

ELECTRICITY STANDING CONTRACT PRICE

*AN APPLICATION BY AGL SA PTY LTD FOR
A REVIEW PURSUANT TO SECTION 31 OF
THE ESSENTIAL SERVICES COMMISSION
ACT 2002*

DECISION

February 2005

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1 DECISION

Pursuant to section 31(8) of the Essential Services Commission Act 2002, the decision of the Essential Services Commission on its review under Part 6 of that Act of the Electricity Standing Contract Price Determination published on 23 December 2004 is to confirm that price determination.

Essential Services Commission of SA

2 THE REVIEW

2.1 Structure of the decision

2.1.1 This decision is structured as follows:

- (a) Chapter 1 sets out the decision of the Essential Services Commission on review of the Electricity Standing Contract Price Determination published on 23 December 2004;
- (b) Chapter 2 sets out an overview of the review;
- (c) Chapter 3 sets out the Essential Services Commission's reasons and decision on the review of the treatment of wholesale energy costs under the standing contract price determination;
- (d) Chapter 4 sets out the Essential Services Commission's reasons and decision on the review of the treatment of retail operating costs under the standing contract price determination;
- (e) Chapter 5 sets out the Essential Services Commission's reasons and decision on the review of the treatment of the retail margin under the standing contract price determination;
- (f) Chapter 6 sets out the Essential Services Commission's reasons and decision on the review of Chapter 4 (price path variation) of the standing contract price determination; and
- (g) Chapter 7 sets out the Essential Services Commission's reasons and decision on the review of the summary of information provided to accompany the standing contract price determination.
- (h) Chapter 8 sets out the Essential Services Commission's compliance with statutory obligations in relation to the review of the price determination against statutory objectives.

2.2 Background

2.2.1 In May 2004, the Minister of Energy referred to the Essential Services Commission (the Commission) a Notice of Reference for an Inquiry into



Standing Contract Prices of AGL from 2005, requiring the Commission to undertake a number of tasks¹.

2.2.2 Briefly, the key tasks required of the Commission were:

Notice of Reference 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

Notice of Reference 3.3: On completion of the Inquiry, the Commission may issue a [price] determination under Part 3 of the Act in conjunction with the making of the final report on the Inquiry

2.2.3 In addition, the Commission was required by the Notice of Reference to release a draft decision and determination (if applicable) no later than 30 November 2004, including the provision for a bridging price for the period to 30 June 2005, and is required to submit a final report and price determination (if applicable) to the Minister and the electricity entity no later than 31 March 2005 and to the public no later than 7 days thereafter².

2.2.4 The Notice of Reference also provided:

Notice of Reference 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

2.2.5 The Notice of Reference also advised the Commission that the Government would be undertaking a legislative amendment process, and that "*these changes will be pursued whilst the price inquiry to which these terms of reference apply, is in progress*", and that the Government anticipated that the Commission's final report and determination (should the Commission consider it appropriate) would be issued pursuant to the new legislative regime³

2.2.6 In July 2004, the South Australian Parliament amended the *Electricity Act 1996* to incorporate standing contract price path arrangements. Part of

¹ The Notice of Reference is dated 26 May 2004 and is set out in full in Essential Services Commission of South Australia (ESCOSA), "*Inquiry into Retail Electricity Price Path: Draft Final Report*", November 2004, Appendix 1, pp 93 – 96. The Notice of Reference is also available electronically from the ESCOSA website <http://www.escos.a.sa.gov.au/resources/documents/040526-D-NoticeOfReferenceElectPrice.pdf>.

² Notice of Reference clauses 4.1.4 & 4.1.5.

³ Notice of Reference clause 1.6 & 1.7.

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those new provisions was proclaimed to operate from 19 August 2004, while the remaining new provisions will be operational from 1 July 2005.

- 2.2.7 As envisaged by the Notice of Reference for the Inquiry, the Commission undertook the Inquiry and retail price determination processes as one process. The Commission produced an Issues Paper and a Discussion Paper⁴ and released associated reports from expert advisors⁵, received public submissions and held a public hearing.
- 2.2.8 In November 2004, the Commission released its draft findings of an Inquiry into a Retail Electricity Price Path⁶ (Draft Inquiry Report), together with a Draft Price Determination setting the electricity standing contract price⁷ together with relevant expert reports⁸ which had informed the Commission's decision-making process.
- 2.2.9 The Commission indicated in both the Draft Inquiry Report and the Draft Price Determination that it intended to finalise the Price Determination in mid-December 2004 to take effect from January 2005, but that, in accordance with the Notice of Referral of the Inquiry into the Standing Contract Prices of AGL, it would receive submissions on the Draft Inquiry Report until February 2005, after which time, the Commission would finalise its Inquiry and Report to the Government.
- 2.2.10 On 23 December 2004, the Commission published a notice⁹ in the South Australian Government Gazette advising that it had made a price determination¹⁰ under the Essential Services Commission Act 2002 ("the ESC Act"). That price determination had the effect of setting the electricity

⁴ Essential Services Commission of South Australia (ESCOSA), *Inquiry into Retail Electricity Price Path: Issues Paper*, June 2004 (refer <http://www.escosa.sa.gov.au/resources/documents/040625-R-ElecPrincIssuesPaper.pdf>) and Essential Services Commission of South Australia (ESCOSA), *Inquiry into Retail Electricity Price Path: Discussion Paper*, September 2004 (refer http://www.escosa.sa.gov.au/resources/documents/040914-ElecRetailPricePathInq_DiscPaper.pdf).

⁵ The Allen Consulting Group, *Final Report Energy Wholesale Price Study*, 13 September 2004 (refer <http://www.escosa.sa.gov.au/resources/documents/040913-R-WholesaleEnergyPriceStudy.pdf>) and Electricity Supply Industry Planning Council (ESIPC), *Estimates of the long run marginal cost of supplying electricity to small customers in 2005* (Information Paper prepared for the Essential Services Commission of SA), 31 August 2004 (refer <http://www.escosa.sa.gov.au/resources/documents/040831-R-ESIPC-LRMCSupplySmallCustomers.pdf>).

⁶ Essential Services Commission of South Australia (ESCOSA), *Inquiry into Retail Electricity Price Path: Draft Final Report*, November 2004 (refer http://www.escosa.sa.gov.au/resources/documents/041130-R-DraftInquiryReport_RetailElecPricePath.pdf).

⁷ Essential Services Commission of South Australia (ESCOSA), *Electricity Standing Contract Price: Draft Price Determination*, November 2004, (refer <http://www.escosa.sa.gov.au/resources/documents/041130-O-ElecStandingContractPriceDraftPriceDet.pdf>).

⁸ The Allen Consulting Group, *Supplementary Report Energy Wholesale Price Study*, 22 November 2004 (refer <http://www.escosa.sa.gov.au/resources/documents/041130-O-AllenReportEnergyWholesalePriceStudy.pdf>).

⁹ *South Australian Government Gazette*, No 118, 23 December 2004, page 4638.

¹⁰ Essential Services Commission of South Australia (ESCOSA), *Electricity Standing Contract Price: Price Determination*, December 2004, (refer http://www.escosa.sa.gov.au/resources/documents/041223-DET_Final_ElecStandingContractPrice.pdf).



standing contract price to apply from 1 January 2005 for the purposes of section 36AA of the Electricity Act 1996 (“the standing contract price determination”).

- 2.2.11 The standing contract price is the price charged by AGL SA Pty Ltd (ABN 49 091 105 092) (“AGL SA”) to small customers for the sale of electricity under the standing contracts which it is required to offer small customers pursuant to section 36AA of the Electricity Act 1996 (“the Electricity Act”).

2.3 The Review Process

- 2.3.1 Part 6 of the ESC Act contains a legislative scheme permitting reviews and appeals in relation to price determinations made by the Commission such as the standing contract price determination.

- 2.3.2 Section 31(1)(a) of the ESC Act provides that:

An application may be made to the Commission by the Minister, or by a regulated entity to which the determination applies, for a review of a price determination.

- 2.3.3 Section 31(2) of the ESC Act sets out the requirements as to form for an application for review:

An application for a review must—

- (a) be in writing; and*
- (b) set out the price determination or part of the price determination, or the decision, to which the application relates; and*
- (c) set out in detail the grounds on which the applicant seeks review and the decision sought on the review; and*
- (d) be accompanied by any information that the applicant considers should be taken into account by the Commission on the review; and*
- (e) be lodged with the Commission within 10 working days after the price determination is published or after receipt of the written notice referred to in subsection (1) (as the case requires).*

- 2.3.4 On 11 January 2005, AGL SA submitted an application for review¹¹ to the Commission in respect of the standing contract price determination under section 31(1)(a) of the ESC Act. AGL SA met the requirements as to the

¹¹ At the time of submitting the application for review AGL SA requested that it be treated as confidential. The Commission made available the Executive Summary on the ESCOSA website (refer <http://www.escosa.sa.gov.au/resources/documents/050128-D-PriceDeterminationReviewExecutiveSummary.pdf>).

form of that application under section 31(2) of the ESC Act. The Commission is therefore able to proceed to assess the review application.

2.3.5 Section 31(3) of the ESC Act requires that the Commission do two things upon receipt of a review application:

If an application is made for a review of a price determination—

- (a) *the Commission must give a copy of the application to each other person who could also have applied for review of the determination; and*
- (b) *invite each such person to join as a party to the review and make submissions on the matter the subject of the review in a manner and within a period specified by the Commission.*

2.3.6 On 12 January 2005, as required by section 31(3) of the ESC Act, the Commission provided a copy of the review application to the Treasurer (being “the Minister” for the purposes of the ESC Act) and invited the Treasurer to join as a party to the review and to make submissions on the matters which are the subject of the review.

2.3.7 On 11 February 2005, the Commission received a submission¹² from the Treasurer.

2.4 Conduct of the Review

2.4.1 As observed by the Commission in Part A (the statement of reasons) of the standing contract price determination, a price determination made by the Commission is not an assessment of a claim put forward by AGL SA, nor is it a decision by the Commission as to two competing claims put forward by AGL SA and another entity.

2.4.2 Instead, properly characterised, a price determination is the independent decision of the Commission, taking into account all relevant matters required by law. In this sense, all information and materials gathered by the Commission, including the information and materials obtained from or provided by AGL SA, are simply matters which are considered by the Commission. The Commission is not, therefore, bound to adopt, accept or assess as correct any person’s submissions or claims in making its own independent decision.

¹² Treasurer of South Australia, Letter to Essential Services Commission of SA, 11 February 2004 (refer <http://www.escosa.sa.gov.au/resources/documents/050211-AglReviewApplicationSub-Foley.pdf>).



- 2.4.3 The review application lodged by AGL SA triggers the commencement of a review process and sets out specific aspects of the standing contract price determination with which AGL SA is dissatisfied.
- 2.4.4 The Commission's role on the review is to consider, in the light of the issues raised by AGL SA in its review application, whether or not the price determination made by the Commission on December 23 2004 should be confirmed, varied or substituted (see Section 31(8) of the ESC Act).
- 2.4.5 AGL SA requested the opportunity to present oral evidence to the review. The Commission has considered this request but is of the view that the Commission will conform with the requirements of procedural fairness by giving due consideration to AGL SA's written review application and that it is not necessary to give AGL SA a hearing by way of personal presentation to the Commission.
- 2.4.6 In undertaking this review, the Commission also has had regard to the submission made by the Treasurer, only to the extent that this submission addressed the issues raised in the AGL SA review application.
- 2.4.7 To assist it to undertake the review the Commission has taken further expert advice on particular matters raised by AGL SA in its review application.

2.5 The grounds of review

- 2.5.1 The grounds of review sought by AGL SA may be summarised as follows:
- (a) Wholesale energy costs have been wrongly assessed by the Commission;
 - (b) Retail operating costs have been wrongly assessed by the Commission;
 - (c) The retail margin has been set below a realistic level by the Commission;
 - (d) The Commission has acted beyond power in providing for Chapter 4 of the standing contract price determination (price path variation); and
 - (e) The Commission has failed to provide a summary of the information on which the standing contract price determination was based.

Decision

Electricity Standing Contract Price

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- 2.5.2 Each of these matters is dealt with separately in detail below, addressing relevant issues raised by AGL SA in the review application and setting out the reasoning of the Commission in respect of each.

3 WHOLESALE ELECTRICITY COSTS

3.1 Issues

- 3.1.1 At paragraph 8.1 of the review application, AGL SA has raised the following issues in respect of the Commission's decisions regarding wholesale electricity costs ("WEC") for review by the Commission:
- (a) The Commission has understated AGL SA's costs in deriving the wholesale electricity costs allowance for the period 1 January 2005 to 30 June 2005 ("***the initial WEC issue***");
 - (b) The Commission has noted that ACG modelling derives wholesale electricity costs which are on average \$2.10 lower than AGL SA's proposed costs and concluded that this reflects a margin applied by AGL SA ("***the risk premium issue***"); and
 - (c) The Commission has excluded certain cost items which are beyond AGL SA's control (and which in AGL SA's opinion are legitimate pass through items) from the list of allowable pass through events ("***the pass through events issue***").

3.2 Commission Approach

Assessment of WEC issues by Commission consultants

- 3.2.1 The Commission asked the Allen Consulting Group (ACG) to respond to the issues raised by AGL SA concerning wholesale electricity costs. ACG had provided advice to the Commission on WEC for the purposes of the Commission's undertaking of the Inquiry into Standing Contract Prices for AGL and the Price Determination.
- 3.2.2 ACG has provided the Commission with a Report¹³ on these matters which, although referred to in this document, is not being publicly released.
- 3.2.3 The ACG Response to Review Application, in addition to responding to the issues in the Review Application, also refers to a report for Piper Alderman,

¹³ The Allen Consulting Group, *Energy Wholesale Price Study Response to AGL SA Review Application*, February 2005.



A consideration of specific aspects of ESCOSA's Final Determination of the electricity standing contract price, by Mr Price ("Mr Price's report").

3.2.4 In summary, ACG's advice to the Commission is as follows¹⁴:

AGL SA has claimed that the Commission has understated AGL SA's costs for the period 1 January 2005 to 30 June 2005, because it did not adjust for the averaging of cap premiums over calendar year 2005. This is not correct. ... we demonstrated that the Commission properly accounted for the averaging of cap premiums.

AGL SA has said that the Commission's assessment is too low and does not appropriately take into account the unhedged portion of AGL SA's forecast load. we explained that our modelling, which is in accordance with finance theory but differs to the approach used by AGL SA, is a robust method for estimating the expected wholesale energy purchase costs,

AGL SA has argued that the Commission's assessment does not adequately reflect the value of underlying risks such as customer churn, load variation and unusual or unexpected system event. ... we explained that our approach has taken account of all risks to the extent possible using the information that is available, and in particular, to the extent that AGL SA provided information or proposed scenarios and associated probabilities for the events that it considered most important. However, while we did not specifically quantify 'churn risk', we did assign a higher weight than its probability to the event that is equivalent to churn risk, namely high demand and high pool prices. ...

Other considerations

3.2.5 The Commission has considered each of the issues raised by AGL SA.

3.2.6 The Commission has taken into account the expert advice it has received from ACG on the issues.

3.2.7 The Commission has had regard to the submission of the Treasurer which put forward the view that there is "no credible evidence that suggests that an increase in the allowance for [WEC] is warranted, as sought by AGL"¹⁵

3.2.8 The Commission's detailed considerations are set out below:

¹⁴ The Allen Consulting Group, *Energy Wholesale Price Study Response to AGL SA Review Application*, February 2005, pp 4-5

¹⁵ Treasurer of South Australia, Letter to Essential Services Commission of SA, 11 February 2004, page 2 (refer <http://www.escosa.sa.gov.au/resources/documents/050211-AglReviewApplicationSub-Foley.pdf>).

3.3 The initial WEC issue

- 3.3.1 AGL SA states that the Commission's methodology for determining the WEC is in error in respect of the Commission's allocation of cap premiums for the initial regulatory period 1 January 2005 to 30 June 2005.
- 3.3.2 In paragraph 8.27 of the review application, AGL SA has also stated that the Commission's comparison of the WEC for the period 1 Jan 2005 to 30 June 2005 with the corresponding period of the "2003 price determination" is not valid "as this benchmark also treats cap premiums in a manner inconsistent with the ACG model."
- 3.3.3 It is AGL SA's view that the Commission allocated cap premiums for the price path period on a "cost reflective basis". As cap premiums are a fixed annual payment for the costs of holding a cap contract for any given year, the Commission understands AGL SA to mean that the Commission adopted an allocation methodology which allocated more of the annual cap premium to the hotter months of the year, where the cap contracts may be considered more likely to be called on. This would leave a smaller proportion of those costs to be recovered across the balance of the year. For example, under such a methodology, if the annual cap premium was \$100, \$40 might be allocated to the hotter first quarter, with \$20 allocated to each of the remaining three quarters.
- 3.3.4 The Commission did not, however, adopt such a "cost reflective basis" in the allocation of cap premiums. Instead, the annual cap premiums have been approximately evenly allocated across each quarter of the three-year regulatory period 1 January 2005 to 30 December 2007. Using the example set out in paragraph 3.3.3, if the annual cap premium is assumed to be \$100, then the Commission's standing contract price determination has assumed an allocation of \$25 to each quarter of the year.
- 3.3.5 The Commission has been advised by the Allen Consulting Group ("ACG"), that on 9 September 2004 ACG provided AGL SA with a WEC calculation spreadsheet containing a non-uniform allocation methodology for the allocation of cap premiums. ACG has further advised the Commission that later on 9 September 2004, in response to the receipt of that spreadsheet, AGL SA advised that the WECs in AGL SA's price path proposal were based on a uniform allocation of cap premiums across each quarter of the year. This advice is confirmed in the expert report of Mr. Price at paragraph 166.



Commission consideration

- 3.3.6 Based on the advice of AGL SA, ACG changed its modelling in the spreadsheet to use a uniform allocation of the cap premium consistent with the approach adopted by AGL SA in its price path proposal. This methodology was incorporated within ACG's Supplementary Report of 22 November 2004, which was relied upon by the Commission in making the standing contract price determination.
- 3.3.7 As the Commission has not adopted a "cost reflective basis" in the allocation of cap premiums, instead allocating the annual cap premium for the regulatory years 2005, 2006 and 2007 approximately evenly across each quarter of the relevant year, all cap premiums are fully recovered by AGL SA under the terms of the standing contract price determination.
- 3.3.8 As AGL SA's statements on this issue are based on a misunderstanding of the methodology applied by the Commission and, on review, the Commission has satisfied itself that the uniform cap premium allocation methodology that it used appropriately allocates those costs across each quarter of the price path period, the Commission confirms the standing contract price determination in respect of the "initial WEC issue".

3.4 The risk premium issue

Methodology

- 3.4.1 AGL SA has stated that in determining the average WEC for each regulatory period, the Commission merely adopted AGL SA's proposed WEC estimate for that period and excluded a \$2.10/MWh margin.¹⁶
- 3.4.2 AGL SA states that the Commission must review this aspect of the standing contract price determination as the resultant discounted WECs fail to provide AGL SA with appropriate risk premiums.
- 3.4.3 In determining the WECs for each quarter of the regulatory period, the Commission did not adopt AGL SA's proposed WECs and discount those WECs by a \$2.10/MWh amount. Instead, the Commission engaged an expert consultant, ACG, to independently provide an analysis of the expected costs of purchasing the required forecast load for the price path

¹⁶ AGL South Australia Pty Ltd, *Review Application in respect of the Electricity Standing Contract Price Determination* published on 23 December 2004, January 2005, paragraph 8.31 (page 20).

period. Based on the methodology developed by ACG, which was developed in consultation with AGL SA¹⁷ and carefully scrutinised by the Commission, the Commission's assessment of the WECs provided an expected cost which was on average \$2.10/MWh different to AGL SA's proposed costs.

3.4.4 ACG has advised the Commission that its methodology was designed to reflect the principle that a prudent standing contract retailer would construct its hedge portfolio to minimise the risk of a loss or a gain.¹⁸

The appropriate way to measure risk, as used in financial portfolio analysis, is the variance [defined by ACG as the sum of squares of the difference between costs of different outcomes and the mean outcome] in wholesale cost of purchasing electricity across an appropriate range of outcomes. The cost of the portfolio that minimises risk across the range of outcomes is in fact the expected wholesale electricity cost. Our analysis therefore estimated the expected wholesale electricity purchase cost for a prudently hedged retailer. We note that the objective of setting the retail price caps for AGL SA can be stated as preserving the value of its retail businesses (that is, determining prices that are expected to deliver a net present value of zero from this activity). We note that it is a standard outcome in finance theory that the value of an asset is determined as the discounted expected payoffs.

...

AGL SA proposed a different method of estimating the wholesale energy purchase cost, namely that the wholesale cost of electricity should be the cost of a specified 'base case' plus an allowed premium for risk. It argued that the risk premium should comprise explicit allowances for:

- risks of pool price and load variation;
- risks of customer churn; and
- other risks such as force majeure.

We explain below that our approach is likely to provide a reasonable estimate of the expected cost of purchasing the forecast, within the practical constraints of what practically can be estimated given data limitations. In contrast, there are sound reasons to conclude that AGL SA's approach would produce an estimate that would exceed the expected cost of wholesale energy purchases.

3.4.5 The approach adopted by ACG differs from that used by AGL SA. It is not correct to state that the ACG approach simply reduces the AGL SA

¹⁷ The Allen Consulting Group, *Energy Wholesale Price Study Response to AGL SA Review Application*, February 2005, Appendix A pages 21-25.

¹⁸ The Allen Consulting Group, *Energy Wholesale Price Study Response to AGL SA Review Application*, February 2005, page 9.



numbers by a fixed amount. The ACG methodology calculates a WEC that already includes provision for those risks nominated by AGL SA.

Commission consideration

- 3.4.6 The Commission has reviewed the matters put forward by AGL SA during the course of the standing contract price determination process and the materials provided by AGL SA in the review application, in respect of the WEC calculation methodology.
- 3.4.7 After further consideration, the Commission is satisfied that the approach proposed by ACG is reasonable, appropriately accounts for risk and is consistent with the statutory factors and objectives which the Commission must consider in making a price determination under the ESC Act.

Allowance for Risk Premium

- 3.4.8 While the actual methodology adopted by the Commission is different to that assumed by AGL SA in the Review Application, the Commission has nevertheless also considered whether the approach which it adopted in any event adequately reflects underlying WEC risks.
- 3.4.9 AGL SA states that, contrary to the objectives set out in section 6 of the ESC Act, the Commission's WEC determination does not adequately reflect underlying risks such as customer churn, load variation and unusual or unexpected system events.
- 3.4.10 The Commission has reviewed and confirmed with ACG that the ACG methodology did incorporate those risks. Section 2.3 of the report by ACG provides a fuller explanation of how the underlying risks have been incorporated in ACG's methodology. ACG state¹⁹:

AGL SA has stated that the Commission's assessment does not adequately reflect the value of underlying risks such as customer churn, load variation and unusual or unexpected system events.

...

... our approach was designed to incorporate all risks through including appropriate scenarios and assigning corresponding probabilities, given that the objective is to estimate

¹⁹ The Allen Consulting Group, *Energy Wholesale Price Study Response to AGL SA Review Application*, February 2005, pp 12-13.

the expected wholesale energy purchase cost. However, our ability to model the broad spectrum of possible future events was limited by the availability of information ...

- 3.4.11 Other methodologies do separately add amounts for various risks to an average purchase cost²⁰, but this is not the approach used by the Commission or its expert advisor ACG.

Commission consideration

- 3.4.12 The Commission is satisfied that ACG has included all relevant risks in its derivation of the “average purchase costs”, in providing advice to the Commission in setting the relevant WECs.

3.5 The pass through events issue

- 3.5.1 Under Chapter 5 of the standing contract price determination, the Commission has provided a mechanism to deal with the occurrence of certain events beyond the control of AGL SA which cause AGL SA to incur materially higher or lower costs in the provision of standing contracts.
- 3.5.2 The mechanism provides that when such an event occurs, and the Commission is persuaded that there has been a material impact on AGL SA (positive or negative) then the associated costs (again, positive or negative) may be passed through to standing contract customers as an additional amount to the standing contract price without changing the underpinning price path controls.
- 3.5.3 As summarised by AGL SA at clause 8.47 of the review application, the events specified by the Commission are:
- (a) A change in taxes event, affecting only the electricity industry;
 - (b) A regulatory reset event, which imposes different obligations on AGL SA as a standing contract retailer;
 - (c) A reserve trader event; and
 - (d) A NEMMCO directions event.

²⁰ See for example the breakdown of WEC costs detailed in Deloitte, *Draft AGL SA Franchise Regulatory Pricing Forecast Costs*, October 2004, prepared by AGL SA auditor. The Commission was provided with this report as part of the price determination process in an e-mail from AGL to the Commission dated 8 October 2004.



3.5.4 Detailed definitions of each of these events are set out in clause 6.1 of the standing contract price determination and it is not necessary for the Commission to repeat those definitions here.

AGL SA application concerning pass through events

3.5.5 AGL SA states that the list of events contained in the standing contract price determination (as set out in paragraph 3.5.3) is too limited and, therefore, that the Commission should vary the standing contract price determination by including two additional pass through events, namely:

- (a) Market charges event; and
- (b) Force majeure event.

Commission consideration

3.5.6 The Commission notes the view of the Treasurer that the list of pass through items should not be extended, and that regard should be had to the existence of the “special circumstances” provisions.

3.5.7 The Commission notes at the outset that there is nothing in the legislative scheme governing the making of a standing contract price determination by the Commission which obliges the Commission to include provision for pass through events.

3.5.8 The Commission does, however, have a discretion under section 36AA(4a)(c) of the Electricity Act to provide that the standing contract price may vary at specified times according to a formula specified in the determination.

3.5.9 In respect of Chapter 5 of the standing contract price determination in relation to pass through events, the decision to exercise the discretion was made having considered the potential benefits to AGL SA and customers through alleviating risk of over or under compensating AGL SA should circumstances change.

3.5.10 There are two specific issues which the Commission has considered in respect of pass through events and AGL SA’s request to include two additional pass through events:

- (a) The statements of AGL SA in respect of the Commission’s treatment of the “special circumstances” provisions of the Electricity Act; and

- (b) The statements of AGL SA in respect of the treatment of pass through events in the Commission's draft Electricity Distribution Price Determination.

"Special circumstances"

- 3.5.11 Under section 36AA(4a)(d) of the Electricity Act, which has been proclaimed to come into operation on 1 July 2005,²¹ the Commission is given a discretion to determine whether "special circumstances" exist and, if it so determines, the ordinary statutory strictures surrounding the making of a price determination under 36AA are relaxed.
- 3.5.12 The Commission considers that, outside of the pass through events which are specified in the standing contract price determination, this statutory provision for "special circumstances" is the appropriate means of dealing with circumstances where AGL SA's costs increase or decrease due to events beyond AGL SA's control.
- 3.5.13 The Commission notes that the submission from the Treasurer indicates²² that the "special circumstances" provision should obviate the need for a long list of pass through items.
- 3.5.14 However, at paragraphs 8.60 and 8.61 of the review application, AGL SA has stated that the Commission's "proposed interpretation" of the term "special circumstances" is such that "*it is unlikely the Commission will countenance such provisions being used where, for example, NEMMCO increases its fees substantially or introduces a new fee.*"²³
- 3.5.15 AGL SA bases this statement on a comment of the Commission contained at page A-22 of Part A of the standing contract price determination (which is also reproduced at page 81 of the Draft Final Report of the Inquiry into Retail Electricity Price Path), which comment is set out in full at paragraph 8.60 of the review application.
- 3.5.16 The Commission does not accept AGL SA's statement, as it is required by law to assess each such application on its merits.

²¹ South Australian Government Gazette, No 76, 19 August 2004, p 3279

²² Treasurer of South Australia, Letter to Essential Services Commission of SA, 11 February 2004, page 1 (refer <http://www.escosa.sa.gov.au/resources/documents/050211-AglReviewApplicationSub-Foley.pdf>).

²³ AGL South Australia Pty Ltd, Review Application in respect of the Electricity Standing Contract Price Determination published on 23 December 2004, January 2005, paragraph 8.61 (page 26).



3.5.17 The Commission therefore confirms that, outside of the pass through events specified in the standing contract price determination, the appropriate vehicle for dealing with “special circumstances” such as force majeure and market charges is that provided for under section 36AA(4a)(d) of the Electricity Act. If any party, including the Commission itself, considers that a particular event is a “special circumstance”, the Commission will address itself to the merits of that application at that time.

Pass through events in the draft Electricity Distribution Price Determination

3.5.18 AGL SA has stated that the Commission has been inconsistent in treatment as between the standing contract price determination and the draft electricity distribution price determination recently released in respect of ETSA Utilities (the electricity distributor).

3.5.19 In particular, the expert advisor retained by AGL SA (through its lawyers Piper Alderman), Mr. Price, expressed a view that it is unclear why the Commission would provide a different and slightly broader range of pass through events for ETSA Utilities in the draft electricity distribution price determination as compared with those provided for AGL SA in the standing contract price determination.

3.5.20 The Commission observes that the reason for the difference in pass through events allowed as between the two price determinations is the difference in the legislative schemes under which each price determination was made.

3.5.21 While all price determinations made by the Commission are ultimately made under Part 3 of the ESC Act, that Act provides that the Commission may only make such a price determination “*if authorised to do so by a relevant industry regulation Act or by regulation under this Act*”.²⁴

3.5.22 The standing contract price determination is authorised by sections 35A(1)(a) and 36AA of the Electricity Act, with the associated rules and requirements governing the making of a price determination (for example, section 36AA(4a)(b) provides that a standing contract price determination must last for at least three years).

²⁴ *Essential Services Commission Act 2002*, section 25(2).

- 3.5.23 The electricity distribution price determination is authorised by section 35A(1)(c) of the Electricity Act, which provides that the making of any such price determination is subject to the National Electricity (South Australia) Law and the National Electricity Rules.
- 3.5.24 The scheme of the National Electricity (South Australia) Law (NEL scheme) and the National Electricity Rules is fundamentally different to the scheme of section 36AA.
- 3.5.25 The result of the NEL scheme is that, when making an electricity distribution price determination, it is the National Electricity Code which has primacy.²⁵ It is this fact which is of importance when considering the differences between the two price determinations.
- 3.5.26 In particular, clause 6.10.5(e) of the National Electricity Code prohibits the Commission from revoking a price determination during the life of the determination other than where the determination was based on false or misleading information or there was a material error in the setting of the determination. This provides very limited opportunities for revising a determination.
- 3.5.27 This prohibition may be contrasted with the express provisions of section 36AA of the Electricity Act which will apply in respect of standing contract price determinations from 1 July 2005. Those provisions clearly permit the revocation or replacement of a price determination in any circumstances deemed to be “special circumstances” by the Commission.
- 3.5.28 Given the existence of this section 36AA scheme, as contrasted with the prohibitions of the National Electricity Code scheme, the Commission was able to provide in the standing contract price determination for a list of pass through events which did not include “extraordinary events” (which is in the draft electricity distribution price determination) as that concept is already dealt with by the Electricity Act’s “special circumstances” provisions for standing contract prices.
- 3.5.29 AGL SA has also stated that the lack of provision for pass through events which are contingent upon the coming into effect of a national regulatory

²⁵ For more detailed consideration of the scheme under which the electricity distribution price determination is to be made by the Commission, see Essential Services Commission of South Australia (ESCOSA), *Draft 2005-2010 Electricity Distribution Price Determination: Part A – Statement of Reasons*, November 2004, Chapter 1 pp 1-11 (refer <http://www.escosa.sa.gov.au/resources/documents/041130-O-DraftElectDistPriceDetPartA.pdf>)



scheme for the electricity supply industry (the proposed market changes event) is a failure in the standing contract price determination.

3.5.30 While the Commission notes that the regulatory bodies for the purposes of such a scheme have been established, those bodies currently have no regulatory role to perform in South Australia. In addition, there is no “scheme” in place as yet dealing with regulatory arrangements. It would clearly be inappropriate for the Commission in these circumstances to purport to deal with potential future regulatory arrangements. To do so would be too uncertain. Instead, these matters are properly to be dealt with through the “special circumstances” provisions, as well as any transitional provisions in relevant legislation, when any national regulatory scheme takes effect.

3.5.31 The Commission therefore does not consider that the standing contract price determination violates the standing contract price determination scheme of the Electricity Act and ESC Act merely because the Commission has made different provisions for pass through events as between the standing contract price determination and the draft electricity distribution price determination.

Risk premium in the Wholesale Electricity Cost

3.5.32 AGL SA’s consultant, Mr. Price, has put forward opinion that the Commission ought, in any event, to include within the Commission’s determination of wholesale electricity costs or retail operating costs a “buffer”, or premium, to account for “possible additional costs” (report of Mr. Price, January 2005, paragraph 289).

3.5.33 The Commission notes four matters in respect of this opinion.

3.5.34 First, it is important to note that Mr. Price refers to “possible” rather than “probable” additional “costs”. In making the provision which it did for pass through events, the Commission was concerned to deal with probable events; that is to say, those events which were more than merely within the realm of possibility. To make provision for all “possible” events would open the standing contract price determination to claims of uncertainty; the limitation to “probable” events sought to strike an appropriate regulatory balance.

3.5.35 Secondly, the Commission observes that Mr. Price has focussed on “possible additional costs” faced by AGL SA. The Commission is equally concerned over possible financial benefits to AGL SA which might accrue

from the occurrence of pass through events, which benefits ought to be passed through to standing contract customers. These benefits and their flow through to standing contract customers is a matter seemingly ignored by AGL SA and Mr. Price.

3.5.36 Thirdly, the Commission's standing contract price determination already includes a premium to allow for certain risks. For reasons explained immediately below, the Commission has not included within that premium all possible risks, as these risks are better dealt with through "special circumstances".

3.5.37 Finally, and most significantly, given the existence of the "special circumstances" scheme to apply from 1 July 2005, it is not necessary to include any additional "buffer", or premium within the standing contract price determination for additional risks. If an event occurs which is deemed to be a "special circumstance", the allocation of costs or benefits (as the case may be) can be dealt with by the Commission in any price determination which follows that event.

3.5.38 To include a "buffer" or premium in anticipation of these events, given the existence of the statutory "special circumstances" scheme, merely provides the potential for windfall gains to be made. This would particularly be the case if the Commission were to consider all "possible" events that might attract such a "buffer".

3.6 *The Commission's decision on review*

The initial WEC issue

3.6.1 The Commission confirms its allocation methodology for cap premiums in the standing contract price determination and therefore confirms the allowable WEC for the initial regulatory period 1 January 2005 to 30 June 2005.

The risk premium issue

3.6.2 The Commission confirms that the WEC calculation methodology used by ACG for the price path period incorporates the relevant risks faced by AGL SA and no additional compensation is required.

3.6.3 The Commission confirms the WEC used in its final determination.



The pass through events issue

- 3.6.4 The Commission confirms Chapter 5 of the standing contract price determination in respect of the pass through events and the conclusion there should only be 4 events, in addition to changes in network charges, that would result in an automatic pass through of net additional costs to AGL SA's standing contract prices.
- 3.6.5 The Commission has decided that it is not necessary to provide any additional "buffer" or premium within either wholesale electricity costs or retail operating costs over and above those already provided for in its standing contract price determination to account for unexpected events given the existence of the "special circumstances" provisions of the Electricity Act (from 1 July 2005).
- 3.6.6 The effect of this decision is that AGL SA, or any other interested party, will be required to approach the Commission and persuade it that "special circumstances" exist where that party considers the standing contract price determination should be amended during the 3 year period of the standing contract price determination. Such an application is the most appropriate vehicle for dealing with any necessary changes to wholesale electricity costs or retail operating costs arising from the occurrence of the "special circumstance", if it is found to exist.
- 3.6.7 It necessarily follows that the Commission will not vary the standing contract price determination by including further classes of pass through events.
- 3.6.8 In making this decision the Commission repeats its views on "special circumstances" as set out at page A-22 of Part A of the standing contract price determination. That is to say, while such circumstances will not be of a minor or trivial nature (in a general sense) each application will, as required by law, be dealt with by the Commission on the merits of the instant case. In putting this position, the Commission expresses no views in the abstract as to when a particular circumstance might be considered special.

4 RETAIL OPERATING COSTS

4.1 Issues

- 4.1.1 In the standing contract price determination the Commission has adopted an average annual electricity consumption of 7.4 MWh, based on the data which it had regard to in the course of making the determination (which included data and submissions provided by AGL SA).
- 4.1.2 The key issue raised by AGL SA for review by the Commission in respect of the Commission's decision on average annual electricity consumption is as follows:

The appropriate decision on the average annual electricity consumption per standing contract customer is 7.0 MWh, and that because the Commission did not adopt AGL SA's figure of 7.0 MWh per annum, the standing contract price determination is in error (see paragraph 9.2 of the review application) ("*the quantum issue*").

In particular, AGL SA states that the adoption of 7.4 MWh by the Commission introduces "*an error into the conversion of the Retailer [sic] Operating Cost per customer figure (\$84.41 per customer in the first quarter of the initial regulatory period) to a dollar per MWh amount.*"²⁶

- 4.1.3 A further issue raised by AGL SA concerned compliance with the legislative requirement of section 26(2) of the ESC Act to provide reasons, insofar as AGL SA asserted that the standing contract price determination does not explicitly state the key assumptions made by the Commission concerning consumption. This matter is discussed in Chapter 7.

4.2 The quantum issue

- 4.2.1 In order to respond to the issues raised in the AGL SA Review Application, the Commission sought independent advice from the distribution network operator and meter reader ETSA Utilities.²⁷ The Commission has reviewed consumption data available to it and has concluded that the average annual consumption per customer of 7.4MWh remains the appropriate figure to

²⁶ AGL South Australia Pty Ltd, *Review Application in respect of the Electricity Standing Contract Price Determination* published on 23 December 2004, January 2005, paragraph 9.2 (page 28).

²⁷ ETSA Utilities, Letter to Essential Services Commission of SA (*Average Annual Electricity Usage by Small Customers*), 27 January 2005 (refer <http://www.escosa.sa.gov.au/resources/documents/050127-ETSA-AveAnnualUsage.pdf>) and ETSA Utilities, Letter to Essential Services Commission of SA (*Average Annual Electricity Usage by Small Customers*), 31 January 2005, (refer <http://www.escosa.sa.gov.au/resources/documents/050131-ETSA-AveAnnualUsage.pdf>).



use in the standing contract price determination. The Commission's reasons for this decision are set out below.

Historical Average Consumption

- 4.2.2 The Commission has analysed all available historical consumption and customer number data together with the most recent data available (in respect of the 2004 calendar year) and it has also looked at trends in average consumption over the past four financial years (2000/01 to 2003/04).
- 4.2.3 While the Commission has reviewed historical information provided by retailers and by ETSA Utilities, it has primarily relied upon distribution data in reaching its conclusions, as a result of data quality issues. These issues are discussed later in this chapter.
- 4.2.4 Under the Electricity Pricing Order, ETSA Utilities provides the Commission with an annual tariff application which contains, among other things, forecasts, estimates and actual data relating to consumption and customer numbers. This data is internally audited by ETSA Utilities and is reviewed by the Commission during the annual tariff adjustment process. The Commission believes that this data is reliable for the purpose of determining average consumption of small customers.
- 4.2.5 The annual data provided by ETSA Utilities is disaggregated by distribution tariff category. Many of these categories relate to large customers only and are therefore not relevant for this analysis. The tariff categories that include small customers are:
- ? Residential
 - ? LV Business single rate
 - ? LV Business 2 rate
 - ? Controlled load
- 4.2.6 These tariff categories encompass the small customer base in SA. There are, however, likely to be some large (>160MWh) customers on a LV Business 2 rate tariff, which need to be excluded from the analysis.
- 4.2.7 The Commission has therefore requested consumption and customer number data from ETSA Utilities that relates purely to small customers. ETSA Utilities has been able to provide the Commission with information on actual average consumption of customers consuming less than 160MWh

per year during the 2004 calendar year. This figure includes hot water consumption, but excludes unmetered supplies (eg. street lighting).

- 4.2.8 This data indicates that the average consumption per small customer during 2004 was approximately 7.46MWh, which is in line with the Commission's estimate of 7.4MWh.
- 4.2.9 It is important to note, however, that the figure derived from ETSA Utilities' data represents average consumption across the total small customer base, not just standing contract customers. It includes the consumption of small customers with a market contract (either with AGL SA or a new entrant retailer).
- 4.2.10 The inclusion of market contract customers in this analysis will only distort the average consumption figure if the average consumption levels of market contract customers are different to that of standing contract customers. AGL SA has suggested to the Commission that the average consumption of a small customer with a market contract may be greater than the average consumption of a small customer with a standing contract, as larger customers tend to be more attractive to new entrant retailers.
- 4.2.11 In response to this view, the Commission notes that there is very little historical information relating purely to the consumption of standing contract customers (ie. excluding customers on market contracts). However, 2003/04 data provided to the Commission by retailers does enable separate average consumption figures to be calculated for AGL SA small customers and for all other small customers. This data is not conclusive on which has the larger average consumption. The Commission therefore believes that there is uncertainty as to whether standing contract customers consume more or less, on average, than a market contract customer and, consequently, it considers there is no basis for departing from the assumption of the figure derived from ETSA Utilities' information of the average consumption of standing contract customers.
- 4.2.12 In addition to analysing 2004 consumption data, the Commission has also reviewed data provided by ETSA Utilities over the 2000/01 to 2003/04 financial years. An estimate of the average consumption of small customers over these years has been calculated by the Commission, whereby an adjustment has been made to exclude large customers from the analysis using the results of the 2004 data discussed above. This data indicates that around 90% of LV Business 2 rate customers are small customers, and that around 60% of the total consumption of customers in



this tariff category relates to small customer consumption. These proportions have been applied to the 2000/01 to 2003/04 period to determine average consumption per small customer.

4.2.13 As shown in Table 1, the Commission has estimated a relatively high average consumption figure of 7.87MWh in 2000/01, with average consumption then stabilising in subsequent years to a figure of 7.48MWh in 2003/04.

Table 1. Average consumption of small customers: 2000/01 to 2003/04

	2000/2001	2001/2002	2002/2003	2003/2004
Total small customer consumption (MWh)	5,810,620	5,555,450	5,669,450	5,736,749
Total small customers	738,453	745,890	750,069	770,335
Average Consumption (MWh/customer)	7.869	7.448	7.559	7.447

4.2.14 While this data encompasses the entire small customer base, including customers on market contracts, it is only in the latter half of 2002/03 and 2003/04 where there is the potential for the average consumption of standing contract customers to be different to that for small customers, given that FRC commenced in SA on 1 January 2003. As stated earlier though, it is unclear to the Commission whether such a difference exists.

4.2.15 The Commission believes that there are a number of key drivers of electricity consumption in SA, such as air conditioning penetration and changes in price. However, in relation to the variation in average consumption of small customers over the four-year period examined, the Commission considers weather to be the major driver of the change.

4.2.16 During 2000/01, SA experienced one of the hottest summers recorded in this state over the past century. This unusually hot summer is likely to explain the relatively high average usage compared to the following three years, which did not experience such extreme summer heat.

4.2.17 The average consumption calculated over the 2001/02 to 2003/04 financial years shows less variation. The Commission acknowledges that standing contract price increases have had some impact on residential consumption during 2003/04 as reported by the Electricity Supply Industry Planning

Council (ESIPC) in its June 2004 Annual Planning Report.²⁸ However, the Commission believes that the minor variation in residential sales is not significant enough to warrant a change to the average consumption figure for standing contract customers of 7.4MWh.

Data quality

4.2.18 As mentioned earlier, the Commission has access to consumption data provided by AGL SA and other retailers in SA. However, there are a number of reasons why this data is believed to be less reliable than distribution data for calculating an average consumption figure:

- (a) As noted in the 2003/04 Annual Performance Report²⁹, there have been a number of general issues concerning data quality in the statistical returns received from retailers;
- (b) Total consumption reported by retailers during 2003/04 does not reconcile well with the amount of electricity reported to be delivered by ElectraNet SA to the transmission network exit points (both those for the ETSA Utilities network and for certain direct connect customers), even after accounting for embedded generation and network losses. There appears to be a significant under-reporting of consumption by retailers in 2003/04³⁰; and
- (c) The consumption data reported by retailers represents billed consumption, as opposed to accrued consumption. Under a 90-day billing cycle, there is likely to be a difference between billed consumption relating to the previous period, and unbilled consumption in the current period. This can distort the average consumption figure in any particular year.

4.2.19 On the other hand, data obtained from ETSA Utilities is believed to be more reliable than retailer data because:

²⁸ Refer Electricity Supply Industry Planning Council (ESIPC), *Annual Planning Report*, June 2004, pages 14-15 (available via the ESIPC website – www.esipc.sa.gov.au).

²⁹ Essential Services Commission of South Australia (ESCOSA), "2003-04 Annual Performance Report, Performance of Regulated Electricity Businesses", November 2004 (refer http://www.escosa.sa.gov.au/resources/documents/041124-O-ELEC_AnnualPerformanceReport_2003-04.pdf).

³⁰ After adding embedded generation to transmission sales, a total consumption figure for 2003/04 of 12,272,000 MWh has been calculated. The difference between this and the 11,302,900 MWh figure reported by retailers could potentially be explained as network losses, and on these numbers the implied network percentage loss would be 8.0%. This is significantly higher than the approved distribution loss factor for 2003/04 and losses calculated for previous years, of around 6%.



- (a) ETSA Utilities assumed full meter reading functions for small customers in late 2003 and, therefore, the 2004-year data is sourced directly from the distributor. 2003/04 data represents part AGL SA and part ETSA Utilities meter reads and there is evidence of problems in collecting billing data during this transition period; and
- (b) ETSA Utilities' consumption and customer number data is provided annually to the Commission in support of ETSA Utilities' annual tariff applications. The data is closely examined by Commission staff each year and has been reviewed by the ESIPC as part of the 2005-2010 Electricity Distribution Price Review. Only minor data problems have been identified to this point.

4.2.20 For these reasons, the Commission believes that data obtained from ETSA Utilities is of superior quality to retailer data, and that it is appropriate to use this data to support the Commission's decision on average consumption.

Implications for future average consumption

- 4.2.21 The Commission is of the view that there is no compelling reason to believe that average consumption will decline from its current levels over the price path period. There are a number of variables that can influence average consumption, including weather. The Commission expects the penetration of electrical appliances, particularly air conditioning, to continue into the future, which would be expected to increase average consumption.
- 4.2.22 Customer churn is also expected to continue, although it is unclear whether this will lead to an increase or decrease in average consumption of the eroding standing contract customer base.
- 4.2.23 The Commission notes that the AGL SA price path proposal incorporates an assumed growth rate in average consumption per customer of 1% per annum.³¹ The Commission believes that future trends in average consumption may be impacted by a number of other factors, including price movements and the impact of demand management initiatives. Given the uncertainty over the effects of these factors on consumption, it believes that

³¹ As advised via email dated 30 August 2004 from AGL SA to the Commission.

there are no compelling reasons to adjust the average consumption upwards or downwards for the period of the price determination.

4.3 *The Commission's decision on review*

The quantum issue

- 4.3.1 The Commission confirms its use of an average annual consumption of 7.4MWh per standing contract customer for the price path period.

5 RETAIL MARGIN

5.1 Issues

- 5.1.1 In the standing contract price determination the Commission set the allowable retail margin for AGL SA in respect of standing contracts at 10 percent of retailer costs (translating roughly to 5 percent of a total customer bill).
- 5.1.2 AGL SA has sought a review of this provision of the standing contract price determination on the grounds that it is not a “*fair return for AGL SA*”³² and that the Commission ought to adopt AGL SA’s proposal of 5 percent of sales.

5.2 The retail margin issue

- 5.2.1 AGL SA has stated that the appropriate margin should be significantly higher (adjusted to 13 percent, with a corresponding reduction in the x factor down to -1.05 percent).
- 5.2.2 AGL SA also states that the margin of 5 percent of sales would only be acceptable to AGL SA where its actual costs were allowed by the Commission and the benchmarks determined by the Commission reflected AGL SA’s prudent and efficient costs.³³ As the Commission has determined costs below those put forward by AGL SA, the 5 percent margin applied to these costs gives a lower dollar quantum than it would if the AGL SA costs were accepted.
- 5.2.3 The Commission notes that the standing contract price determination affects the rights and obligations of not only AGL SA, but also of all small customers who are, or may be, subject to the standing contract price. This is of fundamental importance, as the Commission’s determinations need to account for both AGL SA’s and small customers’ interests (see Section 6 of the ESC Act).

³² AGL South Australia Pty Ltd, *Review Application in respect of the Electricity Standing Contract Price Determination* published on 23 December 2004, January 2005, paragraph 10.2 (page 44).

³³ AGL South Australia Pty Ltd, *Review Application in respect of the Electricity Standing Contract Price Determination* published on 23 December 2004, January 2005, paragraphs 10.14 and 10.15 (page 47).



- 5.2.4 The Commission undertook an extensive analysis of the retail margin in the Discussion Paper³⁴ and in Chapter 9 of the draft final report of the Inquiry into Retail Electricity Price Path.³⁵ The table of EBITDA in Chapter 9 outlined the Commission's assumptions, and resulted in the adoption of the 10 percent margin as broadly indicative of a fair return.
- 5.2.5 AGL SA has provided no additional material that causes the Commission to change its analysis.
- 5.2.6 The Commission notes the submission from the Treasurer which suggests that the retail margin adopted by the Commission represents the upper limit of an acceptable margin.

5.3 The Commission's decision on review

- 5.3.1 Having reviewed the materials upon which it relied in making a decision on the retail margin in the standing contract price determination, the Commission maintains its view that the retail margin set is appropriate.

³⁴ Essential Services Commission of South Australia (ESCOSA), *Inquiry into Retail Electricity Price Path: Discussion Paper*, September 2004 pp 43 – 64 (refer http://www.escosa.sa.gov.au/resources/documents/040914-ElecRetailPricePathInq_DiscPaper.pdf).

³⁵ Essential Services Commission of SA (ESCOSA), *Inquiry into Retail Electricity Price Path: Draft Final Report*, November 2004, pp 57-59 (refer http://www.escosa.sa.gov.au/resources/documents/041130-R-DraftInquiryReport_RetailElecPricePath.pdf)

6 CHAPTER 4 – PRICE PATH VARIATION

6.1 Issues

6.1.1 In Chapter 4 of the standing contract price determination, the Commission allowed for a one-off variation to account for the outcomes of the Inquiry into Standing Contract Prices of AGL. The effect of the variation provisions was to allow the Commission or AGL SA to undertake a process whereby either or both of:

(a) the assumptions as to wholesale electricity cost, retail operating cost and retail margin; and

(b) the x-factor,

could be varied in accordance with the outcomes of the Inquiry if those outcomes represented a material change from the assumptions/inputs into the standing contract price determination.

6.1.2 AGL SA has stated that Chapter 4, in form and in intent, is invalid insofar as it claims the Commission is attempting to exercise powers in excess of those given under the ESC Act and the Electricity Act. The key elements of AGL SA's concern is that the Commission, having given itself a discretion as to whether or not to permit a variation under Chapter 4, has exceeded its powers to the extent that the exercise of that discretion means that the standing contract price may change from time to time.

6.2 The price path variation issue

6.2.1 The Commission's purpose of including the price path variation provisions was to allow a process by which any findings of the Inquiry, which were different from the assumptions in the standing contract price determination, could flow through into that determination.

6.2.2 As outlined in 2.2 above, the Inquiry Terms of Reference require the Commission to provide a final report and price determination to the Minister and the electricity entity no later than 31st March 2005.

6.2.3 The legislative scheme for standing contract price path arrangements generally requires a price determination to be for at least three years (section 36AA(4a)(b)). This means that the Commission having made a price determination in December 2004 would, in the ordinary course, not make another such determination until December 2007.



- 6.2.4 In order to provide a mechanism for the findings of the Inquiry to be incorporated into the price determination process to meet the requirements of the Notice of Reference (which envisaged that a price determination might be a possible outcome of the Inquiry process and to meet the requirements of the Electricity Act), the Commission included Chapter 4 in its Price Determination.
- 6.2.5 AGL SA raised a number of matters in respect of the validity of the Chapter:
- (a) the effect of the Chapter is that the price is not “fixed” as required by section 36AA of the Electricity Act;
 - (b) there are legal authorities which contain doctrine governing the exercise of delegated powers by regulatory authorities which indicate that the Commission is acting beyond power in respect of Chapter 4; and
 - (c) the existence of Chapter 4 denies AGL SA the review and appeal rights of the ESC Act.

“Fixing” of the standing contract price

- 6.2.6 In respect of the view that the effect of Chapter 4 is that the price is not “fixed”, the Commission makes a number of observations.
- 6.2.7 First, the Commission maintains that the price under the standing contract price determination is fixed, insofar as there is a “*requisite degree of certainty for the price offeror in the outcome to ensure contractual certainty for consumers*”.³⁶ Chapter 4 merely allows the potential for variation following the formula in that Chapter in the event that the specified event occurs. The price payable by small customers up until such an event occurs remains known. Similarly, having gone through the Chapter 4 process, a revised price is also known and certain.
- 6.2.8 If AGL SA was correct in regard to the meaning of “fixed” insofar as contractual certainty is concerned, any provisions in market electricity contracts which provided for a revision of the price in response to a future change in, for example, tax rates or the introduction of a new tax, would also be invalid.

³⁶ AGL South Australia Pty Ltd, *Review Application in respect of the Electricity Standing Contract Price Determination published on 23 December 2004*, January 2005, paragraph 11.11 (page 48).

- 6.2.9 Similarly, on AGL SA's view, all pass through events under Chapter 5 of the standing contract price determination would also be invalid.
- 6.2.10 Secondly, to the extent that AGL SA states that the Commission has given itself an "*unfettered, unguided and at large*"³⁷ discretion under Chapter 4, which permits the Commission to vary the standing contract price "*as it sees fit*",³⁸ the Commission does not agree with those assertions.
- 6.2.11 The Commission has set constraints around the time frame for which Chapter 4 will have any application (until 1 July 2005), the event which can trigger the operation of Chapter 4, the timeframes for any variation under Chapter 4, the precise methodology by which a variation under Chapter 4 will affect the standing contract price and the matters which it will take into account.
- 6.2.12 The Commission is of the view that Chapter 4 does not offend the scheme of section 36AA and, correspondingly, does fix a price for the price path period, being one which varies at specified times (when a price path variation event is determined to have occurred) in accordance with a specified formula (the provisions of Chapter 4). While the actual degree of variation to the standing contract price will not be known until a particular event has occurred, the mechanisms are sufficiently well set out to provide the requisite certainty.
- 6.2.13 For the Commission to pre-set actual parameters for any given event would be to ignore the merits of the particular event.

Legal authorities

- 6.2.14 In respect of the legal authorities cited by AGL SA, the Commission observes that (having reviewed the reports of the cases) the facts of those cases are sufficiently different so as to have little relevance to the standing contract price determination.
- 6.2.15 In the circumstances referred to in the authorities cited by AGL SA, the pricing orders were, in the view of the court, uncertain because some of the factors which made up the pricing order required a person to make an

³⁷ AGL South Australia Pty Ltd, *Review Application in respect of the Electricity Standing Contract Price Determination* published on 23 December 2004, January 2005, paragraph 11.23 (page 50).

³⁸ AGL South Australia Pty Ltd, *Review Application in respect of the Electricity Standing Contract Price Determination* published on 23 December 2004, January 2005, paragraph 11.24 (page 50).



estimation of their value and therefore the ultimate price set was subject to subjective differences of opinion³⁹.

- 6.2.16 However, in the case of the standing contract price determination, the price which is to be charged by AGL SA on any given day is certain and ascertainable.
- 6.2.17 This is true in respect of many prices which are subject to an adjustment by CPI. As the actual CPI is not known until the relevant date, the actual price in the future is not known, but the process for determining the price is (and to that extent, the price is certain and ascertainable). Similarly, while the prices charged under AGL SA's market contracts are knowable now, those contracts contain price variation clauses, the effects of which are known, while at the same time the actual outcomes of those clauses cannot be known in advance.
- 6.2.18 When a price path variation event has occurred and the standing contract price is to be varied as a result, the scheme of Chapter 4 results in the old price applying up until the time that the varied price is ascertained and published. This means, contrary to the view of AGL SA, that from a time before the new price is to apply, the price is fixed under the standing contract price determination.
- 6.2.19 The Commission therefore has not been persuaded that anything contained in the legal authorities cited requires the removal of Chapter 4 from the standing contract price determination.
- 6.2.20 The Commission is of the view that the price which AGL SA can charge a standing contract customer at a particular point in time is always known, ascertainable and certain.

Denial of review and appeal rights

- 6.2.21 AGL SA has asserted that the mechanism the Commission has included in Chapter 4 of the Standing Contract Price Determination, to allow for a price path variation for the period until July 2005, denies AGL SA a right to review and appeal under Part 6 of the Essential Services Commission Act 2002, in respect of any decision made.
- 6.2.22 The Commission notes the legislative provision of specific rights of review and appeal apply only to the making of a price determination, and that the

³⁹ Latham C.J at 219 of *Cann's Pty Ltd V The Commonwealth (1945) 71 CLR 210* where he summarises the decision *King Gee Clothing Co. Pty Ltd v The Commonwealth (1945) 71 CLR 184*

Parliament has specifically authorized the making of a determination that provides for prices to be varied according to a formula specified in the determination (section 36AA(4a)(c)). The legislative scheme does not give a statutory right of appeal in respect of decisions made or not made by the Commission during the period of application of the Price Determination. This provides certainty in protecting the operation of determinations made from continuous legal challenge

- 6.2.23 The Commission observes that any decisions made pursuant to the Standing Contract Price Determination, including for example decisions as to whether or not a regulated pass through event has occurred and the quantum effect of such an event, as well as decisions under Chapter 4, are not subject to the specific review process set out in Part 6 of the Act, as such decisions are not themselves price determinations within the meaning of the Act.
- 6.2.24 The Commission is of the view that the inclusion of Chapter 4 in its price determination is authorised by section 36AA(4a)(c) of the Electricity Act, and that the consequence of the non-application of Part 6 of the Act to the price variation mechanisms set by the Commission was intended by the Parliament.
- 6.2.25 The fact that AGL SA does not have the right to review or appeal under Part 6 of the ESC Act, against a decision of the Commission made under Chapter 4 of the Price Determination does not, however, remove the Commission's decision making processes from the general judicial review processes and the supervisory jurisdiction of the courts, nor does it affect AGL SA's right to assert that "special circumstances" exist after July 2005.

6.3 The Commission's decision on review

- 6.3.1 The Commission confirms Chapter 4 of the standing contract price determination as a proper exercise of its discretion under section 36AA(4a)(c) of the Electricity Act and taking into account the Notice of Reference and the objectives and intentions of the Government in making that referral.
- 6.3.2 The Commission is of the view that on any particular day, the price which AGL SA can charge standing contract electricity customer is known, certain and ascertainable.

7 SUMMARY OF INFORMATION

7.1 Issues

- 7.1.1 AGL SA states that the standing contract price determination does not adequately contain a summary of information on which the determination was based; and on the specific matter of the Commission's decision on the average annual electricity consumption, the standing contract price determination does not explicitly state the assumptions made by the Commission concerning consumption.

7.2 The summary of information issue

- 7.2.1 As outlined in 2.2 above, the Commission's consideration of the standing contract price has been lengthy and detailed, commencing with the receipt of a Notice of Referral of an Inquiry in May 2004.
- 7.2.2 The Commission used the Inquiry process to gather information and inform itself on each of the factors relevant to the making of the price determination. The Commission undertook extensive public consultation, released public discussion and issues papers, and engaged consultants with specific expertise to assist it to undertake its task.
- 7.2.3 As outlined in the Price Determination, the making of the price determination and the conduct of the Inquiry are inextricably linked and the draft findings of the Commission in undertaking the Inquiry were taken into account in the making of the Price Determination⁴⁰.
- 7.2.4 The Commission considers that it has provided a full account of the information on which the price determination is based and a statement of reasons for the making of the determination. All documentation relating to the Price Determination, the draft Inquiry Report, and the reports of experts were provided to AGL SA and other parties. The Commission has set out processes and the information it used and assessed in order to come to its decision, together with its reasoning.
- 7.2.5 In relation to the consumption data, the Commission set out in the draft Inquiry Report the factors it considered and the information on which it

⁴⁰ Essential Services Commission of South Australia (ESCOSA), *Electricity Standing Contract Price: Price Determination*, December 2004, pages A-7 & A-8 (refer http://www.escosa.sa.gov.au/resources/documents/041223-DET_Final_ElecStandingContractPrice.pdf).



based its decision to use an average consumption of 7.4MWh per annum for standing contract customers for the analysis of average revenue caps. The information informed the price determination.

7.3 Commission's decision on review

- 7.3.1 The Commission confirms that it has provided an appropriate account of its reasons for decision as required by the ESC Act.

8 COMPLIANCE WITH STATUTORY OBJECTIVES

8.1 Issue

8.1.1 In its review application AGL SA stated that the price determination made by the Commission was contrary to the statutory objectives set out in the Essential Services Commission Act and the Electricity Act⁴¹

8.2 Commission requirements

8.2.1 Section 6(1) of the Essential Services Commission Act 2002 says that the Commission, in performing its functions 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*

8.2.2 Section 5 of the Essential Services Commission Act 2002 (and specifically clauses 5(1)(a), (g) and (h)) confirms that the undertaking of a review under Part 6 of the Act is a function of the Commission and accordingly must be undertaken in conformity with the section 6 objectives set out above.

8.2.3 The Commission notes that the Price Determination which was the subject of AGL SA's application for review, contained within it at *PART A Chapter 4 pages A-13 to A-18*, the Commission's summary statements on the factors

⁴¹ See for example AGL South Australia Pty Ltd, *Review Application in respect of the Electricity Standing Contract Price Determination published on 23 December 2004* paragraphs 7.3, 7.6 and 9.13



to which it had regard in making the Price Determination. In particular these statements detailed the way in which the Commission had regard to the statutory provisions underpinning its decision-making.

8.2.4 This Chapter 8 sets out the Commission's consideration of the section 6 objectives, in undertaking this review pursuant to section 31 of the Act following AGL SA's review application.

8.3 Primary objective

8.3.1 The Commission's primary objective in carrying out its functions, including this Review, is to protect consumer's long-term interests with respect to price, quality and reliability of electricity supply. This is the primary objective set for the Commission in the Essential Services Commission Act, section 6(1)(a), as outlined above. While this is the primary objective there are other objectives set out in the Act to which the Commission must also have regard.

8.3.2 In the Inquiry into AGL SA's proposed prices, the Commission developed this objective (and the remainder of the section 6 objectives) into an objective statement as follows:

"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 consumer's long-term requirements are met".⁴²*

All stakeholders who made submissions to the Inquiry endorsed this statement.

8.3.3 In undertaking the review, the Commission has been mindful of the objectives set out for it in the Act and has sought to ensure that it has set the lowest possible price commensurate with:

⁴² Essential Services Commission of South Australia (ESCOSA), *Inquiry into Retail Electricity Price Path: Draft Final Report*, November 2004, page 24 (refer http://www.escosa.sa.gov.au/resources/documents/041130-R-DraftInquiryReport_RetailElecPricePath.pdf).

- ? Covering the costs that an efficient retailer would incur
- ? Providing a return appropriate for the risks and invested funds
- ? Encouraging efficient investment to meet consumer's long-term requirements.

8.3.4 The Commission engaged its previous consultants, ACG, to review AGL SA's information presented in its review application (including the report from its consultant, Mr Price) concerning the wholesale electricity cost and to advise the Commission if there were any errors in its previous advice or adjustment necessary as a result of new information. ACG's brief had been to identify the prudent wholesale energy costs that an efficient retailer would incur in meeting the standing contract obligations in South Australia. ACG, after reviewing the information provided by AGL SA, advised the Commission that the previously advised WEC still represented its assessment of prudent and efficient wholesale electricity costs. The Commission in reviewing ACG's report, accepts that advice.

8.3.5 The Commission sought independent advice from the distribution network operator and meter reader ETSA Utilities, on the most recent information concerning the average consumption for small customers. The Commission accepts that there is some uncertainty as to the appropriate average consumption to use, but believes that the average of 7.4MWh/a represents the most realistic assessment of future demand.

8.3.6 In terms of reassessing the level of margin allowed, the Commission has reviewed the approach set out in considerable detail in its draft Inquiry Report, and found no evidence that indicates this margin is inappropriate given the risks and the funds invested. The margin is considered, on this basis, to provide an appropriate return and to encourage on-going efficient investment.

8.3.7 The Commission notes that no retail business operating in the South Australian market has commented, either publicly or in submissions to the Commission, that the margin (and prices) set by the Commission in its determination are such that they will be forced to withdraw from the industry in this State. Indeed, there is evidence that retailers continue to compete actively for consumers in the South Australian market.

8.3.8 In summary, the Commission notes its responsibility to have regard to the potentially conflicting objectives set out in section 6 of the ESC Act and section 25 of the Electricity Act, in undertaking this review of its price



determination. It has approached that task with an open mind, and sought additional information to ensure it was able to consider AGL SA's grounds for review. It has given serious consideration not only to the objective of achieving the lowest possible price for consumers but also for ensuring the financial viability of AGL SA and providing the incentive for the long-term investment to meet consumers' needs. Whilst difficult, the Commission has concluded that its original determination, in all key respects, has appropriately balanced those objectives.

8.4 Commission's decision on review

- 8.4.1 Having reviewed the objectives set out in section 6 of the Essential Services Commission Act 2002 and section 25 of the Electricity Act 1996, the Commission considers that the price determination and this review have been undertaken in compliance with these objectives and the other requirements of the ESC Act.
- 8.4.2 The Commission considers that appropriate regard has been had to the objective of facilitating the maintenance of AGL SA's viability and the incentive for long-term investment, and that these have been appropriately balanced against the other objectives which protect consumers' long-term interests and ensure consumers benefit from competition and efficiency.