



17 July 2009

Review of Electricity Pricing and Tariff Structures
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

By email: electricity@qca.org.au

Queensland Competition Authority Review of Electricity Pricing and Tariff Structures – Request for Comments Paper – Stage 1

The Energy Supply Association of Australia (esaa) welcomes the opportunity to comment on the request for comments paper for Stage 1 of the Queensland Competition Authority's review of retail electricity tariffs in Queensland.

esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of over 40 electricity and downstream natural gas businesses. These businesses own and operate some \$120 billion in assets, employ over 40,000 people and contribute \$14.5 billion directly to the nation's Gross Domestic Product.

esaa has long supported the removal of retail price regulation where retail markets are contestable. Prices play an essential role in any market by efficiently signalling both the need for consumers to change their consumption patterns in response to the supply situation and for producers to consider new capacity investments. Retail price caps blunt these important price signals and ultimately prevent efficient market outcomes. Price regulation also prevents the development of flexible and innovative pricing structures that could achieve more effective responses from demand side participants. With a competitive electricity generation sector and price regulated electricity networks, the retail market is by nature competitive and notorious for its narrow margins. Barriers for new retailers looking to enter the market are low as entry does not entail significant infrastructure investment. A study undertaken for esaa by CRA International into the effect of retail price regulation found that price regulation in contestable retail energy markets is likely to confer little or no public benefit but impose considerable direct and indirect costs, thus reducing overall welfare.¹ This study also found that retail price regulation leads to a loss of innovation and customer service as well as a reduction in competition in retail energy markets.

¹ esaa (January 2007) The effects of retail price regulation in Australian energy markets, CRA International. Available from http://www.esaa.com.au/reports_studies.html

The case for removing retail price regulation in jurisdictions where retail markets are contestable is reinforced by the proposed introduction of the Carbon Pollution Reduction Scheme (CPRS) and the expansion of the Renewable Energy Target (RET).

Retail price regulation currently occurs in a relatively stable wholesale electricity market environment. However, the CPRS and expanded RET represent a fundamental transformation of the energy market. The retention of retail price regulation in this new policy environment poses significant risks for electricity retailers and may hinder the development of efficient and competitive electricity markets.

A study undertaken for the Energy Retailers Association of Australia by Farrier Swier Consulting found that the transition to the CPRS will increase wholesale electricity costs as well as introduce new volatility and uncertainty in wholesale electricity markets, in part reflecting carbon price uncertainty. Carbon price uncertainty, reflecting the Australian economy's adjustment to greenhouse gas emissions pricing and ongoing domestic and international greenhouse policy uncertainty, will be particularly acute until effective financial instruments to hedge carbon costs emerge. The CPRS may also challenge the robustness of retailer risk management arrangements, such as electricity contracting, and may expose retailers to the risk of unexpected defaults by emission intensive generators.

The retention of retail price caps in this uncertain and volatile market environment creates the real risk that retailers may be prevented from passing on, in a timely manner, higher wholesale, network, prudential and risk management costs associated with the CPRS and the expanded RET. This could result in significant losses for retailers and potentially threaten the financial viability of existing players.

For regulators, the task of setting appropriate retail prices that are competitive but still allow retail businesses to meet their costs and manage risks will be increasingly complicated. Faced with arguably unprecedented market volatility and no history from which to derive forecasts, there is an increased risk of regulatory error that could lead to retailer failure. This would result in increased volatility and risk in the energy market, reduce competition and potentially undermine system reliability and security of supply.

The inadequacy of existing retail price regulation frameworks to accommodate the CPRS was addressed in the draft recommendations of the Australian Energy Market Commission's (AEMC) second interim report of its Review of Energy Market Frameworks in light of Climate Change Policies. The AEMC found that increased electricity costs and volatility are likely to be difficult for retailers to manage through financial instruments and that for competition to be effective retailers must be able to charge cost reflective prices to end use customers. An inability to do so could lead to a cost/price squeeze that dampens competition in the market and may cause retailers to exit.

The need for cost reflective retail prices was also acknowledged by the Council of Australian Governments when it formally amended the Australian Energy Market Agreement for the pass through of carbon costs under the CPRS and the expanded RET into retail prices, where those prices are regulated, at its 2 July 2009 meeting.

However, where governments choose to continue to regulate retail electricity prices, even where retail markets are contestable and the effect of regulation may be highly deleterious, increased flexibility in the setting of retail price caps and an appropriate methodology that allows for the full and timely pass through of costs associated with the CPRS and the RET are imperative to ensure a financially viable and competitive retail sector. The risks to the electricity market from the under recovery of carbon costs far outweigh the risk of over recovery in a contestable retail electricity market, particularly as any over recovery would be eroded through competition.

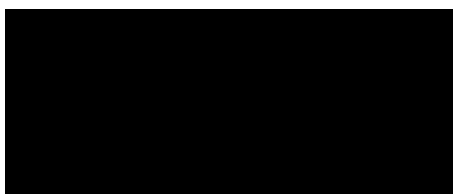
To ensure an appropriate methodology is developed and applied across all jurisdictions that choose to retain retail price regulation, esaa considers that a single, nationally consistent methodology for determining retail electricity prices should be developed and adopted across Australia. The AEMC, with responsibility for rulemaking and market development, should be charged with determining an appropriate methodology.

Any retail price setting methodology should be based on real, not modelled or arbitrarily determined costs, to encourage and facilitate competition, including through new entrants. Such an approach ensures that consumers face prices reflecting all efficient costs and can make rational consumption decisions as a result. In particular, for the CPRS to operate efficiently and provide least-cost emission reductions, consumers need to be exposed to the cost implications of greenhouse gas emissions.

Should governments wish to protect some consumers against price rises then this is best achieved through social policy measures, such as Community Service Obligation payments, rather than through distorting retail electricity prices. The current CPRS design proposes to offer substantial financial support to consumers – to the extent of potentially overcompensating some consumers – to offset increased energy costs resulting from the CPRS.

Retail price regulation in contestable electricity markets imposes considerable direct and indirect costs on the Australian community with little to no offsetting benefit. However, retail price regulation in the context of a CPRS and expanded RET will actually threaten the viability of Australia's electricity markets. Should governments choose to continue to regulate retail prices in this environment then a single national methodology for the regulation of retail prices needs to be developed by the AEMC to ensure that retail prices are cost reflective and the significant transformation of the Australian energy markets can be managed as best as possible.

Yours sincerely



Brad Page
Chief Executive Officer