



**EnergyAustralia**

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Brian Parmenter  
Chairman  
Queensland Competition Authority  
Level 19, 12 Creek St  
Brisbane QLD 4000

electricity@qca.org.au

**EnergyAustralia Pty Ltd**

ABN 99 086 014 968  
Level 33  
385 Bourke Street  
Melbourne Victoria 3000

Phone +61 3 8628 1000  
Facsimile +61 3 8628 1050

enq@energyaustralia.com.au  
energyaustralia.com.au

Dear Mr Parmenter

## **Submission to the QCA interim consultation paper on regulated electricity prices**

### **1. Executive Summary**

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EnergyAustralia welcomes the opportunity to make a submission to the Queensland Competition Authority (the Authority) interim consultation paper on regulated electricity prices.

EnergyAustralia is one of Australia's largest energy companies, providing gas and electricity supply to over 2.7 million household and business customers. We used to be known as TRUenergy. EnergyAustralia owns and operates a multi-billion dollar portfolio of energy generation and storage facilities across Australia including coal, gas and wind assets with control of over 5,600 MW of generation in the National Electricity Market.

We have been involved in retailing in the Queensland electricity market since 2007 and have experience in operating in other National Electricity Market states for much longer. In our view, there are some fundamental issues in the Queensland retail market that need to be addressed in this review of regulated retail prices. The principles and objectives in the Delegation and Terms of Reference are soundly based and we're supportive of the broad approach taken by the Queensland Government. However, we would like to see the Queensland market move away from regulated pricing in the near future.

For this next regulatory period, we encourage the Authority to focus on the following areas:

- Ensure that each component of the regulated retail tariff is set at adequate levels – we've seen a decline in competitiveness in Queensland since the last pricing determination and believe that current tariffs are currently not cost-reflective and are set too low.
- Adopt an approach to the energy cost component based on the long run marginal cost of generation – this will provide stability for customers and industry and improve levels of competition and place downward pressure on regulated prices.
- Take additional steps to consider and address the low level of market competitiveness.
- Provide incentives to customers to take up a time-of-use tariff – particularly while tariff 11 is being transitioned to a cost reflective level.
- Set up a transparent and predictable pricing methodology that does not create unnecessary risks for retailers and variable outcomes for customers.
- Make improvements to the consultation process to allow stakeholders to engage effectively in the review – this should include better access to data, more clarity on the modelling approach and sufficient review time.

## 2. Introduction

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The Ministerial Delegation and Cover Letter outline the following key principles for a new regulatory period beginning in July 2013:

1. The three-year Delegation and Terms of Reference (ToR) will provide a degree of certainty and stability for consumers and industry.
2. Customer impacts arising from measures taken to reform the industry and address cost drivers must be considered and carefully managed.
3. The Authority must consult extensively with stakeholders and the community providing information and ensuring that all stakeholders understand the intent and timing of the review process.
4. All decisions made by the Authority should be fully explained, with information to be clearly communicated and easily and publically accessible.
5. Queensland customers should be encouraged to take up time-of-use tariffs to assist in altering the demand profile and provide material benefits in reducing network and generation infrastructure.

EnergyAustralia recognises that the Queensland Government in establishing the Delegation and Terms of Reference for the Queensland Competition Authority (the Authority) is seeking to make further improvements in the approach to determining electricity prices in Queensland. We are supportive of these principles, and below have outlined the main points that we believe should be considered by the Authority in this consultation.

### 2.1. The Delegation and Terms of Reference will provide a degree of certainty and stability

The Delegation and ToR set out various objectives and approaches that should be used to achieve certainty and stability. These can be summarised as follows:

- Take an approach that will manage short-term price shocks for customers and that may assist industry in the long-term investment in the sector (Cover Letter – point 1).
- Make a determination that has regard to the 'actual costs of making, producing or supplying the goods or services' (ToR - 3a).
- It is important that continuity in decision-making is maintained in regard to key cost components, as this delegation is for a three-year period (Cover Letter – point 3).
- A Network + Retail (N+R) cost build up framework must be used in determining regulatory prices, where the network cost component is treated as a pass-through cost (ToR - 5c).

We recommend that the objectives outlined in the first two points can be met if the Authority bases the energy cost component on long run marginal cost (LRMC) as a floor price as this will provide the stability and long-term investment signals required in the next regulatory period. Further discussion on this approach is outlined in section 3 below.

The latter two objectives listed above relate to the cost build up and modelling approach. The N+R approach has been used in the past by the Authority. However, the creation of longer-term methodology is required to support the annual determination of regulated electricity prices across a three-year period. This is an important consideration, particularly as a variety of approaches have been used in the past to determine the various retail components of the regulated tariff (energy, operating costs, margin, and headroom) and not all may be suitable for the upcoming regulatory period. Importantly, the new three-year methodology must include a provision for revising any assumptions during the regulatory period that may lead to material changes for retailers or customers. Our thoughts and recommendations to the Authority on the approach to determining each R component are covered in sections 4-6.

In terms of network costs, we support any continued efforts that are made to improve the cost reflectivity of network tariffs whilst enabling the Authority and retailers to minimise price shocks to customers. We would like to see the Authority set a predictable transitional pathway where retail tariffs may be affected by significant changes in network tariffs (e.g. rebalancing or step changes in overall cost). Retailers face risks relating to timing issues associated with applying the N+R framework in that final regulated retail prices may be based on draft network tariffs. This issue is discussed further in section 7.

## **2.2. Customer impacts must be considered and carefully managed**

As a retailer, we must consider customer price impacts as price shocks lead to increases in calls, complaints, churn and therefore costs. They also place extra pressure on customers in hardship. We are committed to working with our customers through price changes and hardship. So, we support the principle of transition arrangements for tariffs that require substantial price increases in moving to cost reflective levels. Moving tariff 11 to cost-reflective levels as soon as feasible will assist in achieving other objectives set out in the Delegation such as encouraging the take up of time of use tariffs (see section 2.5) and assist in developing the competitiveness of the market. However, we would not like to see significant changes in network tariffs that put additional pressure on retail margins when regulated retail tariffs are already in a transition phase.

In deciding how to manage customer impacts, the Authority will need to assess what a reasonable price increase is for different customer groups. It's very hard to tailor this approach effectively when a large number of customers are all on the same tariff (e.g. tariff 11). Customers on this tariff are likely to be affected based on overall usage levels, not on the basis of need.

Keeping tariff 11 at low levels to aid vulnerable customers is not recommended. Inefficiently priced tariffs lead to higher costs for all customers over the long-term. Therefore, we strongly support the use of targeted measures to assist customers who are more highly impacted by price shocks via concession policies. If designed appropriately, targeted hardship measures should provide a better outcome for customers in need. The Authority may be in a position to assist the relevant parties in recommending a targeted approach to concessions.

## **2.3. The Authority must consult extensively with stakeholders and the community**

Having entered the Queensland electricity market in 2007 when retail competition began, and now being one of the major second tier retailers in Queensland, EnergyAustralia appreciates the opportunity to participate in consultations on the regulated retail price. We believe all stakeholders will benefit from an open consultation process that allows adequate time for engagement and review.

However we note that point 6 in the ToR requires the Authority to 'publish an interim consultation paper identifying key issues when calculating N and R components of each regulated retail electricity tariff and transitioning relevant retail tariffs over the three-year delegation period.' We're disappointed that the Authority has relied on excerpts and the attached Delegation and ToR rather than adequately examining the issues and approaches, it considers necessary for a price determination. This approach is not in keeping with an open and extensive consultation. Other issues may be introduced later in the process and this could limit the opportunity for stakeholders to respond.

## **2.4. Publication of clear and accessible information**

In this consultation process, we would like to see a better demonstration that costs forecasts produced by any modelling approach used are reasonable and will be reliable across all years of the delegation. This analysis would be aided if supported by a graphical comparison of key profiles, full datasets and/or sensitivity analysis showing the effect those different approaches have on the outputs. In the last review, significant errors were found in the ACIL modelling. Although ACIL corrected these errors in their final report, it caused confusion and detracted from the time available for stakeholders to comment on the draft determination. The Authority should also allow adequate time for all stakeholders to familiarise themselves with the models and data before public forums are held or submissions are due.

These steps would improve transparency and allow interested groups to satisfy themselves that the modelling is based on a real-world approach, can be sense-checked by stakeholders, and ultimately, can be relied upon to produce valid forecast values in the Queensland market.

## **2.5. Queensland customers should be encouraged to take up time-of-use tariffs**

EnergyAustralia appreciates the peak demand issue in Queensland and the need to address this urgently so customers are not faced with escalating network and generation costs in coming years. The peak demand issue is best managed, in our view, by ensuring that cost-reflective, time-of-use (TOU) tariffs and a greater level of usage data are made available to customers. As these measures are put in place, the market will be able to send the right price signals to customers and customers will be able to better understand their usage patterns and take action to minimise their energy costs. If enough customers

take action to reduce their usage in peak times, then this should reduce infrastructure expenditure that would otherwise be required.

The point in the Delegation Cover Letter about rewarding customers who take up TOU tariffs is important. Retailers certainly have a role to play in helping customers to understand what this change would mean for them and providing additional information to raise awareness of energy usage amongst customers. However, these steps would be largely superfluous if there was not some benefit to customers in moving from the common residential or business flat tariffs to a new TOU tariff.

TOU tariffs for customers with solar panels should be considered separately from other customers. This could assist in providing an incentive to the embryonic battery storage industry to develop solutions for customers to be able to store PV exports for use at peak times. It would also support development of the solar industry on a purely commercial basis and reduce the potential need for subsidies.

In considering how to make tariff 11 cost reflective and how to minimise additional cost impacts from solar customers, we urge the Authority to address how an appropriate TOU tariff can be made financially attractive to customers **in the first year of the regulatory period**. This is the best way to encourage a higher take up of TOU tariffs than has been seen with tariff 12 recently.

### **3. Why the Authority Should Base the Energy Cost Component on LRMC**

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Since the Authority hasn't provided details of what approaches it is considering for the calculation of the WEC component, we have outlined the reasons that we support the approach of using LRMC as a floor for this regulatory period. The key points we discuss below outline how and why a LRMC based approach:

- provides certainty and stability (section 3.1)
- benefits customers by promoting competition (section 3.2)
- is required to support investment in new generation in Queensland (section 3.3)
- is representative of the actual costs faced by retailers in Queensland (section 3.4)
- is preferred to using a market cost alone (section 3.5)

Additionally we address the arguments that have previously been levelled against using an LRMC based approach (section 3.6).

#### **3.1. A LRMC based approach will provide certainty and stability for customers and industry**

In our view, the certainty and stability sought by the Queensland Government can only be achieved using LRMC to determine the energy cost component. Other components of the regulated retail tariff (such as the retail costs, margin and headroom) typically vary by a much smaller degree than the energy costs. The network costs do have a greater potential to affect the regulated retail price, but as this cost must be passed-through directly (Terms of Reference point 5c), the Delegation is clearly referring to stability of the energy cost component of the regulated tariff.

In terms of customer impacts, a more highly variable energy price would likely lead to customer dissatisfaction. Such a tariff that will by definition lead to higher price increases (and more price decreases), and customers are likely to focus on times that the price increases and not appreciate the longer term picture, not the reasons for the price increases.

#### **3.2. A LRMC based approach benefits customers by promoting competition**

Most retailers tend only to change base retail prices for customers once a year in Queensland. Throughout the year it is more likely that retailers will offer alter discounts and utilise a mix of sales and marketing channels to attract and retain customers. Having accepted an offer of a particular discount from a retailer, many customers would be quite disgruntled if the retailer were to reduce the discount level or increase the base price. Retailers want to retain customers and realise so have to set prices and discounts at levels that they are reasonably likely to remain profitable over the time they retain the customer.

The regulated retail tariff sets a natural benchmark in the market. Customers, Government, regulators and other consumer groups will therefore assess overall value of negotiated tariffs in relation to the

regulated tariff. In Queensland, retailers are at risk of continuing to be exposed to regulatory decisions that set the regulated tariff at unprofitable levels. These decisions induce retailers to limit discounts and sales and retention activity, particularly via more active channels (see section 6.1). The key element of the regulated retail tariff that leads to variability is the energy cost component.

Customers will benefit more from a stable energy cost, as retailers are more able to offer higher discounts to customer than when the energy price fluctuates. By this mechanism, a more stable energy cost promotes competition and produces a downward pressure on prices over time.

### 3.3. Supporting investment in new generation

For the next regulatory period, the Delegation asks the Authority to have regard to 'the actual costs of making, producing or supplying the good or services'. Modelling LRMC would allow the Authority to determine the minimum cost to supply load under conditions that allow generators to earn an economic return on their investment. An LRMC approach would provide a truer reflection of wholesale electricity costs faced by retailers over the long-term as it allows the recovery of fixed and variable costs associated with generation (unlike a market-based approach).

In the Final Report for 2012-13, the Authority stated that although the LRMC as a floor approach might provide additional security for generation investment that this wasn't required as the market was already providing 'timely and efficient' information.<sup>1</sup> EnergyAustralia questions this view given the time that would be required to develop, build and commission a baseload power station is likely to be between three and five years, whereas liquidity in the financial market historically has struggled to extend beyond three years and at present is limited to eighteen months. If investment in new generation were required to focus on short-term price signals then it may result in encouraging future investment in lower capital cost plant even though this may not be best or most efficient choice.

We recognise that the latest report from AEMO on the timing requirements for new generation indicates that new investment in generation may not be required until 2020-21.<sup>2</sup> However, we believe that there is considerable uncertainty surrounding these forecasts, particularly in relation to the forecast for industrial load projects in Queensland and consequently these forecasts may adjust significantly in the future.

It would be shortsighted if the Authority were to focus only on the cost pressures faced by Queensland customers and use this to support the use of a short run approach to energy cost when new investment may be required. There is a significant risk in this case that investment signals will result in a delay to new generation or investment in the wrong type of plant. Both outcomes would increase costs for customers in the medium to longer term.

The principles in the Delegation around assisting long-term investment in the sector indicate to us that that the Queensland government is seeking a regulated tariff that does holistically consider long-term generation costs. Using a LRMC approach in determining the energy cost component will fulfil this principle whereas using a market-based approach to the energy cost won't. A market-based cost provides a less stable price and this in itself is unattractive to investors; and it will be even less attractive if the prices are seen to be too low and not able to provide the return required.

### 3.4. LRMC is representative of the actual costs faced by retailers in Queensland

Two of the three main retailers in Queensland operate or control almost 3,000 MW of generation, in comparison demand in Queensland has averaged just over 5,800 MW in the last twelve months. Clearly, with this level of generation ownership controlled by vertically integrated retailers their energy costs will be heavily influenced by the long run costs from operating such plant.

The Queensland market is currently oversupplied due to lower growth in energy demand and this is resulting in low prices in the contract and spot markets. These low prices are not sustainable as generation is just not profitable at these levels. This is evidenced by below par financial performance for CS Energy<sup>3</sup>, Stanwell (excluding profit from coal royalties), the credit issues experienced by Intergen (Millmerran & Callide C 50% share) and the recently announced shutdown of two coal units at Tarong.<sup>4</sup> We also would not be surprised if further capacity were to be withdrawn in Queensland.

<sup>1</sup> QCA Final Report 2012-13, pg 22-23.

<sup>2</sup> AEMO, <http://www.aemo.com.au/Electricity/Planning/Reports/Electricity-Statement-of-Opportunities>

<sup>3</sup> CS Energy Forecast Report 2012-13, [http://www.csenergy.com.au/content-\(35\)-key-financials.htm](http://www.csenergy.com.au/content-(35)-key-financials.htm).

<sup>4</sup> Stanwell Media Release – Stanwell to withdraw Tarong Power Station units from service – 11 October 2012, [www.stanwell.com](http://www.stanwell.com).

In these circumstances, generators will be looking to sell contracts at higher prices based a return on long run costs. Retailers need to find generators willing to sell contracts and this isn't always possible with a limited number of generators to buy from. So, we suggest that retailers in Queensland will have limited options to pay energy costs at levels below the long run costs of generation.

Non-vertically integrated retailers in Queensland using long-dated power purchase agreements will be facing paying energy costs that reflect LRMC. In relying on PPAs, retailers are contracting directly on a long-term basis with a generator who is seeking to cover the long-term costs of generation and therefore will be seeking to achieve values at LRMC.

As we've outlined above, the prices observed in the Queensland wholesale market are strongly influenced by LRMC and need to allow generators to achieve a return on their investment in the long term. It's true that short-term fluctuations in wholesale market contract prices do occur, but this it is misguided to think that this somehow represents a truer cost to retailers when retailers clearly face a combination of long and short-term costs. Depending on the retailer and the period in question, this mix of long and short-term approaches to hedging load will vary, but it doesn't mean that only short-term costs should be used.

We believe that the Authority should not choose a model that will produce the lowest energy cost in any year, nor should they choose a model that doesn't cover the actual costs of producing energy in the long-term. Doing so will fundamentally harm investment and retail competition in Queensland and could have major negative impacts to industry structure and retailer viability.

### 3.5. Issues with using a market-based approach alone

We are concerned that several factors will result in wholesale market prices increasing in Queensland across the regulatory period (and beyond). We also believe that market uncertainty will be higher than usual due to the concurrence of events expected to occur between now and 2015-16. These trends could not only lead to a higher than expected market-based energy cost, but also lead to a scarcity of reliable or consistent wholesale data for use in modelling. It is our strong view that the contract market lacks the liquidity to support a market-based approach to determine the wholesale energy cost.

In more detail, the trends that will affect the outlook until 2015-16 include:

**Unpredictability of wholesale prices:** Generation in Queensland is largely controlled by the two Government owned generators, a recent reaction to low demand and financial pressures by one of these generators has been to temporarily mothball some of its units until demand increases. While the outlook for wholesale prices at a point in time may seem low, strategic decisions such as this can significantly affect wholesale prices at any time when it occurs.

Wholesale prices are clearly weather dependent and retailers risk resurgence in demand driving up wholesale costs over a hot summer or some other event. Prices can rise quickly especially during a hot summer such as that experienced in 2006-07. The market is influenced by spikes in spot price and so these events can affect the price of wholesale contracts in future summers as well.

Although overall demand has been lower than anticipated, Queensland has been short on peaking capacity in recent years. If a market-based approach errs on the low side then retailers, particularly smaller, non-vertically integrated retailers could face major financial pressures.

**Carbon and Gas Prices:** In the medium term, we expect that carbon, increasing gas costs and the potential for increasing industry demand for electricity will see a sustained increase in wholesale prices. Notably, the export of coal seam gas from late 2014 is likely to increase the opportunity cost for fuel in Queensland; this will potentially alter the behaviour of over 3,000 MW of gas-fired generation in Queensland. This price pressure will occur within the 2013-16 regulatory period and is likely to have an impact on Queensland wholesale prices when liquidity returns.

**Carbon price uncertainty:** Carbon certainty remains an issue with the Federal election due to be held by the 30<sup>th</sup> November 2013. The Federal Opposition have indicated that they would attempt to repeal the carbon legislation if they were to win this election. Consequently, there is uncertainty in late 2014 and from 2015 onwards, with limited buyers and sellers of carbon inclusive contracts. This makes it very difficult for retailers to manage their load in Queensland.

The issues outlined above will affect the Queensland wholesale market during the coming regulatory period. At this point, Queensland forward prices are illiquid from 2014 onwards and consequently this will

make it difficult for the Authority to establish a reasonable market-based approach that will give a reliable estimate of energy costs and an approach that can be consistently used in all years. We believe that LRMC provides a more stable energy price irrespective of wholesale market liquidity and volatility.

### 3.6. Addressing the perceived issues with the LRMC as a floor approach

The typical arguments against using the LRMC as a floor approach are summarised in the Final Report<sup>5</sup>:

- Modelling of LRMC is opaque as it relies on black box modelling
- Ignores the existence of the NEM and the its effect on the wholesale price
- The regulated price shouldn't underwrite generation - costs of generation are not relevant to retail price (see section 3.3)
- Too long term – LRMC doesn't reflect the costs incurred by a prudent retailer in a particular year

These arguments all misconstrue the issues in some way as we demonstrate below.

**Black box modelling:** We understand the benefit of having a transparent and predictable model for producing key cost components of the regulated retail tariff. However, the modelling of wholesale costs (spot prices or wholesale contracts) is also opaque. This is noted also in the Authority's Final Report 2012-13.<sup>6</sup>

**Ignores the impact of the NEM on wholesale price:** In section 3.4, we demonstrated how the underlying input costs of generation are seen in long-term average wholesale market prices. In any case, we are not recommending that the Authority rely on LRMC alone. We advocate an LRMC as floor approach, which involves assessing the market costs as well.

**Too long term:** In our interpretation of the Delegation, there is nothing to suggest that the Queensland Government is seeking to achieve prices that are reflective of the wholesale market costs in each particular year rather than over the longer term. The LRMC does reflect wholesale market prices over the long term and by taking this longer term, view provides a more stable price for customers and retailers.

This aside, it's perhaps more relevant to consider what would be achieved if the energy cost component of the regulated tariff were based on a market-based energy component which increased the variability of the retail tariff. It may appear on the surface that this is sensible economically, but we don't believe it is beneficial to customers to have a more highly variable annual energy price changes. We doubt that customers would be able to respond in a significant way to such a blunt price signal over this period. Customer usage patterns depend heavily on household appliances such as heating, cooling and refrigeration as well as on customers' ability to time-shift or decrease usage.

It may be sensible to have the retail price fluctuate if electricity price changes occurred much more frequently and if customers could respond within approximately the same timeframe as occurs in faster-moving markets. For this reason, we believe that longer-term price signals provided by basing the energy cost on LRMC is a better choice when setting the regulated retail tariff. We also believe it's more important to focus on providing intra-day and seasonal price signals to customers (e.g. via TOU pricing) to address the issue of escalating costs arising from peak demand (section 2.5).

If the Authority again moves in the direction of considering that 'LRMC is an estimate of long term generation costs rather than purchasing wholesale electricity in the forthcoming year'<sup>7</sup> we ask the Authority:

- to justify why a longer term energy purchase cost isn't suitable,
- to outline what benefits are expected for customers, retailers and generators if a short-run approach is used to calculate the energy costs component, and
- to explain how this will affect competition in Queensland.

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<sup>5</sup> QCA Final Determination: Regulated Retail Electricity Prices 2012-13, May 2012 (QCA Final Report 12-13), pg 22-23.

<sup>6</sup> QCA Final Report 2012-13, pg 24.

<sup>7</sup> QCA Final Report 2012-13, pg 22.

## 4. Energy Cost Components

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### 4.1. Load profile data

In response to the 2012-13 draft determination, we submitted that there were issues with the way that the load profile had been modelled.<sup>8</sup> We provided data to show that four years of load profile data was not enough to show a typical load shape for the forecast year as 2007-08 had many fewer summer weekdays with a temperature over 32°C. Origin also made the point in a slightly different way in that they recommended only using the last three years of data thereby excluding 2007-08. The Authority's final view was that ACIL had appropriately taken into account weather patterns in modelling the load shape.

Whilst we accept, some of the arguments in ACIL's final report to the 2012-13 decision, (particularly that this does change significantly over time), we would like to see a better demonstration by ACIL that their modelling approach does lead to a suitable load forecast. This is particularly relevant when considering the recent load shape changes that have resulted from the increased uptake of solar panels in Queensland.

In the last price determination, we note that ACIL ran 41 years of load data and producing 410 years of prices and from the 410 years of prices, they selected the median year (based on a load-weighted average price). Taking this load year that produced this price year, they calculated the hedging strategy on the basis of this load. We are concerned that a load that produces an average price is not necessarily an average load.

We recommend that a better way to come up with a representative hedging strategy would be to calculate the 'shape premium' (load weighted average price / time weighted average price) for all 410 years of prices and then choose the load that is associated with the median shape premium (rather than the median average price). It would also be useful to have access to the 41 sets of load data and the 410 sets of price data to carry out our own modelling and satisfy ourselves of the reliability of the modelling approach.

### 4.2. Calculation of market-based cost

During the last review (2012-13), we were disappointed with the approach and quality and level data put forward by ACIL Tasman (ACIL) in modelling the energy purchase costs via a market-based approach. While ACIL were approached on the issue following the release of the draft determination, they did not adequately explain the results nor did they provide enough detail or time for industry participants to assess whether the outcomes of the data were probable in the real world.

The Authority noted in its Final Report that retailers still saw issues with the hedging approach as it relied on thinly traded contract data.<sup>9</sup> With their still being uncertainty in the market (see section 3.5), we caution the Authority in setting a methodology for energy purchase costs that could lead to perverse outcomes.

### 4.3. Calculation of LRMC

There are two typical modelling approaches used to calculate LRMC: the standalone approach and the incremental approach. The standalone approach to calculating LRMC incorporates the existing mix of generation plants with additions to match demand growth. On the other hand, the incremental approach doesn't consider existing plant, and only seeks to calculate the costs associated with the next type of plant required to be built. However if the next plant required is a peaking or intermediate gas plant, the LRMC will be very high compared to existing base load coal.

We recommend that the Authority consider using a standalone approach to calculating LRMC as it considers the existing mix of plant and doesn't produced varied results depending on the type of generation required. It's even more important to consider the existing mix of plant given that some plants are on long-term shutdown. The incremental approach would clearly not produce the outcomes intended for the regulated retail price.

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<sup>8</sup> QCA Final Report 2012-13, pg 27.

<sup>9</sup> QCA Final Report 2012-13, pg 21.

#### **4.4. Inclusion of carbon**

Carbon price uncertainty is still an issue with the Federal election due to be held by the 30<sup>th</sup> November 2013. We expect considerable uncertainty the level of carbon price inclusion in wholesale contracts, especially in the latter part of the regulatory period. Any methodology put in place by the Authority should ensure that the inclusion of the carbon price can be altered to reflect carbon costs faced by retailers.

In the calculation of LRMC, we recommend using Treasury projections in the absence of a better approach to including carbon costs.

#### **4.5. Energy losses**

We recommend that the Authority include transmission and distribution losses and apply losses to the green scheme purchase costs to reflect accurately the energy costs incurred by retailers.

### **5. Retail Cost Components**

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#### **5.1. Choice of the representative retailer**

In the last determination, the Authority chose to base retail costs on a representative retailer, which was a standalone, incumbent retailer of sufficient size to achieve economies of scale, had a mix of market and non-market customers, served customers in other NEM jurisdictions, and was not vertically integrated with an electricity generator.

We understand that it is the overall approach that must be considered and that cost allowances should support competition without unnecessarily increasing customer's bills. The approach taken by the Authority for the 2012-13 period is reasonable in some aspects, however we suggest that the Authority consider a new entrant retailer rather than an incumbent retailer as levels of competition have declined since the last price determination and more effort must be made to set all cost components at sufficient levels.

#### **5.2. Calculation of retail operating costs (ROC)**

We don't believe the approach taken the Authority on retail operating costs in the last review fully captured Queensland specific costs. To rectify this issue we would be supportive of a combination of a bottom-up analysis of retail costs, supplemented by a benchmarking approach.

Some costs are different in Queensland. Costs per customer will typically vary with the number tariffs and offers, the number and rate of change of regulatory requirements, etc. compared to the total number of customers to be supported. For example, average costs per customer in Queensland are impacted by the higher costs we face in supporting solar customers on feed-in tariffs. This arises as solar customers cost us more in retail operating costs than comparable customers and due to the higher prevalence of solar customers in Queensland. The reasons are easy to appreciate: solar customers call us more, are more complex to support during the quoting/solar panel installation process, require additional changes to our IT systems, and have higher levels of complaints (which is unsurprising as the higher complexity means that more can go wrong).

A benchmarking approach alone, assumes that other regulators have correctly calculated ROC and that costs are very similar between jurisdictions. If the Authority wants to ensure that retail tariff is set at an adequate level then we suggest that it take a different approach to that used in the last determination and look specifically at Queensland retail costs.

#### **5.3. Calculation of customer acquisition and retention costs (CARC)**

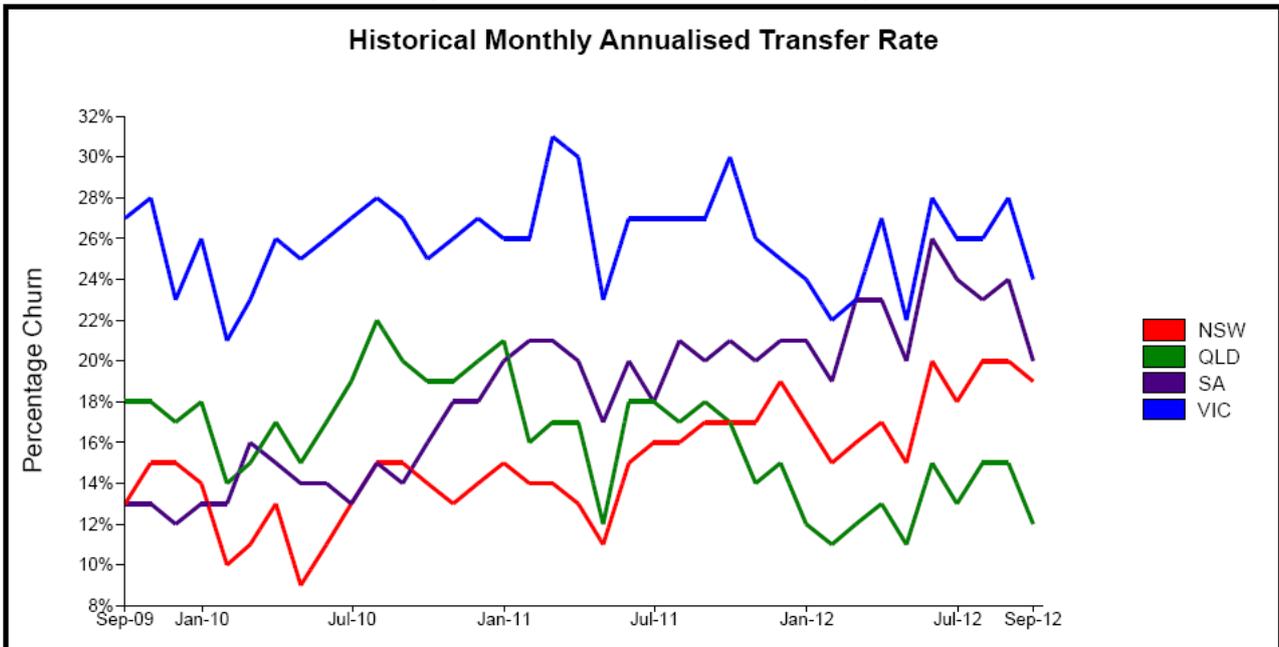
As discussed in the section above for retail costs, we would like to see the Authority use a different approach to determining the CARC allowance. We note that retailers spend on CARC may need to increase if the market is to become more competitive since current levels of churn are lower levels in the last 12 months than they were over the last three years (section 6.1).

## 6. Retail Margin and Headroom

### 6.1. Competition

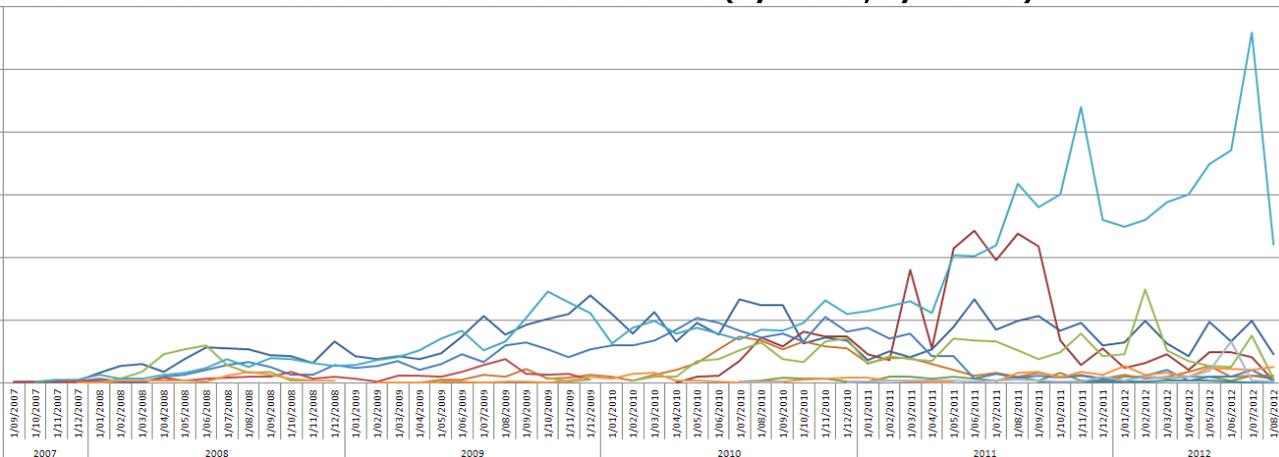
Churn data from AEMO (Australian Energy Market Operator) shows that the annualised monthly churn rate in Queensland in this year has been hovering between 11-15% and is much lower than other competitive states in the National Electricity Market (Chart 1).<sup>10</sup> Even the number of transfers per month is lower than in 2011.

**Chart 1: AEMO Historical Monthly Annualised Transfer Rate – September 2012**



We've taken a look at our own churn reports that shows which retailers we've lost customers to, and this shows an interesting trend in Queensland since mid 2011 (Chart 2). Three to four times as many of our Queensland customers move to one of the large retailers, and churn levels to all other retailers are quite low. Obviously, the limited nature of reporting means that can't make any definitive conclusions, however we do think this is significant and is likely to represent an overall trend in the industry where large retailers are finding it easier to compete for customers than second tier retailers.

**Chart 2: Numbers of customers lost to other retailers (by month, by retailer)**



Anecdotally we understand that many retailers have pulled back on marketing activities in Queensland and now mainly using passive channels (e.g. online quoting) rather than spending on active marketing and expensive channels (such as doorknocking).

<sup>10</sup> AEMO, NEM Monthly Retail Transfer Statistics – September 2012, <http://www.aemo.com.au/Electricity/Data/Metering/Retail-Transfer-Statistical-Data>

All indications show that the Queensland electricity market is not particularly competitive and if anything is declining since the last price determination. The Authority should ensure that it doesn't set retail tariffs too low, as customers receive the longer-term benefits that result from a fully functioning and competitive market. The Authority has previously commented on this fact:

- ...the Authority has recognised: ...
- b) the importance of maintaining a competitive market in the future by not deterring the entry of new retailers which can drive efficiency in the market and potentially lead to lower prices and a wider range of services in the longer term.<sup>11</sup>

## 6.2. Margin

Considering the margin in isolation is not easy as it requires an assessment of the levels of adequacy of the cost components and the level of risk faced by retailers. The 5.7% margin on total costs set during the last determination is in line with other jurisdictions, but this is meaningless if the Authority doesn't set the cost allowances for energy and retail costs at an appropriate level.

If the Authority proceeds with a market-based approach to determining the energy cost component, then this would introduce market risk and we would suggest this should be reflected in a higher margin if this risk is not already compensated for elsewhere.

## 6.3. Headroom

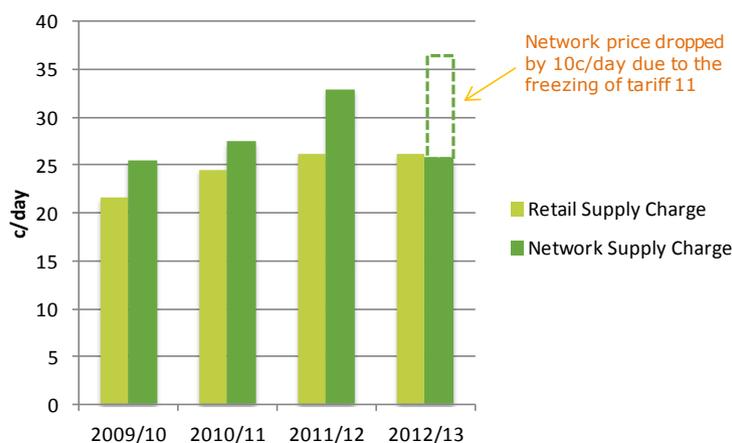
Given the discussion above on the low levels of competition in Queensland, particularly amongst smaller retailers, we believe that headroom should be increased and at the very least should be no lower than the current level of 5%.

## 6.4. Cost reflectivity

In terms of the cost reflectivity issues, we are most concerned about tariff 11, the most common residential tariff. Chart 3 shows, a comparison of the fixed components of tariff 11 and the associated Energex network tariff (8400). The fixed components are also known as supply charges. It's apparent from the chart that the retail supply charge paid by the customer has not always covered the network supply charge cost incurred by the retailer.

The current year is a little unusual as the price of tariff 11 was frozen and the network supply charge was set lower than usual as part of the subsidy arrangement introduced by the Queensland Government.

**Chart 3: Comparison of the fixed components of retail tariff 11 and network tariff 8400<sup>12</sup>**



Importantly, the retail supply charge also needs to cover the fixed retail operating costs, which are around 35c/day, ex GST<sup>13</sup>. This means that a cost reflective supply charge for tariff 11 would be

<sup>11</sup> QCA Final Report 2012-13, pg 52.

<sup>12</sup> Energex: Tariff 8400, <http://www.energex.com.au/about-us/network-regulation-and-pricing/network-prices>. QCA tariff gazettals: <http://www.qca.org.au/electricity-retail/NEP>. Supply charges in c/day, nominal \$, ex GST

approximately 71c/day - made up of an unadjusted network supply charge of around 36c/day and retail operating costs of 35c/day. This would bring the residential supply charge to the level that residential customers would pay in other jurisdictions.

This change may require a transitional arrangement depending on the other changes in costs also occurring next year, however this tariff is clearly not based on efficient costs and rectification of this has been delayed for far too long already. Ultimately, maintaining regulated prices at such low levels is hindering competition and not delivering benefits that might otherwise be delivered to Queensland customers in the longer-term.

## **7. Network Cost Component**

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While the network costs will be passed through to the retail tariff, we note that there have been issues in the past with the final network tariffs being available in time to set the final retail tariffs. Retailers are taking a risk that there will be negligible change between the draft and final network tariffs. As there is a possibility of this situation occurring every year, we ask the Authority to consider either how this issue can be overcome, or how allowance can be made for the risk.

## **8. Summary**

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In conclusion, we believe it is critical that the Authority use a consistent and reliable approach in determining the energy cost component of the regulated retail tariff. The approach chosen should be able to be used in all years and should result in an adequate and stable retail price level each year of the regulatory period. As outlined in detail above, we believe that the most suitable approach would base the energy component on the LRMC of generation as a floor price.

All parts of the regulated tariff, the overall cost build up methodology and transitional arrangements all need careful considering in this review for two main reasons. Firstly, we see indications that market competitiveness in Queensland is starting to decline further and urge the Authority to take action. In addition, this review will set a methodology for a three-year period and it's vital that this be effective in addressing these issues for all stakeholders.

If you would like to contact me about this submission, please call me on (03) 8628 1242.

Yours sincerely

**Melinda Green**  
Regulatory Manager - Pricing

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<sup>13</sup> Based on the 20120-13 ROC value of \$130.67, excluding margin, headroom and assuming that all costs end up in the supply charge