

Ergon Energy Corporation Limited

**Review of Electricity Pricing and Tariff
Structures**

**Stage 1 Request for
Comments Paper
– Submission**

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Stage 1 Request for Comments Paper
Submission
Queensland Competition Authority
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1 INTRODUCTION

Ergon Energy Corporation Limited (Ergon Energy) welcomes the opportunity to provide comment to the Queensland Competition Authority (QCA) on its Review of Electricity Pricing and Tariff Structures.

This submission is provided by Ergon Energy in its capacity as a Distribution Network Service Provider (DNSP) in Queensland.

Ergon Energy has structured this submission in two parts:

Part A: Sets out Ergon Energy's general comments in relation to the consultation.

Part B: Provides detailed comment on each of the QCA's specific questions, where Ergon Energy considers it is relevant to comment as a DNSP.

Ergon Energy is available to discuss this submission or provide further detail regarding the issues that it has raised should QCA require.

2 PART A – GENERAL COMMENTS

Ergon Energy welcomes the Ministers' Direction to the QCA to review existing retail tariffs and ensure the long term management of peak electricity demand. In general terms, however, there are further considerations to which the QCA must turn its mind in order to achieve the objectives of this review.

Ergon Energy notes the Queensland Government's commitment to the Australian Energy Market Agreement (AEMA). One of the commitments, stated in Clause 14.11 of the AEMA, provides that all parties agree to phase out the exercise of retail price regulation for electricity and natural gas where effective retail competition can be demonstrated. Until this can be achieved in Queensland, Ergon Energy recognises that the Notified Prices are an important part of the energy market in Queensland.

Ergon Energy notes that the focus of the QCA's consultation appears to be on customers in South East Queensland. However, given the level of competition in regional Queensland, the majority of customers in Ergon Energy's distribution area are on the Notified Prices. Therefore the effectiveness of tariffs and the Benchmark Retail Cost Index (BRCI) process, and consequently the outcome of this review, will also impact on customers in regional Queensland. This is recognised in the scope of the terms of the Ministers' Direction Notice.

Ergon Energy considers it essential that retail tariffs are significantly restructured to ensure the effective long term management of peak demand and the provision of incentives for more efficient electricity use. If this is achieved, it will bring significant benefits to all Queenslanders. The achievement of this goal would:

- limit the long term growth of electricity prices, relevant to the network component of electricity supply costs, for Queensland customers; and
- limit the growth trend of the Community Service Obligation payment made by the Queensland Government to cap electricity prices for customers in regional Queensland who are customers of Ergon Energy Queensland. Reduction of future growth of the network cost component of the Community Service Obligation would allow the Queensland Government to apply the money saved to other needs.

To achieve this objective while retail prices remain regulated, the retail pricing framework should enable cost reflective pricing including the pass through of Powerlink, Ergon Energy and Energex Corporation (Energex) prices to customers via the Notified Prices. The characteristics of the Queensland distribution networks means tailored peak demand management and price signalling by both Ergon Energy and Energex is required to allow price signals to reflect network specific issues and customer demand characteristics. This in turn will allow the development of industries that can assist with management of the peak demand growth in Queensland.

The pass through of network price signals can be achieved via an 'aggregated' retail tariff which transparently incorporates a retail cost component (including energy costs and retail cost to serve) and the relevant underlying network cost component (or network price). A further benefit of such approach is that that the annual determination of Notified Prices would be limited to the retail components of the retail tariffs (e.g. wholesale energy cost and cost to serve). The components of the network tariffs, once approved by the Australian Energy Regulator (AER), would then be aggregated with the relevant retail tariff components determined by the QCA. The 'aggregation' approach for 'like' retail and network cost components would facilitate cost reflective pricing and must also provide sufficient transparency of the underlying cost structures such that the delivery to customers of signals contained in the network prices (e.g. demand based

pricing) is achieved. While the indexation approach would be simplified the aggregation and network cost pass through approach would likely result in a significant increase in the number of Notified Prices, consistent with the number of underlying network prices.

A network price pass through approach, and the achievement of the objective of long term management of peak demand, has implications for the current Uniform Tariff Policy. It is considered that the intent of the Uniform Tariff Policy is to ensure equity in electricity prices between regional Queensland and South East Queensland. Uniformity of Notified Prices is perhaps therefore best considered as the vehicle, rather than the goal in its own right. A practical outcome must therefore be determined which addresses both the intent of the Uniform Tariff Policy and the ability for Ergon Energy, and Energex, to send network price signals to their customers.

As a transitional measure, the pass through of South East Queensland network costs may be a practical first step to restructuring retail tariffs. However, delay in structuring retail tariffs to allow Ergon Energy's network price signals to be sent through to its customers will limit the effectiveness of the long term management of peak demand.

Ergon Energy acknowledges that it is not an expert on the impacts of the BRCI on retail tariff cost reflectivity in South East Queensland. However, Ergon Energy is able to make informed comments based on our knowledge of network tariffs generally, relevant publicly available information and a clear understanding of the BRCI methodology.

3 PART B – RESPONSES TO SPECIFIC QUESTIONS

3.1 Effectiveness of the current BRCI methodology in achieving cost reflective regulated retail electricity tariffs

Does the current BRCI framework produce regulated retail electricity prices that are reflective of the costs of supplying electricity in south east Queensland, including accounting for network costs and for all State and Commonwealth Government environmental obligations?

The BRCI does not accurately capture the changes in underlying network tariffs

The network component of the BRCI does not reflect the increase in the underlying network costs for each customer in South East Queensland (or for each customer in regional Queensland). The BRCI methodology averages the Aggregate Annual Revenue Requirements (AARR) of both Ergon Energy and Energex for the purposes of calculating the network cost component of BRCI adjustment. The averaging methodology on total revenue is not reflective of the network cost for retail customers either within South East Queensland alone, or across Queensland. The BRCI methodology would only result in a cost reflective outcome relative to South East Queensland if the costs, and therefore the AARRs, of both Ergon Energy and Energex were the same. This is not the case.

In broad terms therefore, to the extent that Ergon Energy's costs have increased at a lower rate than Energex's costs, the BRCI would understate the required retail tariff increase relative to the underlying network cost increases for customers in South East Queensland. On this basis, if the intent of the BRCI is to ensure that retail tariffs are adjusted to reflect changes to the costs of supplying electricity in South East Queensland then it would, in the first instance, be necessary to limit its consideration to changes in Energex's costs.

Simply adjusting the BRCI methodology to use only the change in Energex's AARR to calculate the network cost component of the BRCI would still result in significant inconsistencies in cost reflectivity at the customer, or retail tariff level. That is because Ergon Energy and Energex calculate network tariffs for each customer or customer class on a cost reflective basis in accordance with approved Pricing Principles Statements developed in accordance with the QCA's Final Determination. This means that individual network tariffs and their underlying components necessarily change at significantly different rates annually, relative to movements in the total AARR. As such, a simple average approach to adjusting Notified Prices leads to under-recovery in relation to some network tariffs, and over-recovery for others. The outcome is a cross-subsidy in retail tariffs, where revenue from customers on more profitable retail tariffs must be used to balance the loss from customers on less profitable (or potentially unprofitable) retail tariffs. The current BRCI methodology is therefore too simplistic to properly reflect the actual underlying annual network cost changes.

It should be noted that the network component of the BRCI also incorporates changes in Powerlink's Transmission Use of System (TUOS) charges incurred by Ergon Energy and Energex. The QCA requires that Ergon Energy and Energex pass through any locational signals sent by Powerlink. This results in TUOS rates which are higher for customers located further north in the state. As is the case for Ergon Energy and Energex's network tariffs, Powerlink's charges can increase by different amounts at

each connection point. This further complicates the ability of the simplistic approach taken by the BRCI to calculate actual network cost increases.

BRCI does not allow for structural changes in the underlying network tariffs

The BRCI framework adjusts each of the Notified Prices by a single index intended to estimate the change in costs of supply across the state. This does not provide the QCA the opportunity to consider whether the structure of the Notified Prices actually reflects the structure of the underlying network tariff. While Ergon Energy structures its network tariffs such that there is only one network tariff suitable for each customer, there is not a one-to-one relationship between network tariffs and the Notified Prices. That is, while a customer will only meet the conditions for one network tariff, they may be eligible for a choice of multiple retail tariffs and there may be customers on different network tariffs on the same retail tariff. For example:

- Customers on Tariff 11: Several different classes of Ergon Energy network customers, which all have different network tariffs, can be eligible for Tariff 11. Customers on Ergon Energy's network tariffs including 'Demand Medium', 'Demand Small', 'Volume Large' or 'Volume Small' for all three pricing zones (East, West, and Mt Isa) could be on Tariff 11. In addition, there are different costs for those customers in unregulated isolated networks; and
- Customers on Tariff 20 or Tariff 43: The same is applicable for customers on Tariff 20 or Tariff 43. Customers on Ergon Energy's network tariffs including 'Demand High Voltage', 'Demand Large', 'Demand Medium', 'Demand Small', 'Volume Large' or 'Volume Small' for all three pricing zones (East, West, and Mt Isa) may be on either Tariff 20 or Tariff 43. In addition, there are different costs for those customers in unregulated isolated networks. Further, network customers may also be classified as an Individually Calculated Customer (ICC) or a Connection Asset Customer (CAC) and have an individual network tariff calculated for them and also be on either Tariff 20 or 43.

Therefore, an averaging approach to adjustments to the Notified Prices, where a consolidated retail tariff is intended to recover a range of possible network tariffs (while all other cost components remain comparable), must therefore produce different headroom outcomes for each combination of network tariff and Notified Price.

BRCI does not adequately compensate for the underlying network tariff fixed costs

Ergon Energy is unable to comment on the total quantum of Notified Prices relative to the cost of supply in South East Queensland. However, there are clear indications of the under-recovery of network components in the existing retail tariff structure. The fixed charge in the retail tariff in some instances is not sufficient to cover the fixed charge in the associated network tariff, let alone accounting for any retailer fixed costs, for example:

- There is no fixed charge within Tariff 31 or Tariff 33 even though the corresponding network tariffs for both Ergon Energy and Energex have fixed cost components;
- The Tariff 11 fixed charge is less than Energex's Domestic network tariff fixed charge;
- The Tariff 20 fixed charge is less than Energex's Business Small network tariff fixed charge; and
- The underlying demand charges in network tariffs are not recovered at all in the retail tariffs that do not have demand-based components.

The BRCI framework can conflict with electricity policy objectives

Where the retailer is not able to recover all of its fixed costs through the fixed component of the Notified Prices, to avoid a financial loss it must rely on the customer increasing their electricity consumption such that profit (which should exist) in the variable component compensates for under-recovery of the fixed costs of supplying the customer. In such circumstances where the structure of the Notified Prices is not reflective of the underlying cost structure to the retailer, a retailer which assists customers to reduce electricity consumption may be doing so at a financial loss, rather than just a revenue reduction.

The BRCI framework can limit effective retail competition

In the majority of cases, the individual network charges (based on a customer's applicable network tariff) are levied on customer's retailer. If the actual network cost in relation to a customer is not incorporated fully into the Notified Price which a retailer can charge that customer, there is a risk of under-recovery (or over-recovery) of costs by the retailer. If this risk of under-recovery is great enough it will limit effective retail competition and in extreme circumstances could lead to retailer market failure.

If not, would the BRCI methodology as it is currently applied be appropriate if existing retail tariffs were reviewed for cost reflectivity and the BRCI framework then applied to the revised tariffs?

Ergon Energy considers that a review of the cost reflectivity of Notified Prices is an appropriate first step to be undertaken by the QCA. However, as discussed above, the BRCI mechanism is flawed and results in cross-subsidisation between the tariffs in the Notified Prices. Therefore, even if the review of existing retail tariffs resulted in the Notified Prices being made cost-reflective, the averaging approach of the BRCI would mean that with each successive year the cost reflectivity of individual retail tariffs would change as the underlying network tariffs change relative to the average. This would require additional "step changes" to re-align the Notified Prices with cost reflectivity in the future, while in the interim, retailers would bear the risk of under-recovery of costs. Ergon Energy believes that such step changes to customer costs should be avoided.

3.2 Assessment of alternative pricing methodologies for setting regulated retail electricity tariffs

Cost of Energy

What is the most appropriate method to estimate the cost of energy for the (future) tariff year(s) under review?

Ergon Energy considers that in order to achieve goals such as improved energy efficiency and reduction of carbon emissions, it is important for customers to see, and understand, the true cost of energy.

If the LRMC is included, how should it be estimated?

No comment.

If the cost of purchasing energy in the market is included, how should it be estimated?

No comment.

If a mix of LRMC and purchase cost is to be adopted, as is the case at present, how should estimates of these two components be combined?

No comment.

How should the potential cost changes associated with environmental obligations such as the CPRS and the expanded RET be included?

The Ministerial Council on Energy has agreed to recommend to the Council of Australian Governments that an amendment be made to the Australian Energy Market Agreement. This amendment would commit all parties to ensuring that the Carbon Pollution Reduction Scheme costs can be passed on to customers. Ergon Energy supports this recommendation. In this regard, Ergon Energy considers there should be a consistent national approach to the manner in which the full pass through of emissions costs to consumers on regulated retail tariffs is achieved.

Network Costs

Should network costs be removed from retail tariffs and treated as a direct cost pass-through to customers?

Retail tariffs must pass through the network pricing signals of Powerlink, Ergon Energy (for customers in regional Queensland) and Energex (for customers in South East Queensland). This is critical to achieving the long term management of peak demand, demand generally, and consumption levels across the whole of Queensland. The question of whether network costs should be removed from retail tariffs and directly passed through to customers (i.e. unbundled retail tariffs) or remain a pass through component of retail tariffs (i.e. 'aggregated' retail tariffs) is an important secondary issue, most likely driven by the desire for simplicity on customer bills (while still delivering the price signal).

Notified Prices must pass through the underlying network pricing signals

Notified Prices should compensate electricity retailers for the total cost of supplying their Queensland customers, and contain sufficient headroom to foster a competitive electricity market. However, as demonstrated above, there is currently no direct or indirect incorporation of network tariffs, or costs, into the current Notified Prices. This means that retailers may not be adequately compensated for the costs they incur in providing retail services.

In undertaking the BRCI calculation, the QCA was not required (or allowed) to consider whether the existing Notified Prices were structured to provide appropriate compensation for network costs. As a result the annual indexations were applied to Notified Prices which have no clear link to the underlying network tariffs. This timely consultation allows for a review of the fundamental structure of retail tariffs.

The under-recovery of underlying costs in Notified Prices could lead to retailer market failure, or the risk of under-recovery could lead to retailers choosing to withdraw from the Queensland electricity market. While Notified Prices exist, the best method of avoiding this risk is for the underlying regulated network prices to be passed through to customers.

To date the Notified Prices have acted as a barrier to Ergon Energy's and Energex's network price signals being seen by non-market customers. Only the Large market customers on Ergon Energy's network have been able to see, and therefore respond to, Ergon Energy's price signals. These customers represent only a small percentage of the total customers connected to Ergon Energy's network.

In order to achieve the Queensland Government's objective of effective retail competition, retail prices must be cost reflective and include sufficient headroom. A significant advantage of cost reflective pricing is that it sends appropriate signals to customers to enable distributors to effectively manage peak demand and demand more generally, on the electricity network. This is, in the long run, the key to reducing the future expenditure required to support demand and load growth, and ultimately limit electricity cost increases for customers.

To achieve this objective in regional Queensland, Ergon Energy must be able to send its own network price signals to customers. This would require Ergon Energy's network prices to be 'aggregated' into retail tariffs applicable to regional Queensland customers. It is important that both Ergon Energy and Energex are able to send different network price signals to their customers, reflective of the characteristics of each network. In the same way, a network price pass through approach will allow each distributor to send different signals to different classes of customers and to customers in different regions.

A further advantage of a passing through network costs is that it simplifies the determination of the Notified Prices. The retail components of the Notified Prices become the only elements that require consideration by the QCA. Sending price signals to manage demand is a function of the network component of electricity prices, rather than the retail component. As such, where it is appropriate to include a demand signal, this will be delivered via the regulated network prices and incorporated into the 'aggregated' retail tariff via the pass through mechanism. If, on the other hand, a demand component was included in the Notified Price which was not reflective on the underlying network price, then retailers would be over-charging (or undercharging) customers relative to their actual underlying retailing costs. This situation is clearly to be avoided.

Setting a simplified regulated retail tariff also places responsibility for more innovative pricing with the experts, the competitive retailers. Competitive retailers, rather than the regulator, have the knowledge and the ability to respond dynamically to customer needs. The role of Notified Prices should remain a safety net, not a competitive market tool.

Network Prices may be separately passed through or aggregated in Notified Prices

There are several alternative approaches to passing through network costs to customers. One option is for network prices to be clearly separated from retail tariffs and directly passed through to customers as a separate line item (or items) on a retail bill.

An alternative approach is to aggregate the network prices into retail tariffs consisting of both retail and network cost components. For example a retail tariff may contain:



- a fixed charge component, calculated by adding the retail fixed charge to the network fixed charge; plus
- a variable charge component (i.e. relative to volume of electricity consumed), calculated by adding the retail variable charge to the network variable charge; plus
- a demand charge, which is reflective of the demand charge in the underlying network tariff.

This form of retail tariff is termed an 'aggregated retail tariff'. Ergon Energy considers that an aggregated retail tariff is likely to be simpler from a system and administration perspective and less confusing for customers. The aggregation of appropriate (or 'like') components simplifies the retail bill, while still providing what is considered to be sufficient transparency of signalling to customers.

The full transparency of a separately identified network price pass through on customer's bills could result in eight or more separate line items representing the separate retail, distribution and transmission cost components appearing on the bill. Therefore any potential benefits of this approach must be balanced against the additional system costs, which would ultimately be worn by customers, and the increased complexity of retail bills. The greater complexity of retail billing could ultimately result in the price signal being lost.

Other jurisdictions in the National Electricity Market, which retain regulated retail prices, generally structure their retail tariffs on the basis of a cost-reflective network component plus a retail component. This aggregated, or bundled, retail tariff approach recognises that the responsibility for the regulation of electricity networks and network prices is the domain of an economic regulator. As such, the retail tariff review process does not attempt to estimate or calculate the network cost component of retail tariffs, but instead combines them with the retail costs as pass through costs. Importantly this approach removes the potential of imposing an unreasonable and uncontrollable financial risk upon electricity retailers in relation to the under-recovery of network costs.

In Queensland, the financial risk is greater where the goal is to set uniform Notified Prices applicable to customers across two distribution networks. Ergon Energy and Energex are two separate distribution businesses with different network assets, cost drivers, and customer characteristics. As a result, both businesses necessarily have different network tariff structures and tariffs. To achieve the principle of cost reflectivity, Ergon Energy also has different distribution network prices for similar customers in different regions (e.g. East Zone, West Zone and Mt Isa) and TUOS network prices that vary up the state. This further complicates the ability to set consolidated or averaged Queensland-wide retail prices which ensure adequate recovery of underlying network costs.

Trying to determine a uniform retail tariff with these major differences causes a significant dilemma when setting Notified Prices which must also be cost reflective. Other jurisdictions with regulated retail prices and a uniform tariff policy generally achieve this because there is only one distributor and one transmission entity sending out the same network signal to customers of the same type across the State (e.g. South Australia).

Ergon Energy understands that NSW and Victoria do not have a uniform tariff policy. Rather, NSW ensures its regulated retail tariffs are cost reflective for each distribution region within the State, while Victoria no longer has any regulated retail tariffs. Accordingly, regional and rural NSW and Victorian customers can pay more for their electricity compared with residents in metropolitan areas. While cost differentials in NSW and Victoria have not been investigated, it is likely that the cost differential

between customers in regional Queensland and South East Queensland are significantly higher than the regional and metropolitan cost differentials in southern jurisdictions. This is likely a key driver of the Queensland uniform tariff policy.

In 2002 Victoria introduced a Network Tariff Rebate (originally called the Special Power Payment) as a temporary policy measure which ceased in 2008, to assist regional and rural customers through the transition to full retail competition in the electricity market. This was not a uniform tariff policy (and would not support a uniform tariff policy) but was rather a temporary rebate policy to assist eligible customers by providing rebates calculated relative to costs for average customer consumption levels. It was replaced with rebates to encourage eligible households in regional and rural Victoria to switch to solar hot water.

How should a direct cost pass-through be handled in the context of the Queensland Government's Uniform Tariff Policy?

The Queensland Uniform Tariff Policy operates by setting regulated prices which apply to customers irrespective of their location in Queensland, and irrespective of variations in their underlying supply costs. It is considered that the intent of the policy is to ensure equity in electricity prices between regional Queensland and South East Queensland. Uniformity of Notified Prices is perhaps therefore best considered as the vehicle, rather than the goal in its own right.

Both a direct cost pass through of network tariffs, and an aggregating of network tariffs in the Notified Prices, are likely to cause issues for the continuation of a Uniform Tariff Policy. For reasons discussed above, the notion of a uniform price is inconsistent with the underlying network cost structures to which retailers are exposed. The clearest examples of this issue are the ICC and CAC National Metering Identifiers (NMIs) on the Ergon Energy (and Energex) network. Each of these customers has an individually calculated network tariff which reflects the assets used to supply the customer. These customers, by definition, each have a dedicated supply system which is specific to the customer. It is not appropriate to have a common network tariff for these customers. Each individual customer's network tariff will change by a different amount each year depending on the assets used to supply them.

The cost pass through approach is also consistent with the AER's Framework and Approach Decision Stage 1. In that decision, the AER indicated that they are likely to classify the design and construction of new large customer connection assets as an "Alternative Control Service" rather than as a "Standard Control Service". In this context, large customers are defined as ICC, CAC and Embedded Generators. This change in classification removes new large customer connection services from the revenue cap and requires each distribution entity to provide such connection services under a price-cap approach¹.

It is problematic to have a uniform tariff with elements of the network tariff being specific to each ICC and CAC. To achieve cost reflectivity the NMI specific (or site-specific) costs must flow through to the retail tariff. For unique costs to flow through to the aggregated retail tariff, that element of the costs must be outside the Uniform Tariff Policy. As such, the site specific costs should be considered outside the intent of the Uniform Tariff Policy.

¹ Final Decision: Framework and Approach paper – Classification of Services and Control Mechanisms Energex and Ergon Energy FY2010 - 15.

As discussed above, it is also important that both Ergon Energy and Energex are able to send different network price signals to their customers, reflective of the characteristics of each network. However, this would also be inconsistent with the Government's Uniform Tariff Policy, as the network cost component of the Notified Prices would be different for customers connected to each network.

To achieve this outcome, a practical approach must therefore be determined which addresses both the intent of the Uniform Tariff Policy and the ability for Ergon Energy to send network price signals to its customers.

Thus far, the discussion in this submission has related to Ergon Energy's regulated network. However, Ergon Energy also owns and operates 34 isolated networks. These networks are not subject to economic regulation under the National Electricity Rules and as such the network costs are charged on a different basis to the regulated network. Further, a large number of customers on these networks have card operated meters installed. Given the technical limitations of these meters a different retail tariff structure may be required for customers on isolated networks as opposed to those on the regulated distribution network. This creates specific challenges for applying the Uniform Tariff Policy to those customers.

What would be the implications for the achievement of cost reflectivity and demand management if network costs were directly passed through?

The pass-through of network costs is a vital step in achieving both retail tariff cost reflectivity and demand management objectives. As discussed above, the pass through of network costs can be achieved via a direct pass through or an 'aggregating' approach. Ergon Energy considers that an aggregated retail tariff is likely to be simpler from a system and administration perspective and less confusing for customers.

The ultimate benefit to customers of effective signalling includes the ability for customers to have greater control over managing their electricity costs. Importantly, reduction of peak demand and demand generally is, in the long run, the key to reducing the future expenditure required to support demand and load growth and ultimately limit electricity cost increases for customers.

Allowing retail tariffs to pass through network costs results in the ability for appropriate peak demand price signals to be sent to customers. This creates an incentive for the development of initiatives to assist customers to manage peak demand. In turn, this may create new opportunities in the market to assist with the reduction of peak demand, in line with the Government's policy of creating green jobs, stimulating the economy and promoting greater economic efficiency in the building of Queensland's infrastructure.

Retail costs and the retail margin

What are the fixed and variable components of retail operating costs and how do these costs vary for customers in different tariff classes?

To ensure cost reflectivity in retail prices, an allowance for retail operating costs of an efficient retailer should be included in the retail cost component.

How should the retail margin for an efficient retailer operating or potentially operating in the south-east Queensland electricity market be determined?

To ensure cost reflectivity in retail prices, the retail margin must provide an appropriate risk-adjusted return to compensate the equity investors and debt providers. That is, it must represent an appropriate return on capital investment for a retailer.

How should the current level of headroom be determined and how should it be factored into regulated retail electricity tariffs to ensure that it remains relatively stable?

No comment.

Escalation of Regulated Tariffs

The Authority seeks stakeholders' comments on whether to continue with a single escalation factor or to apply different escalation factors to different tariffs or tranches of tariffs?

If network tariffs are passed through to customers via the Notified Prices, then the retail tariff escalation process need only deal with escalation of the retail components (e.g. wholesale cost of energy and cost to serve). This could provide an opportunity to simplify the approach to the structure and the escalation factor of the Notified Prices. To the extent that there is consistency between the underlying retail cost structures of the retail components, use of a single escalation factor may be possible. The underlying load shape assigned to each tariff, which is a driver of underlying costs (e.g. wholesale energy), will be important in determining the appropriate escalation factor.

Achieving Pricing Certainty

What are the benefits and risks of moving to a longer regulatory period from the current annual indexation?

If network tariffs are passed through to customers via the Notified Prices, then the retail tariff escalation process need only deal with escalation of the retail components.

Network tariffs are approved by the AER² prior to the start of each financial year. Once approved, those network tariffs would then be incorporated, or aggregated, directly into the relevant retail tariffs determined by the QCA. This process would continue to apply annually irrespective of whether it was considered appropriate to escalate the retail component annually or, as suggested in the Ministers' Direction Notice, every three years.

If a network cost pass through was not adopted, the risks involved in a longer regulatory period increase. This is a result of the difficulty of forecasting network costs for each customer or retail tariff type more than one year in advance. The potential for variation of network prices year to year makes any forecast risky and to use such a forecast to set Notified Prices would place the risk of under-recovery on retailers. This is further exacerbated by the fact that both distributors operate under a revenue cap. This means that the AARR (or Annual Revenue Requirement from 1 July 2010) approved by the regulator at the time of the Final Determination may not be the AARR used to calculate network tariffs for that particular year. This is the result of the annual overs/unders

² The AER commences responsibility for the economic regulation of Ergon Energy and Energex from 1 July 2010.

process and the ability for both distributors to seek cost pass throughs where significant unexpected events occur (i.e. Cyclone Larry). The network businesses would continue to charge retailers the approved network prices and retailers would bear the financial risk of the inconsistency between the actual network prices and the forecasts made for indexation purposes. Such an approach has the potential to have a detrimental impact on retail competition and the development of retail products.

Distribution businesses have no price certainty beyond their current Revenue Determination of five years. This further complicates the application of an indexing approach to the network cost component of retail tariffs. For example, adoption of a three year indexation (as opposed to a network price pass through) would mean that in the last year of a second three year term, not only would the actual network prices be unknown, but the AARR would also be unknown.

Whilst longer term price certainty of both the network and retail component of a retail tariff is likely to be beneficial for a customer, the risks identified above far outweigh the potential benefit. To avoid this risk, the network cost component of retail tariffs should be passed through to customers, and as such should not form part of the indexation approach.

If a longer regulatory period is adopted, how should prices be set for that longer period?

As discussed above.

Reopening Pricing Decisions under Special Circumstances

What events, if any, should trigger reopening of a retail pricing decision?

Competitive retailers operating in the Queensland electricity market bear the risk of Notified Price under-recovery, and as such are best placed to comment on re-opening triggers to address that risk.

If a decision is made to retain the BRCI for 2010/11 (or a similarly simple mechanism used to adjust existing Notified Prices as a transitional measure prior to tariff re-structure) there is a risk that such an indexing calculation may need to be re-opened. This is because of the effect the new Regulatory Determinations for both Ergon Energy and Energex may have on network prices. This could be avoided by the transitional measure of allowing a pass-through of Energex's network tariffs in Notified Prices. In such circumstances, eligibility for the new Notified Prices would need to identify how to link retail customers within Ergon Energy's distribution network to the appropriate Notified Price (with the most relevant Energex cost pass through).

Should such a reopening be prospective only or also seek to recover losses incurred prior to the reopening?

Competitive retailers operating in the Queensland electricity market bear the risk of Notified Price under-recovery, and as such are best placed to comment on re-opening triggers to address that risk.

3.3 Assessment of existing tariffs

Current Tariffs and Tariff Structures

Are any of the current tariffs insufficient to recover the efficient cost of supplying electricity in south-east Queensland?

As discussed above, it is considered likely that the BRCI mechanism has not resulted in the adjustment of individual retail tariffs to reflect changes in the underlying network costs. Therefore, it is possible that some of the current retail tariffs are insufficient to recover the efficient cost of supplying electricity in South East Queensland.

Do the current tariff structures send appropriate price signals to customers to enable them to manage their use of electricity and, if not, why not?

The network price signals, including those intended to help manage peak demand, are not currently reflected in the existing retail tariff structures. As discussed above, such signalling is the role of the distribution businesses and it is important that the distribution businesses retain the role of determining price signalling for network-related issues. This is best achieved by a pass through of network prices, rather than attempting to develop retail tariff structures which deliver network price signals. This ensures that the network businesses retain the flexibility to develop price signals to manage customer demand (and ultimately reduce capital expenditure and customer cost) within the regulatory arrangements overseen by the AER.

Specific examples are:

- Tariffs with flat rate prices (e.g. Tariff 11, 20 and 41) do not reflect the true cost of supplying energy at different times of day or times of the year. Time of Use tariff structures would allow customers the opportunity to choose when they used certain appliances and thus save by using the appliance in lower priced time periods (or pay higher prices in peak, high cost, periods);
- Many customers in Class 2 dwellings (i.e. units or apartments) cannot take advantage of off-peak tariffs for appliances such as water heaters. Time of Use tariff structures would allow customers the opportunity to choose when they used certain appliances and thus save by using the appliance in lower priced time periods (or pay higher prices in peak, high cost, periods); and
- Minimum payment charges in Tariff 31 and Tariff 33 can act a barrier to customers to reducing their energy consumption for appliances on these tariffs. The minimum payment charge is unlikely to cover the fixed and variable costs in the underlying network charge and the retail components of the charge.

Do the current tariff structures facilitate effective retail competition and, if not, why not?

As retail tariffs are generally set well below the cost of supply in regional Queensland, effective competition is limited in regional Queensland. This is demonstrated by the QCA's recent decision to extend Ergon Energy's Minimalist Transitioning Approach (MTA) by another twelve months. The MTA was introduced because the level of churn in Ergon Energy's area was expected to be so low that it did not warrant the expense of moving to a fully automated system to cope with customer transfers prior to the introduction of FRC. Given the level of customer churn remains low enough for the MTA

to continue, it is considered that retail competition is not effective in Ergon Energy's area.

Obsolete Tariffs

Are there any tariff categories which no longer serve a customer need that cannot be accommodated in another tariff? If so, is it reasonable for those tariff categories to be retired?

The retail tariffs can be appropriately restructured if the network tariff is passed through in either an aggregated or unbundled form. This is considered a preferable approach to retail pricing and would effectively mean that all current retail tariff categories would become redundant.

Could any current tariff category be consolidated into another tariff category? Would such consolidation unfairly discriminate against any particular customer class?

Adoption of a network pass through approach simplifies the retail component of the Notified Prices. As a result it may be possible to consolidate the retail component into a small number of options. For example, the retail component may be similar for all customers who use less than 100MWh per annum.

If limiting the consideration to existing tariffs it may therefore, for example, be possible to consolidate the retail component of Tariff 11 and Tariff 20 for which customers who use less than 100MWh per annum should be eligible.

Adopting a cost-reflective approach to restructuring tariffs may result in significant price changes for some customers. The price change may be positive or negative depending on current tariff cost reflectivity. Adoption of cost reflective tariffs is not, however, considered discriminatory. To the extent that price changes result in customer hardship, this must be managed by appropriate government hardship policies and effective retailer customer hardship programs, to deliver assistance where it is required.

Are there any tariff categories that provide perverse price signals?

Specific examples of tariffs that currently provide perverse price signals are:

- Tariff 21 provides perverse price signals as it encourages customers to consume more energy to achieve a lower average unit energy price; and
- Tariff 62 provides perverse price signals as it encourages customers to consume more energy in peak periods to achieve a lower unit energy rate.

3.4 Any other comments

The Authority seeks stakeholders' comments on any other matters considered relevant to the review.

System Considerations

Depending on the extent of changes to tariff structures, industry participants will need between 3 and 6 months from the time that structures are finalised in order to implement system changes.

Customer Education

It is apparent that many customers currently have a low level of understanding of the cost drivers of electricity supply and use. While appropriate pricing is an essential step in customer empowerment (e.g. providing lower tariffs for customers who consume energy in particular time periods) a clear and comprehensive education campaign will be an essential element of any change to electricity pricing. Government and industry will both play important roles in this activity.

Retail Tariff Eligibility

It is considered that eligibility for retail tariffs should primarily be based on two principles:

- The customer's network tariff; and
- The sophistication of the customer's meter.

If a direct network price pass through is not adopted, it remains essential that network prices and retail tariffs are appropriately aligned in terms of customer classification and eligibility. Network tariff eligibility would determine the aggregated retail product available to customers.

Meter sophistication should also be a determinant of tariff eligibility. As such, a customer with a demand meter should have access only to a demand tariff. This will ensure appropriate utilisation of available technology to achieve signalling objectives. A switch from current state to the application of this rule may be considered to result in discrimination against some customers on the basis of their existing metering sophistication. For example, customers currently on Tariff 22 may be required to move to Tariff 43 (which has a demand component) while other customers, potentially with the same characteristics, will be entitled to remain on Tariff 22. Subject to the characteristics of the customer, this may be either beneficial or detrimental in terms of total cost.

Meter sophistication is a critical factor in determining the sophistication of price signalling that can be provided to customers. Accumulation meters allow delivery of only basic signalling such as block tariffs, seasonal tariffs or, for more advanced accumulation meters, basic Time of Use signals. Interval metering opens up a far wider range of signalling options to achieve the objectives of peak load reduction, demand side management and energy efficiency. Further consideration of the costs and benefits of interval metering roll-outs to particular customers should therefore be given in Part 2 of this Review.

It is recognised that a future decision on a program to introduce interval metering is dependent on a thorough cost/benefit analysis. The benefits derived from any such roll out are considered to increase to the extent that effective price signalling, utilising the metering sophistication, is able to be delivered to customers. While it is also recognised that prior to the introduction of interval metering limited price signalling is available to accumulation metered customers, it remains important and beneficial to structure retail tariffs in a manner which enables even limited signalling to be provided. This will also ensure greater readiness for industry and customers to respond to future advanced signalling options. Earlier introduction of a pricing approach which aids customer education regarding the different supply costs which make up their electricity bills should only assist the achievement of government's objectives stated above.

Stage 2: Request for Comment Paper

The purpose of Stage 2 is to review retail tariff structures which may assist in the long term management of peak electricity demand.

Ergon Energy's submission on Stage 1 considers:

- It is critical that the network pricing signals of Powerlink, Ergon Energy and Energex are passed through to customers via the Notified Prices;
- Passing through network costs simplifies the Notified Price structures and indexation mechanism; and
- Sending price signals to manage demand is a function of the network component of electricity prices, rather than the retail component. As such, where it is appropriate to include a demand signal, this will be delivered via the regulated network prices and incorporated into the 'aggregated components' of the Notified Prices via the pass through mechanism. If, on the other hand, a demand component was included in the Notified Price which was not reflective on the underlying network price, then retailers would be over-charging (or undercharging) customers relative to their actual underlying retailing costs. This situation is clearly to be avoided.

To date the sending of appropriate peak demand signals in network prices has been stifled due to Notified Prices preventing the pass through of the underlying network prices.

Accordingly, Ergon Energy considers Stage 2 should address issues concerning the delivery of network price signals such as:

- What is the best way to ensure that network prices (as approved by the AER) can be aggregated with the retail component of Notified prices (as determined by the QCA) without diluting the price signals, and thereby and maximising their effectiveness for reducing long term peak demand.