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Professor Roy Green
Chairman
Queensland Competition Authority
Level 27, 145 Ann Street
Brisbane, QLD, 4000

By email: electricity@qca.org.au

Dear Professor Green,

CANEGROWERS response to QCA Draft Determination Regulated Retail Prices for 2017-18

CANEGROWERS notes that the increase in energy costs expected to occur between 2016–17 and 2017–18 has been largely offset by expected decreases in network costs for many notified prices. While this is a welcome development, it is very disconcerting that the regulated retail electricity prices contained in the draft determination of regulated retail prices for 2017-18 are higher than required by the Ministerial directive.

CANEGROWERS notes the QCA proposed continuation of transitional tariffs and the application of lower network prices in the calculation of proposed retail tariffs in the Ergon network. However, we have several concerns with the draft determination and ask the QCA to take these into account in making its final determination.

Flawed application of the N+R framework

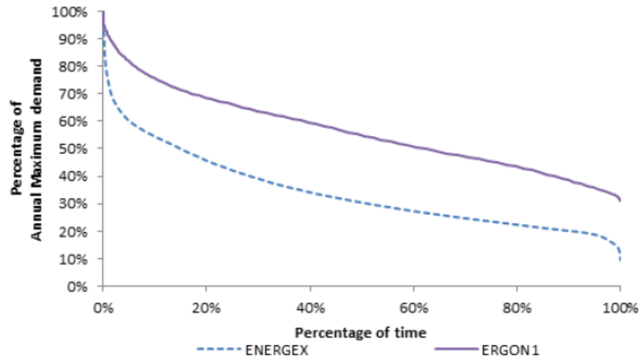
In calculating the underlying cost structure, QCA has applied Energex network costs and applied these to the Ergon network. It has not taken account of the fact that many of the costs in the Energex area do not apply in the Ergon area. A significant factor is that the Energex load profile is peakier than the Ergon load profile. This means that the cost of energy in Energex load profile is higher than that faced by Ergon.

This is acknowledged in the draft determination, but not taken into account in the proposed retail prices. Presumably the reason (as previously advised by QCA) for this is to minimise the impact of the determination on the government's payment to Ergon in the state's uniform tariff policy (UTP).

Using the Energex NSLP to calculate the prudential costs exacerbates the problem. It loads Ergon customers with costs that may exist in the Energex network but do not exist in the Ergon network. This approach comes down to the QCA's interpretation of the UTP and its application.

It is important that Ergon customers are not saddled with costs that exist in the Energex system and not in the Ergon network. The consequence of the QCA approach is to reduce the cost of the UTP to government. It does not to promote competition in the Queensland retail electricity market or to set a framework for all electricity industry participants that promotes efficient, economical and environmentally sound supply and use.

Figure 8 - Ergon vs Energex Net System Load Profile in FY 2015

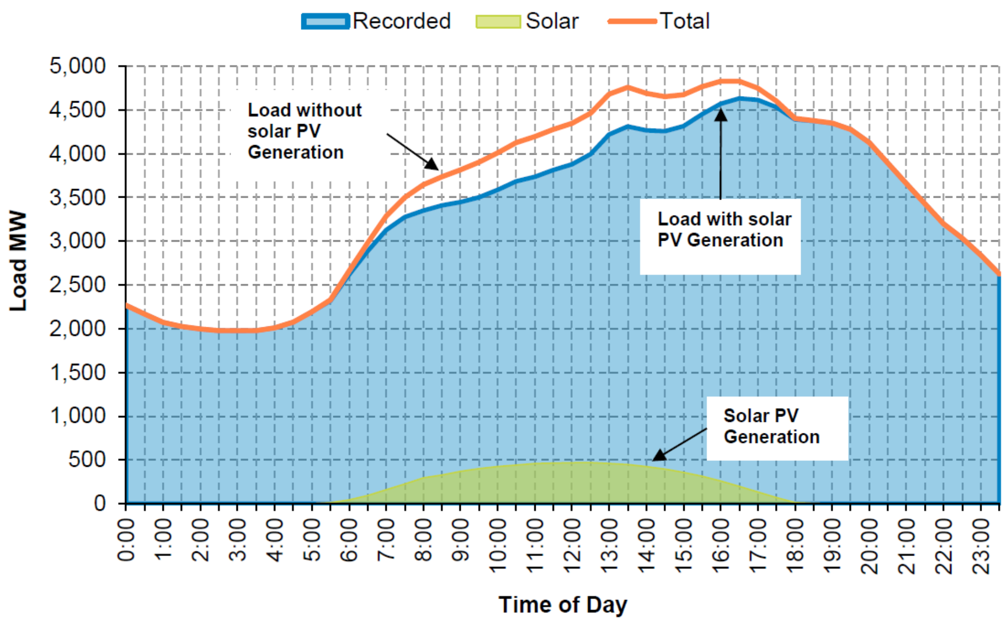


Source: Sapere analysis of AEMO data

In the Draft Determination QCA reports "Over the past few years, the Energex NSLP has become peakier due to increased solar generation reducing daytime demand but having no effect on the evening peak demand. Figure 8 shows how the NSLP has become peakier over time". This observation is at odds with the information contained in Energex's Distribution Annual Planning Report, 2016/17-2020/21, Volume 1.

> "The net result is that on a typical peak day, there may be an overall reduction in network peak demand as a result of solar PV. As shown in Figure 9 for 1 February 2016, the system peak occurred at 4.30 pm, and it was estimated that solar PV reduced the peak by more than 197 MW. This was a fairly overcast day and accordingly the solar PV generation was reduced to about 75% of normal generation" (Energex DAPR, p35).

Figure 9 – Energex System Demand – Solar PV Impact, 1 February 2016



Source: Energex DAPR 2016/17-2020/21

The Energex NSLP shows that even on a cloudy day, PV is materially reducing the system peak. This is the opposite to the claim made in the QCA Draft Determination.

CANEGROWERS recommends the QCA calculate prudential costs based on the Ergon NSLP, <u>not</u> the Energex NSLP.

Large-scale Generation Certificate (LGC) prices

QCA proposes to increase the charges for LGCs at a punitive 49.9% higher in 2017-18 than in 2016-17. This begs the question for which retailers in the Ergon distribution system have the proposed charges been calculated, a new marginal retailer or an incumbent retailer? The charges identified appear to be set for a marginal retailer that has no long-term offtake contracts in place and has not made an investment in renewable energy capacity. Aware of the Australia wide policy preference for renewable energy generation and a stronger policy push towards renewable energy in Queensland, an efficient prudent retailer with evergreen customer contracts (Ergon Retail) would have managed this risk by being long with respect to renewables.

Just as retailers in the Energex network have managed their LGC price exposure, as the long-term incumbent retailer in regional Queensland, to manage its exposure Ergon retail will have longstanding purchases of Large-scale Renewable Energy Target (LRET) and Small-scale Renewable Energy Scheme (SRES) certificates. The QCA approach to setting the LGC component of prices is likely to deliver Ergon a windfall trading gain in the purchase of its certificates.

CANEGROWERS recommends the QCA calculates the LGC component of prices based on the behaviour of an efficient long term incumbent retailer.

Excessive Retail Cost Allowances

Prior to the 2016–17 determination, QCA estimated allowances for retail costs based on publicly reported data and benchmark observations of other regulatory decisions. In the 2016–17 price determination QCA, moved away from estimating efficient retailer operating costs. Instead it relied on advice from ACIL Allen in relation to efficient retail costs. QCA describes the ACIL Allen methodology as “a combination of bottom-up and benchmarking methods to estimate retail costs for residential and small business customers, informed by analysis of publicly available data, observed market offers, and detailed confidential information provided by retailers” (QCA draft determination, p29).

The ACIL Allen cost estimate is a bottom-up methodology supported by benchmarking, as noted in the draft determination. Although <u>not</u> cost based, it has become the new benchmark used by QCA for retail costs. This approach carries forward the previous excessive retail cost allowances in real terms.

The QCA’s dismissal of comments from consumer groups who considered that retail allowances should be reduced in real terms for 2017–18 because “stakeholders have not provided evidence, and we have no compelling evidence, that actual costs have fallen in real terms for retailers in the electricity market”, implies the 2016-17 retail allowances were cost based. As noted, they were not.

In the draft determination QCA acknowledges that to do another bottom-up estimate for 2017-18 was too hard – it would be costly, time-consuming and would place a significant reporting burden on retailers (QCA draft determination, p30). Instead, QCA infers the cost from observed retail mark ups on estimated cost of goods sold (COGS) and reverses the onus of proof. It is concerning that the QCA has not investigated widespread consumer concerns that electricity retail gross margins are excessive and should be lower.

The ACIL Allen benchmark is based on the difference between retail electricity price observations from across the NEM for market and standing contracts, on the one hand, and estimated costs other than retailer costs, on the other. The difference is deemed to reflect retailer costs. The resulting QCA estimates for retailer costs are excessive for two key reasons. The methodology:

i. does not provide a basis for estimating efficient retailer costs under conditions where a large portion of observed electricity prices incorporate substantial "residues", or excess margins, over and above efficient retail costs. It amounts to incorporating non-existent costs in notified prices.
ii. includes significant competition costs (customer acquisition and retention costs) that are in fact not incurred by Ergon Retail, where retail competition is not viable and does not occur for <100MWh customers under the current UTP.

CANEGROWERS raised these issues in its May 2016 submission to the 2016-17 Draft Determination. The result is retail prices well above costs. Concerns about excessive and unchecked retail margins are a principal driver of the federal Government's recent decision to commission an ACCC inquiry into retail prices and costs. That decision represents a formal recognition that the concerns raised by consumers and dismissed in the draft determination are sufficiently serious as to require an ACCC enquiry[1]. See especially item 8 below of the ACCC ToR but also the other variables that closely resemble those set out in CANEGROWERS' May 2016 submission to QCA.

1. the key cost components of electricity retail pricing and how they have changed over time
2. the existence and extent of any barriers to entry, expansion and/or exit in retail electricity markets
3. the extent and impact of vertical integration
4. the existence of, or potential for, anti-competitive behaviour by market participants and the impact of such behaviour on electricity consumers
5. any impediments to consumer choice, including transaction costs, a lack of transparent information, or other factors
6. the impact of diverse customer segments, and different levels of consumer behaviour, on electricity retailer behaviour and practices
7. identifying any regulatory issues, or market participant behaviour or practices that may not be supporting the development of competitive retail markets
8. the profitability of electricity retailers through time and the extent to which profits are, or are expected to be commensurate with risk
9. all wholesale market price, cost and conduct issues relevant to the inquiry.

Standing Offer Adjustment

One reason standing offer contracts may result in higher prices than market contracts is the fact that the customers who rely on them may be higher cost customers. They may be relatively slower to pay their bills, there may be more bad debts or defaults and there may be other reasons why the retailer requires a higher capital base to support its operations. Retailers offering lower market rates can reduce their operating capital needs by offering, for example discounts for early payment and incentives for customers to set up automatic deductions or other lower cost payment channels to settle their accounts.

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[1] ACCC, Electricity Supply & Prices, 27 March 2017, https://www.accc.gov.au/regulated-infrastructure/energy/electricity-supply-prices-inquiry

For the QCA to propose allowing a 5 per cent mark up above cost of goods sold significantly overstates the size of the margin required. In regional Queensland, Ergon faces no customer acquisition cost. Customers have no alternative but to use Ergon retail. The lack of acquisition cost, is likely to more than offset any additional margin (standing offer adjustment) to reflect the terms and conditions of the standing offer and any adverse selection bias in the customer base. In any case, where all customers remain with the incumbent retailer, there is no adverse selection bias in the first place. .

Conclusion

In calculating every component of the cost stack to determine the “actual costs of making, producing or supplying the goods or services”, QCA has taken estimates at the high end of each cost range. This appears to be designed not to promote competition in the Queensland retail electricity market or to set a framework for all electricity industry participants that promotes efficient, economical and environmentally sound supply and use, but to minimise the payment the government makes in application of the its uniform tariff policy (UTP).

CANEGROWERS supports cost reflective pricing. The evidence presented in the QCA Draft Determination is that many elements of the proposed electricity price build up in regional Queensland are very much higher than the actual costs. This has resulted in regional electricity consumers bearing a larger expense than envisaged in the Queensland Government’s UTP. This additional cost to electricity users, encourages them to explore alternative sources comes as a cost saving to the state government.

Yours faithfully

Dan Galligan
Chief Executive