Regulated Retail Electricity Prices 2014-15 – Interim Consultation Paper

AGL submission to the Queensland Competition Authority

Date: 09 September 2013

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Executive Summary

AGL welcomes the opportunity to provide feedback on the Interim Consultation Paper. AGL looks forward to continuing to work closely with the Queensland Competition Authority (***the QCA***) through the next stages of the process to set the 2014-15 notified prices.

General Comments

AGL supports the QCA's position that "*a key objective of notified prices is to facilitate the development of competition in the Queensland retail electricity market and to provide a transition to price deregulation*.[1] In light of the Queensland Government's stated intention to remove electricity price regulation and introduce price monitoring in south-east Queensland (***SEQ***) from 1 July 2015, the 2014-15 determination process will represent the final occasion that prices in SEQ will be set by a regulator, rather than market forces. AGL considers it imperative that the final set of notified prices do not undermine the transition to deregulation.

AGL's submission addresses a number of issues with the methodologies for calculating notified prices which could have the effect of setting prices at levels which would reduce competition and impede the transition to price monitoring in SEQ.

Energy Costs

AGL firmly believes the calculation of the wholesale energy cost (***WEC***) using a market-based approach needs to ensure that the WEC is not less than the long run marginal cost (***LRMC***) of electricity generation. AGL again notes that adopting this approach within the period of the Delegation would limit short-term volatility in retail prices and provide longer-term certainty for the retail industry.

AGL understands that the QCA is reluctant to move away from its current market-based approach for 2014-15. If the QCA is minded to continue using the current approach it needs to be adjusted to account for uncertainty in futures markets associated with carbon policy and the additional risks for retailers contracting in those markets.

Impacts of carbon policy uncertainty

Following the election on 7 September of representatives to the Federal Parliament it is a distinct possibility that the current carbon pricing mechanism will be amended during 2014-15. Based on the Coalition's stated policy of removing the carbon pricing mechanism and introducing a 'direct action' climate change plan the QCA will need to consider the likely impacts of such a significant policy change on the determination of 2014-15 prices. The impacts of current carbon policy uncertainty on 2014-15 prices include:

- That the uncertainty related to the timing of a change in carbon policy has exacerbated the lack of liquidity in the futures contracts market. Whilst liquidity may marginally improve as policy uncertainty diminishes, AGL considers that it is unlikely that this issue will be resolved by such a time as to allow the QCA to be confident that 2014-15 futures prices are appropriate for calculating the WEC i.e. even with the conclusion of the 2013 Federal election, the passage of any proposed legislation to amend the Clean Energy Act 2011 is uncertain. AGL therefore suggests that the QCA considers using data on OTC electricity forward contracts which

[1] QCA, Interim Consultation Paper, Regulated Retail Electricity Prices for 2014-15, July 2013. Page 22.

exclude the impact of carbon at the time of trading and settle the contracts using a 'carbon pass-through' clause developed by AFMA; and

- Due to the level of uncertainty around the details of the 'Direct Action' policy, and the timeframe for its implementation, AGL suggests that the QCA continues to monitor developments in the Federal Parliament throughout the 2014-15 price determination process, and consider any potential impact on the energy cost approach as required.

At this stage, AGL considers the most appropriate approach for developing retail prices is to consider two scenarios:

i) the current carbon pricing mechanism (i.e. 2014-15 fixed price permit $25.40); and

ii) no carbon price.

Retail Costs, Margin and Headroom

AGL supports the maintenance of the QCA's benchmarks set in the 2013-14 Determination for retail costs, margin and headroom. The alignment with IPART's benchmarks for 2013-14 provides consistency.

1. General Comments

AGL Energy Ltd (***AGL***) welcomes the opportunity to provide comments to the Queensland Competition Authority (***the QCA***) on the Interim Consultation Paper, Regulated Retail Electricity Prices 2014-15, Cost Components and Other Issues (***Consultation Paper***).

Regulated Retail Prices and price monitoring in 2015

AGL supports the QCA's position that "*a key objective of notified prices is to facilitate the development of competition in the Queensland retail electricity market and to provide a transition to price deregulation*".[2] In light of the Queensland Government's stated intention to remove electricity price regulation and introduce price monitoring in south-east Queensland (***SEQ***) from 1 July 2015, the 2014-15 determination process will represent the final occasion that prices in SEQ will be set by a regulator, rather than market forces. AGL considers it imperative that the QCA's final set of notified prices do not undermine the transition to price monitoring.

AGL's submission addresses a number of issues with the methodology for calculating notified prices which could have the effect of setting prices at levels which would reduce competition and impede a smooth transition to price monitoring in SEQ.

Structure of Submission

In this paper, AGL has responded to the Consultation Paper in the following structure:

- Section 2 discusses network costs;
- Section 3 considers the range of issues in establishing the energy purchase cost allowance;
- Section 4 discusses the retail operating cost allowance and retail margin; and
- Section 5 comments on retail competition in the Queensland electricity market and other considerations.

[2] QCA, Interim Consultation Paper, Regulated Retail Electricity Prices for 2014-15, July 2013. Page 22.

2. Network Costs

The terms of reference requires the QCA to set notified prices for residential and small customers based on Energex network prices and for large customers, based on Ergon Energy network prices. The approach taken by the QCA is in accordance with the terms of reference and AGL does not propose any change to this approach.

Unless the timeframe for approving network prices is amended in line with IPART's current rule change proposal, AGL considers that the approach taken by the QCA to set the 2013-14 remains appropriate for setting 2014-15 prices, that is, to set the notified prices based on network tariffs submitted to the AER for approval in April with a pass-through mechanism if there are material difference between the submitted and final approved tariffs.

3. Energy Costs

3.1. Wholesale energy costs

AGL continues to advocate for the calculation of the wholesale energy cost (***WEC***) using a market-based approach whereby the WEC should not be less than the long run marginal cost (***LRMC***) of electricity generation. AGL again notes that adopting this approach within the period of the Delegation would limit short-term volatility in retail prices and provide longer-term certainty for the retail industry. AGL acknowledges that at this point within the Delegation and with the Queensland Government's stated intention to move to price monitoring in 2015 amending the WEC approach would result in significant additional work for the QCA.

Potential approaches for 2014-15

The QCA has noted that:

> *"retaining its earlier hedging-based approach would provide certainty to stakeholders…… the Authority has also made clear its preference for using a hedging-based approach because of its transparency and the fact that it reflects the actual value of the electricity purchased from the NEM in a given year."*

While it could be argued that maintaining the current hedging-based approach may provide some certainty to retailers - the nature of the methodology and current uncertainty associated with Commonwealth Government carbon policy means the approach in its current form is not suitable to be directly applied in 2014-15. If the QCA is minded to continue using the current approach rather than utilise LRMC it will need to be adjusted to account for uncertainty in futures markets associated with carbon policy and the additional costs to retailers or to adjust returns to account for the additional risks retailers are facing when contracting in those markets.

During the consultation on 2013-14 notified prices AGL raised a number of other concerns with the 'hedging approach' used by ACIL Allen and the results used to determine the 2013-14 WEC. Due to the complex nature of the modelling approach, including the requirement to update relevant inputs and assumptions required, it is anticipated that we will provide more detailed feedback on these types of issues through the process of determining 2014-15 notified prices.

AGL also remains opposed to the use of the 'price distribution' approach as described in ACIL Allen Consulting's Draft Report to the QCA's Final Determination of prices for 2012-13. AGL detailed its concerns with this approach in our submission to the 2012-13 Review of Regulated Retail Electricity Tariffs and Price – Draft Methodology Paper.[3]

Impacts of carbon policy uncertainty

Following the election on 7 September of representatives to the Federal Parliament it is a distinct possibility that the current carbon pricing mechanism will be amended during 2014-15. Based on the Coalition's stated policy of removing the carbon pricing mechanism and introducing a 'direct action' climate change plan the QCA will need to consider the likely impacts of such a significant policy change on the determination of 2014-15 prices.

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[3] AGL Energy Ltd., Review of Regulated Retail Electricity Tariffs and Price – Draft Methodology Paper, AGL submission to the Queensland Competition Authority, 12 December 2011.

Based on the current 'hedging approach' used by ACIL Allen there are a number of specific issues which the QCA will need to deal with in the process of determining the 2014-15 regulated prices including:

- Does the carbon policy uncertainty affect the use of 2014-15 futures contracts in determining the WEC? If so, how should be the current approach be amended?
- How might the QCA consider any potential impacts on electricity generators from a 'direct action' climate change plan and whether these would flow through to wholesale electricity prices?
- Should retail prices be calculated based on a particular carbon policy scenario or a number of scenarios?

2014-15 futures contracts in Queensland

AGL highlighted in two recent submissions made to the QCA (i.e. 2012-13 Draft Determination and 2013-14 Interim Consultation Paper) that due to liquidity concerns, AGL does not agree that futures prices provide a reliable estimate of the 'efficient cost' faced by retailers serving a small customer load in Queensland.

This lack of liquidity in the futures contracts market has been exacerbated due to the uncertainty related to the timing of a change in carbon policy. Whilst liquidity may marginally improve as policy uncertainty diminishes AGL considers it unlikely that this issue will be resolved in time to allow the QCA to be confident that 2014-15 futures prices are appropriate for calculating the WEC. AGL notes that even with the conclusion of the2013 Federal election, the passage of any proposed legislation to amend the Clean Energy Act 2011 is uncertain.

Current 2014-15 futures prices are likely being priced to reflect participants views on the likelihood of different policy outcomes, combined with different cost assumptions under those policies i.e. a participant might value a futures contract based on no carbon pricing mechanism in 2014-15 while another participant might factor in a proportion of the fixed carbon price.

AGL suggests that the QCA and its consultants should consider using data on OTC electricity forward contracts which exclude the impact of carbon at the time of trading and settle the contracts using a 'carbon pass-through' clause developed by AFMA. This would allow an impact for carbon to be included exogenously depending on the election and subsequent policy outcomes.

'Direct action' policy and wholesale electricity prices

The Coalition describes its policy position on climate change as a 'Direct Action Plan'. The 'Direct Action Plan' comprises a number of initiatives designed to reduce greenhouse gas emissions including establishing an Emission Reduction Fund which will support emissions reduction activity by business and industry.[4]

The 'Direct Action Plan' and other announcements to date by Coalition spokespeople on its climate change policy have not provided sufficient detail to allow the calculation of any potential impact of the policy on wholesale electricity prices. It is possible that electricity generators could face additional costs which they would likely seek to recover in the wholesale electricity spot market.

[4] Liberal Party, The Coalition's Direct Action Plan, Environment & Climate Change. Page 1

Due to the level of uncertainty around the details of the 'Direct Action' policy, and the timeframe for its implementation, AGL suggests that the QCA continues to monitor developments in the Federal Parliament throughout the 2014-15 price determination process, and consider any potential impact on the energy cost approach as required.

Carbon policy assumptions for retail prices

As noted earlier, even with the conclusion of the 2013 Federal election, uncertainty remains regarding the current carbon pricing mechanism and the nature of any replacement policy.

Therefore, AGL suggests that the QCA calculates retail prices using the two scenarios:

- a scenario based on the current legislated carbon pricing scheme i.e. assume fixed price of $25.40/carbon unit under the carbon pricing mechanism for 2014-15 ; and
- a scenario which assumes that no carbon cost applies to electricity generators.

These scenarios are plausible and can be modelled by QCA's consultants without significant change to existing models and pricing approach.

3.2. Green costs

LRET

AGL is of the view that in determining the cost allowance for LRET compliance the QCA should consider the range of costs that would be experienced by a retailer sourcing LGCs. They will not only be sourced from the market. Therefore AGL considers that, in setting the allowance for a retailer's cost of compliance with the LRET scheme, using the LRMC of compliance is the most appropriate approach in setting a regulated retail electricity price.

The QCA has expressed a preference for continuing to use market data to estimate LRET compliance costs where this data is "robust". If the current approach is continued AGL requests that the QCA make the data available on LGC prices and any assumptions used for the RPP.

SRES

AGL notes that the nature of the SRES makes it very difficult for regulators to accurately forecast an accurate SRES allowance for a future period. AGL does not support the use of market prices to set a future cost of scheme compliance for retailers. Numerous changes in the market and other regulatory decisions have meant that fundamentals of the STC market have changed over time, and this could continue over the coming years. In recent months the STC has tended toward the $40/STC clearing house price indicating that the final STP is more likely to clear the market of certificates. On this basis, AGL suggests that the current approach should be maintained.

3.3. NEM fees and ancillary services charges

AGL supports the continuation of the approach the QCA used in previous determinations to assess the NEM fees and ancillary service charges.

4. Retail Costs

4.1. Retail operating costs

In the 2013-14 review, as in previous reviews, the QCA adopted IPART's benchmark for retail operating costs (***ROC***) but had used the QCA's own estimate of customer acquisition and retention costs (***CARC***). In its Final Determination for 2013-14, the QCA set the ROC allowance at $162.16 per customer, including CARC. This has addressed AGL's concerns about the level of ROC which were outlined in its submission to the Draft Determination in 2013-14.

Given the planned move to price monitoring in Southeast Queensland on 1 July 2015, it is important that there are no material changes in approach to the setting of benchmarks for 2014-15. In AGL's view, the allowance for ROC set by the QCA in 2013-14, maintained in real terms, is a reasonable benchmark to use for 2014-15.

AGL also agrees with the QCA decisions to:

- allocate the ROC to the fixed component of the general supply tariffs; and
- not allocate any ROC to the controlled load tariffs.

Although some portion of the ROC will vary indirectly with electricity consumption, such as bad debts, generally ROC is unlikely to vary irrespective of the customer's electricity consumption. For simplicity, AGL considers that it is appropriate to treat ROC as a fixed cost.

Furthermore, treating ROC as a fixed cost will allow the controlled load tariffs to be set without any allocation of ROC. These tariffs can only be supplied in conjunction with a residential or business tariff and the residential or business tariffs will already account for the total ROC of that customer.

4.2. Retail margin

As with retail operating costs, the QCA had adopted IPART's benchmark for retail margin of 5.7% in its Final Determination in 2013-14.

AGL supports the application of this benchmark for 2014-15 to maintain consistency with its previous review as well as consistency with other jurisdictions, namely NSW.

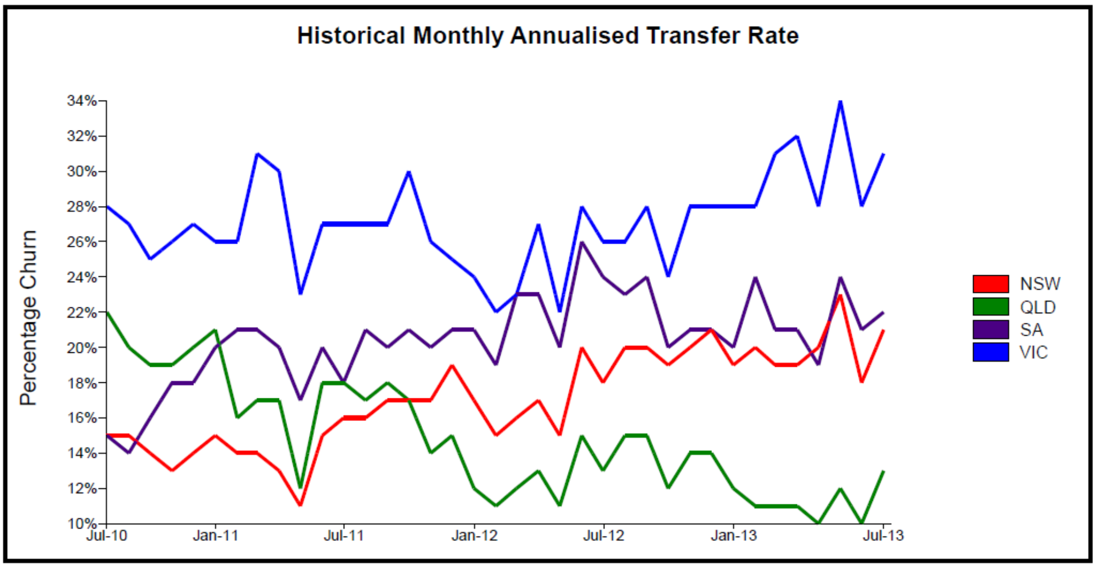
5. Competition and Other Issues

5.1. Competition and headroom

Information such as market share and the number of active retailers are useful in assessing the level of competition. However the churn, switching or transfer rate remains the key statistic used by AEMO and retailers to assess the level of competition.

Since late 2011, the churn rate in Queensland has remained well below that of the other three jurisdictions in the National Electricity Market. Aside from the upturn in the churn rate in July 2013, the AEMO monthly retail transfer statistics showed that the churn levels in Queensland have been trending down (see figure below).

Figure 3: AEMO NEM monthly retail transfer statistics, July 2013



The QCA points out in the Consultation Paper that competition may have been affected by the Government's intervention by "freezing" Tariff 11 in 2012-13 which has increased uncertainty and the risk of retailing in Queensland.

Although true, this ignores the significant shift the QCA made in its approach to setting regulated prices in 2012-13, and more specifically, the determination of the energy cost allowance. AGL believes that the movement to setting the WEC solely based on short run market prices rather than utilising long run generation costs at a time when the market was in a state of structural oversupply would have driven similar impacts on competition even without the Government's intervention. The churn levels in Queensland since the lifting of the tariff freeze would continue to suggest that is the case.

It could be argued that by including a headroom allowance of 5% when setting the notified prices for the 2012-13 and 2013-14 reviews the QCA, to some extent, mitigated the impact of its WEC methodology change.

As discussed in the Consultation Paper, AGL agrees that this approach is consistent with the terms of reference which require the QCA to have regard to "*the effect of the price determination on competition in the QLD retail electricity market*".

AGL has consistently maintained that, at a minimum, a headroom allowance of 5% should be allowed to ensure a sustainable level of competition. This is generally consistent with the headroom determined by IPART in the 2013-16 review of NSW retail electricity prices.

5.2. Accounting for unforeseen or uncertain events

AGL believes that, in principle, any cost pass-through should not be limited to certain events nor should it be bound by a materiality threshold. The QCA does not intend to set a fixed materiality threshold for pass-through but is planning to limit the mechanism to:

- any change in network charges used in the setting of retail prices compared to the final network prices approved by the Australian Energy Regulator; and
- any difference between the costs of SRES used in the setting of retail prices and the actual cost incurred by retailers.

AGL considers the limiting of cost-pass through to these specific events would be a poor regulatory framework in the long-term but the QCA consultation is focussed on 2014-15 regulated prices with any pass through only relevant to the current financial year.

At this point in time, AGL cannot identify any requirement for pass-through of 2013-14 costs except for the potential changes in the cost of SRES and as such, generally supports the cost pass-through mechanism for 2014-15 as outlined in the Consultation Paper.

5.3. Transitional Arrangements

Transitional arrangements for Tariff 11

In the 2013-14 determination, the fixed and variable components of Tariff 11 were set on a three year path to reach cost reflective levels by 1 July 2015. Given the Government's announcement on the removal of price regulation by 1 July 2015, prices will no longer be set by the QCA for 2015-16.

To reduce any confusion in July 2015 regarding the impact of the movement to price monitoring and any underlying Tariff 11 price changes due to a need for cost reflectivity, AGL considers that it is appropriate for the QCA to pursue a quicker transition and to attempt to set Tariff 11 to a cost reflective structure for 1 July 2014.

Transitional arrangements for tariffs made obsolete in 2012-13

For the 2013-14 determination, the QCA had established a seven year transition for obsolete tariffs although this was overruled by the Queensland Government which limited the price increase for these tariffs to 10%.

Following the Government's announcement on 17 June 2013 of its intention to remove price regulation from 1 July 2015 in south east Queensland, the transitional arrangements regarding the obsolete tariffs will no longer apply to south east Queensland customers after 2014-15.

Accordingly, it is important that the QCA takes account of this when it revisits the transition of these obsolete tariffs to cost reflective levels in 2014-15.

Allowing new large customers access to transitional tariffs

In the 2013-14 Determination, the QCA decided that all business customers should have access to transitional tariffs.

In practice, this is applicable only to customers in the Ergon Energy area since customers in south east Queensland using more than 100 MWh a year are no longer eligible to access notified prices.

AGL maintains that, given the Government's long-term intentions on tariff reform, new customers should not be able to access tariffs which are not cost reflective.