Ergon Energy Corporation Limited
and
Ergon Energy Queensland Pty Ltd

Submission on the *Regulated Retail Electricity Prices 2013–14*
Draft Determination
Queensland Competition Authority
22 March 2013

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1. INTRODUCTION

Ergon Energy Corporation Limited (EECL) and Ergon Energy Queensland Pty Ltd (EEQ) welcome the opportunity to provide comment to the Queensland Competition Authority (QCA) on its *Regulated Retail Electricity Prices 2013–14 Draft Determination* (Draft Determination).

This submission is provided by:

- EECL, in its capacity as a Distribution Network Service Provider (DNSP) in Queensland; and
- EEQ, in its capacity as a non-competing area retail entity in Queensland.

In this submission, EECL and EEQ are collectively referred to as 'Ergon Energy'.

Ergon Energy has structured this submission into the following sections:

- Section 2 outlines our general comments relating to the Draft Determination; and
- Section 3 provides our specific comments on certain aspects of the Draft Determination.

Ergon Energy is available to discuss this submission or provide further detail regarding the issues raised, should the QCA require.

1. GENERAL COMMENTS

1.1. Transitional Arrangements

Ergon Energy welcomes the QCA's move to rebrand the 2012–13 obsolescent tariffs as "transitional" tariffs. This will improve customer understanding of which tariffs can be accessed throughout the transitional period. Ergon Energy is also pleased to note that new customers will now be eligible to access the transitional tariffs. Our customers will fare more equitably under this change in eligibility.

Ergon Energy supports the provision of a seven year transition period[1] to allow customers time to adjust to the price rises and alternative tariff structures associated with the cost-reflective retail tariffs. With respect to the proposed removal of Tariffs 41 (Large) and 43 (Large) from 2014–15, Ergon Energy suggests that the QCA retain these tariffs for a minimum of two years. This approach will support the flexibility to subsequently establish a final transition arrangement for these customers that aligns with the implementation of EECL's network tariff strategy and therefore removes the need for these customers to experience an unnecessary interim retail tariff structure.

In light of the significant cost impacts on very large customers from paying retail electricity prices based on their site-specific network charges, Ergon Energy supports the continuation of a transitional regulated retail tariff for very large customers. Further, we agree with the continuation of using the (Standard Asset Customer) High Voltage Demand network tariff as the basis for setting the regulated retail tariff for Ergon Energy's very large customers.

1.2. Customer Impacts

The QCA's Draft Determination on the 2013–14 Notified Prices will have a significant cost impact on most of Ergon Energy's retail customers. As a result, Ergon Energy is conscious that the risk of customers entering into hardship will increase. As many customers in regional Queensland have limited opportunities to access market offers (as the costs of supply are typically higher than the Notified Price), we understand that the QCA needs to balance the benefits of encouraging competition in south east Queensland with the price impacts on regional Queensland.

[1] For Tariffs 21, 37, 62, 65, 66, 20(Large) and 22(Small and Large), as outlined in the Draft Determination.

2. SPECIFIC COMMENTS

2.1. Energy Costs

2.1.1. Wholesale Energy Costs – Volume Weighted Average Price

Ergon Energy supports the principle of using a volume weighted average price to determine the average price of the cost of hedging providing:

- The wholesale market has sufficient liquidity such that this approach cannot be easily distorted by individual trades; and
- The resulting book build period length is representative of how retailers hedge in the wholesale electricity market.

Ergon Energy considers that distortions can occur either as a result of insufficient volume of trades or a disproportionate volume of trades in the year leading up to the contracts settlement. This risk is accentuated by the required static approach to book building the wholesale prices where all quarter prices conclude around April each year due to the QCA's legal requirement to publish the Notified Prices Final Determination by the end of May each year.

ACIL Tasman has determined that the d-cypha trade contracts are heavily traded and quotes 10,000 MW of trades. While Ergon Energy acknowledges this is much better than the volume of trade on Tradition Financial Services (TFS) contracts (50 MW), the d-cypha trade contracts still only represent a small proportion of total trades in the electricity wholesale market.

In regard to each contract type, Ergon Energy makes the following comments concerning the required liquidity for a volume weighted average price methodology:

- The peak and cap contracts are far from actively or liquidly traded. Current traded volume (which is quoted to be between 10 MW and 85 MW) is not a representative volume to determine prices on this basis. Further, a single large trade would move the benchmark by a significant amount if the prices increase or decrease shortly before April 2013 when ACIL Tasman and the QCA must finalise their approach; and
- While the flat contracts are traded more than peak and cap contracts, the traded volume is still insufficient. ACIL Tasman notes that the flat contracts traded volume on d-cypha are between 1,015 MW and 3,999 MW. The average demand in Queensland for any quarter (after 2001) has been above 5,000 MW with Quarter 1 (Q1) generally above 6,000 MW. This means that the d-cypha trade volume represents much less than actual volume consumed. For a liquid market to work, it would be expected that the traded volume was a multiple of the consumed volume.

  It is also noted that the trading period has not increased as expected. The first trades only appear in October 2011 and no quarter is really traded until August 2012, which means that the book fill period for Q3 is only nine months. This period is far too short for prudent risk management.

Though Ergon Energy remains a strong advocate for using a volume weighted average, we are mindful that this can only be achieved if there is sufficient liquidity. While there is no objective way of determining minimum liquidity, it should at least be equal to the expected physical consumption with a sufficient book build period representative of how retailers hedge in the wholesale electricity market.

Until there is enough liquidity to determine the prices from a volume weighted average price, Ergon Energy suggests returning to the time weighted approach which was used previously under the Benchmark Retail Cost Index. This period should be extended to three years to reflect longer dated deals.

It is recognised that certainty around a carbon scheme was only introduced on 8 November 2011 and that the first date of price averaging should start from this date.

If using a liquidity based mechanism, being either time-weighted or volume-weighted, the broadest possible base should be used in undertaking the calculation. The QCA should give consideration to

including liquidity observed in Over-the-Counter (or OTC) brokered markets, for example those provided by TFS and ICAP, rather than just relying on d-cypha.

2.1.2. Wholesale Energy Costs – Forward Volatility Premium

Ergon Energy notes that in order to publish the prices in May for the following financial year, ACIL Tasman needs to close assumptions in April. Ergon Energy also notes that by closing the assumptions in April, the retailer takes the risk on price volatility (i.e. price could adversely move against the retailer) and load forecast risk (i.e. load forecast could adversely move against the retailer, including change in customers numbers, weather, shape etc.) into the following year. Retailers do not hedge the full forecast load by April for the following year. Rather, retailers continue to hedge to their revised load forecasts, as evidenced by the trades occurring in the market.

Short of a very complicated catch up mechanism the following year, Ergon Energy cannot suggest an alternative to closing the assumptions in April which would not require intra-year determinations that would be arduous and cause price uncertainty for consumers. Therefore, as ACIL Tasman must determine a price by April, Ergon Energy considers that it is appropriate that the above risks are compensated for in the wholesale energy allowance.

The forecast risk should be captured by ensuring all variables that can continue to change the load forecast are appropriately captured in the load traces, while the price volatility risk should be included as part of the estimated hedge price in determining the 95th percentile of the hedged outcomes.

Ergon Energy suggests modelling the potential price movements as an option. Options volatility is well understood and can be modelled using market based inputs. Ergon Energy suggests using the Black-76 model to describe the forward movement. The inputs into the Black-76 model are:

- Market price;
- Strike price;
- Risk free rate;
- Volatility; and
- Days to maturity.

The market price and strike price should be equal to the quarterly price of the hedges as determined by ACIL Tasman. The risk free rate should be the Reserve Bank of Australia's (RBA) cash rate (currently 3 per cent) and the volatility should be what is currently published by d-cypha (currently 10 per cent). The days to maturity should be the difference between the day that ACIL Tasman stops their assumption for forward curve prices and the start of the quarter (some trading happens within the prompt quarter, but this is usually to correct for temporal issues instead of structural).

The value of each quarterly option should then be adjusted to the size of each option. The volume uncertainty with the near quarter (Q3) is smaller than the further quarter (Q2) as more of the nearer quarter is likely to have been filled already. Ergon Energy suggests using a two year book build period to estimate how much is left to fill. This would mean that Q3 2013 would start two to three months (mid April 2013 to 30 June 2013) after close of the QCA assumptions. This means that it would still have 3/24 months[2] (12.5 per cent) of its volume left to fill while Q2 2014 would start 12 months after close of assumptions (1 April 2013 to 1 April 2014) which would leave 50 per cent of hedging (12/24 months). Once the value of the options has been calculated for 1 MW, this should be multiplied by the volume left to fill.

[2] For the purposes of this analysis, we have assumed a cut-off date at end March 2013.

Applying ACIL Tasman's numbers from the Draft Determination and current (as of March 2013) assumptions from d-cypha and the RBA provides the following results:

Quarter Start	1/07/2013	1/10/2013	1/01/2014	1/04/2014
Quarter Name	Q3	Q4	Q1	Q2
Days to start of quarter	91	183	275	365
Market and Strike price	53.53	54.97	65.77	53.28
Value of call option (1 MW)	1.28	1.99	3.07	2.98
Proportion of book still to fill	12.47%	25.07%	37.67%	50.00%
Value of option * book fill	0.16	0.50	1.16	1.49
Total cost of option	0.04	0.13	0.29	0.37

The total cost of option is determined by multiplying the value of option by the book fill with what proportion of the year relates to that quarter. For example, Q3 has 92 days of 365 in the year (non-leap year). This means that the value of option multiplied by book fill of $0.16/MW needs to be multiplied by 92/365 which gives the total cost of option of $0.04/MW.

If assumptions do not change this would add $0.83/MW to the total cost of hedges for 2013.

2.1.3. Other Energy Costs – Prudential Capital

In setting the prudential capital allowance, ACIL Tasman has used the Weighted Average Cost of Capital (WACC) rate currently applied to the Queensland DNSPs[3] (9.72 per cent) as a starting point and subtracted a return on cash (3 per cent) to give a net funding cost of 6.72 per cent.

Ergon Energy considers that it would be more appropriate to use a WACC rate for an electricity retailer as opposed to an electricity distributor. It is noted that the Independent Pricing and Regulatory Tribunal (IPART), as part of its annual review of regulated retail electricity prices, determines a WACC rate for an electricity retailer. Further, IPART is in the process of undertaking a more detailed review of an appropriate WACC rate for an electricity retailer for the purposes of a three year electricity retail pricing determination commencing in 2013–14. The draft report is due for release in April 2013. Ergon Energy believes the QCA should consider IPART's findings.

2.2. Retail Costs

2.2.1. Retail Operating Cost (ROC) Allowance

Ergon Energy notes that the QCA has decided to continue to use a benchmarking approach to determining the ROC allowance and will base its estimate of ROC for 2013–14 on the 2012–13 allowance, escalated by inflation. Ergon Energy also notes that the QCA has committed to considering any new information identified in IPART's upcoming Draft Determination on ROC in preparing its Final Determination.

While acknowledging the benefits of a benchmarking approach, it is important to consider any Queensland specific issues that may impact on a retailer's operating costs. For example, with the significant price rises experienced by Queensland electricity customers over the past few years, more customers are entering into hardship. For retailers, this means increased operating costs due to higher debt levels, longer debt carrying times, increased resources invested into financial management and hardship programs etc. Also, large price rises in residential tariffs are likely to drive a significant increase in phone calls to our National Call Centre which may adversely impact the ROC.

2.3. Accounting for Unforseen or Uncertain Events

Ergon Energy supports the inclusion of a cost pass through mechanism where there has been a material change in the actual costs of supply during the year.

[3] As determined by the Australian Energy Regulator in Ergon Energy and Energex's Final Distribution Determination for the 2010–15 regulatory control period.

2.4. Metering

Ergon Energy would like to reiterate that any tariff changes that require a meter change will require a "Form A" to be lodged by the customer's contractor[4] and the customer's switchboard may need to be upgraded to comply with the requirements of the Queensland Electricity Connection and Metering Manual (QECMM).

It should be noted that there will be instances where the cost of upgrading switchboards for compliance may be considerable. However, the introduction of transitional tariffs means customers can factor in these costs when assessing the benefits of moving tariffs (excluding obsolete tariffs such as Tariff 37).

Additionally, consideration needs to be given to the uncertainty surrounding customer demand for meter changes as result of customers wishing to move to alternative tariffs. This impacts our metering program and may lead to inefficiencies. As stated in our submission to the Transitional Issues Consultation Paper,[5] transition methods should accommodate a gradual transfer of customers to new tariffs in a cost effective and efficient manner.

2.5. Obsolete Tariffs

Ergon Energy supports the removal of obsolete Tariffs 53, 63 and 64 from 2013–14.

2.6. Tariff Schedule

The draft Tariff Schedule for 2013–14 currently states "Tariff 43 – General Supply Demand – Time-of-Use (Obsolescent)".[6] This title should reference Tariff 43 (Large).

[4] Customers whose premises were connected to the network from 2005 onwards or who have had switchboard upgrade work completed that has required the submission of a "Form A" (e.g. solar inverter energy system installation) should already have meter isolation link/s installed and Ergon Energy can install the meter without further electrical work being required. Those premises connected prior to 2005 will require assessment by the customer's electrical contractor to confirm the level of compliance and where identified, will require the installation of meter isolation link/s and submission of a "Form A" by the customer's electrical contractor to permit the installation of the new meter by Ergon Energy.

[5] Ergon Energy (2013), *Submission on the Regulated Retail Electricity Prices 2013–14: Transitional Issues, Consultation Paper,* 7 January 2013, p6.

[6] Refer to page 128, Appendix E.