

David Walsh

From: Danial Morris [danial.morris@jackgreen.com.au]
Sent: Monday, 31 August 2009 5:25 PM
To: General Electricity Address
Subject: Review of electricity pricing and tariff structures

Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

RE: Review of Electricity Pricing and Tariff Structures

To whom it may concern,

Jackgreen is pleased the QCA is considering moving away from the current BRCI method for changing tariffs in Queensland. The build up approach to determining tariff rates is a better way to ensure pricing is in line with cost. However, Jackgreen still has reservations of how the system will work and there are a few issues that we would like to put to your attention.

In response to the review of the proposed changes Jackgreen has broken down its analysis into two areas. First is comment on the proposed changes and the formats that they might take. Second is comment on the tariff structures and future directions in making tariffs contain price signals for consumers.

Proposed new pricing methodology

Network pass through

Passing the network charges straight through is far more efficient than the previous system. Too often the increases in tariff prices are heavily eroded by the networks increase and not only in the Queensland but most states. As the retailers have no control on this item it is logical to pass it through just like on larger commercial contracts and as is done in other countries that have deregulated electricity markets.

There is also agreement that the network charges should actually be shown as a separate line item on the invoice to make customers aware of what makes up their invoice and to educate on the price signals.

Modeling market based energy costs

It is agreed that there is a need to move to a model that is more reflective of the actual cost of energy. It is true that retailers make use of hedging strategies and the use of financial products. It would be wise to use the information available from the Sydney Futures Exchange as their traded volume has now risen to be greater than the annual volume of energy used. This information would provide a very good window to the expected price of power and fits the desire to use information that is publicly available.

Prudential's are also a very high cost in the market. Large sums of capital are tied up for a new retailer. Yet the costs associated with this would not be recognised in the calculations. It would be assumed that the analysis is done on the retailers who hold the majority of the market in Queensland. If these were to be sold off then there would be a requirement for billions of dollars in prudential to be made and these costs will need to be addressed. Yet it is these exact costs that new entrants are forced to provide and yet are not recognised in the analysis. A cost for this prudential overhead needs to be factored in to determine the actual real costs and allow more competition.

It is known that wholesale energy prices alone can go from an average around \$45 to a high of \$10,000. There are not that many industries that have such fluctuation. Further to that the retailers are exposed to a double risk. That is not only can the price move on them but there is also massive risk associated with volume. Weather and generator pricing patterns places significant variables to any forward assumptions. To compound this further there is a direct correlation between high volume and the high price of power especially in the residential sector. The retailer unfortunately has to take the customer using more power during times of high prices. This compounding risk demands higher rewards as there can be no guarantee that hedging will be fully reflective of the actual load profile of a customer base. The volume risk can't be effectively hedged and so it is real. Any cover that is taken will turn out to be too little or too much. Both options have additional costs for the retailer and they need to be accounted for. The pricing model needs to accommodate the load shape and not just the price to counter the issues raised here. It may be that each tariff is priced for energy rather than an industry average as not all retailers are currently in all industries or have a balanced portfolio.

Setting the Retail margin

It was noted in the last determination for 09-10 that the retail margin could be as high as 8% so we would challenge the 5% that is offered. It is worth starting with what is a risk free return. Government bonds are currently making around 5% with little or no risk. The retail margin would need to be greater than a risk free return even if it only had a very small risk. However, we all know that the industry has many risk factors that command a premium.

Using the expected return process to determine the retail margin allows comparison to other industries to view the ratio of risk and reward. The telecommunication industry could be used for comparison. It too was deregulated and opened up to competition where retailers would buy wholesale from Telstra. Their industry has lower risks than power but is still useful for comparison. They have also recently had a squeeze on margins due to the world economic downturn. Yet Optus posted third quarter year to date figures that showed EBITDA of 29.6%. Similar industries expect there to be margins in the 20% area. So why does the electricity retailer face higher risk yet only receive a 5% margin? It could be argued that the vertical integrated retailers merely price transfer the margin from the network side of the business which has received very large increases in the past few years. But these are not available to retailers who do not have network assets and should not be considered.

When taking the bottom up approach it is also worth considering the cost of money. AEMO is settled weekly, yet a residential customer will not be invoiced for the load some 3 months later and then receive the payment another month after that. The retailer has a very long delay in payment. There are large costs to having paid out all this cash and collecting a third of year later. This cost needs to be included. Further to this, in the case of bad debts, the retailer wears the cost for both itself and the networks. The Network has no credit risk only the retailer.

One of the formats to assess retail margin is to look at cash flows. There is a very strong possibility that an event like June 2007 can and will happen again. During one week in that period the cash flows required to pay NEMMCO settlements went up 597%. Retailers had to find this massive increase in cash immediately or lose their licence. The costs associated with raising this additional money on very short notice would neutralise all profit for the year or possibly see the foreclosure of the business. It would be worth noting that there is a second cash flow implication of this event. The prudential requirements also went up and all retailers were forced to stump up even more cash for a 12 month period. The risk of such an event happening again is very likely so the cost of carrying this cash requirement should be incorporated into the analysis.

The Retail margin needs to be set at a higher rate than 5% especially when the risk free rate is equal to it and the cost of money has gone up. The claims that the cost of money is low due to the economic downturn are not well founded. Just this week the Australian banks will be raising rates again despite the RBA keeping rates down. Australian reality is that the cost of money is high compared with the rest of the world and this needs to be considered in the setting of retail margin.

Retail costs

It is noted in the review at point 6.2 that there is no allowance for customer acquisition as it was felt that there was enough market penetration. If this line of view is taken then the next obvious question that follows from a market that is heavy into competition is the churn cost. If the market has so many people taking up other retail offers then each of the retailers will be losing a significant amount of clients also known as churn. There is a distinct cost for churn and a continuing need to find new customers to replace the old or incentives for customers to stay. A cost for these activities should be added into the cost build up, otherwise the retailer will be losing their customer base and heading for hard times.

Retail headroom

The argument in section 6.4 of the review suggests that headroom is not available as some areas do not have competition so it would only increase prices. Could it be possible to have a headroom adjustment in the Energex area only? Granted, that it may go against the Uniform Tariff Policy to keep prices fixed across networks. It may be worth considering other alternatives that will still deliver the objectives of the policy whilst creating more competition. A small increase in the Energex area by way of a short term special arrangement that would see the headroom clearly added onto the tariff rate. This would keep the tariff at a common base rate but add in an additional levy for the development of competition. The base rates for both Ergon and Energex would still remain the same.

Price certainty and unexpected events

It is agreed that there is a need for price certainty in the market place but there are some issues that will need to be addressed in the future and can't be priced into the market just yet due to the uncertainty. The CPRS system is something that will impact the industry and change prices. However, the tariff price should be set now and have a mechanism that allows for an increase when it becomes clear what the price of the green issues is. Adding cost in now will be incorrect and only inflate prices. There is no real way to gauge what the final cost will be until we get there. A special mechanism needs to be set up now that allows the correct increase in real prices to be added on. It may be that in the first year of the scheme the cost is merely a regulated pass through. That way the uncertainty is

removed and the risk too. It will also mean that the consumer will only pay once the cost is known and not years before hand. In addition to the special mechanism there will need to be some education sent to the consumers with plenty of notice that the green costs of these schemes will be passed through but only at the cost rate and not before hand. They will need to be briefed so that if there is a step change they are expecting it.

In section 5.4 of the review there is mention of the AER determination coming through in a pass through manner once it is clear. It is agreed that this is a good option. However, the wording of the review suggests that there is a need to still review even if it is on pass through to make sure that the prices remain stable. Jackgreen has a concern that this may stagger the increase to the customers over a period of time. This can't be acceptable if the retailer is expected to pay the full cost on the increase. It will only destroy the profit for the whole year and does not encourage retailers to enter this space until the decision is made. For this reason it should be passed through in entirety so as to remove the risk and create certainty even if this means an increase in pricing later.

In the same light as the above paragraph, section 5.2 of review has a similar issue about the new process to build up a price. "The Authority therefore considers that a N+R cost build up approach which will allow full cost reflectivity to be achieved (over time if the difference between notified prices and efficient costs is significant) should be adopted." It is suggested here that if the actual price is gauged to be too much higher than the current pricing it will be staggered over time. More clarification will be required for this statement. It would seem very unjust to clarify that the actual cost for a retailer is in fact higher than present but you are not entitled to recover that cost for some years. This just says that the retailer must forgo a profit or take a loss. The point to this new model is to correct previous wrongs and to address them to create a competitive market. If the increase is to be staggered it would be hoped that it would be no greater than 2 years. May we suggest that there are increases each half year rather than annually?

In relation to the Annual review of cost estimates, and the reopening of pricing decisions under special circumstances, it is agreed that a mechanism should be in place so that the costs can be reflected in the prices for things that can't be foreseen and circumstances changing. However, the tolerance levels here might need adjustment. Jackgreen has some reservations about where this number is set. Should it be too far away from the yearly increase in tariff pricing, then it may pose an issue where real costs exceed the built in increase that is set by the authority but not high enough to reach the review point. Consideration should be given to set the review percentage closer to the annual price increase rate so as not to create a large gap.

Tariff changes

Changes to the tariff structure are very welcomed. It is well known that the current structure in no way sends pricing signals to consumers. As an example tariff 33 is not very good at reflecting costs. It is discounted like an off peak rate yet it runs for 18 hours in the day. From an energy purchase perspective it costs 50% or greater for energy costs as it is off peak and shoulder rates.

Jackgreen agrees with the removal of declining tariffs. It is also agreed about the introduction of Time of use meters to send the right pricing signals to consumers. A program to speed up mass roll outs of smart meters would be a step in the right direction.

The introduction of sunset clauses is a good step forward. It may be that a time of use meters may be introduced by a certain date rather than force the customer off the tariff. This may give more options to the customer and may increase the take up if they can access a better time of use rate.

Yours faithfully

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