.
- 1.7 It is anticipated that the Commission’s final report and determination (should the Commission consider it appropriate) will be issued pursuant to the new legislative regime.

### 2. REFERENCE

I PATRICK CONLON, Minister for Energy, hereby refer to the Commission the matter described in paragraph 3.1 of the Terms of Reference for the Commission to investigate pursuant to Part 7 of the Act, in accordance with the Terms of Reference specified below.

### 3. TERMS OF REFERENCE

The following are the Terms of Reference for the inquiry specified pursuant to section 35 of the Act:

- 3.1 The Commission is to investigate the standing contract price proposal (“**the Proposal**”) that will apply to small customers from 1 July 2005 for a period of no less than three years.



- 3.2 In assessing the proposal, the Commission's evaluation will be limited to reviewing the electricity entity's prudent controllable costs which, together with the relevant network tariffs, comprise the final standing contract prices charged to small customers. There should be no provision for specific headroom allowed in the prudent controllable costs determined by the Commission.
- 3.3 On completion of the inquiry, the Commission may issue a determination under Part 3 of the Act in conjunction with the making of its final report on the inquiry.
- 3.4 In determining whether the electricity entity's controllable costs are justified as the prudent costs incurred in supplying small customers, in addition to the requirements of Parts 2 and 3 of the Act, the Commission is to have regard to:
  - 3.4.1 the electricity entity's justification for its proposed charges, presented as part of the proposal;
  - 3.4.2 The wholesale electricity contracts and hedging strategies that would be utilised by a prudent electricity entity in providing the standing contracts to each of the residential and business customer classes in South Australia;
  - 3.4.3 The electricity entity's actual underlying wholesale electricity contracts, hedging strategies and other arrangements for securing electricity for supply in South Australia, as well as the method for allocating these costs between large and small customers and within the small customer class;
  - 3.4.4 The retail operating costs that would be incurred by a prudent electricity entity in delivering the range and standard of services that are required of the electricity entity in providing standing contract services to South Australian small customers;
  - 3.4.5 The electricity entity's actual operating costs in providing standing contract services to South Australian small customers, and the method of allocating its costs between the different customer classes;
  - 3.4.6 The electricity entity's proposed margin on standing contract sales, and its actual margin achieved in recent years, and whether these are reasonable having regard to the entity's investment in the business, the risks of standing contract retailing in South Australia, and the equivalence with standing contract retailer margins interstate without Government risk management schemes;
  - 3.4.7 Any cross-subsidies between, and within, business and residential small customer classes, and whether these cross-subsidies are justified to prevent a disproportionate price impact on any small customer group;
  - 3.4.8 The prices charged and costs incurred in providing comparable services in other States and Territories of Australia, and whether the reasons for any differences can be justified; and
  - 3.4.9 any other factors the Commission considers relevant.

#### **4. CONDUCT OF INQUIRY**

- 4.1. Following the receipt of these terms of reference, the Commission's inquiry process shall consist of at least the following:

- 4.1.1 The publication of a notice of inquiry, as required pursuant to section 36 of the Act, no later than 7 days following receipt of these terms of reference;
  - 4.1.2 The release of an issues paper within 1 month of receipt of these terms of reference, in whatever form the Commission considers appropriate, setting out the information it requires the electricity entity to provide by a date specified in the Paper, and seeking comment on the key issues it should address in its investigations;
  - 4.1.3 The release of a Discussion Paper following the release of the electricity entity's proposal, as the basis of a consultation process on the proposal and on other information available to the Commission on components of the electricity entity's controllable costs;
  - 4.1.4 The release of a draft decision and determination (if applicable) to the Minister and electricity entity for comment no later than one week prior to the public release of a draft decision and determination;
  - 4.1.5 The release of a draft decision and determination (if applicable) no later than 30 November 2004, including provision for a bridging price for the period to 30 June 2005; and
  - 4.1.6 The submission of a final report and price determination (if applicable) to the Minister and electricity entity no later than 31 March 2005, and to the public no later than 7 days thereafter.
- 4.2. The final price determination (if considered appropriate) should allow for an adjustment within the period for which the determination applies based on such factors and as frequently as considered appropriate by the Commission.
- 4.3. The consultation process may consist of a public hearing, public seminar or workshop but the Commission may receive and consider any written submissions as it thinks appropriate.

## 5. DEFINITIONS

In this notice:

- 5.1 "business customer class" means those small customers not included in the residential customer class and excluding unmetered supplies;
- 5.2 "controllable costs" refer to those costs of the electricity entity which comprise the wholesale cost of electricity, retail operating costs, retail profit margin and any other cost (other than network charges) incurred by the electricity entity in carrying out its obligations under relevant legislation;
- 5.3 "proposal" refers to the document or documents provided by the electricity entity to the Commission in response to its initial information request as set out in the Issues Paper. The documents may include confidential components which the Commission must not publicly release and must treat in accordance with section 30 of the Act;



- 5.4 “residential customer class” means the group of small customers consuming electricity in premises wholly or principally as private residence; “small customer” has the meaning given to it in the Electricity Act 1996;and
- 5.5 “standing contract price” has the meaning given to it by section 36AA(6)(b) of the Electricity Act 1996

Dated 26 May 2004

**HON PATRICK CONLON MP**

Minister for Infrastructure

Minister for Energy

Minister for Emergency Services



**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 than 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.