



INQUIRY INTO RETAIL ELECTRICITY PRICE PATH FINAL REPORT

March 2005

ELECTRICITY

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GLOSSARY OF TERMS

ACCC	Australian Competition and Consumer Commission
ACG	Allen Consulting Group
AFMA	Australian Financial Managers Association
AGL SA	AGL South Australia Pty Ltd – ACN 091 105 092
B2B	Business to Business
CCGT	Combined Cycle Gas Turbine
CCSA	Conservation Council of South Australia Inc
COMMISSION	Essential Services Commission of SA established under the <i>Essential Services Commission Act 2002</i> . This legislation repealed the <i>Independent Industry Regulator Act 1999</i> . The Commission is the same body corporate as the former SA Independent Industry Regulator.
CPI	Consumer Price Index
DUOS	Distribution Use of System
EBITDA	Earnings before interest, tax, depreciation and amortisation
ECC	Energy Consumers Council
EPO	Electricity Pricing Order
EPO	Electricity Pricing Order
ERAA	Energy Retailers Association of Australia
ESC ACT	Essential Services Commission Act 2002
ESCOSA	Essential Services Commission of SA
ESIPC	Electricity Supply Industry Planning Council
ETSA	ETSA Utilities is a partnership of CKI Utilities Development Limited (ARBN 090 718 880), HEI Utilities Development Limited (ARBN 090 718 951), CKI Utilities Holdings Limited (ARBN 091 142 380), HEI Utilities Holdings Limited (ARBN 091 142 362) and CKI/HEI Utilities Distribution Limited (ARBN 091 143 038) which is authorised to operate an electricity distribution network by an electricity distribution licence issued by the Commission under section 17(1) of the <i>Electricity Act 1996</i> .
FRC	Full Retail Competition or Full Retail Contestability
GJ	Gigajoule
GST	Goods and Services Tax
IES	Intelligent Energy Systems Pty Ltd
IPA	International Power Australia Pty Ltd
IPART	Independent Pricing and Regulatory Tribunal (NSW)
IT	Information Technology
kW	Kilowatt
LRMC	Long Run Marginal Cost
LV	Low voltage
MP	Member of Parliament
MWh	Megawatt Hour
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company Ltd

NPV	Net Present Value
NSW	New South Wales
OCGT	Open Cycle Gas Turbine
OFGEM	Office of Gas and Electricity Markets, UK
POE	Probability of Exceedence
PV	Present Value
Q1, Q2, Q3, Q4	Quarter 1, Quarter 2, Quarter 3, Quarter 4
QTR	Quarter
REC	Renewable Energy Certificates
ROC	Retail Operating Costs
SA	South Australia
SACOSS	South Australian Council of Social Service
SAIIR	South Australian Independent Industry Regulator
SRMC	Short Run Marginal Cost
TOR	Terms of Reference
TUOS	Transmission Use of System
UK	United Kingdom
WACC	Weighted Average Cost of Capital
WEC	Wholesale Energy Cost
WREAG	Western Region Energy Action Group

SUMMARY

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

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

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

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

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

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

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

Draft Report

The Commission released a number of papers during the course of the Inquiry, culminating in release of a Draft Report in December 2004. Comments were sought from stakeholders on all papers, including the Draft Report, and those views have been taken into account in preparing this Final Report.



Price Determination

Due to a desire to commence the price path regime from 1 January 2005 and the legislative requirement for that regime to cover a period of at least three years, the Commission released a draft Price Determination in late November and a final determination in late December 2004. The determination included provisions for adjustment to the price path if the findings in this Final Report differed significantly from those used in the determination.

In early January 2005, AGL SA requested a review of the Commission's determination. The Commission released its decision on the review on 21 February 2005.

Neither the review, nor the submissions on the draft Report leading to the production of this Final Report, have resulted in the Commission changing its conclusions from those in the draft Report. Consequently, the Price Determination of late December 2004 has not been altered by the Commission, and the price path for the three years from 1 January 2005 remains unchanged.

Conclusions

As part of this Inquiry, the Commission undertook a comprehensive evaluation of the input costs which comprise the retailer tariffs: namely, the wholesale energy costs, the retailer operating costs and the retail margin. The Commission was assisted by consultants; stakeholder comments on the Issues Paper, Discussion Paper and Draft Report; and by access to AGL SA's actual costs and audited reports. Stakeholders and AGL SA were given significant opportunities to comment on the Commission's analysis and to contribute additional information to assist in the Inquiry.

During the Inquiry, it was necessary to modify a number of assumptions from those adopted in the draft Report or in earlier discussion papers. In particular, the number of standing contract customers assumed in the draft Inquiry Report was reduced significantly as a result of a major move from standing to market contracts which occurred in the period from June to December 2004 (requiring, for example, a change in the January 2005 starting number of standing contract consumers from approximately 610,000 in the draft Report to 530,000 in this final Report). This is another example of the fluidity that is still associated with assumptions about the competitive electricity market in South Australia, and highlights the difficult task that was undertaken by the Commission.

As a result of its work, however, the Commission has determined that the prudent controllable costs of AGL SA, and consumer demand parameters, should be set at the following levels for each quarter over the price path period (all prices are in March 2005 dollars):

YEAR	QUARTER	STANDING CONTRACT CONSUMERS	AVERAGE CONSUMPTION (MWH/QTR)	WEC (\$ PER MWH) (REAL \$ MAR 05, EXCL GST)	ROC (\$ PER CUSTOMER) (REAL \$ MAR 05, EXCL GST)	RETAIL MARGIN (% OF WEC + ROC)
2005	Jan-Mar	520,000	1.9	92.03	84.41	10.0
	Apr-Jun	496,000	1.9	59.50	84.83	10.0
	Jul-Sep	473,000	1.8	61.86	85.25	10.0
	Oct-Dec	457,000	1.8	63.79	85.67	10.0
2006	Jan-Mar	441,000	1.9	98.11	86.10	10.0
	Apr-Jun	425,000	1.9	63.43	86.53	10.0
	Jul-Sep	412,000	1.8	59.79	86.96	10.0
	Oct-Dec	400,000	1.8	61.67	87.39	10.0
2007	Jan-Mar	388,000	1.9	92.37	87.82	10.0
	Apr-Jun	376,000	1.9	61.70	88.26	10.0
	Jul-Sep	365,000	1.8	60.35	88.70	10.0
	Oct-Dec	355,000	1.8	62.92	89.14	10.0

Separately to the work on prudent input costs, the Commission considered the form of regulation and the controls that should be put in place around the price path. Again, AGL SA and stakeholders provided assistance to the Commission in identifying the most effective system of regulation. As a result, the Commission has concluded that it should, in making a price determination for the sale of electricity under the standing contract:

- ▲ Apply the price control as an average “retailer tariff” cap (applied only to the non-network costs) for the combined total of standing contract tariffs, based on forecasts of customer numbers and consumptions for each tariff in May each year;
- ▲ Require AGL SA to pass through the actual network charges of ETSA Utilities, and any changes in those charges when they occur (such that the standing contract prices will equal the sum of the approved retailer tariffs and the ETSA Utilities tariffs, plus GST);
- ▲ Impose a side-constraint on each tariff such that no residential customer can receive an increase in the retailer tariff (for the same level of consumption) of more than CPI plus four percent in any regulatory year commencing 1 July; and no small business customer can receive an increase in the retailer tariff of more than CPI plus four percent or \$40 per annum, whichever is the greater;
- ▲ Provide for cost pass-through arrangements to apply in limited circumstances where certain of AGL SA’s exogenous costs are altered significantly from those applying at the time of this Inquiry;



- ▲ Provide for AGL SA to open new tariffs, and to close existing tariffs, at the start of any regulatory year commencing 1 July, with appropriate review by the Commission and protection of consumer interests;
- ▲ Provide for the price path escalation factors to be revised in the event that the “special circumstances” provisions in the Electricity Act are activated.

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

As a result, the Commission decided to set AGL SA’s retailer tariffs for the six month period commencing 1 January 2005 at 2.5% above December 2004 levels, with increases in the 2004-05 average retailer tariff cap (\$91.51 per MWh) of [CPI minus 1.05%] to apply from each 1 July thereafter (but the CPIs for the first and last regulatory years are for nine month periods).

The Commission therefore has, as a result of its investigations, replaced the increases in standing contract tariffs sought by AGL SA in its August 2004 proposal with the increases set out in the following Table:

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

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

* CPI is for nine months ending 31 March 2005.

** CPI is for twelve months ending 31 March 2006.

*** CPI is for nine months ending 31 December 2006.

Observations

The Commission, in reviewing prudent costs for operating as the standing contract retailer in the SA market, has observed the two key factors that contribute to electricity costs in SA are the energy costs and the network charges: both are influenced by the extremely peaky nature of energy demand in this State (related to the high use of air conditioners). Other factors, such as the low consumer density due to the dispersed location of consumers, also contribute to higher network costs.

The Commission recognises the importance of measures to manage demand for energy for air-conditioning, and emphasises the need for a concerted effort to make consumers aware of the cost implications of this demand and to inform consumers on the options to

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

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

During the Inquiry, the Commission received a number of submissions from community organisations commenting on the impact of high electricity prices on vulnerable customers. The Commission is also concerned at these impacts, although it has concluded it is not possible to address such impacts via tariff structures. It also recognises that there are many complex issues at play, which it has been unable to consider in this Inquiry.

Accordingly, the Commission decided to review, in conjunction with its Consumer Advisory Committee, the impact of current prices and concession provisions on vulnerable customers. This work will focus on electricity disconnections and will assist the Commission to decide if it is necessary to modify Commission regulatory instruments (such as the Energy Retail Code) to achieve better outcomes for vulnerable customers. The work will also provide some data on which characteristics of vulnerability can be assessed and thus inform work done elsewhere on appropriate targeting of concessions to vulnerable customers. The Commission commenced this work in December 2004, and expects to complete its review in mid 2005.

PART A:
INQUIRY APPROACH

1 BACKGROUND TO INQUIRY

1.1 *Competition and Retail Pricing*

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

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

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

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

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

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

1.2 *IPART Review of Methodology*

Following the release of the Commission's December 2003 Report, the South Australian Premier asked the Independent Pricing and Regulatory Tribunal (IPART) 'to undertake a

¹ Essential Services Commission of SA (ESCOSA), *2004 Electricity Standing Contract Price: Final Report*, December 2003 (refer <http://www.escosa.sa.gov.au/resources/documents/031231-R-2004ElecStandingContractPrice-FinalReport.pdf>).



review of the methodology used by the Essential Services Commission of SA to consider a determination of 2004 prices'. IPART was not asked to review the level of prices, simply the methodology.

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

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

IPART's recommendations are briefly summarised as follows:

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

² Independent Pricing and Regulatory Tribunal (IPART), *South Australia 2004 Electricity Standing Contract Price: Review of ESCOSA Methodology – Report to the Premier of South Australia*, March 2004 (Refer <http://www.escosa.sa.gov.au/resources/documents/040330-R-IPARTReportSAGovt.pdf>).

- ▲ **IES methodology for assessing benchmark incumbent costs** – the notional prudent price should be estimated using a similar methodology at the next review but with earlier data verification against actual contract data;
- ▲ **assessing retail costs** – actual costs could be used as a cross-check against benchmarks, although the uncertainties and limitations involved should be recognised;
- ▲ **assessing retail margins** – benchmarking should provide the reference point but the method of specifying these margins (as a percentage or dollar amount) should be examined further. Market-specific risks reflected in the wholesale cost should be identified or excluded from the retail margin;
- ▲ **allowance for headroom** – the proposed medium-term review should adopt a clear and consistent position on the issue; this is a policy issue on which government may wish to provide direction.

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

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

1.3 Legislative Changes

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

The new provisions of Section 36AA are as follows:

- 4a *The following provisions apply in relation to the fixing by the Commission of a standing contract price for an entity for the purposes of this section:*
 - (a) *the Commission may fix the price by a determination of a kind referred to in section 35A(1)(a);*
 - (b) *a determination must provide for the expiry of the determination at the end of a period of not less than 3 years specified in the determination;*
 - (c) *a determination may provide for prices that vary at specified times according to a formula specified in the determination;*
 - (d) *unless the Commission determines that special circumstances exist*



- (i) a determination may not be made to take effect before the expiry date of the last preceding determination made by the Commission in accordance with this subsection;
- (ii) a determination may only be made if the entity has made a submission to the Commission stating the price that the entity proposes be fixed by the Commission as the entity's standing contract price, and the entity's justification for the price, not less than 6 months and not more than 9 months before the making of the determination;
- (ii) the Commission must, before making a determination, have conducted an inquiry under part 7 of the Essential Services Commission Act 2002 into the question of the appropriate price to be fixed as the standing contract price;
- (e) a submission under paragraph (d) must comply with any requirements as to the form and content of such submissions imposed by the Commission by written notice served on the entity.

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

The Commission, in its June 2004 Issues Paper³, outlined to AGL SA the information it required in AGL SA's submission, in accordance with its power to seek information under Part 5 of the ESC Act.

AGL SA submitted its price path proposal to the Commission on 20 August 2004. There were two submissions: a public version which was placed on the Commission's website on 23 August⁴, and a Commercial-in-Confidence version, submitted under Part 5 of the ESC Act as it included commercially sensitive material.

1.4 Details of the Inquiry

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

In summary, the Commission is required to:

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

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

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

³ Essential Services Commission of SA (ESCOSA), *Inquiry into Retail Electricity Price Path: Issues Paper*, June 2004 (refer <http://www.escosa.sa.gov.au/resources/documents/040625-R-ElecPrictnlqIssuesPaper.pdf>).

⁴ AGL South Australia Pty Ltd, *Proposal for Retail Electricity Prices for Standing Contract Customers for January 2005 – June 2008: Public Version*, August 2004 (Refer <http://www.escosa.sa.gov.au/resources/documents/040823-R-AGLStandingContractPriceProposal.pdf>).

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

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

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

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



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

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

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

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

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

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

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

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

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

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

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

1.5 Process of the Inquiry

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

A notice was published in the Advertiser on 28 May 2004 with the full Terms of Reference of the Inquiry and details on how to make a submission.⁵

A Paper entitled "*Inquiry into Retail Electricity Price Path: Issues Paper*"⁶ was released by the Commission on 25 June 2004. In response, the Commission received nine submissions, from AGL SA, Origin Energy, TXU, International Power Australia Pty Ltd (IPA), the Conservation Council of South Australia Inc (CCSA), the Energy Retailers Association of Australia (ERAA) and Business SA. The submissions are available on the Commission's website.⁷

On 20 August 2004, AGL SA submitted a price path proposal for the period to 30 June 2008, as requested in the Issues Paper. A public version of AGL SA's price path proposal was placed on the Commission's website.⁸

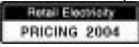
The Notice from the Minister also required the Commission to release a Discussion Paper following the receipt of AGL SA's price path proposal.

A paper entitled "*Inquiry into Retail Electricity Price Path: Discussion Paper*"⁹ was released on 14 September 2004. In response, the Commission received eleven submissions from AGL SA, EnergyAustralia, the Minister for Energy, Energy Consumers Council (ECC), Energy Retailers Association of Australia, ETSA Utilities, NRG Flinders, Origin Energy, SA Council of Social Service (SACOSS), TXU and UnitingCare Wesley.

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

⁵ Public Notice, published in The Advertiser, 28 May 2004 (refer <http://www.escosa.sa.gov.au/resources/documents/040531-MR-ElectStandingContractPriceInquiry.pdf>).

⁶ Essential Services Commission of SA (ESCOSA), *Inquiry into Retail Electricity Price Path: Issues Paper*, June 2004 (refer <http://www.escosa.sa.gov.au/resources/documents/040625-R-ElecPrincInqIssuesPaper.pdf>).

⁷ Submissions to *Inquiry into Retail Electricity Price Path: Issues Paper*; can be accessed via the "Retail Electricity Pricing 2004" icon  on the ESCOSA Home page (www.escosa.sa.gov.au)

⁸ AGL South Australia Pty Ltd, *Proposal for Retail Electricity Prices for Standing Contract Customers for January 2005 – June 2008: Public Version*, August 2004 (Refer <http://www.escosa.sa.gov.au/resources/documents/040823-R-AGLStandingContractPriceProposal.pdf>).

⁹ Essential Services Commission of SA (ESCOSA), *Inquiry into Retail Electricity Price Path: Discussion Paper*, September 2004 (Refer http://www.escosa.sa.gov.au/resources/documents/040914-ElecRetailPricePathInq_DiscPaper.pdf).



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

The draft Inquiry Report was released publicly on 30 November 2004, following receipt of comments from the Minister and AGL SA on the draft provided one week earlier. Accompanying the draft Inquiry Report was a draft Price Determination, setting out arrangements for a standing contract price path for the three year period commencing 1 January 2005. Comments were sought on the draft Price Determination by 15 December 2004, and on the draft Inquiry Report by 12 February 2005.

The Commission received five submissions on the draft Price Determination. It issued a final Price Determination on 23 December 2004, which commenced on 1 January 2005.

On 11 January 2005, AGL SA submitted a review application on the Price Determination under Section 31 of the ESC Act. The Commission referred the application to the Treasurer as required under Section 31(3) of the ESC Act, and commenced a process to review its decisions in the areas specified by AGL SA. The Commission released its decision on the review application, confirming its Price Determination, on 21 February 2005.

The TOR of the Inquiry required that a Final Report (and Price Determination if applicable) was to be submitted to the Minister and AGL SA no later than 31 March 2005, and to the public no later than 7 days thereafter.

This Report is in accordance with that requirement. As indicated in the Report, the Commission has confirmed the basis of its December 2004 Price Determination and there has been no need to alter the terms of that determination.

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

2 AGL SA'S PRICE PATH PROPOSAL

The purpose of this Inquiry was to investigate AGL SA's standing contract price proposal for small customers, submitted to the Commission in August 2004.

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

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

2.1 Overview

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

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

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

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

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

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



2.2 Form of Regulation

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

- ▲ prices would be set for a period of three years, excluding the half year of transition from January to June 2005;
- ▲ prices would be set according to a constraint on AGL SA's average revenue; thus the retail price change figures in the table above refer to changes in AGL SA's average revenue per MWh of sales on standing contracts;
- ▲ individual tariffs would be permitted to increase by a greater extent, CPI+5%, to allow for the unwinding of existing cross subsidies between business and residential consumers and cross subsidies within tariffs;
- ▲ should AGL SA wish to increase prices above the price path, it would be required to justify such an increase to the Commission;
- ▲ changes in taxes, market related changes (such as an industry levy for the national regulator) or new charges introduced (such as reserve trader charges) would be treated as passthrough items.

2.3 Wholesale Energy Costs

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

- ▲ AGL SA's view that energy supply in South Australia is characterised by the following:
 - relatively high fuel costs for power generation due to the high proportion of gas-fired generation plant and gas being more expensive than coal;
 - a large proportion of peaking plant that is more costly to run and operate;
 - generation and network assets with a relatively lower utilisation factor than elsewhere in the National Electricity Market (NEM); and
 - relatively high interregional and regional loss factors.
- ▲ AGL SA's view that the current wholesale electricity costs it incurs for the small customer market are at a level consistent with the fuel costs, the costs of imports, the market risks and characteristics of the SA load shape and that these costs are above what has been allowed by the Commission in prior Price Determinations;
- ▲ AGL SA's view that there is an inverse relationship between the level of contracts undertaken by retailers and pool prices;
- ▲ AGL SA's hedging approach;

- ▲ risk allowances for weather, pool prices, market events (such as supply side events) and National Electricity Market Management Company (NEMMCO) directions;
- ▲ an allowance for NEMMCO participant fees, ancillary charges, renewable energy levy and bank guarantee fees; and
- ▲ 2004/05 line losses of 8.12%, based on NEMMCO published loss factors for transmission and distribution.

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

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

2.4 Retail Operating Costs

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

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

- ▲ only the costs associated with customers consuming less than 160MWh are taken into account – costs relating to providing services to commercial and industrial customers and customers in other jurisdictions have been excluded;



- ▲ costs incurred in other AGL entities that relate to SA small customers are taken into account;
- ▲ marketing costs not related to standing contract customers have been excluded.

2.5 Retail Operating Margin

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

PART B:
INQUIRY CONSIDERATIONS

3 OBJECTIVES

As outlined in Section 1.4, the Commission is required to have regard to a large number of factors in undertaking this Inquiry. The IPART Report (Section 5.1) emphasised the importance of providing, at the commencement of an Inquiry, clarity of the objectives for price regulation of standing contracts.

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

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

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

Objective For Retail Electricity Price Path

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

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

3.1 Submissions

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

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

- *“ensuring the costs of the declared retailer in meeting the responsibilities of supplying electricity to small customers in South Australia over the period are considered in light of the expected market*

¹⁰ Origin, TXU, IPA, NRG Flinders and AGL SA were all generally supportive.

¹¹ AGL South Australia Pty Ltd, Letter to Essential Services Commission of SA (*Submission: Inquiry into Retail Electricity Price Path*), 30 July 2004, page 3 (refer <http://www.escosa.sa.gov.au/resources/documents/040730-AGL-ElecPricePath.pdf>).



conditions applying in South Australia during that time and noting the extension of the declared retailer obligations to supply all small customers who are not on market contracts or who may return from a market contract with another retailer during that period.

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

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

Business SA commented:¹³

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

ERAA pointed to a position taken by UK regulator Ofgem when stating:¹⁴

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

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

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

While the Discussion Paper did not specifically raise again the issue of the overall objective for the retail electricity price path, a number of submissions contained comments on this subject.

¹² Origin Energy, Letter to Essential Services Commission of SA (*Submission: Inquiry into Retail Electricity Price Path – Issues Paper*), 30 July 2004, page 1 (refer <http://www.escosa.sa.gov.au/resources/documents/040730-Origin-ElecPricePath.pdf>).

¹³ Business SA, Letter to Essential Services Commission of SA (*Submission: Inquiry into Retail Electricity Price Path – Issues Paper*), 27 July 2004, page 2 (refer <http://www.escosa.sa.gov.au/resources/documents/040701-O-BusinessSA-ElecPricePath.pdf>).

¹⁴ Energy Retailers Association of Australia Incorporated, Letter to Essential Services Commission of SA (*Submission: Inquiry into Retail Electricity Price Path – Issues Paper*), 2 August 2004, page 6 (refer <http://www.escosa.sa.gov.au/resources/documents/040802-ERAA-ElecPricePath.pdf>).

¹⁵ Conservation Council of South Australia, Letter to Essential Services Commission of SA (*Submission Issues Paper: Inquiry into Retail Electricity Price Path*), 30 July 2004 (refer <http://www.escosa.sa.gov.au/resources/documents/040730-CCSA-ElecPricePath.pdf>).

EnergyAustralia, one of the new entrant retailers offering market contracts in South Australia to small consumers, argued that the over-riding objective should be to encourage further competition. It stated that new entrant retailers incur higher costs than the incumbent retailer. It proposed that the price path should be set for a “fail safe” and pro-competition purpose, not for the lowest possible prices an incumbent monopoly can deliver.

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

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

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

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

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



3.2 Commission Comment

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

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

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

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

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

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

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

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

Therefore, for the purpose of setting the retail price path, the Commission will interpret the ‘consumer long-term interest’ as the lowest possible price commensurate with ensuring a number of other objectives:

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

4 STAKEHOLDER COMMENTS

The Terms of Reference of the Inquiry required the Commission, as a minimum, to:

- ▲ publish a Notice of Inquiry advising stakeholders of the Inquiry;
- ▲ release an Issues Paper;
- ▲ release a Discussion Paper following receipt of AGL SA's proposal;
- ▲ release a draft decision and determination;
- ▲ publish the final decision, no later than 7 April 2005.

The Commission has complied with each of these requirements. In addition, a public hearing was held in October 2004.

All submissions have been made available on the Commission's website, together with a number of consultant reports prepared for the Commission.

The nine submissions on the Issues Paper were discussed in the Discussion Paper released in September 2004. The eleven submissions on the Discussion Paper were discussed in the draft Inquiry Report released in November 2004. The Commission will not repeat those matters in this final Report.

The Commission received five submissions on the draft Price Determination in December 2004, from:

- ▲ AGL SA
- ▲ Minister for Energy
- ▲ NRG Flinders
- ▲ SACOSS
- ▲ TXU

The Commission received only one submission on the draft Inquiry Report, from:

- ▲ NRG Flinders

AGL SA advised the Commission that it would not provide further comments on the draft Report, as its submission on the Price Determination and particularly its application for a review of that determination, had addressed all of its issues. The Treasurer also made a submission to the Commission on AGL SA's application for review of the Price Determination.

These submissions are summarised and discussed in the following sections.



4.1 AGL SA

AGL SA has provided a number of submissions to the Commission on the draft Inquiry Report and Price Determination. The most comprehensive submission was its application for review of the Price Determination of 23 December 2004, submitted on 11 January 2005. An executive summary of that application was placed on the Commission's website on 28 January 2005.¹⁶

Many of AGL SA's submissions (and the application for review) have been confidential, containing in AGL SA's view information that is commercially sensitive and which would impact on its ability to compete if released. The Commission has been sensitive to this situation, but it has made it difficult for the Commission to undertake an open and fully consultative process during the Inquiry.

AGL SA's submission on the draft Price Determination focussed on the structure and process (and made a separate response on the proposed level of standing contract charges). AGL SA raised concerns with:

- ▲ The rights of review provided for in the determination.
- ▲ The specification of values for a range of variables such as customer numbers, customer consumption and consumption by tariff. It proposed that these variables be defined and the basis for deriving them be clarified.
- ▲ The limited range of cost pass-through events, and requested the addition of a number of other events such as a force majeure event and market charges event.
- ▲ The wording of various clauses in the draft determination (many of which were addressed in the final determination).

AGL SA's major concerns with the draft Inquiry Report were outlined in its application for review. In brief (and because this application was classified as confidential by AGL SA), it raised concerns with:

- ▲ the application of cap contract costs, especially the allocation in the period January to June 2005;
- ▲ the treatment of certain additional risks (on top of the estimated WEC), and the assumed removal of these costs (averaging \$2.10 per MWh) from AGL SA's estimated WECs;
- ▲ the assumed average consumption per consumer of 7.4 MWh/per annum, and the impact of this on the retail operating cost per MWh;
- ▲ the level of the retail margin;
- ▲ the lack of information to support the Commission's assumptions;

¹⁶ AGL SA Pty Ltd, *Executive Summary to the review application in respect of the Electricity Standing Contract Price Determination published on 23 December 2004*, January 2005 (refer <http://www.escosa.sa.gov.au/resources/documents/050128-D-PriceDeterminationReviewExecutiveSummary.pdf>).

- ▲ the restricted nature of the pass-through provisions;
- ▲ the incorporation of provisions to adjust the price path parameters following the conclusion of this Inquiry, claiming this was beyond power of the Commission.

Because these concerns were raised as an application for review, the Commission was required to respond to these claims within six weeks of the application (ie by 22 February 2005). Accordingly, the Commission has commented on these concerns in its Decision on the review application, released on 21 February 2005.¹⁷

4.2 Minister for Energy

The Minister noted that the proposed price path would provide consumers with some relief from high prices and greater certainty about prices over the medium term.

The Minister raised a number of concerns associated with:

- ▲ the proposed period of the price path, ending on 31 December 2007, as this would not align with ETSA Utilities' annual price adjustment;
- ▲ whether the Commission placed too great a reliance on AGL SA's actual costs rather than the prudent retailer costs;
- ▲ the tariff rebalancing formula, and particularly the different treatment of residential and other small consumer categories. The Minister stated that the residential category should not experience increases greater than CPI over the period;
- ▲ the inclusion of Reserve Trader events in the pass-through arrangements, as this was seen as a normal risk for retailers and should be covered in their hedging arrangements or retail margin.

4.3 NRG Flinders

NRG Flinders made submissions to both the draft Price Determination and the draft Inquiry Report.

It noted that most of the issues it had raised in submissions on the Issues and Discussion Papers had been satisfactorily addressed by the Commission in its draft Report, and consequently it broadly supported the overall pricing framework proposed.

NRG Flinders main concerns related to:

- ▲ the three year (rather than three and a half year) price path period;
- ▲ the narrow definition of "change in taxes event", as it was restricted to changes affecting only the electricity industry;

¹⁷ Essential Services Commission of SA (ESCOSA), *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 (refer http://www.escosa.sa.gov.au/resources/documents/050218-R-AGLReview_FinalDecn.pdf).



- ▲ setting the wholesale electricity price at a level on the low side of credibility, putting at risk the development of additional generation and growth in competition. In particular, NRG Flinders believed certain cost assumptions were unrealistic, and in particular:
 - rates of return were too low;
 - generator transmission losses were ignored;
 - systematic host retailer risks from profiling were not considered; and
 - the declining forward cost curve was unrealistic and at odds with forward market prices elsewhere in the NEM.

4.4 SA Council of Social Service

The SACOSS submission repeated its earlier concerns on the potential impacts of the determination on vulnerable households, but acknowledged the comments of the Commission in the draft Report that it would work with consumer groups to examine consumer impacts (and particularly the impact of disconnections).

Specific issues raised by SACOSS included:

- ▲ the tariff rebalancing constraint would allow supply charges to increase faster than the energy component, impacting on small consumers;
- ▲ the treatment of bad debts as an operating cost rather than part of the retail margin, and the possible implications of this on disconnection policy.

4.5 Treasurer

The Treasurer made a submission to the review process which considered AGL SA's application for a review of the Price Determination.

The Treasurer outlined the Government's rationale for establishing the medium term price path setting process, and in particular the legislative provision for "special circumstances". He indicated this obviated the need for a long list of "pass-through" events.

The Treasurer noted there had been a reduction in wholesale pool prices in the NEM in recent years, and referred to the Electricity Supply Industry Planning Council (ESIPC) research to support this and to argue against AGL SA's request for a higher WEC. The Treasurer queried whether the Commission had given too much emphasis to AGL SA's actual costs rather than to the prudent costs of a standing contract retailer.

The Treasurer considered that the retail margin adopted by the Commission of 10% of retailer controllable costs represented the absolute upper limit of an acceptable margin, and referred to margins approved by interstate regulators.

Referring to AGL SA's request for more items to be treated as pass-throughs, the Treasurer stated this failed to acknowledge the trade-off between risk and return; and if

allowed, “the retail margin should be smaller to reflect the lower level of risk facing the retailer.” Accordingly, the Treasurer argued there is no justification for costs such as Reserve Trader, NEMMCO fees, greenhouse abatement costs etc to be included as pass-through items.

4.6 TXU

TXU considered the Commission’s analysis to be well balanced, and believed that the price path would deliver the benefits of pricing stability and predictability to consumers.

TXU’s main concerns related to the impact of the decision on future generating capacity in South Australia, and particularly:

- ▲ the decreasing wholesale energy cost estimates were at odds with market evidence of an increasing shortage of supply;
- ▲ the energy cost for the last year of the price path is below the cost of additional capacity;
- ▲ the Commission’s methodology was not presented in sufficient detail to allow independent review.

TXU stated that the Commission’s retail operating cost allowance was well below the benchmark level used in Victoria, as was the retail margin allowance. On the other hand, it supported the CPI plus 2% increase in retail operating cost allowed for over the price path period.

TXU endorsed the general approach to pass-through provisions, but argued that additional factors (such as new emissions trading or renewable energy schemes, or industrial disputes) should be included.

It also raised the issue of the definition of CPI, arguing that the Adelaide index would be more appropriate than the weighted average of eight capital cities index proposed by the Commission.

5 KEY ASSUMPTIONS

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

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

This section 5, and sections 6, 7 and 8, set out the Commission's investigations, analysis and conclusions.

5.1 Customer Numbers

As indicated, the Inquiry concerned the prudent costs of delivering retail services to standing contract customers. However, estimating the number of standing contract customers at any time over the three year price path period is a difficult task, and required the Commission to project not only the overall churn rate but also to distinguish between those consumers choosing market contracts with AGL SA and other retailers.

At the end of December 2004, approximately 258,000 market contracts had been entered into by small customers at some time over the period since 1 January 2003: this represents approximately thirty five percent of the estimated 740,000 small customers in South Australia.

However, the number of customers on market contracts at end December is less than the number reported above, as some customers have returned to standing contracts and others have had multiple market contracts. The Commission's best estimate is that there were approximately 530,000 customers on standing contracts at end December 2004 (and therefore approximately 210,000 on market contracts).

The Commission has not publicly released details of the number of market contracts held by each retailer, as that data is submitted by the industry as confidential information. This situation prevents the Commission from reporting the number of small customer market contracts held by AGL SA in addition to the standing contract customer base.

While the churn rate from standing contract to market contracts has been extremely high during 2004, driven significantly by the government one-off incentive payment (now expired), it is expected to taper off as the market becomes more established. There is little relevant information from other markets to provide guidance as to how the churn rate



will move over the coming years, and specifically how many customers will adopt market contracts with retailers other than AGL SA.

The Commission has determined that the number of standing contract customers will reduce from approximately 530,000 at the start of the price path period, to approximately 350,000 at the end in December 2007. It has applied this reduction reasonably evenly by quarter across the three years, for use in determining the net present value of different cost and revenue streams (see Chapter 12).

Given this uncertainty about standing contract numbers in future years of the price path, the Commission decided to undertake the Inquiry in a manner which minimised the sensitivity of its conclusions to this assumption. In particular, the Commission has:

- ▲ adopted a methodology for determining energy cost which is driven by the consumption profile of small consumers rather than by the total MWh consumed. The average cost per MWh consumed is essentially independent of the number of small consumers;
- ▲ taken a broad view of the operating costs of servicing small customers, rather than attempting to build-up a cost structure for different numbers of consumers. In particular, the Commission has formed the view that the services provided by AGL SA to standing contract and market contract customers are similar (in that both customer types access telephone inquiries, billing and other consumer support services); it is therefore appropriate to refer to the number of small customers serviced by AGL SA, rather than just the standing contract customer number, in considering the economies of scale available to AGL SA in its retail operating services.

The Commission estimates that, over the three-year price path period, AGL SA could be expected in any year to service between 450,000 and 630,000 small customers (on both standing contracts and market contracts). This range places AGL SA at the middle to upper end of customer numbers served by retailers in the Australian energy market. Further, AGL SA is now gaining small gas customer market contracts following the commencement of gas competition in July 2004, and services provided to these customers are able to be provided from the same resources servicing the electricity market.

While it is unlikely that these estimates of customer numbers will be borne out in practice, the Commission's methodology is sufficiently insensitive to such variations that it should have little impact on the price path.

5.2 Customer Consumption

On the other hand, the level of consumption per standing contract customer is important if the Commission is converting costs per customer into costs per MWh for tariffs.

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

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

There is very limited information available to the Commission on these impacts that is of much assistance in forecasting future consumption of standing contract customers. The Electricity Supply Industry Planning Council (ESIPC), in providing forecasts for the electricity distribution price review, has estimated very small changes in average consumption per small customer in each of the key tariff categories over the next five years: these forecasts primarily address the first three items above (and apply to the total small customer market, not just standing contract customers).

In its draft Final Report, the Commission reported it had “chosen to assume an average consumption of approximately 7.4MWh per annum for standing contract customers throughout the price path period. This is the average consumption used by AGL SA in its 2003 estimates provided to the Commission in the last price review, reflecting average consumption of all small customers.”¹⁸

In its application for review of the Commission’s Price Determination in January 2005, AGL SA stated that the correct average consumption per standing contract customer was 7.0 MWh per annum.

The Commission accepts there is a degree of uncertainty about this number, reflecting both the accuracy of reported consumptions and the issue of whether the average consumption of standing contract customers is different from market contract small customers.

¹⁸ Essential Services Commission of SA (ESCOSA), *Inquiry into Retail Electricity Price Path: Draft Final Report*, November 2004, page 43 (refer http://www.escosa.sa.gov.au/resources/documents/041130-R-DraftInquiryReport_RetailElecPricePath.pdf).



The Commission has analysed all available historical consumption and customer number data (including the 2004 calendar year), and reviewed trends in average consumption over the past four financial years (2000/01 to 2003/04), as provided by AGL SA and other retailers.

However, as noted in the 2003/04 Annual Performance Report¹⁹, there have been a number of concerns with the quality of data provided by retailers in their annual returns:

- ▲ total consumption reported by retailers does not reconcile well with the amount of electricity delivered by ElectraNet SA to the transmission network exit points; there appears to be a significant under-reporting of consumption by retailers in 2003/04;
- ▲ the consumption data reported by retailers represents billed consumption, as opposed to accrued consumption. Under a ninety 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 is especially a problem when (as has been observed) retailer billing systems have encountered difficulties in managing the transfer of customers between retailers.

Given these concerns, the Commission sought information from ETSA Utilities on consumption by key tariff categories, as an alternative means of estimating the average consumption of small customers.

Under the Electricity Pricing Order (EPO), ETSA Utilities provides the Commission with an annual tariff application that 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.

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
- ▲ Low Voltage (LV) Business single rate
- ▲ LV Business two rate
- ▲ Controlled load.

These tariff categories encompass the small customer base in South Australia. There are, however, likely to be some large (>160 MWh) customers on a LV Business two rate tariff, which need to be excluded from the analysis.

¹⁹ Essential Services Commission of SA (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).

The Commission therefore requested consumption and customer number data from ETSA Utilities relating purely to small customers. ETSA Utilities provided the Commission with information on actual average consumption of customers consuming less than 160 MWh per year during the 2004 calendar year. This figure includes hot water consumption, but excludes unmetered supplies (eg street lighting).

This data indicates that the average consumption per small customer during 2004 was approximately 7.46 MWh, which is in line with the Commission's previous estimate of 7.4 MWh.

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).

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.

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.

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 ninety percent of LV Business two rate customers are small customers, and that around sixty percent 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 an average consumption per small customer.

As shown in Table 5.1, these estimates produce a relatively high average consumption figure of 7.87 MWh in 2000/01, with average consumption then stabilising in subsequent years to a figure of 7.45 MWh in 2003/04.



Table 5.1: Average consumption of small customers: 2000/01 to 2003/04

	2000/01	2001/02	2002/03	2003/04
Total small customer consumption (MWh)	5,810,620	5,555,450	5,669,450	5,736,749
Total small customers (average)	738,453	745,890	750,069	770,335
Average consumption (MWh/customer)	7.869	7.448	7.559	7.447

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 in 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 South Australia on 1 January 2003. As stated earlier though, it is unclear to the Commission whether such a difference exists.

The Commission believes that there are a number of key drivers of electricity consumption in South Australia, 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.

During 2000/01, South Australia 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.

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 ESIPC in its June 2004 Annual Planning Report.²⁰ However, the Commission believes the variation in residential sales is not significant enough to change its average consumption figure from the 7.4 MWh per annum used in the draft Final Report.

The Commission has used an average consumption per standing contract customer of approximately 1.9, 1.9, 1.8 and 1.8 MWh for the respective four quarters of each calendar year over the price path period.

5.3 Load Profile

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

²⁰ Available from the Electricity Supply Industry Planning Council website (www.esipc.sa.gov.au).

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

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

ESIPC used its load profile to estimate a long run marginal cost (LRMC) of energy, based also on estimated new entrant generating costs in South Australia. These new entrant costs were also used by Allen Consulting Group (ACG), the Commission's consultants in determining WEC, in considering upper cost bounds for new supply contracts for the 2007/08 year (for currently uncontracted load).

The Commission's consultants, in estimating the wholesale electricity cost, used both ESIPC and AGL SA demand profile forecasts to construct a number of different scenarios for possible future supply (see Chapter 6 for details). AGL SA uses its own demand profile to develop its contract purchasing strategy.

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

6 WHOLESALE ENERGY COST

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

6.1 Historical WEC Allowance

The Commission has determined a WEC for standing contract supply on two previous occasions: in late 2002, for supply during 2003, and in late 2003 for supply during 2004. Both of these decisions have been comprehensively reported and the methodology subjected to extensive evaluation and comment.

The December 2002 decision set an allowable WEC for 2003 supply at a weighted yearly average of \$71 per MWh.

At the commencement of this Inquiry in May 2004, the allowable WEC was \$68.5 per MWh, based on a review by the Commission in late 2003 of forward contract prices.

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

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

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

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



6.2 AGL SA's Proposal

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

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

However, the Commission can report that the numbers for WEC estimated by AGL SA are all higher than the value of \$68.5 per MWh last set by the Commission in December 2003, and in most cases by a significant degree. The AGL SA proposed prices do fall each year over the period, but even in 2006/07 and 2007/08 are above the December 2003 approved WEC.

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

6.3 Submissions

The Commission received many submissions on the Discussion Paper, consultant reports and Draft Determination, addressing the estimation of WEC.

A number of submissions stated that it was not possible to comment on the AGL SA proposed WEC, as insufficient details were provided due to the commercially confidential restriction applied. A number criticised the modelling by the Commission's consultants (ACG), claiming that the methodology was not fully disclosed and was unable to be assessed in any detail: the process was not transparent.

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

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

- ▲ structure of the five scenarios;
- ▲ cost of gas for both Open Cycle Gas Turbines (OCGT) and Combined Cycle Gas Turbine (CCGT);
- ▲ forward swap contract prices; and
- ▲ use of historical pool prices in modelling.

However, the Commission has not changed its conclusions in this Final Report from those reported in the draft Report and used in the December 2004 Price Determination. The Commission reviewed its conclusions in response to AGL SA's application for a review of the determination in January 2005, and in its Decision of 21 February 2005 confirmed its earlier conclusions.

6.4 Commission's Considerations

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

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

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

It is not the intention of the Commission to outline in detail here the analysis undertaken by ACG: that is available in the two reports released by the Commission on the ACG work, together with some further comments in the Commission's decision on AGL SA's application for review. However, a brief description of the work and its underlying analysis is provided here so as to illustrate the overall approach.

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

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



incorporated AGL SA's actual contract costs into its pricing decision, where those contracts were deemed to have been reasonable and prudent at the time of purchase.

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

The ACG methodology required detailed knowledge of AGL SA's existing contracts for supply over the period evaluated, and an estimate of prudent contract prices for that quantity of the standing contract load not already contracted for those future years.

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

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

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

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

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

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

A number of generators (specifically TXU and NRG Flinders) were critical of the Commission's estimates of WEC for each year of the price path, observing that it reduced each year, whereas the tightening supply/demand situation in the market would be expected to result in an increasing price. The Commission makes a number of observations on this criticism. First, AGL SA's proposal itself contained reducing estimates for WEC over the price path. Second, a high proportion of the WEC is based on contracts already written, and new contract prices represent only a small proportion of the total. Third, newer contracts are replacing the very high cost contracts that were necessarily entered into by AGL SA in the 2001 and 2002 period, prior to the commencement of FRC. Finally, the Commission's estimates of the cost of swap contracts for 2006/7 and 2007/8 do in fact show an increasing price trend (although not necessarily up to the LRMC of new generation as estimated by ESIPC).

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

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

Further, it is necessary to consider the linkages between demand level and pool price: are they perfectly correlated such that high prices only occur wherever demand is high, or do high prices occur on other occasions and if so, can these be predicted in advance? Evidence suggests that, whilst there is some correlation between high demand and high prices, it is far from perfect, and retailers must protect against unforeseen events that result in high pool prices.

In the September 2004 Discussion Paper and accompanying ACG report²¹, the five scenarios were described and were stated to represent a credible range of possible events, having regard to those which might have a significant impact on AGL SA's

²¹ Essential Services Commission of SA (ESCOSA), *Inquiry into Retail Electricity Price Path: Discussion Paper*, September 2004 (Refer http://www.escosa.sa.gov.au/resources/documents/040914-ElecRetailPricePathInq_DiscPaper.pdf); and Allen Consulting Group, *Final Report: Energy Wholesale Price Study*, September 2004 (refer <http://www.escosa.sa.gov.au/resources/documents/040913-R-WholesaleEnergyPriceStudy.pdf>).



exposure (eg a 2000/01 type summer with very high temperatures and air-conditioning demand).

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

ACG reviewed the comments received from stakeholders and held discussions with AGL SA and the Commission to consider what changes, if any, should be made to the scenarios and other assumptions. These changes were reflected in its final report to the Commission.

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

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

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

Case A: based on current market prices;

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

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

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

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

6.4.1 ACG Model Results

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

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

However, the ACG scenario model had some difficulty accommodating the six month bridging period January to June 2005, which includes the high cost Q1 contracts. The scenario modelling was restricted to use of only two scenarios, as data was unavailable for the six month period for the remaining three scenarios. Accordingly, ACG advised the Commission:

"We have been unable to use scenarios 3, 4 or 5 to estimate the wholesale electricity cost for January to June 2005. The reduction in the information available necessarily implies that the precision of our estimates for this period is lessened ... Accordingly, after discussions with the Commission, we have not provided an independent recommendation for the wholesale energy purchase cost for the January to June 2005 period".²²

²² Allen Consulting Group, *Supplementary Report Energy Wholesale Price Study*, November 2004, page 20 (refer <http://www.escosa.sa.gov.au/resources/documents/041130-O-AllenReportEnergyWholesalePriceStudy.pdf>).



The Commission developed a WEC for that period in two ways: by reviewing AGL SA's estimates, and by considering contract price changes since its 2004 WEC decision in late 2003.

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

As indicated in Section 6.1, the Price Determination for 2004 supply had an average WEC of \$87.6 for Q1 and \$63.8 for Q2, an average of \$75.7 per MWh. The Commission is not aware of any significant changes in the NEM in the period since it made its December 2003 determination which would suggest that this estimate would not apply equally in early 2005 as it did in early 2004 (indeed, in its December 2003 determination, the Commission observed that contract prices were declining and that prices in 2005 could be reduced as the high cost 2001 contracts disappeared).

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

6.5 Summary

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

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

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

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

In making its final Price Determination, the Commission revised the numbers provided by AGL SA in its proposal, and used instead the estimates reported above.

7 RETAIL OPERATING COST

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

7.1 Current Provision

The Commission has extensively reviewed retail operating cost (ROC) benchmarks from interstate jurisdictions in setting the operating cost allowance for the 2003 and 2004 standing contract tariffs²³. Those reviews resulted in the Commission setting an ROC of \$80 per customer in 2003 and \$82 per customer in 2004.

7.2 AGL SA's Proposal

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

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

7.3 Submissions

Submissions on the AGL SA proposal, the Commission's Discussion Paper and the draft Inquiry Report presented no new evidence, but referred to benchmark allowances in other jurisdictions.

The Energy Consumers Council (ECC) stated that it believed the ROC allowance should be reduced to levels currently applying in NSW, whereas industry participants drew attention to the notional allowances underpinning the Victorian price path agreements. These views therefore cover a range of approximately \$70 to \$92 per customer per year.

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

²³ Essential Services Commission of SA (ESCOSA), *2004 Electricity Standing Contract Price: Final Report*, December 2003 (refer <http://www.escosa.sa.gov.au/resources/documents/031231-R-2004ElecStandingContractPrice-FinalReport.pdf>); and Essential Services Commission of SA (ESCOSA), *Inquiry into Electricity Standing Contract Prices: Final Report and Determination*, October 2002 (<http://www.escosa.sa.gov.au/resources/documents/FinalReport-InquiryElecStandingContractPrices.pdf>)



7.4 Commission's Considerations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

7.5 Conclusion

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

This allowance is below the level proposed by AGL SA.

8 RETAIL MARGIN

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

8.1 Current Provision

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

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

8.2 AGL SA's Proposal

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

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

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

8.3 Submissions

Submissions to the Discussion Paper and draft Inquiry Report presented a range of views. The ECC stated that the margin should be a fixed amount, and lower than the current allowance. The Minister for Energy could see no justification for an increase from present levels. Retailers and generators, on the other hand, referred to experience in the UK and Victoria to argue that a margin of seven to ten percent of total sales was necessary to cover a retailer's risks and give an appropriate return in the competitive market.

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

8.4 Commission's Considerations

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



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

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

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

The Commission remains attracted to the attempt of quantifying the margin by calculating a prudent EBITDA. It accepts the view that bad debts should be included in operating costs and not EBITDA.

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

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

The revised calculation for EBITDA is as follows:

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

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

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

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

8.5 Conclusion

The Commission used a retail margin of ten percent of the combined wholesale electricity costs and retailer operating costs as the basis for setting the price path.

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

9 PRICE PATH AND CONTROLLABLE COSTS

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

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

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

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

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

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

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

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

Treating network charges as a pass-through was supported by all stakeholders commenting on the Issues and Discussion Papers. Under the South Australian legislative



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

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

9.1 Price Path Period

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

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

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

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

10 FORM OF REGULATION FOR RETAILER CONTROLLABLE COSTS

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

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

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

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

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

10.1 Stakeholder Comments

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



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

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

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

The Commission received a number of submissions addressing these issues.

10.2 Discussion

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

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

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

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

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

The Commission, as previously reported, has identified the justified level for wholesale energy cost, retail operating cost and retail margin for each year (and indeed, every quarter of each year) of the price path to December 2007. In addition, the Commission has estimated the average number of consumers and level of demand (MWh) for each of the above periods, based on ESIPC forecasts and AGL SA assumptions regarding customer churn.

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

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

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

10.3 Price Control Options

10.3.1 Cost components and individual tariffs

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

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

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

10.3.2 Average price cap applied to total standing contract revenue

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

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

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



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

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

10.3.3 Average price escalation applied to individual tariffs

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

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

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

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

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

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

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

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

Nevertheless, major or unexpected events that have a significant impact on costs and margins, should be a basis for a review and potential revision. This is considered further in Section 11.

10.4 Preferred Price Control System

Having considered the relative merits of the different approaches, the Commission determined to apply an average price cap to the combined total of the retailer (standing contract) tariffs (10.3.2. above), in conjunction with tight side-constraints on individual tariff changes. This provides AGL SA with some flexibility in adjusting tariffs over the three years to reduce cross-subsidies across and within customer classes, but will prevent major step-changes in prices to individual consumers.

The price control system is as follows:

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



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

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

10.5 Pass-through Events

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

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

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

10.6 Price Path Variation Event

The Commission made a Price Determination in December 2004 (which commenced on 1 January 2005 for the three year period 2005 to 2007), based on the conclusions in the draft Inquiry Report. Accordingly, in setting the values of the average retail price cap and escalation factors in the Determination, it had not concluded this Inquiry and had not had the opportunity to review its draft conclusions based on stakeholder feedback. The Commission could have changed its prudent cost components (and hence the average retail price cap and escalation factors) in the Final Report from those on which the Price Determination was based, as a result of submissions on the draft Report.

Therefore, it provided for a Price Path Variation Event in the Price Determination, to allow the Commission to revise its average price cap escalation factor (CPI minus X) in the

event it changed the prudent cost components from those in the draft Report, where such changes would have had a material impact on the escalation factor.

Based on the findings of this Final Inquiry Report, the Commission does not propose to declare a Price Path Variation Event.

10.7 Implications of Price Control System

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

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

Apart from the uncertainties relating to the key input assumptions regarding WEC, consumer numbers and average consumption, there are other uncertainties relating to:

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

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

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

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



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

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

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

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

11 SPECIAL CIRCUMSTANCES AND PRICE PATH RE-OPENING

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

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

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

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

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

12 AGL SA REVENUE AND PRICE PATH

The Commission has in previous sections set out its analysis of the information presented to it on the three key areas of cost: wholesale energy cost, retail operating cost and retail margin. In all three areas, it has come to different views on costs than those presented by AGL SA. It has also set out how it has established a price path system and accommodated material events that are outside its considerations.

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

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

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

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

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



- ▲ Average price cap increase of CPI minus 1.05 percent from 1 July 2007 (where CPI is the nine months increase of December quarter 2006 to March quarter 2006).

In a separate investigation, the Commission has reviewed the network charges of ETSA Utilities, which will flow through directly into standing contract charges for small customers. Its draft determination in that regard was handed down at the same time as the draft Inquiry Report. The Commission's draft position in that review was that network charges to small consumers will be reduced, commencing 1 July 2005 and increasing at below CPI for the following five years.

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

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

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

13 CUSTOMER IMPACT

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

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

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

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

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

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

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

It is the Commission's understanding that the equivalent standing contract tariffs in Victoria increased from 1 January 2005 by an amount less than CPI (on average)²⁴. Similarly, Victorian network charges are to increase from 1 July 2005 by an amount less

²⁴ The average annual tariff adjustment on 1 January 2005 in Victoria is CPI – 1.5% for TXU, CPI – 1.3% for Origin/Powercor, CPI – 0.5% for Origin/Citipower, CPI – 1.5% for AGL, and CPI – 0.5% for AGL/Pulse. See www.doi.vic.gov.au/DOI/Internet/Energy.nsf "Energy Prices 2004 to 2007". Increases of CPI – 0.5% apply from 1 January 2006, except for AGL where it is CPI – 0.9%.



than CPI (on average)²⁵, such that it could be expected that the retailer controllable cost allowances in Victoria will also increase by an amount less than CPI.

This preliminary analysis would suggest that the retailer controllable cost allowance would increase slightly in SA relative to the allowance in Victoria, over the three year period. The SA network charges for small customers will decrease, relative to a small increase in Victoria. However, it is difficult to confirm this assessment as the component parts will change each six months (in both SA and Victoria) during 2005.

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

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

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

13.1 Individual Tariff Assessment

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

As the Commission increased AGL SA's retailer tariffs by a straight 2.5% on 1 January 2005 (and allowed no tariff restructuring until 1 July 2005), and as the network charges

²⁵ New network charges are to be set by ESC Victoria commencing 1 July 2006.

from ETSA Utilities will also not change until July 2005, it is likely that these cross-subsidies will be unaffected in the first six months of the price path.

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

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

13.2 Vulnerable Customers

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

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

The Commission has not been able as part of this Inquiry to address the concerns of consumer groups about the impacts of high electricity prices on these consumers. However, the Commission has commenced in late 2004 a major review, with the assistance of the Consumer Advisory Committee, of customer disconnections: it has already undertaken a preliminary review of the 2003-04 experience with the assistance of consultants. This review will provide the opportunity for a thorough examination of payment issues and the impacts on vulnerable customers of an inability to meet their electricity charges. The Commission believes that such a review presents an opportunity



for the community, retailers and government to examine the underlying issues and to develop innovative solutions that may better address the needs of such consumers.

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

The Commission therefore welcomes the offer of those bodies from the social service sector to work with the Commission in 2005 to examine these issues and to help identify possible improvements in concessions, advisory and tariff arrangements that will allow assistance to be better targeted to the most vulnerable customers.

14 FACTORS CONSIDERED BY THE COMMISSION

Section 1.4 outlined the factors the Commission is required to have regard to in undertaking this Inquiry. This Section comments on the consideration given by the Commission to each factor.

14.1 Terms of Reference of Inquiry

14.1.1 TOR 3.1: Investigate the standing contract price proposal

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

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

14.1.2 TOR 3.2: Restricted to prudent controllable costs

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

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

14.1.3 TOR 3.4.1: AGL SA's justification

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

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

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

14.1.4 TOR 3.4.2: Prudent retailer energy contracts

The Commission engaged consultants to assist it:

- ▲ review AGL SA's existing contracts for supply over 2005 to 2008, to determine if they were prudent;



- ▲ determine what a prudent retailer's hedging and contracting strategy would be;
- ▲ estimate what future quantities of swap and cap contracts would be required, and what prudent prices would apply.

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

14.1.5 TOR 3.4.3: AGL SA's contracts and hedging strategy

Consultants and Commission staff reviewed AGL SA's existing contracts that relate to electricity supply from 2005 to 2008, and considered them in the context of AGL SA's overall hedging strategy and risk management policy.

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

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

14.1.6 TOR 3.4.4: Prudent retail operating costs

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

14.1.7 TOR 3.4.5: AGL SA's actual operating costs

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

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

14.1.8 TOR 3.4.6: AGL SA's proposed margin

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

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

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

14.1.9 TOR 3.4.7: Cross-subsidies

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

14.1.10 TOR 3.4.8: Interstate prices

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

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

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

14.2 Essential Services Commission Act 2002 Part 2 Factors

14.2.1 Section 6(1)(a): Protection of consumer long-term interest

The Commission's analysis has determined the prudent level of costs that AGL SA would be expected to incur in meeting its standing contract retailer obligations. It



has comprehensively reviewed AGL SA's costs, and independently determined the costs that a prudent retailer would be expected to incur. It has set a fair return based on AGL SA's investment in the business and the risks it faces.

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

14.2.2 Section 6(1)(b)(i): Promote competitive and fair market conduct

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

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

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

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

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

14.2.3 Section 6(1)(b)(ii): Prevent misuse of monopoly or market power

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

The Commission therefore needs to ensure that its Price Determination prevents AGL SA from abusing this situation. The prices set must attempt to replicate a truly

competitive market and ensure AGL SA's prices are at a level which provides an appropriate risk adjusted return (and no more).

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

14.2.4 Section 6(1)(b)(iii): Facilitate entry into markets

For the reasons set out in 14.2.2 above concerning wholesale energy prices, the Commission's decision should provide an opportunity for other retailers to join the market and offer competitive prices to consumers.

14.2.5 Section (1)(b)(iv): Promote economic efficiency

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

14.2.6 Section 6(1)(b)(v): Ensure consumers benefit from competition and efficiency

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

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

Further, as mentioned in 14.2.2 above, the standing contract prices also provide an opportunity for retailers to offer market contracts to consumers at even lower prices: the existence of strong competition between retailers should also lead to benefits to those consumers who take up the opportunity to switch.

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

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

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



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

14.2.8 Section 6(1)(b)(viii): Promote consistency in regulation

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

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

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

14.3 Essential Services Commission Act 2002 Part 3 Factors

14.3.1 Section 25(4)(a): Particular circumstances of regulated industry and goods being regulated

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

14.3.2 Section 25(4)(b): Costs of supplying the services

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

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

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

While it is difficult to estimate future costs when the actual future costs depend on such factors as the weather, NEM outcomes and the behaviour of other market participants, the Commission has used expert advice and modelled a number of different scenarios in producing its best estimate of the future costs of supply.

Further, the Commission released reports and discussion papers that outlined its assumptions and approach, and sought comment on them from stakeholders (including AGL SA).

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

14.3.3 Section 25(4)(c): Cost of complying with laws and regulations

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

14.3.4 Section 25(4)(d): Return on assets in the regulated industry

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

14.3.5 Section 25(4)(e): Relevant interstate benchmarks

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

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

14.3.6 Section 25(4)(f): Financial implications

In setting the relevant cost components for determining the standing contract prices, the Commission has had regard to AGL SA's costs and the financial implications of this decision on its viability (see 14.2.7 above).

The Commission has also had regard to the financial implications for consumers, and has sought to protect consumers' interests with respect to price (see 14.2.1 above).

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

14.3.7 Section 25(4)(g): Factors specified by Act or Regulation

As indicated previously in Section 1.4, there are a number of other factors specified in the Electricity Act including consistency with the National Electricity Code; promoting efficiency and competition; promoting the establishment and maintenance of an efficient system of electricity generation and supply;



establishing proper standards of reliability and quality of supply; and protecting the interests of consumers.

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

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

14.3.8 Section 25(5)(a): Costs and benefits of regulation

The Commission does not believe there have been any significant costs of regulation imposed on AGL SA as a result of the Price Determination. There are no major ongoing or compliance costs associated with the decision, apart from those required by law.

14.3.9 Section 25(5)(b): Articulate trade-off between costs and standards

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

14.4 Summary

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

15 CONCLUSION

The Commission has undertaken this Inquiry into AGL SA's proposed standing contract price path in accordance with the Terms of Reference: these also required it to have regard to the factors in Parts 2 and 3 of the *Essential Services Commission Act 2002*. How the Commission considered each of these factors has been outlined in section 14 of this Report.

The Commission released an Issues Paper and a Discussion Paper as part of this Inquiry; it also held a public hearing. It released a draft Final Report and draft Determination, and a final Determination in December 2004. As a result of AGL SA seeking a review of the Determination, it also released a Decision on the Review Application in February 2005. Through these means, it has obtained valuable input from stakeholders and informed itself on key issues relevant to the Inquiry. Further, the Commission engaged expert consultants to assist it in specific areas of inquiry, and also met with AGL SA officers on numerous occasions to better understand the costs associated with the role of standing contract retailer in South Australia.

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

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

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

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

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

Fourthly, it has considered operating costs associated with the provision of services to standing contract customers, and expressed that as an average cost per customer. This

was particularly informed by an audit of AGL SA's actual operating costs in meeting standing contract customer obligations, and by benchmark costs determined in previous investigations.

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

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

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

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

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

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

APPENDIX 1

Essential Services Commission Act 2002

NOTICE OF REFERENCE UNDER PART 7

Standing Contract Prices of AGL from 2005

1. BACKGROUND

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

2. REFERENCE

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

3. TERMS OF REFERENCE

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

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

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

4. CONDUCT OF INQUIRY

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

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

5. DEFINITIONS

In this notice:

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

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

Dated 26 May 2004

HON PATRICK CONLON MP
Minister for Infrastructure
Minister for Energy
Minister for Emergency Services

PROPOSAL

For

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

August 2004

Public Version

EMBARGOED to 5pm Sunday 22 August 2004



EXECUTIVE SUMMARY

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

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

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

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

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

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

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

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

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

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

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

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