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**Review of Electricity Pricing and Tariff Structures -  
Request for Comments Paper**

Thank you for the opportunity to comment upon the Authority's *Review of Electricity Pricing and Tariff Structures - Request for Comments Paper*.

TRUenergy welcomes the Queensland Government's decision to review price setting arrangements for electricity customers on standard contracts. However we are concerned by the tight timeframe imposed on the Queensland Competition Authority (QCA), and believe that additional time is required to fully consider how the current arrangements could best be improved. To facilitate this process, the 2010/11 price adjustment review should be undertaken largely within the existing Benchmark Retail Cost Index (BRCI) framework, whilst adopting specific recommendations which could be adopted in time for that decision. The broader review should continue in a parallel, with the final recommendations adopted for the 2011/12 decision.

*Effectiveness of current BRCI methodology*

Electricity margins in Queensland have deteriorated significantly since the commencement of full retail contestability, and are now well below cost-reflective levels. As a consequence TRUenergy remains a passive new entrant in the market, and has not engaged in the aggressive customer acquisition campaigns which characterised our entry into the South Australian retail market. As we discuss below, the margin erosion has been a result of both the BRCI methodology, and the decisions of the QCA in applying the methodology.

In response to the specific question as to whether the BRCI has produced regulated retail electricity prices that are reflective of the costs of supplying electricity in south east Queensland, the obvious answer is no, because it was not designed to do so. The BRCI framework imposes uniform tariff increases across two distribution areas with different underlying energy and network costs. Energy costs are based upon the Queensland NEM load, and network prices the weighted average of Energex and Ergon network price movements.

To achieve cost reflectivity in south-east Queensland, both the energy cost and network cost allowances provided for in retail tariff adjustments must reflect

these costs specifically within the Energex network area. This cannot be achieved within the current BRCI framework.

However, it is not purely the BRCI framework that has prevented cost-reflectivity. In addition a number of decisions taken by the QCA in applying the framework have contributed to the erosion of retail margins. These decisions have received detailed commentary in TRUenergy submissions. An underlying theme is the reluctance of the QCA to acknowledge the asymmetrical risks of regulating retail pricing, and an unwillingness/inability to adjust settings in response to the level of market activity.

Estimating the costs of energy retailing, including the cost of energy, is at best problematic. This is evidenced by the range of plausible outcomes identified by the QCA's previous consultants, CRA, for the 2008/09 BRCI, with a range of 5.38% to 13.2%. Whilst assumptions and methods may be rationalised on a number of grounds, there is nevertheless a degree of arbitrariness in any decision to apply a specific price adjustment, with the contrary approach often supported by at least as substantive a case.

As a consequence, there is a temptation and a tendency for regulators to set cost components around the mid-point of the consultant's analysis. TRUenergy has consistently argued the dangers of such an approach on the grounds that the greater risk is underestimating rather than overestimating costs. If costs are overestimated, competition will ensure that any excess margins will be rapidly eroded within a national retail market in which new entrant retailers can rapidly respond to price signals. On the other hand, underestimating prices is unsustainable, potentially leading to retailer withdrawal (as has already occurred in Queensland) or failure, and the collapse of investment signals

For the 2008/09 Decision the Authority went further and chose to adopt not the mid-point, but the option with the lowest BRCI impact - within the 5.38% to 13.2% range, the final BRCI was set at 5.38%. Nevertheless, our point is that regulators should not attempt to set efficient retail prices, given that doing so is impossible in the context of a highly volatile and dynamic wholesale market.

The only jurisdiction which did not adopt the efficient cost approach, has become the most competitive retail energy market in the world. As identified in the QCA summary paper, the Victorian Government "*set prices which ensured that small customers retained access to electricity at reasonable prices while also encouraging developments in competitive markets.*" Whilst regulators cannot identify efficient prices (but in attempting to do will generally suppress retail margins), allowing prices to be set within a reasonable range gives the regulator the flexibility to adjust prices in response to the development of the competitive market.

In this respect, TRUenergy believes a regulator's role in retail price setting should be analogous to the Reserve Bank's setting of interest rates. The Reserve Bank undertakes interest rate adjustments in response to relevant market conditions. If the economy is contracting, an expansionary position is adopted. Similarly in the context of retail price adjustments, regulators should respond to market conditions, specifically the development of the competitive market. If there is objective market evidence of a lack of competitive activity, the regulator should

adjust their pricing determinations accordingly. The Victorian framework provided this opportunity, whereby it was not always the mid-point of the consultant's analysis that was adopted, but rather prices were allowed to vary within an acceptable range. The QCA should adopt a similar approach when considering each of the retail cost components.

In Queensland's case the retail market is currently characterised by a rapidly declining customer transfer rate, little marketing or customer acquisition activity, and either dormant or exiting retail strategies. This objective evidence is consistent with our view regarding the lack of cost-reflectivity in regulated tariffs, and the need for a more expansionary price setting approach which seeks not to set efficient prices, but adjustments within what is determined as an acceptable range.

### *Cost of Energy*

TRUenergy supports the approach adopted by the New South Wales Government for the 2010-13 Retail Price Determination. The Government has directed IPART to establish a framework whereby energy costs are derived from market prices, with LPMC representing a floor below which the annual energy cost allowance cannot fall. Such an approach recognises the asymmetrical risk of setting retail energy prices, as discussed above.

The same approach should also be adopted when considering the costs of an expanded RET scheme. The MRET scheme was characterised by high prices in the initial phases of the scheme, responding to high start-up costs for qualifying generators. However, when REC prices subsequently fell, regulators failed to recognise the longer-term position held by retailers, and adjusted downwards the REC allowance in the retail price cost-stack, creating a funding short-fall. Pricing RET costs at the market price, but with LPMC as floor, will prevent this reoccurring.

Market-based wholesale electricity costs should be derived from publicly available sources, to provide transparency and the opportunity for validation. TRUenergy was generally supportive of the rolling two-year hedging approach adopted by the QCA in previous determinations, which was also the approach adopted in the Victorian arrangements. It should be applied to the Energex net system load profile to represent the costs of supplying south-east Queensland in a transparent manner.

The cost of carbon, and the consequent level of retail price adjustments, should not be considered until there is greater regulatory certainty on the scheme that will be introduced, and greater liquidity in post-CPRS energy and risk markets. This is also consistent with our view that energy costs should be determined on an annual basis.

### *Network costs*

Cost reflectivity in retail prices cannot be achieved until network costs are treated as a direct cost pass through to consumers. Given the Queensland Government's Uniform Tariff Scheme, and the objective for cost-reflectivity in south-east Queensland, retail price adjustments must include a direct pass through of

Energex's network charges. To achieve a uniform retail tariff, the Government would need to provide a direct subsidy to the Ergon distribution business, or directly to Ergon customers.

#### *Retail costs*

TRUenergy supports the QCA's current approach of escalating retail costs by 60% of average weekly earnings (AWE) and 40% of CPI. However, there is a strong case for increasing the retail margin, given that prices remain below cost-reflective levels, and recognising the asymmetrical risk of price setting arrangements.

The most recent benchmark review of retail margins was conducted by Frontier Economics for the 2007-10 New South Wales determination which identified an acceptable margin range of 4-6%. Consistent with the Victorian approach of allowing cost components to vary within the reasonable range in response to market dynamics, TRUenergy recommends an increase in the retail margin to 6%.

TRUenergy has generally supported the method of calculating customer acquisition costs in recent BRCI decisions. However, we have disputed CRA's calculation of intra-retailer transfers. Initially we were concerned that CRA had included standard-market transfers (which will decline over-time) in their analysis, but not market-market-transfers (which will increase in the early years of competition). Although CRA subsequently claimed that market-market transfers had been included, we doubt this for the following reasons:

- CRA claimed that its estimates were based on South Australian data, but ESCOSA does not collect data on market-market transfers
- No jurisdiction collects data on market-market transfers, whereby it is unclear how any estimate could be derived
- CRA's intra-retailer transfer rate estimate has declined over time, whereas if market-market transfers were included there would be no reason to suspect that their increase would not at least compensate for the decline in standard-market transfers.

As there is no data available on intra-retailer market-market transfers, TRUenergy believes they should be removed from the analysis. Instead the allowance should consider only transfers between retailers. However, basing acquisition costs upon the actual transfer rate becomes self-reinforcing, whereby a low transfer rate, provides for a low CAC allowance, which in turn restricts competitive activity. An assumed rate should be adopted from observations of other markets which have demonstrated effective competition. These markets show that with appropriate price setting arrangements, transfer rates can be expected to achieve at least 25%, with an escalation of approximately 5% each year for the first five years of FRC. Consequently the CAC allowance for 2010/11 should be set 20% above the 2007/08 allowance (in addition to the annual 60% AWE and 40% CPI increase), with a further 5% increase for 2011/12.

#### *Escalation of regulated tariffs*

Cost-reflectivity for individual tariffs cannot be achieved under the BRCI's single multiplier approach. TRUenergy supports a weighted average price cap (WAPC)

method, whereby the BRCI would set the overall increase, but beneath which individual tariffs and components could be rebalanced. The challenge in Queensland is that regulated tariffs apply to all active retailers, not just the "incumbents."

To address the potential for differing views among retailers regarding how tariffs should be rebalanced, the QCA should take confidential submissions from retailers on how greater cost reflectivity could be achieved within the WAPC, and make rebalancing decisions based upon those submissions.

### *Pricing certainty*

TRUenergy believes that pricing certainty is best achieved through the setting of fixed principles, rather than through a long-term (3 year) pricing decision. Recognising the shortcomings of setting energy cost allowances more than 12 months in advance, IPART has included an annual re-opening provision for energy costs if the updated estimate is outside a 10% tolerance level. The AEMC, in the context of considering the impact of a CPRS on price setting arrangements, has gone further to recommend a six-month re-opening provision (initiated by retailers) recognising the potential for even greater volatility in carbon-price environment, which TRUenergy would also support.

In our view, if the calculations for a re-opener are undertaken on an annual basis, those calculations should be used in the setting of prices for that year. The danger of not doing so is that if a 10% tolerance is set, and the review identifies a 9.5% underestimate in energy costs, a corresponding erosion in retail margins will occur if this is not reflected in prices. If the same underestimate occurs in the following year, by the end of the regulatory period there will be a 19% shortfall in funding for energy costs.

Certainty is better achieved through establishing the method by which prices will be set, including:

- Energy cost allowances based on market prices, subject to annual review, with a LRMC floor, and potential for a six-month re-opener (consistent with the AEMC recommendation)
- Pass through of Energex network charges, with the Uniform Tariff Policy achieved through direct subsidy to Ergon or its customers
- Retail costs escalated by 60% AWE and 40% CPI, with the CAC allowance based on inter-retailer transfers and increased by 5% for each of the first 5 years of FRC.
- A retail margin of 6% until the market achieves the level of activity characterised by maturely competitive markets.

### *Reopening*

Under the cost-reflectivity objective, any material change to the cost base of retailers should be considered as reasonable grounds for a re-opener of pricing arrangements. A recent South Australian example was the introduction of a mandated energy efficiency scheme, for which ESCOSA approved an additional retail allowance under the current pricing determination's re-opening provisions. As there are no limits to the potential for retail costs to be impacted by market or regulatory events, it would be unwise to attempt to specify the events under

which the events could trigger a reopening. Instead, the QCA should be required to consider any reasonable claim for re-opener on the basis of a material change to retailer costs.

Please contact me on (03) 8628 1122 if you require additional information.

Yours sincerely,

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