Mr Gary Henry
Queensland Competition Authority
L19 12 Creek St
Brisbane QLD 4000
SENT BY EMAIL

13 April 2012

Dear Mr Henry,

Re: Draft Determination – Regulated Retail Electricity Prices 2012-13

Thank you for the opportunity to provide a response to the 'Draft Determination – Regulated Retail Electricity Prices 2012-13'.

As you are aware, QEnergy is a new electricity retailer in Queensland. QEnergy offers its services to residential and business customers around Queensland, with a strong focus on building relationships with Queensland businesses. QEnergy has had particular success in offering choice to small business customers outside of South East Queensland, who have not previously had the opportunity to benefit from competition. QEnergy employs 45 Queenslanders in South Brisbane, so has invested heavily in the future of the Queensland retail electricity market.

As noted in our previous submissions, QEnergy supports the decision to introduce a new price determination process based on a network (N) plus retail (R) cost build-up approach, where network costs are treated as a pass-through and retail costs are determined by the Queensland Competition Authority (the Authority). In our view, this approach promotes transparency and reduces risk for all participants in the setting of tariff prices.

QEnergy also considers that in the large part, the draft determination reflects the proposed methodology. In particular, QEnergy commends the Authority on making some allocation within the pricing buildup for headroom.

However, QEnergy considers that the major flaw in the draft determination is that the headroom allowance is insufficient to maintain competition within even the South-East Queensland marketplace. QEnergy also considers that the pricing buildup omits an allowance for the requirement to provide prudential capital (and the consequent cost of this capital) to participate in the national electricity market. These issues, as well as other issues of import to the draft determination, are discussed in greater detail below.

Insufficient headroom to support ongoing competition

As noted by the Authority in its draft determination, the process of competition has been developing well since Full Retail Competition was announced in 2007, at least in South-East Queensland. However, until price regulation is removed, it will remain vulnerable to the regulatory price-setting process. The proposed allocation of insufficient headroom in the Authority's draft determination will undo much of the good work done so far.

The inclusion of retailer headroom in the BRCI process to date has had the purpose of ensuring that there is scope for retailers to provide discounts to customers, thus promoting the entry of new retailers into the market and the development of competition. In this way,

the Authority's price gazettals to date have effectively set a price cap on the market, thus allowing competition to deliver discounts and efficient pricing to customers (as well as minimising the Ergon Energy Community Service Obligation).

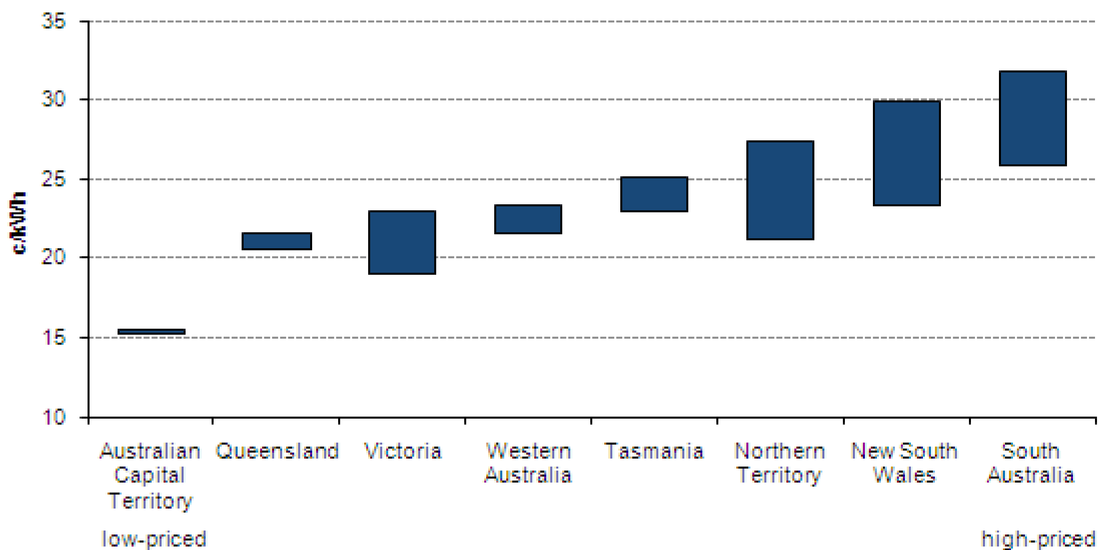
The level of headroom set by the Authority in the draft determination effectively constrains product discounts against the 'as is' position – the gazetted tariff – to only 5%. Pricing is a core reason for consumers to churn, and consequently, if the pricing offer is constrained significantly relative to the 'as is' position, the likelihood of customer acceptance of this offer is reduced dramatically.

Retailers make their decisions as to where to deploy their sales forces based on both achieving an appropriate customer return – which has been addressed by the Authority – but also the likely propensity to churn and consequent conversion rates of the prospective customer base. The establishment of a low level of headroom – as put forward by the Authority in the draft determination – and consequent low conversion rates will make Queensland an extremely unattractive market for prospective retailers.

Note that the graph in the Authority's draft determination page 45 makes it clear that Queensland churn rates have been falling steadily since the announcement of the methodology review in September. This is indicative of market concern regarding the import of the current review.

Putting this into the context of genuine market data, reviewing the Authority's current Price Comparator, residential customer offers range from 5% to 10% discounts (and in addition, other non-discount incentives). This is in excess of the 5% headroom allowed by the Authority in the draft determination.

Market surveys and retail experience indicate that residential customers will churn for 5%. However, as shown in the chart below from the Office of the Tasmanian Economic Regulator, headroom even prior to this draft determination has been higher in all other states than in Queensland with the exception of the Australian Capital Territory (ACT):



In the case of the ACT, the Australian Energy Markets Commission in 2010 determined that there was no effective competition in that market for small retail electricity customers. Note also that the ICRC remit, unlike that of the Authority, does not include provision in its price-

setting process to consider the impact of determinations upon competition, so this outcome is unsurprising.

Under the Authority's draft determination, retail costs will increase by around 20% – carbon impact 10%, increases in environmental schemes 2%, network increases 8% – whilst revenues increase by only 4% for the average residential customer or remain essentially flat for the average business customer. Queensland's position as an appropriate market for retailers to allocate their resources will be diminished still further.

Additionally, experience indicates that business customers require a larger incentive to churn and current market contracts offer discounts of 15% to 20%. This is significantly in excess of the allocations put forward in the Authority's draft determination and suggests that there is absolutely insufficient room for ongoing competition for small business customers under the Authority's draft determination.

Finally, current contract discounts of above this 5% will leave existing customers on market contracts as marginal customers, requiring retailers in South-East Queensland to exercise regulatory disruption clauses and break market contracts by returning customers to tariff. Whilst it may be argued that competitor retailers could charge higher than tariff and then discount to tariff, existing companies undertaking this strategy have been plagued by complaints and bad press and further erosion of customer confidence in the market.

The cessation of electricity competition in South-East Queensland will have a whole range of flowon impacts to other participants dependent on retail electricity market competition, including brokers, marketing companies, recipients of sponsorship (these breakages have already commenced), and affiliated community groups.

Over time, a framework for competition – including a sufficient component of headroom – allows more customers to move off the regulated tariff onto contracts, and continues to create a framework in which customers have choice, and where competition rather than the regulator disciplines prices. Essentially, headroom is required to create the conditions for long-term price competition which is good for customers in the medium- to long-term.

Under the Authority's draft determination, there will be insufficient headroom for competition in South-East Queensland, and what the Authority argues is a well-functioning competitive market will be exited by new entrant retailers from the perspective of marketing for new customers (including QEnergy). Whilst any customers who had already churned to new entrant retailers will be supported without loss at tariff levels, marketing for new customers in Queensland will not be commercial given more appropriate headroom levels – both explicit and implicit – interstate.

In terms of setting an appropriate level of headroom, QEnergy recommends that the Authority continue its approach of an explicit setting of the level of headroom, but that it review market discounts – 5% to 10% for residential customers and 15% to 20% for business customers – and set headroom at these levels. As discussed below, competitive pressures will compete away any excess headroom so the Authority should err on the high side rather than the low side. If the Authority so wished, these levels could be lowered in future years but at least it would avoid the wholesale destruction of competition in South-East Queensland that appears likely under current settings.

No longer setting a price ceiling

The Authority's proposed insufficient level of headroom is also significant because it means that, in effect, the Authority is no longer setting a price ceiling. Instead, under its proposed methodology, the Authority will set the competitive market price.

A price ceiling both protects consumers and supports competition. It removes the capacity for any suppliers with market power to charge excess prices or make excess profits at the expense of consumers and, simultaneously, allows retailers to compete by offering discounts to consumers below the default price ceiling. The setting of a price ceiling is one of the key aspects of the current approach that has, to date, successfully managed to foster the process of competition in Queensland.

The insufficient level of headroom in the Authority's draft determination will leave the South-East Queensland market open only to the two incumbent retailers – AGL and Origin Energy – resulting in an effective re-regulation of South-East Queensland as well as regional Queensland.

Capital requirements and return on capital

An electricity retailer – like any market trader – requires two different types of capital:

- *Business capital*, to fund establishment and growth of the business as well as customer payment delays. This capital is risky by nature and represents the investors' equity in the business.
- *Prudential capital*, bank guarantees which provide surety to market counterparties that the retailer will be able to deliver on its market obligations.

According to the Authority, the retail margin represents the reward to investors for committing capital to a business and for accepting risks associated with providing retail electricity services. The type of capital to which the Authority is referring is business capital and is covered by the retail margin.

As noted above, the second type of capital required by the electricity retailer is prudential capital, and the volume of this prudential capital required in the Australian electricity market is a barrier to entry for retailers. It appears that the Authority's proposed methodology and draft determination do not include the costs of providing prudential capital to these markets as this is a very different type of capital from that required to run the business and hence which is covered by the retail margin.

For a non-vertically integrated incumbent retailer of the type identified as the model retailer within the Authority's draft determination, some of the prudential capital required by the Australian Energy Markets Operator (AEMO) can be managed through the acquisition of either reallocation hedges, or straight hedges with separately purchased reallocation credits available through a traded market. Under a reallocation hedge – or through a reallocation certificate – the guarantee requirement is passed to another party, say a generator. For the calculations in the following sections, the full load is considered to be hedged using straight hedge cover with reallocation credits purchased against all of it. This additional cost is also covered in subsequent sections.

The costs per customer of prudential capital are a function of the actual amount of capital required by providers, and the cost of capital to the retailer. Both of these elements are in large part determined by the credit rating of the retailer, a point on which the review is

silent. Given that, out of the three incumbents across Australia – TRUEnergy, AGL and Origin Energy – two have sub-investment grade and one an investment grade rating, QEnergy considers that modelling the retailer as having a sub-investment grade (BBB) rating and consequently funding costs, prudential requirements and expected returns is appropriate.

However, QEnergy recognises that setting the funding costs based on market participants rather than benchmarking may be difficult. At the very least, though, comparisons should be drawn between the allowable rate of return for regulated monopolies relative to the amount allowed for retailers. Retail risks are significantly higher than those of a regulated monopoly:

- retailers are subject to competition and can lose customers easily;
- retailers have much higher uncertainty around price inputs – the Australian electricity market is the most volatile commodity market in the world;
- the Authority's determination period is shorter than that of AER for distributors (one versus five years)
- retailers have a much greater challenge in raising funds because of the less securitisable nature of the assets on retailer balance sheets (customer cashflows versus hard assets such as transformers).

QEnergy considers that the cost of or return on capital allowed by the Authority in calculating the cost of prudential capital should reflect returns appropriate to a sub-investment grade entity. However, if this is not possible, they should be on a par with that of the regulated distribution businesses operating in Queensland, ENERGEX and Ergon Energy. This was determined by the Australian Energy Regulator to be 9.72% in the most recent Distribution Determinations, and is the figure that has been used for calculation throughout.

To participate in the electricity markets, retailers must provide prudential capital to:

- AEMO for excess offset against the reallocation credits in place by the retailer
- hedge counterparties for the swap hedging in place
- Network Service Providers for the network collections undertaken on their behalf

All three counterparties require bank guarantees in favour of the party extending credit to the retailer.

The indicative costs of providing prudential capital to allow operation in the market for the non vertically integrated incumbent model retailer are given below. QEnergy considers that the Authority should include an explicit allowance for these costs separate from the retail margin (which covers return to business equity) or retail operating costs (in which it is not considered).

Cost of prudential provision to AEMO

Support for AEMO prudentials is calculated by AEMO on a quarterly basis with the method published on the AEMO website. Most retailers use the reduced trading limit methodology which in gross terms requires a guarantee to support only the time period between consumption of the energy and the payment to AEMO, approximately four weeks. A retailer can partially offset the guarantee requirement by purchasing a reallocated hedge, however this is only a partial offset as seven days and the GST portion of the energy cost cannot be covered by the reallocation transaction.

Unusually, in AEMO's case the guarantee is required to be a one hour callable guarantee, thus incurring additional cost.

Cost of funding the reallocated load can be calculated as follows:

{(ave daily load x regional reference price x volatility factor x loss factor + GST) x credit time period} – {(ave daily reallocated load at the node x regional reference price x volatility factor) x (credit time period – reaction time period)} x (cost of capital + cost of guarantee)/365

which QEnergy calculates as:

{(1MWh * $51.21 * 2.6 * 1.05) * 1.1) * 42} – {(1.05MWh * $51.21 * 2.6) * (42-7)} * (0.0972+0.025) / 365

= $0.5242 /MWh

Note that average daily load is at the meter and therefore the calculation specifically includes a grossup for loss factors. On the other hand, reallocated load volume is at the node and consequently needs to be grossed up for loss factors.

Regional reference prices and volatility factors are based on the assumed impact of carbon on these variables as published by AEMO in their recent consultation paper 'Credit Limits Methodology Version 10 Summary of Changes'.

Cost of funding is assumed to be at the level allocated to ENERGEX and Ergon Energy in the last distribution determination (9.72%).

Banks are currently charging 2.5% administrative charges for the provision of a bank guarantee against cash (the capital assumed to be priced at 9.72%).

Cost of prudential provision to hedge providers

Hedge providers require bank guarantees to cover the potential future credit exposure for the hedges they provide. This is calculated by summing the notional hedge amount (volume by price) for each hedge and then applying the 10% for the hedges maturing in the next 12 months and 12% for hedges maturing beyond 12 months.

For each MWh hedged this is calculated as:

(volume in MWh x price in MWh x 10% for first 12 months x 12% for remainder of hedge) x (cost of capital + cost of guarantee)

(1MWh x $66.13 / MWh x average 11%) x (0.0972 + 0.025) = $0.8889 / MWh

Cost of prudential provision to network companies

Network companies require credit support to be provided for the period between the use of the NUoS services and the payment of the network invoice. The amount is calculated as 25% of the total annual retailer charges, although there is a threshold under which credit support is not required. The calculation of prudential costs payable to networks are a function of the total number of small and large customers which the incumbent retailer holds, and their credit rating which we assume to be sub-investment grade. In this case QEnergy calculates the cost of prudential guarantees to networks for a BBB retailer with 40% market share as is given overleaf:

Network guarantee requirement for large incumbent with 40% market share and BBB rating

Maximum credit allowance	Annual report rev		1,736,400,000.00
			25%
	max credit allowance		434,100,000.00
Credit allowance for retailer	Allowance for BBB		37.5%
			162,787,500.00
Network charge liability	Network liability for small customers		290.00
	Network liability for large customers		1,056.00
	Number of small customers in SEQ		1,204,000.00
	Number of large customers in SEQ		112,000.00
	Assume retailer has 40%		481,600.00
			44,800.00
	Network liability small customers		139,664,000.00
	Network liability large customers		47,308,800.00
			186,972,800.00
Guarantee requirement	Net network liability excluding allowance		24,185,300.00
	Net network liability for small customers		18,065,813.53
	Net network liability for large customers		6,119,486.47
	Per customer cost for small customers	$	37.51
	Annual cost of funding at 9.72%	$	3.65
	Annual cost of guarantee at 2.52%	$	0.94
	Funding cost per small customer	$	4.58

Note that the total cost of network prudentials is given on a fixed per customer basis, rather than as a variable rate basis as has been the case in previous calculations, for ease of calculation.

Retail operating cost

Turning to more subsidiary issues, the Authority considers its retail operating cost of $83.78 per customer appropriate based largely on benchmarking by IPART. IPART in turn used proprietary information from incumbent retailers, although the Authority was not given access to the information to which it is benchmarking.

QEnergy considers this ROC to be low on the basis that the infrastructure required to support customers is fixed regardless of the number of customers – a fact acknowledged as important by the Authority in its reference to the higher figures of OTTER and the ICRC. In NSW there are a larger number of customers to spread this cost across. Given that the

Authority requires the retailer to service customers on a standalone basis then the per customer cost should be higher than that proposed by IPART.

Estimation of energy costs

QEnergy considers the Energy Purchase Costs component of the Authority's draft determination to be largely valid and well thought out, using visible market data with transparent methodologies in determining the wholesale costs faced by a retailer.

However QEnergy has a concern regarding the calculation of the Large Renewable Energy Certificates. Here, ACIL used the historic AFMA curves in calculating the average 2012 and 2013 LGC price. The 2012 price used weekly prices from 7 January 2010 to 18 January 2012 which includes prices prior to the split between the Large and Small certificate schemes at 1 January 2011. These prices would have been heavily influenced by the oversupply of certificates from April to December 2010, the impetus for the splitting of the two schemes.

As such, QEnergy considers that these prices do not in fact reflect the scheme which is currently operating and so should be excluded from the calculation. QEnergy suggests that ACIL use only 2011 data to calculate both the 2012 and 2013 prices. As QEnergy does not have access to the underlying series used by ACIL to calculate these prices we cannot offer specific alternative pricing, rather we are suggesting a change in the included calculation period.

In addition, ACIL has not made any allowance for the cost of reallocation certificates as discussed in previous sections. These certificates can be priced and purchased independently of the underlying hedge, and current prices will increase as of 1 July 2012 with the introduction of carbon, just as the level of required prudential support will increase. Market pricing obtained by QEnergy for the period post 1 July 2012 is $0.94c / MWh.

QEnergy's position

QEnergy considers that the proposed gazetted tariff prices in the Authority's draft determination do not support the Authority's remit to consider the impacts of the determination on competition, and will lead to a removal of genuine electricity competition in South-East Queensland. As proposed in the draft determination, headroom allocations are too low and opportunities for non-incumbent retailers to compete by offering attractively priced products into the market are insufficient and are not attractive relative to other markets in which retailers can operate.

This will lead to a re-regulation of South-East Queensland with an effective oligopoly being re-established, driving poor outcomes for consumers in terms of long-run efficient price setting, product innovation and customer service.

As previously foreshadowed, based on the Authority's draft determination, QEnergy will most likely not actively market to small Queensland customers after the new framework commences if the levels incorporated in the draft determation are left in place. QEnergy will focus instead on growing its business and customer base in other states.

QEnergy also notes the significant sovereign risk issues that arise from the proposed regulatory change, both for incumbent businesses like Origin Energy and AGL who purchased State assets and for businesses such as QEnergy who have invested to establish in the State but will withdraw from competitively retailing should the levels as proposed be

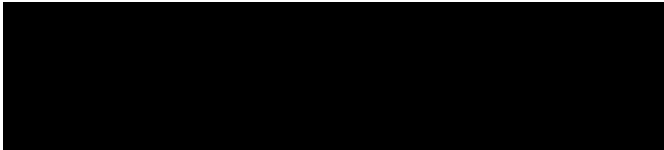
gazetted (although we will clearly continue to service existing customers in accordance with our licence obligations).

QEnergy considers that these outcomes will be bad for Queensland and bad for consumers, and accordingly QEnergy respectfully suggests that the Authority should:

- increase headroom levels to current market discounts – 5% to 10% for residential customers and 15% to 20% for business customers – to allow current contracts to remain on foot and competition to continue at the current 'acceptable' levels;
- increase retail operating costs to a level more consistent with the considerably smaller market available to retailers in South-East Queensland than the model state of NSW;
- make specific allowance for the costs of prudential provision by the model retailer which appears to have been omitted from the calculation;
- include the cost of reallocation certificates into the Authority's energy costs;
- omit 2010 prices from the LREC time series when calculating average LREC prices.

Thank you again for the opportunity to comment on these issues. If you have any queries or comments regarding this letter, please do not hesitate to contact Kate Farrar, Managing Director on (07) 3339 9500.

Yours sincerely



Kate Farrar
Managing Director