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Inquiry into Electricity Price Path: Draft Determination

Essential Services Commission of SA
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Submission on the Electricity Price Path Draft Determination

SPI Australia ("TXU") is pleased to submit our views on the Electricity Price Path Draft Determination released by ESCOSA ("the Commission") in November 2004.

Overall we found the Commissions analysis to be well balanced and even handed. In our view the proposed price path will deliver the benefits of pricing stability and predictability to SA consumers, the incumbent retailer, and competing retailers. It is likely that competition will continue to develop under the proposed pricing regime.

We acknowledge the analysis the Commission has undertaken with respect to ensuring that a robust investment environment will continue in SA, and appreciate that the Commission has taken industry concerns in this area seriously. Despite this analysis, certain aspects of the determination leave us concerned about the future of generation investment adequacy in SA.

Our concern on this front is driven by the decreasing wholesale energy cost estimates used to develop the price path. This appears to be at odds with the NEMMCO Statement of Opportunities, which indicates that new generation investment will be required in the SA/Vic region prior to the 2007 summer. According to our estimates, the energy cost factored into the last year of the price path is below the cost of additional capacity, and will therefore deliver insufficient funds to the retail sector to be committed to generation investment prior to the end of the price path.

Even if weather patterns and other factors result in SA being able to cope without additional capacity prior to the end of the price path, there is no doubt that investment will be required in the period immediately following the end of this pricing period. The need for retailers to be able to commit funds to underwrite such capacity investment is likely to lead to a step-wise price increase for consumers following the end of this price path, as prices will need to be increased to recover the funding shortfall. Such an outcome would appear to be inconsistent with one of the key objectives of the price path ie. Consumer pricing stability. We urge the Commission to reconsider its wholesale energy cost estimates to mitigate this risk.

More detailed comments on the key parameters of the determination are included in the attached submission. We recommend that the Commission incorporate the changes suggested below into its final determination in order to optimize the outcome of this review.

Given the relatively brief period available for analysis of the draft determination, we are only able to provide our initial views at this time. We shall continue to analyse the inquiry draft final report, and provide more detailed comments if appropriate in our response to the "Inquiry into Retail Electricity Price Path Draft Final Report" due in February 2005.

We would be happy to further discuss or clarify our views on an SA retail electricity price path. I can be contacted on (03) 8628 1244, to facilitate such discussions.

Yours sincerely

Peter Carruthers
Regulatory Manager, Policy

TXU Detailed comments on ESCOSA retail price path Draft Determination

In the sections below, we briefly outline our key comments related to the detail of the draft determination.

Retail Operating Cost ("ROC")

In establishing the appropriate cost base for determining the retail price path, the Commission has allowed a ROC of $84/Customer. This is well below the benchmark level used in Victoria, which is more reflective of the appropriate ROC cost input. We urge the Commission to adopt the Victorian ROC value.

On a more positive note, we support the use of the CPI + 2% escalation factor built into the ROC cost estimate. This appropriately recognizes the cost impacts of increasing levels of customer churn – resulting in reductions in numbers of AGL customers and reductions in economies of scale available to the incumbent.

Retail Margin

In a similar vane to the ROC issue, we note that the Commission has opted to maintain the Retail Margin at around current levels (ie. 5% on total bill), rather than adopt the benchmark value of 6-7% from Victoria. In our view this is an overly conservative position, which has failed to factor in the self-correcting nature of retail margin in a competitive market. We recommend the Commission adopt the benchmark margin of 6-7% on the total bill amount.

Wholesale Energy Cost Allowance

As acknowledged in the Commission's draft final report, TXU is strongly of the view that it is appropriate to match a multi-year retail price path, with a long run wholesale energy cost. We note however, that the Commission has decided to adopt the short-term based ACG methodology to calculate the appropriate wholesale cost estimate for the end of the price-path period.

In our earlier submission, we outlined in some detail our concerns with the ACG methodology. We appreciate that one of the key concerns that we (and others) expressed at that time (ie. the use of historical pool price outcomes), has been addressed in the draft determination calculations. While this appears to have improved the accuracy of the methodology outcomes, we remain concerned that many of the other issues we raised have not been addressed. On the most fundamental level, we remain concerned that the methodology has not been described in sufficient detail and does not meet the transparency standards that would be expected from a public determination process. We urge the Commission to discontinue the use of this approach in future reviews.

Supply Side Investment & longer term retail price impacts

According to the 2004 Statement of Opportunities from NEMMCO, supply side investment will be required in the combined Victoria / South Australia region by summer 2007/8[1], prior to the end of the SA retail price path. In order for this investment to occur, it will be necessary for SA retailers (including the incumbent) to have sufficient confidence in the retail market to underwrite the construction of new generation plant. In other words, retailers will need to have confidence that the retail market will deliver sufficient revenue to cover the long-term costs of funding such plant in order for them to make the required commitments.

In our view, the actual cost of supplying the SA regulated customer base in the 2007 year is likely to be in the excess of $75/MWh. We have based this estimate on using the $72.11/MWh from ESIPC's "cost curve 8"[2] which includes a more realistic Internal Rate of Return and a 5% higher gas cost than the ESIPC base case. 75% of this 2005 estimate has then been escalated at CPI (@2.5%) for two years in order to obtain a 2007 estimate of around $75/MWh. Our basis for escalating 75% of the base year data at CPI is that one of key cost drivers in determining the cost of new plant in SA is the cost of gas, which tends to be CPI indexed and makes up about 75% of plant costs. In our view this estimate is still on the low side, because the ESIPC fuel estimate was much more than 5% below the true cost of fuel in SA, and also because this methodology has failed to take into account the forecast worsening load factor of the SA small consumer demand.

Having concluded that new entry costs are likely to be at least $75/MWh in 2007, it is with some concern, given the NEMMCO supply/demand forecasts, that we note the wholesale cost element of $72.74/MWh[3] prepared by ACG and used by the Commission for the 2007/8 summer in the draft determination.

Apart from raising questions over the ability of the SA power industry to fund itself sustainably into the future, this apparent underestimation of cost assumptions also raises the risk of exposing SA consumers to a step price increase immediately following the end of the price path. This scenario is a real possibility due to retailers needing to increase retail tariffs at the end of the price path, in order to fund new generation investment, which by then will be required urgently. Exposing consumers to such price increases would appear to be at odds with the price path objective of providing stable long-term prices to consumers into the future.

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[1] NEMMCO Statement of Opportunities 2004, Figure 2.4, page 2-10.

[2] ESIPC Information Paper prepared for the Essential Services Commission of SA, "Estimates of the long run marginal cost of supplying electricity to small customers in 2005", Table on page 7.

[3] Allen Consulting Group, Supplementary Report Energy Wholesale Price Study, Table 1.2, page 7.

In order to prevent investment shortfalls and reduce the risk of step price increases to consumers following the price path, we therefore recommend that the Commission reconsider the pricing used in the final year of the period covered by this draft determination.

Re-opener provisions

We broadly support the direction taken by the Commission on re-opening and pass-through costs with respect to the price path. The approach proposed appears to be based on the sound principle that the incumbent retailer should not be exposed to risks they cannot control, but equally should be fully responsible for manageable risks. Since the majority of costs fall into the latter category, the objective of providing pricing stability to consumers is supported by this approach.

The categorization of Reserve Trader costs and NEMMCO Direction costs as pass-through events are in accordance with the principles above. In addition to this we would suggest that re-openers or pass-throughs should be foreshadowed with respect to the imposition of:

- Any substantive new Emissions Trading or mandatory Renewable energy schemes within the term of the price-path;
- Industrial disputes impacting the market (apart from disputes centered around AGL);
- Fees or charges resulting from mandatory restriction pricing, or administered pricing.

The other significant re-opening provision is the Commission's power to adjust X factors or other elements of the determination following the conclusion of the inquiry process in the first quarter of 2005. While this is somewhat un-orthodox, we do accept it seems to be a reasonable compromise position given the various legal constraints to which the Commission is bound, and the relatively short period after the start of the price-path for which this power will remain available.

Inflation Indexation

We note that the Commission has determined that the Consumer Price Index, All Groups Index Number (weighted Average of eight capital cities) is to be used as the key inflation index. We are not clear why the Commission has opted to use the "All Capitals" index rather than the local Adelaide index. In our view the use of the Adelaide index would appear to be more directly linked with South Australian economic conditions, and therefore more appropriate for the SA consumer. Our experience is that the use of the local index is more commonly used in other states for electricity price escalation, and we would suggest the Commission consider the use of the local index in this case as well.