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Dear Treasurer

Advice on justification for July 2016 South Australian retail electricity price increases

The Essential Services Commission (**Commission**) is pleased to provide you with this Advice on the justification for the July 2016 South Australian retail electricity price increases announced by AGL, Origin Energy and EnergyAustralia (**Specified Retailers**). This Advice is provided pursuant to your request issued on 22 June 2016 under section 5(f) of the Essential Services Commission Act 2002 (ESC Act).

SUMMARY OF ADVICE

The July 2016 South Australian retail electricity price increases announced by the Specified Retailers can be justified by movements in the wholesale cost of electricity.

The primary reason for the announced retail electricity price increases is an increase in the wholesale cost of electricity. The Commission has sought information and evidence from a range of stakeholders and sources and confirms that the wholesale cost of electricity has risen significantly and that this change can explain the announced retail price increases.

Background

In June 2016, the Specified Retailers made separate announcements on retail electricity prices to apply in South Australia from July 2016 for residential and small business customers. AGL announced a 12 percent average price increase, Origin Energy announced a 6.5 percent increase and EnergyAustralia announced a 15 percent increase.

Following those announcements, you requested Advice from the Commission on the justification of those price increases. The Commission provided its Draft Advice to you in relation to this matter, in December 2016. The terms of reference for the Advice, which are attached, required Advice to be provided within one month of the Commission receiving your response to the Draft Advice. The Commission received your response to the Draft Advice on 22 March 2017.

Methodology for the Commission's review

The Commission has considered the reasonableness of the price increases announced by the Specified Retailers for residential and small business customers using a wide range of evidence. It has examined the retailers' cases using several approaches. It has:

- ▶ conducted analysis of independently sourced wholesale electricity forward prices
- ▶ reviewed changes in generation cost inputs, which the Specified Retailers claim is being reflected in wholesale electricity prices
- ▶ compared the announced price increases with those applied by the Specified Retailers to commercial and industrial customer prices, and
- ▶ compared the announced price increases with price changes made by other retailers.

The Commission has focussed on the reasons for the announced price increases. In particular, it has examined changes in costs incurred by retailers that may explain those increases. The Commission comments briefly on the reasons for underlying input cost changes, but has not sought to conduct a detailed review of those related markets to substantiate the reasonableness of the input cost movements.

Information relied upon by the Commission

In preparing this Advice, the Commission has relied upon the following information and evidence:

- ▶ Presentations and additional confidential information provided by the Specified Retailers to the Commission to substantiate each retailer's reasons for the announced price increases.
- ▶ Information from other stakeholders, to test the validity of the information provided by the Specified Retailers and to ensure that the Draft Advice presents a balanced view, rather than relying solely on the justifications provided by the Specified Retailers alone. Those stakeholders included retailers, electricity generation asset operators, other regulators, industrial users and industry brokers.

Findings

Finding 1: The price increases announced by the Specified retailers are driven primarily by movements in wholesale electricity costs

Information provided by the Specified Retailers to the Commission demonstrates that the most significant reason for the price increases announced by the Specified Retailers was the estimated increases in the market costs of procuring wholesale electricity from the National Electricity Market.

The Commission has verified those increases against various sources of information, including forward contract price movements and underlying generation cost increases. Findings on those matters are discussed below.

Finding 2: The forward price of wholesale electricity in South Australia has increased significantly

Each of the Specified Retailers referred to forward curve price data as the basis for their forecast wholesale cost of electricity forecasts. Notwithstanding the lack of trading volume (particularly for South Australian electricity products) on the ASX Energy Market, the data nonetheless provides a useful reference point. The Commission sourced electricity swap price and volume data from the Australian Energy Regulator, to independently assess the forward price information used by the retailers to underpin their justifications of the price increases announced in June 2016.

This information shows that the forward price estimates (assuming a flat usage profile) generally fell in the range of \$40 per MWh to \$80 per MWh for FY16 and were similar for FY17 up until about September 2015, when they started increasing to a range of \$80 per MWh to \$120 per MWh by September 2016.

The simple average of the forward prices for FY16 and FY17, as measured between 1 April and 30 June, has increased by more than 60 percent, from \$49 per MWh to \$82 per MWh.

The \$33 per MWh increase is not inconsistent with information presented by the Specified Retailers, although it does not take into account the premium that is applied for the mass market load profile, which is discussed separately below.

Finding 3: The spot price of electricity in South Australia has increased and that trend may continue

The spot price of electricity in South Australia has increased significantly since the closure of Northern Power Station on 9 May 2016.

On an unweighted basis, the average spot price of electricity in South Australia was \$51 per MWh between 1 September 2015 and 8 May 2016, and \$128 per MWh between 9 May 2016 and 31 August 2016.

In addition, the frequency of high price events in the wholesale market has increased. Using \$300 per MWh as an example (because this is the exercise price of publicly traded electricity price caps):

- ▶ During the period from 1 September 2015 to 8 May 2016, electricity spot prices exceeded \$300 per MWh on 67 (out of a possible 12,000) occasions – or 0.6 percent of the time.
- ▶ During the period from 9 May 2016 to 31 August 2016, electricity spot prices exceeded \$300 per MWh on 338 (out of a possible 5,500) occasions – or 6.1 percent of the time.

Since 9 May 2016, occurrences of spot prices exceeding \$300 per MWh in South Australia have increased by more than tenfold.

Given the supply-demand balance and trends in input costs of generation (discussed below), that trend is likely to continue in 2017.

Finding 4: Increases in forward prices and spot prices are consistent with increases in the underlying cost of electricity generation

The closure of the Northern Power Station, which followed the withdrawal of capacity at the Pelican Point Power Station in 2015, has created a tighter supply-demand balance in South Australia. While there is sufficient firm capacity to meet peak demand during winter without reliance on the Heywood interconnector, the interconnector may need to be relied upon to meet peak demand during summer, should wind-powered generation be unavailable.

The mix of generation plant in South Australia has also changed markedly in recent years. Wind-powered generation has displaced coal-fired generation, making the state more reliant on gas-fired generation to meet baseload demand. The wholesale cost of gas has increased significantly, making gas-fired generation more expensive. While wind-powered generation has, in itself, put downward pressure on spot prices, it has driven out less expensive forms of generation and contributed to more volatile spot price outcomes. Wind generation is not firm due to its intermittency and retailers therefore cannot obtain firm hedge products from it. This is contributing to the further reduction in availability of forward contracts, which has been an issue in South Australia since at least 2007-08.

Finding 5: The load profile of small customers in South Australia is getting 'peakier', which is influencing residential and small business prices

The load profile of residential and small business customers is peakier (more volatile) than that of commercial and industrial customers, which is reflected in increased wholesale energy costs for that market segment.

There is evidence to suggest that the residential and small business load profile is worsening (getting peakier) over time. The deterioration in the total South Australian system load profile since 2010 coincides with the commencement of the rapid uptake of solar PV, which tends to generate at times that are different to peak demand. The deterioration of the load profile for mass market customers contributes to the increased 'shape premium' that is reflected in retail prices for those customers.

Finding 6: The price increases are consistent with a marketing strategy of discounting market offers from standing offers

Retailers generally increased standing offer prices by more than market offer prices, from July 2016. The gap between standing and market offer prices has widened, which creates two effects:

1. It maximises the size of the 'discount' between standing and market offer prices, which is the primary market strategy of retailers.
2. It extracts a greater margin from standing offer customers, which can be used to subsidise market offer prices. The retailers can take advantage of the lower propensity of standing offer customers to switch to market offers.

The widening gap between standing and market offer prices highlights the benefits that can be attained by customers that switch from a standing offer to a market offer.

Finding 7: The price increases for small customers are consistent with those implemented by the Specified Retailers for commercial and industrial customers

Recognising that the load profile is flatter (and therefore wholesale costs should be lower), evidence from the Specified Retailers on movements in retail price for commercial and industrial customers shows that these prices have been subject to the same wholesale electricity cost pressures that mass market customer prices have. In a competitive commercial and industrial customer market, this provides additional assurance that the movements in wholesale electricity costs are reasonable.

Finding 8: The price increases announced by the Specified Retailers are within the range of increases implemented by other retailers

The Commission has compared the price increases announced by the Specified Retailers to those implemented by other retailers, to ascertain whether or not the increases were market-wide.

Other retailers have also, on average, increased their retail prices. However, there is a wide spread of price changes, ranging from a small decrease in market offers to a 27 percent increase in standing offers.

The clear insight arising from these estimates is that there are a variety of different pricing structures in the market and there are significant savings to be made by switching from higher priced standing offers to lower priced market offers, and even between the market offers made by different retailers.

Finding 9: Concentration of generation ownership may be limiting the effectiveness of retail electricity competition in South Australia

There is a high degree of vertical integration between retailers and generators in South Australia. The Specified Retailers own a total of 67 percent of the total firm generation capacity, with AGL owning 46 percent. AGL, as owner of the gas-fired Torrens Island power station, has increased ability to set the spot price given the closure of Northern power station.

Should you wish to discuss this Advice further, please contact Mr Adam Wilson, Chief Executive Officer, on 8463 4801.

Yours sincerely



Brett Rowse
Chairperson