

**Submission by the Queensland Council of Social Service (QCOSS) on the Queensland Competition Authority (QCA) Methodology Paper: Review of Regulated Retail Electricity Tariffs and Prices.**

**About QCOSS Inc**

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Queensland Council of Social Service (QCOSS) is the peak body for over 600 welfare and community sector organisations in Queensland. For over 50 years QCOSS has worked to promote social justice and exists to provide a voice for Queenslanders affected by poverty and inequality. We act as a State-wide Council that leads on issues of significance to the social, community and health sectors. We work for a Fair Queensland and develop and advocate socially, economically and environmentally responsible public policy and action by community, government and business.

QCOSS is funded by the Department of Employment, Economic Development and Innovation (DEEDI) and the Department of Justice and Attorney-General (DJAG) for an energy consumer advocate project in Queensland. The objective of the QCOSS Energy Consumer Advocacy Project is to examine and provide quality input into Queensland Government energy policies for all residential consumers in Queensland and with special consideration of the needs of pensioners, low income earners and energy consumers experiencing financial hardship. This work is supported by an advisory group involving other key consumer groups.

**About this Submission**

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QCOSS has engaged Etrog Consulting Pty Ltd to provide advice to QCOSS in relation to the review of regulated retail electricity tariffs and prices and the matters that impact on residential consumers in Queensland. The report from Etrog Consulting that follows was prepared in consultation with and on behalf of QCOSS and should be taken as the QCOSS response to the QCA Methodology Paper.

This consultancy was funded by the Consumer Advocacy Panel ([www.advocacypanel.com.au](http://www.advocacypanel.com.au)) as part of its grants process for consumer advocacy projects and research projects for the benefit of consumers of electricity and natural gas.

The views expressed in this document do not necessarily reflect the views of the Consumer Advocacy Panel or the Australian Energy market Commission.

We look forward to continuing to represent the interests of Queensland consumers in all energy related matters. For further information or to clarify any aspect of this submission, please contact Linda Parmenter, Manager Low Income Consumer Advocacy on 3004 6900 or email [lindap@qcross.org.au](mailto:lindap@qcross.org.au).



## REPORT

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# Regulated Retail Electricity Prices 2012-13: Comments on Draft Methodology Paper

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## 1. INTRODUCTION

This report has been prepared by Etrog Consulting Pty Ltd for Queensland Council of Social Service (QCOSS). It comments on the Draft Methodology Paper on Regulated Electricity Prices to apply in Queensland from 1 July 2012 to 30 June 2013, which was published by the Queensland Competition Authority (the Authority) on 11 November 2011, inviting submissions from interested parties.

At the same time, the Authority also released a draft methodology written by ACIL Tasman for estimating energy purchase costs.

The Authority held a workshop in Brisbane on 25 November 2011 on the draft methodology for determining 2012-13 regulated retail electricity prices, which we were pleased to attend. We would like to thank the Authority for holding the workshop, which we found very informative and useful. With the agenda for the workshop, the Authority also circulated some responses from ACIL Tasman to a few initial questions raised by AGL, and a description of the ACIL Tasman Powermark model.<sup>1</sup>

The Authority has requested that submissions to the Draft Methodology Paper should be received by 9 December 2011. This report has been developed in consultation with QCOSS with the understanding that QCOSS is intending to include this report in its submission to the Authority on the Draft Methodology Paper.

We have developed this report taking into account all the materials referenced above, as well as discussion at the workshop that was held on 25 November 2011.

### 1.1. DELEGATION FROM THE MINISTER

As stated in Chapter 1 of the Authority's Draft Methodology Paper, on 22 September 2011, the Authority received a Delegation from the Minister for Energy and Water Utilities (the Minister) under section 90AA(1) of the *Electricity Act 1994* requiring it to determine notified electricity prices<sup>2</sup> to apply from 1 July 2012 to 30 June 2013 (the price determination). The Delegation also includes Terms of Reference for the price determination. The Minister's covering letter and Delegation were provided in Appendix 1 to the Draft Methodology Paper.

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<sup>1</sup> The Authority's Draft Methodology Paper and the ACIL Tasman paper have been published on the Authority's website at [www.qca.org.au/electricity-retail/NEP/DMP](http://www.qca.org.au/electricity-retail/NEP/DMP), along with slides from presentations made by ACIL Tasman at the workshop that was held on 25 November 2011.

<sup>2</sup> Notified electricity prices are the regulated retail electricity prices that a retailer may charge its non-market customers, as defined under section 90 of the *Electricity Act 1994*

Chapter 1 of the Draft Methodology Paper outlines various relevant requirements that the *Electricity Act 1994*, *Electricity Regulation 2006*, and the Delegation place on the Authority. However, it does not include the following comment in the Minister's covering letter, which we believe is important:

*With the introduction of the new price setting methodology in 2012-13, the Government wishes to again stress that the Authority must consider the impact of price rises on consumers when determining regulated prices.*

The Authority must consider the impact of price rises on consumers when determining regulated retail electricity prices for 2012-13.

## **1.2. LACK OF DATA TO MODEL THE EFFECTS THAT THE NEW PROPOSED REGULATED TARIFFS AND PRICES WILL HAVE ON QCOSS' CONSTITUENCY**

QCOSS represents the interests of residential consumers, with a particular focus on low income and other vulnerable consumers.

We previously commented in August 2011 in our review of the Issues Paper on Regulated Retail Electricity Tariffs and Prices which was published by the Authority on 24 June 2011 that we would have liked to have been able to model the effects that the new proposed regulated tariffs and prices will have on QCOSS' constituency, and to have taken into account the results of that modelling in our review at that time. However, as we stated then, we found it impossible to do any meaningful modelling, because there was too much uncertainty.<sup>3</sup>

As we pointed out then, in Energex's proposed network tariff structure for 2012-13, the block sizes are only proposed, we do not have data showing the distribution of usage across the Energex area for customers at large, let alone for low income consumers, we do not know what will be the magnitude of the fixed charge as compared to the variable charges in the network tariffs, and we do not know what will be the magnitude of the differences between the variable charges in each block of the proposed Inclining Block Tariff. Will they be significantly different, or hardly different? As explained later in this report and in our previous report, these issues will be very significant to QCOSS' constituency, and could have a major effect in determining whether low income consumers are better off or worse off as a result of the proposed changes.

Our previous comments again apply to the current Draft Methodology Paper.

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<sup>3</sup> Our previous comments are contained in our report which was included in QCOSS' submission to the Authority in August 2011 which has been published on the Authority's website at [www.qca.org.au/electricity-retail/RevEPandTS/IssuesPaper.php](http://www.qca.org.au/electricity-retail/RevEPandTS/IssuesPaper.php)

We again urge the Authority and the Queensland Government to make available at the earliest opportunity sufficient data to enable modelling of the effects that the new proposed regulated tariffs and prices will have on QCOSS' constituency to be undertaken, and also for those parties to release any modelling that they have already undertaken to support the policy decisions that have been made to date.

Low income customers are supported by a range of concessions and other measures in line with the Queensland Government's social policy objectives. Depending on the outcomes that result from the current review of regulated electricity prices, the existing measures may be adequate or may prove highly inadequate to be effective at assisting low income consumers in future. Major restructuring of the concessions framework may be required, and it is better that this is known sooner rather than later, so that appropriate changes can be made to the concessions framework in time before new regulated tariffs and prices are implemented. Financial counsellors and others who advise these consumers also need prior information on how any new tariffs will affect their clients, so that they can give them appropriate advice on their use of electricity, their budgeting, and any assistance that may be available to them.

### 1.3. THE PROCESS FOR DETERMINING REGULATED RETAIL PRICES FOR 2012-13

We understand that the Delegation requires the Authority to publish on 30 March 2012 its draft price determination of regulated retail electricity tariffs to apply from 1 July 2012. This will leave little time for meaningful stakeholder analysis and comment for the Authority to take into account before its final price determination and gazettal of the final retail tariffs are due no later than 31 May 2012. We see nothing in the Delegation that prevents an earlier publication ahead of the draft price determination – perhaps an interim draft price determination.

We urge the Authority to consider an interim publication – in February 2012 – to inform stakeholders on an interim basis regarding the prices that might be set in regulated electricity prices from 1 July 2012.

### 1.4. STRUCTURE OF THIS REPORT

The remainder of this report comments on various matters in the Authority's Draft Methodology Paper on Regulated Retail Electricity Prices for 2012-13, and largely follows the same structure as the Draft Methodology Paper.

- Section 2 considers the definition of a representative retailer.
- Section 3 covers treatment of network costs.
- Section 4 covers the energy cost component of retail tariffs.



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- Section 5 covers retail costs.
- Section 6 covers setting the R component of retail tariffs.
- Section 7 covers other issues.

## 2. REPRESENTATIVE RETAILER

Chapter 2 of the Draft Methodology Paper considers what should be the characteristics of a representative retailer, given that the Delegation requires the Authority to “consider the retail costs that would reasonably be incurred by an efficient, representative retailer, the characteristics of which should be determined by the Authority”.

We do not accept the retailers’ arguments that the representative retailer should be a new entrant, standalone retailer of small or moderate size.<sup>4</sup> Rather, we support a definition of a representative retailer that is consistent with the previous Benchmark Retail Cost Index (BRCI) definition of the retailer as an incumbent, standalone Queensland electricity retailer with a substantial and representative cross-section of customer types. We concur with the view of the Authority that its “task is to set prices that will sustain an appropriate level of competition in the market in order to place downward pressure on prices but not set prices so high as to deny consumers those benefits that come from a competitive market in terms of greater efficiency and lower prices”.<sup>5</sup>

The Authority concludes that it considers that the representative retailer is one that:

- Is an incumbent retailer of sufficient size to have achieved economies of scale;
- Serves small and large retail customers in SE Queensland and other jurisdictions across the NEM;
- Retail electricity on a standalone basis; and
- Is not vertically integrated with an electricity generator.<sup>6</sup>

We concur with the Authority’s conclusion. In particular, we are concerned with the first two parts of this conclusion. We concur with the view of the Authority that “the south east Queensland electricity market is attractive to retailers who are actively seeking market share with a wide range of market offers for consumers. There does not appear to be any reason to believe that the level of competition is deficient or that further steps need to be taken to attract new entrants. On this basis the Authority considers that the definition of the representative retailer should be based on an incumbent retailer, not a new entrant.”<sup>7</sup>

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4 Draft Methodology Paper, page 7

5 Draft Methodology Paper, page 13

6 Draft Methodology Paper, pages 13 to 14

7 Draft Methodology Paper, page 11

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The representative retailer should be an incumbent retailer of sufficient size to have achieved economies of scale, which serves small and large retail customers in SE Queensland and other jurisdictions across the NEM.

### 3. TREATMENT OF NETWORK COSTS

As discussed in section 1.2 above, we remain concerned regarding the uncertainty of the effects that the new proposed regulated tariffs and prices will have on QCOSS' constituency. We understand from previous submissions and from the workshop we attended on 25 November 2011 that retailers also have similar concerns about the effects that new tariffs and prices will have on their customers, and consumers in general are uncertain what the changes in prices from 1 July 2012 will mean for them.

The Delegation sets out: "In calculating the regulated retail tariffs for the relevant tariff year, the Authority should, to the extent possible, base its determination on a Network (N) plus Retail (R) cost build-up approach to setting notified prices, where N (network cost) is treated as a pass-through and R (energy and retail cost) is determined by the Authority."

A major part of the uncertainty in the regulated retail tariffs and prices arises from lack of information on the network tariffs and prices on which they will be based. The Authority has noted: "Network costs include the costs associated with the use of transmission and distribution networks and typically account for around 50% of the total cost of providing electricity to households."<sup>8</sup>

One of the key outstanding issues is how to maintain alignment of retail and network tariffs. As noted by the Authority: "Energex's network prices are routinely approved by the AER just prior to the start of each financial year. Under the National Electricity Rules, Energex is required to submit revised network prices at least two months prior to the commencement of the financial year. There is no formal limit under the National Electricity Rules on the time the AER can take to approve the pricing proposal. The Authority is currently required to publish final notified retail electricity prices to apply in the coming financial year by 31 May each year. Any change in the network tariffs proposed by Energex and approved by the AER after the Authority had published final notified prices would potentially result in a misalignment with them."<sup>9</sup>

The Authority has considered various options for maintaining alignment between retail and network tariffs. It found that:

- Requesting the AER to revise its processes in order to approve network prices earlier would require legislative or rule changes which the Authority cannot guarantee.
- Adjusting regulated retail prices to apply from 1 August instead of 1 July to accommodate potentially late approval of Energex network prices by the AER would also require legislative or rule changes which the Authority cannot guarantee.<sup>10</sup>

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8 Draft Methodology Paper, page 15

9 Draft Methodology Paper, page 19

10 Draft Methodology Paper, page 20

The Authority proposed instead to “request Energex to supply the Authority with its proposed network tariffs and prices when they are submitted to the AER and use these as the basis for notified prices to apply from 1 July each year. Should there subsequently be any change to those proposed tariffs and/or prices, regulated retail prices could be adjusted after 1 July to reflect any changes approved by the AER.”<sup>11</sup> In making this proposal, the Authority stated that to date, the AER has not made changes to Energex’s final proposed prices.<sup>12</sup> This statement was questioned at the workshop, and either way we believe that a process is required in case the AER does make changes to Energex’s final proposed prices.

By its own admission, the Authority’s proposal “may also be problematic because the National Energy Customer Framework will allow changes to retail prices only once every six months. While it may be possible for the Queensland Government to opt out of imposing this restriction in Queensland, changing all notified prices twice in quick succession would impose additional costs on retailers and increase the potential for confusion amongst consumers.”<sup>13</sup>

We concur with the view of the Authority that it should request Energex to supply the Authority with its proposed network tariffs and prices when they are submitted to the AER and use these as the basis for regulated retail prices to apply from 1 July 2012.<sup>14</sup> However, we are particularly concerned at the additional costs that may be incurred for little or no gain, as well as the confusion and other undesirable effects on customers if regulated retail prices are changed twice in quick succession. We therefore suggest that should there subsequently be any change to those proposed network tariffs and/or prices, regulated retail prices should only be changed if the change is particularly material. The Authority should propose a materiality threshold in its draft price determination. We believe that this should meet the criterion in the Delegation that the network cost should be treated as a pass-through “to the extent possible”.

The Authority should request Energex to supply the Authority with its proposed network tariffs and prices when they are submitted to the AER and use these as the basis for notified prices to apply from 1 July 2012. Should there subsequently be any change to those proposed network tariffs and/or prices, regulated retail prices could be adjusted after 1 July to reflect any changes approved by the AER, regulated retail prices should only be changed if the change is particularly material, and the Authority should propose a materiality threshold in its draft price determination.

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11 Draft Methodology Paper, pages 19 to 20

12 Draft Methodology Paper, page 20

13 Draft Methodology Paper, pages 19 to 20

14 The Authority’s Draft Methodology Paper proposed solutions that would apply “each year” (page 20). This may be presumptuous given that the Authority’s Delegation is currently only for a single year.

#### 4. ENERGY COST COMPONENT OF RETAIL TARIFFS

Under the Delegation, the R component of each retail tariff is to include appropriate allowances for energy and retail costs.

In the Issues Paper, the Authority identified the following items for possible inclusion in the energy cost component:

- The cost of purchasing wholesale energy from the National Electricity Market (NEM);
- Renewable energy costs incurred by retailers in meeting their obligations under State and Commonwealth Government greenhouse gas emissions abatement schemes; and
- NEM participation fees and ancillary services charges imposed by the Australian Energy Market Operator (AEMO), as well as the costs associated with network energy losses.<sup>15</sup>

Each of these is considered in turn in this section of our report.

We noted in section 2 above that we concur with the view of the Authority that its “task is to set prices that will sustain an appropriate level of competition in the market in order to place downward pressure on prices but not set prices so high as to deny consumers those benefits that come from a competitive market in terms of greater efficiency and lower prices”.<sup>16</sup>

We also read:<sup>17</sup>

*The greatest risk to competition and the incumbent retailer is if the energy purchase costs (EPC) is underestimated. However, the need to ensure costs are not underestimated needs to be balanced against the requirement that prices are cost reflective. Assumptions such as the load forecast and contract cover used in the pool price modelling will need to be considered in this context.*

It is unclear how to interpret this. We understand, of course, that all estimates are uncertain. We believe that there are risks both in underestimation and in overestimation of costs. We would not expect ACIL Tasman to set out to guard against underestimation more than against overestimation in its estimation of energy purchase costs.

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15 Draft Methodology Paper, page 21

16 Draft Methodology Paper, page 13

17 ACIL Tasman draft methodology, page 4

## 4.1. THE COST OF PURCHASING WHOLESALE ENERGY

### 4.1.1. Cost-based vs. market-based approaches

We concur with the view of the Authority that it is more appropriate to use a market-based approach rather than to use a Long Run Marginal Cost (LRMC) based approach, for the reasons given by the Authority:

- LRMC is an estimate of generation costs rather than the cost to a retailer of purchasing wholesale electricity.
- LRMC ignores prevailing market conditions, which can be influenced by a range of factors and which can have a significant influence on energy purchase costs.
- LRMC ignores the existence of the NEM and the major impact it has had on the wholesale price of electricity.<sup>18</sup>

We agree with the view of the Independent Competition and Regulatory Commission (ICRC) that regulated retail prices should not be used to attempt to correct concerns about the long-term investment in electricity generation.<sup>19</sup>

We also agree with the Authority that no LRMC “floor” should be included. As stated by the Authority, “there appears to be sufficient reliable information available in the market for a firm to make a timely and efficient decision about investing in generation in the NEM without the need for the additional security of an LRMC floor in regulated retail electricity prices in Queensland”.<sup>20</sup>

As we stated in our previous submission, there is no basis for a LRMC “floor”, and if there were to be a “floor” it would reasonably be counter-balanced with a “cap”. This approach was taken in South Australia where ESCOSA developed low and high estimates of LRMC to provide a price floor and price ceiling for its market-based energy cost estimate, which was based on a weighted average of market contract prices.<sup>21</sup>

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18 Draft Methodology Paper, page 23

19 *Final Technical Paper: Model for determining the energy purchase cost of the transitional franchise tariffs*, Report 3 of 2010, ICRC, March 2010, section 3.2, available at [www.icrc.act.gov.au/\\_data/assets/pdf\\_file/0009/184878/Report3\\_2010\\_Technical\\_Paper\\_Final\\_ICRC\\_Web.pdf](http://www.icrc.act.gov.au/_data/assets/pdf_file/0009/184878/Report3_2010_Technical_Paper_Final_ICRC_Web.pdf)

20 Draft Methodology Paper, page 23

21 *2010 Review of Retail Electricity Standing Contract Price Path, Final Inquiry Report & Final Price Determination*, ESCOSA, December 2010, section 2.3.3, available at [www.escosa.sa.gov.au/library/101208-ElectricityStandingContractPrice-FinalPriceDetermination-PartA.pdf](http://www.escosa.sa.gov.au/library/101208-ElectricityStandingContractPrice-FinalPriceDetermination-PartA.pdf)

In regard to an LRMC “floor”, we concur with the comment in the previous Issues Paper:

*The Authority also questioned why this security would be needed with regulated prices but not if the market was entirely deregulated, in which case only market costs would be available.<sup>22</sup>*

We ask the same question and have no reasonable answer other than that a LRMC “floor” is not required.

The Authority should use a market-based approach rather than a cost-based approach to estimate the cost of purchasing wholesale energy.

#### 4.1.2. Hedging-based approach vs. other market based approaches

We continue to support a hedging-based approach, based on actual reported trading in forward electricity contracts. While it is true that these contracts for the periods from January 2013 onwards were thinly traded in the months before a carbon tax was legislated, we note that:

- Contracts for the first half of the tariff year for which regulated prices are now being set – specifically Q3 2012 and Q4 2012 – have been traded in volume with published pricing for some time even before the carbon tax was legislated. As ACIL Tasman stated: “there are no reliable contract prices for the latter half of the 2012/13 financial year”<sup>23</sup> – but there are for the first half.
- Interest is now being shown and contracts are now being traded with published prices for the second half of that tariff year – viz. Q1 2013 and Q2 2013.

On that basis, we believe that using a hedging-based approach to estimate energy purchase costs for 2012-13, similar to that used in previous years to calculate the BRCI, may still be possible. We concur with the view that now that uncertainty over the carbon tax has diminished, and trading in forward electricity contracts has recovered, a hedging-based approach should be reconsidered as the preferred method of estimating energy purchase costs. An alternative approach which does not rely on the availability of contract market data may not be required for the setting of regulated retail electricity prices for 2012-13.

The Authority should reconsider whether it is still possible to set regulated retail electricity prices for 2012-13 based on available contract market data.

<sup>22</sup> Issues Paper, page 10

<sup>23</sup> ACIL Tasman draft methodology, page 13



In the event that the Authority does determine that there is still insufficient contract market data available, then an alternative approach may be required for 2012-13. ACIL Tasman suggested an alternative market-based approach to estimating energy costs that does not rely on hedging contracts, and the pros and cons of this approach were discussed in some detail at the workshop that was held on 25 November 2011.

As stated by the Authority:<sup>24</sup>

*While the approach requires some use of 'black box' modelling, the Authority notes that the same can be said of other approaches supported in submissions, including LRMC and the hedging-based approaches adopted in the BRCI. That said, the Authority acknowledges that the alternate approach is more complex than the hedging-based approach and that this may reduce the transparency of the approach for stakeholders. This is a key reason why the Authority would have preferred to continue with the hedging-based approach it had previously used. However, on balance, given the lack of market data for a hedging-based approach, it appears that ACIL's approach is the most reasonable for the Authority to adopt in the current circumstances.*

The approach of ACIL Tasman to estimate the cost of purchasing wholesale energy may be the most reasonable approach for the Authority to adopt if (and only if) it determines that there is still insufficient contract market data available to adopt a hedging-based approach for 2012-13.

#### 4.1.3. Accounting for energy losses

We note and concur with the Authority's proposed approach to accounting for energy losses:<sup>25</sup>

*As outlined in the ACIL Report, ACIL has proposed to take account of both transmission and distribution losses in its energy cost estimates.*

*Given that the Authority is determining regulated retail tariffs that are cost reflective in the Energex area, and that the load information upon which ACIL will be estimating energy costs is being supplied by Energex, it would appear consistent to only take account of those energy losses that occur in the Energex area.*

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<sup>24</sup> Draft Methodology Paper, pages 24 to 25

<sup>25</sup> Draft Methodology Paper, page 27

*The Delegation requires the Authority to adopt loss factors published by AEMO. The Authority will use the most recent transmission loss factors and AER-approved distribution loss factors that are available from the AEMO website at the time of preparing its decisions.*

We also concur with ACIL Tasman's proposal to "apply the Energex distribution loss factor (DLF) as published by Australian Energy Regulator and a load weighted Marginal Loss Factor (MLF) for the Energex area to allow for transmission losses from the reference node".<sup>26</sup>

As reported by the Authority,<sup>27</sup> Ergon Energy proposed: "Only one transmission loss factor (TLF) can be incorporated into the energy cost estimate (per retail tariff). Therefore, Ergon Energy suggests that the highest TLF in Energex's area be used as the proxy for South East Queensland mass market customers."<sup>28</sup>

We see no basis for using the highest TLF and agree instead with ACIL Tasman's proposal to apply the load weighted MLF.

The Authority should apply the Energex distribution loss factor (DLF) as published by Australian Energy Regulator and a load weighted Marginal Loss Factor (MLF) for the Energex area to allow for transmission losses from the reference node.

#### 4.1.4. Carbon pricing

As we pointed out in our previous submission on the Issues Paper, carbon pricing should not impinge directly on retailers. Rather it will impinge on generators, and will be reflected in energy purchase costs in future contract prices and forecast spot prices. It will thus be accounted for in energy purchase costs.

We agree with ACIL Tasman that carbon pricing "will add to the wholesale cost of electricity. ACIL Tasman proposes to incorporate an allowance for carbon pricing in its pool price modelling so the resultant electricity prices will include a carbon pricing allowance. The allowance will be in the form of increased generation costs through a carbon price applying to combustion emissions and the increased fuel prices through fugitive emissions from fuel production."<sup>29</sup>

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<sup>26</sup> ACIL Tasman draft methodology, page 16

<sup>27</sup> Draft Methodology Paper, page 27

<sup>28</sup> Ergon Energy submission to the Issues Paper, page 20

<sup>29</sup> ACIL Tasman draft methodology, page 8 and page 18

We suggest that this will not be an “allowance” as such, but rather recognition that carbon pricing will change some generators’ cost structures, and therefore will change generators’ bidding behaviour. We believe this is the correct approach to carbon pricing if this modelling is adopted.

As discussed in section 4.1.2 above, we support a hedging-based approach, based on actual reported trading in forward electricity contracts. If such an approach is used, in whole or in part, those hedging prices apply whether or not a carbon tax is in place. Thus, no further adjustment for carbon pricing will be required. The Authority and ACIL Tasman should not feel obliged to produce separate results both with and without carbon pricing; the use of a hedging-based approach based on actual reported trading in forward electricity contracts should not be dismissed just because it does not produce two sets of results.

The Authority stated: “Retailers suggested that the Authority should estimate a pass-through for carbon costs separate to the energy costs allowance. AGL suggested that the Authority adopt the approach outlined in the Australian Carbon Benchmark (ACB) Addendum that AFMA published.”<sup>30</sup>

We do not accept the concept of a *pass-through for carbon costs separate to the energy costs*. There should be no such thing. A pass-through suggests costs that are incurred by retailers that are outside their control. Thus for example network costs and GST can be considered to be pass-through items. Given that the carbon tax will be levied on generators and not on retailers, carbon pricing cannot be a pass-through cost for retailers.

In the NEM, energy purchase costs are not pass-through items. Retailers buy energy through a variety of different arrangements, including bespoke bilateral contracts, purchasing of standard contracts, Over the Counter (OTC) trades, spot market purchases, and in some cases through vertical integration. They can also hedge through other mechanisms such as cap contracts. Retailers are responsible for managing their own portfolios, attempting to minimise their purchase costs while managing the risks associated with them. Some retailers may choose load following hedges to cover all or part of their load. The costs of all these types of purchases are covered in the allowance given to retailers for wholesale energy purchase costs, and none is considered a pass-through cost.

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30 Draft Methodology Paper, page 28

8 December 2011

We are aware of the existence of the Australian Carbon Benchmark (ACB) Addendum that has been published by the Australian Financial Markets Association (AFMA). AFMA has published four versions, in December 2008, December 2009, March 2010 and August 2010. Each version has been made available to be built into other trade documentation between contracting parties. It is a means by which parties to contracts (who may be carbon-emitting or non-carbon emitting generators or banks or other financial institutions) can choose to specify payment obligations between them in different circumstances. We could envisage other similar Addenda being written – to cover for example different drought circumstances, or fuel shortages, or pay negotiations, or other possible events that could have different outcomes that may affect generators' cost bases. None of these would entail pass-through costs for retailers.

We understand that the Authority is not privy to the OTC or other trades that retailers have used to purchase energy for 2012-13, and is not privy to the extent to which any of the trades have made use of this particular Addendum or any other Addendum, and nor should it be.

Further, as we have discussed above, any price adjustment mechanism in any such Addendum is not a pass-through and is merely a mechanism among many others that can form a part of the contractual terms that are at the heart of retailers' wholesale energy purchasing arrangements.

We also note that the Authority is required under its Delegation to consider the efficient costs of a representative retailer, which will certainly vary from the actual costs that the Queensland retailers incur.

The Authority should not make a specific allowance for carbon pricing. The effects of the carbon tax should be incorporated in energy purchase costs either through the costs of hedging contracts that include all cost elements including any carbon costs on generators, or through modelling where generator bids and contract offers take into account the carbon impost on the generators.

### *Addendum – 8 December 2011*

As we finalise this report on 8 December 2011, we have become aware of a possibly relevant article that appeared on the website of the ABC this morning.<sup>31</sup> The article claims that “electricity generators and retailers are gearing up for double, even triple dipping” on the carbon tax, through inappropriate pass-throughs to consumers. The article references the submission of AGL to the Authority’s previous Issues Paper, which we have also referenced above. Though we have been unable to verify the claims in the article in the time available, we felt we should through this report make QCOSS and hence the Authority aware of the claims. We expect that the Authority will ensure that Queensland consumers do not make unnecessary multiple payments related to the carbon tax through regulated retail prices.

## **4.2. QUEENSLAND GAS SCHEME**

We agree with the Authority that market prices are the most accurate indicator of the representative retailer’s cost of purchasing Gas Electricity Certificates (GECs) to comply with the requirements of the Queensland Gas Scheme. We also agree that an LRM approach would be less transparent and potentially more complicated than a market-data based approach.<sup>32</sup>

We note the Authority’s comment: “The GEC market has a relatively small number of participants purchasing certificates that are created monthly at most, and certificates are surrendered only once per year. Given these characteristics, it is not surprising that transaction volumes are low.”<sup>33</sup> The market is what it is, and it provides the appropriate latest market data for the Authority to use to estimate the representative retailer’s cost of purchasing GECs. We do not believe that the costs would be more accurate if they made use of historic GEC prices. On the contrary, they would be less accurate when looked at from the point of view of an efficient representative retailer. We do not believe that the Authority should use a longer time series of data to estimate GEC costs for 2012-13.

As stated by ACIL Tasman (albeit in another context in regard to Large-scale Generation Certificates): “a low volume of trading does not necessarily mean that the traded prices are an unreliable source on which to base the estimation of the cost of the scheme”.<sup>34</sup>

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31 *Double dipping on the carbon tax*, written by Jane Shaw, the editor of *The Kings Tribune*, 8 December 2011, available at [www.abc.net.au/unleashed/3718192.html](http://www.abc.net.au/unleashed/3718192.html)

32 Draft Methodology Paper, page 29

33 Draft Methodology Paper, page 29

34 ACIL draft methodology, page 21

We note that ACIL Tasman has reported that “the GEC market is now oversupplied with low prices”.<sup>35</sup> The effects of this oversupply should not be overlooked, and must be taken into account in estimating the costs of scheme compliance for an efficient representative retailer.

The Authority should use the same length of time series to estimate GEC costs for 2012-13 as it used previously in the calculation of the BRCI for 2011-12.

### 4.3. ENHANCED RENEWABLE ENERGY TARGET

On 1 January 2011, the Renewable Energy Target scheme was split into two separate schemes – the Small-scale Renewable Energy Scheme (SRES) and the Large-scale Renewable Energy Target (LRET), collectively known as the Enhanced Renewable Energy Target.<sup>36</sup>

#### 4.3.1. The Small-scale Renewable Energy Scheme (SRES)

The SRES covers small-scale technologies such as solar panels and solar hot water systems installed by households and small businesses. Retailers have an obligation to purchase Small-scale Technology Certificates (STCs) based on the expected rate of STC creation, which is determined by the Office of Renewable Energy Regulator’s (ORER) Small-scale Technology Percentage (STP).

We are concerned that the Authority intends to continue to rely exclusively on the ORER’s Clearing House price of \$40 to estimate the costs to an efficient representative retailer of purchasing all its STCs for 2012-13.<sup>37</sup> While this may be used to estimate the cost of some of the STCs that an efficient representative retailer would purchase, we note that the Authority and ACIL Tasman have both acknowledged that a proportion of STCs are being purchased based on market prices that are readily available. Based on advice from ACIL Tasman, the Authority is proposing that it cannot estimate the cost of an STC to an efficient representative retailer taking into account these market prices, because “it would need to forecast the proportion of STCs likely to be traded in 2012-13. ACIL considered that this may be difficult, as information on the volumes of STCs traded outside the Clearing House is not readily available.”<sup>38</sup>

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35 ACIL draft methodology, page 23

36 Draft Methodology Paper, page 30

37 Draft Methodology Paper, page 32

38 Draft Methodology Paper, page 32

We do not accept this approach. Essentially in taking this approach the Authority has estimated the proportion of STCs likely to be traded in 2012-13 outside the Clearing House, and has deemed that estimate to be zero. We do not believe that the Authority can justify zero to be the best estimate of the proportion of STCs likely to be traded in 2012-13 outside the Clearing House. Therefore, this approach does not comply with the Authority's obligation under its Delegation. We suggest that the Authority is required to make the best estimate it can of the proportion of STCs likely to be traded in 2012-13 outside the Clearing House, and we suggest that the fact that there are trades and market prices will show that best estimate not to be zero. As stated by ACIL Tasman: "an active market for STCs has developed outside the clearing house".<sup>39</sup> The market prices are also known. Again in the words of ACIL Tasman: "the current market price for STCs is well below the official \$40 price".<sup>40</sup>

In estimating the cost of STCs, the Authority should take into account the fact that an active market for STCs has developed outside the clearing house, and the current market price for STCs is well below the official \$40 price. An efficient representative retailer should be expected to be taking advantage of that market and not paying \$40 to purchase all its STCs.

#### 4.3.2. The Large-scale Renewable Energy Target (LRET)

The LRET sets annual targets for the amount of electricity that must be generated by large-scale renewable energy projects like wind farms. Retailers must purchase a set number of Large-scale Generation Certificates (LGCs), which is determined on the basis of achieving the annual target. The number of LGCs required to be surrendered by retailers to discharge their liability each year is determined by ORER's Renewable Power Percentage (RPP). Retailers are required to surrender STCs and LGCs to fulfil their ERET obligations. If a retailer fails to meet its obligations, it will incur a penalty.

We support the use of market-based data to estimate the costs of LGCs. We agree with the Authority that a market-based approach is more likely to reflect the costs to retailers of complying with various environmental schemes and that it is superior to an LRMC based approach for a range of reasons.

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39 ACIL Tasman draft methodology, page 22

40 ACIL Tasman draft methodology, page 22

8 December 2011

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#### 4.3.3. Catch-up from previous years

The Authority states: “The Authority is of the view that providing some catch-up of costs from previous years when setting cost reflective prices for 2012-13 is beyond the current task. Rightly or wrongly, the legislation at the time prevented these costs from being recouped. In addition, it is not appropriate to consider the issue of “un-recouped” costs for some cost elements without a consideration of the ex-post reasonableness of the other costs used in the 2011 BRCI calculation, making the task a de-facto review of the 2011 BRCI. Even if permitted to do so, the Authority would not be so inclined.”<sup>41</sup>

We concur with the view that catch-up is not appropriate, for the reasons stated in the Draft Methodology Paper.

#### 4.4. NEM PARTICIPATION FEES AND ANCILLARY SERVICES CHARGES

We have no issue with NEM participation fees and ancillary services charges being estimated in future as per the previous BRCI framework.<sup>42</sup>

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41 Draft Methodology Paper, page 32

42 Draft Methodology Paper, pages 32 to 33



## 5. RETAIL COSTS

### 5.1. RETAIL OPERATING COSTS

We concur with the ongoing benchmarking approach to retail operating costs. We are concerned that the Authority proposes to add to the benchmark where new costs are identified, because, as we submitted previously in regard to the BRCI for 2011-12, we believe that negates the value of the benchmark. We note that: “The Authority will have regard for any costs incurred in those jurisdictions that are not relevant to Queensland.”<sup>43</sup> This is the obvious counter-balance, but may still not be sufficient to save the integrity of the benchmark.

We are also concerned regarding the statement: “Where reliable information on the individual components of retail costs is readily available, the Authority will consider adjusting its estimate to include those costs.”<sup>44</sup> Adjusting to include those costs would require knowledge of what element of the benchmark those costs previously represented. That information may not be readily available, and attempts at decomposition of the benchmark into all its component parts may not be fruitful and may introduce inaccuracy rather than correct for accuracy.

We caution that with substantial adjustment up or down, the benchmark approach will lose its validity, as it will morph into an actual costs approach that is not properly thought through.

We support an ongoing benchmarking approach to retail operating costs. We are concerned that substantial “adjustments” to benchmarks will destroy the worth of the benchmarks, and we caution against such adjustments.

### 5.2. CUSTOMER ACQUISITION AND RETENTION COSTS (CARC)

We have previously expressed our view that there is no justification for including an allowance for CARC. We retain this view, though we understand that the Authority is intent on retaining such an allowance.<sup>45</sup>

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43 Draft Methodology Paper, page 36

44 Draft Methodology Paper, page 36

45 Draft Methodology Paper, page 37

We note that the inclusion of CARC explicitly allows for marketing to support a competitive market. It implicitly recognises that there is effective competition in the electricity market in the Energex area, because an efficient representative retailer would only be expending any funds on customer acquisition and retention if that was the case. Because of the Queensland Government's Uniform Tariff Policy, it also has the side effect that Ergon Energy customers are paying for the costs of customer acquisition and retention, even where there is no effective competition, and therefore no funds are being expended on those activities.

If the Authority is to make an allowance for CARC, we concur with the Authority continuing with a benchmarking approach.

### 5.3. RETAIL MARGIN

We concur with the view of the Authority "that the retail margin should compensate retailers for systematic risks through the retail margin while non-systematic risks are compensated for elsewhere in the determination".<sup>46</sup>

We retain the view that the existing gross retail margin of 5% of total costs that was allowed in the BRCI calculations is realistic, and should not be any higher in the new tariffs. Arguably, it could be lower, because the retailers will be compensated based on efficient costs, rather than the BRCI mechanism that might have borne no relationship to their actual efficient costs and was not cost-reflective. Under the BRCI, retailers therefore faced higher risks than should be the case under the new framework for setting regulated retail prices.

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<sup>46</sup> Draft Methodology Paper, page 38

## 6. SETTING THE R COMPONENT OF RETAIL TARIFFS

### 6.1. ENERGY COSTS

ACIL Tasman has noted that “regardless of the chosen approach, an estimate of the cost of supplying each tariff is required. ACIL Tasman envisages that this will be best achieved by estimating the cost of supplying the individual tariff load traces. In effect, each tariff will have a different load shape and thus have different associated wholesale energy costs. The pool price modelling across the NEM will provide the half-hourly prices which can then be applied to each tariff load to establish the market cost of supplying it.”<sup>47</sup>

We note however that many different tariffs are settled in the NEM using the same Net System Load Profile (NSLP). Such tariffs will effectively have the same load shape for settlement purposes, and differentiating them will be incorrectly ascribing to them structures of cost to the representative retailer that do not actually apply to the retailer.

We also note that the Authority intends to allocate energy costs on a fully variable basis, which “would be consistent with comments made in submissions and the approach taken by IPART in its recent review of NSW retail electricity tariffs for 2010-13”.<sup>48</sup>

The cost of energy to the representative retailer of any given tariff needs to take into account how energy that is consumed on that tariff is settled in the NEM. We concur with allocating energy costs on a fully variable basis.

### 6.2. RETAIL COSTS

We understand that the Authority intends to follow the approach adopted by IPART in regard to retail operating costs – which treated 75% of retail operating costs and 100% of CARC as fixed cost components, and 25% of retail operating costs as variable cost components.<sup>49</sup>

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47 ACIL Tasman draft methodology, page 7

48 Draft Methodology Paper, page 42

49 Draft Methodology Paper, pages 43 to 44

We also note: "Given that the retail margin is calculated as a percentage of total costs, the Authority considers that an appropriate approach would be to apply the retail margin equally (on a percentage basis) to each component (fixed and variable) of retail tariffs. This would mean that, in dollar terms, larger customers would pay a higher margin than smaller customers, but that all customers pay the same margin as a percentage of their total bill."<sup>50</sup>

We believe this is a reasonable approach to the allocation of retail costs.

### **6.3. EFFECTS ON LOW INCOME CUSTOMERS OF THE ALLOCATION OF FIXED AND VARIABLE CHARGE COMPONENTS**

As mentioned in section 1.2 above, and as discussed previously in our submission to the Issues Paper, QCOSS represents the interests of residential consumers, with a particular focus on low income and other vulnerable consumers, many of whom are relatively small users of electricity, because they do not have the high-usage electrical equipment that more affluent households may have, such as swimming pool pumps and large air conditioning systems.

That is not to say that all low income households are low users of electricity. Indeed there are also low income householders who support large families, and there are those who are high users of electricity because of medical requirements or poor quality housing and inefficient appliances. People who are home during the day may also be using more electricity because they require cooling throughout the day, while others may be able to switch off cooling when they are out during the day and rely instead on the cooling systems provided by others, such as their employers. Customers with low income but high usage of electricity may be particularly in need of concessions in the form of a package of support outside any tariff mechanism.

Given different tariffs that in total are revenue neutral, i.e. they bring in the same revenue when applied across the customer base, tariffs which have higher fixed charges and lower variable charges have an adverse impact on lower usage consumers as compared with tariffs which have lower fixed charges and higher variable charges. Conversely, higher usage customers would prefer tariffs with lower variable charges and higher fixed charges.

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50 Draft Methodology Paper, page 44

## 7. OTHER ISSUES

### 7.1. ACCOUNTING FOR UNFORESEEN EVENTS

As we stated in our previous submission on the Issues Paper, we do not support a cost pass-through or catch-up mechanism.

As previously stated, it is our view that it is generally not appropriate to revise tariffs mid-year based on unforeseen events. It deflects responsibility from retailers to mitigate the effects of such events, even though they are the parties that are generally best placed to do just that. It is inequitable to pass such risks onto consumers who have no means of mitigating them.

Retailers lack incentives to control costs if they can just pass through costs that they incur in a given category. For example, the Authority suggested that “unforeseen AEMO changes (such as a reserve trader or direction event)” may be types of events that would be subject to cost pass-through events occurring.<sup>51</sup> That type of event generally occurs because retailers have not contracted adequately for wholesale purchases, so allowing such an event to have cost pass-through is counter-productive.

We concur with the view of the Authority that “Cost pass-through mechanisms tend to be included where a price path is longer than one year as forecasting becomes more difficult the longer the price path”,<sup>52</sup> whereas the Delegation that the Authority received is for a single year only, and is for a single determination to set those prices.

We do not support a cost pass-through or catch-up mechanism. We do not believe that the gazetted prices should be adjusted via a cost pass-through during the tariff year or via a catch-up mechanism in a subsequent tariff year.

We note that in its consideration of a cost pass-through or catch-up mechanism, the Authority refers to events that “are generally beyond a retailers’ control but may impose material costs or benefits on them”.<sup>53</sup> We also note that the Delegation does not envisage the Authority considering actual retailers’ costs or benefits, but rather it limits the Authority to consideration of an efficient representative retailer’s costs.

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51 Issues Paper, page 35

52 Issues Paper, page 34

53 Draft Methodology Paper, page 46

If the Authority nonetheless does choose to implement a cost pass-through or catch-up mechanism, and finds it has the ability to do so, then the following parameters should apply. The application of cost pass-through or catch-up should be strictly limited to events that would be wholly outside an efficient representative retailer's control. The events that might be considered would need to be tightly defined in the Authority's determination of prices. The circumstances that might trigger a cost pass-through or catch-up mechanism should be capable of adjusting prices up or down; they should definitely not be one-way. The trigger should also not be dependent on retailer initiation, which might be actioned only if the mechanism would be likely to put prices up, and not down.

## 7.2. TRANSITIONAL ARRANGEMENTS

We welcome the statement that "in its draft price determination the Authority will consider the impact on customers specified in the Delegation of the new tariff structures and whether any transitional arrangements are warranted".<sup>54</sup>

Without wishing to pre-empt any of the calculations that will be in the Draft Decision, we would like the Authority to consider in particular the effects that new tariffs may have on low income customers.

As discussed in section 6.3 above, those customers may be:

- Low usage customers who may be adversely affected by high fixed charges; or
- Customers with high non-discretionary electricity use, who may be adversely affected by the Inclining Block Tariff structure that is being implemented.

We appreciate that while the Authority does have jurisdiction over the extent to which tariffs comprise fixed or variable charges, the Queensland Government rather than the Authority made the decision to implement an Inclining Block Tariff. We also appreciate that the Delegation requires the Authority to pass-through network costs to the extent possible in its determination of regulated retail tariffs, and the Authority has no jurisdiction over the setting of network charges.

Notwithstanding these limitations, it is the Authority that determines regulated retail tariffs. In that determination process, it is the Authority that must consider the impact on consumers of the new regulated retail tariffs as a whole, besides the Authority's analysis of the various cost elements that make up the regulated retail tariffs.

We therefore again highlight the following comment in the Minister's covering letter to the Delegation, which we quoted in section 1.1 above, because we consider it to be important:

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<sup>54</sup> Draft Methodology Paper, page 47

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*With the introduction of the new price setting methodology in 2012-13, the Government wishes to again stress that the Authority must consider the impact of price rises on consumers when determining regulated prices.*

The Authority must consider the impact of price rises on consumers when determining regulated retail electricity prices for 2012-13.

### **7.3. TERMS AND CONDITIONS OF RETAIL TARIFFS**

We note the comment: “The Authority understands that it will be responsible for determining the retail tariffs and prices while the Queensland Government (in conjunction with Energex and, possibly, Ergon Energy) will be responsible for determining the associated eligibility criteria and other terms and conditions.”<sup>55</sup>

We urge the Authority to impress upon the Queensland Government the importance of determining the associated eligibility criteria and other terms and conditions in an open consultative process.

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55 Draft Methodology Paper, page 47