QCOSS Energy Consumer Advocacy Project

QCOSS Submission to the QCA Consultation Paper on Cost Components and Other Issues

7 January 2013

QCOSS
queensland council of social service inc
WORKING FOR A FAIR QUEENSLAND

About QCOSS

The Queensland Council of Social Service (QCOSS) is Queensland's peak representative body for the community services industry. QCOSS represents approximately 600 member organisations working across Queensland in a broad range of portfolios. We support organisations and work to address the causes of poverty and disadvantage. A key part of this role is our engagement with the State Government to secure the best outcomes for QCOSS members and support the needs of vulnerable Queenslanders.

QCOSS is funded by the Department of Energy and Water Supply and Department of Justice and the Attorney-General for an energy consumer advocacy project in Queensland. The purpose of this project is to advocate on behalf of Queensland consumers and particularly vulnerable and low income households in relation to energy and pricing. This work is supported by an advisory group involving other key consumer groups in Queensland.

About this Submission

The Queensland Council of Social Service (QCOSS) welcomes the opportunity to comment on the QCA Consultation Paper on Cost Components and Other Issues. QCOSS has actively participated in all stages of the QCA pricing and tariff review process as the outcomes are of great significance to Queensland consumers, particularly in view of the recent rising energy costs experienced by households and the scope of tariff reform expected from 2013-14.

QCOSS has engaged Etrog Consulting Pty Ltd to provide advice to QCOSS on the Queensland Competition Authority (QCA) Consultation Paper on Cost Components and Other Issues with a focus on 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 Consultation Paper on Cost Components and Other Issues.

This consultancy was funded by the Consumer Advocacy Panel (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.

Preliminary Comments

It is critically important that electricity price increases are both fully justifiable and minimised to the greatest extent possible, while maintaining a viable, sustainable, efficient and competitive electricity industry. The methodology used to determine the regulated price must therefore be defensible and based on the most accurate data available. Our views as to the appropriateness of the QCA's assessment of retail and

energy costs are outlined in the attached submission prepared by Etrog Consulting on our behalf. While there are many points on which we note our support for the QCA approach, the submission raises a number of issues including:

- the importance of modelling the effect that changes to regulated retail electricity tariffs and prices will have on consumers;
- the setting of network tariffs that comprise the N cost component;
- the importance of considering the costs and benefits of different options to allow for time of use signals in wholesale energy costs;
- the need for wholesale energy cost calculations to reflect market and legislative realities, including the impact of the carbon price;
- the inclusion and allowance for Customer Acquisition and Retention Costs;
- the allowance for the retail margin;
- the calculation of the Small-scale Renewable Energy Scheme costs; and
- the inclusion and allowance for headroom.

The manner in which costs are allocated and recovered across the customer base through tariff design is also of great importance to consumers, because tariff design can benefit some groups of consumers while others are significantly disadvantaged. Our submission therefore also comments on the impact on some customer segments that will result from the revised tariff arrangements, in particular as a result of the expected increase in the fixed charge component. It is our strong view that there should be a public and full examination of the customer impacts of the proposed changes before and during a transition period. We believe the QCA should take into account the directions provided in the Minister for Energy and Water Supply's covering letter to the Delegation which would require the QCA to consider the impacts of price increases on struggling Queensland households and businesses when determining regulated retail electricity prices for the next three years.

Tariff reform will affect households with different energy consumption patterns differently. In particular, customers at the extremes of low and high consumption could be significantly worse off. Assistance in the form of concessions and support for energy efficiency will be required where those affected customers are vulnerable or disadvantaged. While we understand that concessions and other assistance are matters for the Queensland government we would suggest that it is the remit of the QCA, given the instructions in the covering letter to the Ministerial Delegation, to take account of the price impacts on various customer segments in making its determination. We intend to provide input to the government separately on these issues through the public consultation currently underway to develop a 30 Year Energy Plan for Queensland.

Further detail in relation to all these matters and additional points follows in the attached submission. We look forward to continuing to represent the interests of Queensland consumers in energy related matters. For further information or to clarify any aspect of this submission, please contact Carly Allen, Team Leader Low Income Consumer Advocacy on 07 3004 6909 or email carlya@qcoss.org.au.

REPORT

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Regulated Retail Electricity Prices 2013-14: Comments on Cost Components and Other Issues

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The information in this report is of a general nature. It is not intended to be relied upon for the making of specific financial decisions.

TABLE OF CONTENTS

EXECUTIVE SUMMARY

This report has been prepared by Etrog Consulting Pty Ltd for Queensland Council of Social Service (QCOSS). It comments on the Consultation Paper on Cost Components and Other Issues in regard to regulated retail electricity prices to apply in Queensland from 1 July 2013 to 30 June 2014. The Consultation Paper was published by the Queensland Competition Authority on 12 December 2012, inviting submissions from interested parties in relation to the three cost components – network, energy and retail – and other matters relevant to this review that the Authority is required to consider.

Our main concerns are in the following areas (section references in this report are given in brackets). On other matters, we would be concerned if the Authority were to depart from its previous positions in its determination of regulated retail prices.

Introduction

- The Authority must particularly take into particular account the impacts of price increases on struggling Queensland households and businesses when determining regulated retail electricity prices for 2013-14. (section 1.1)

- We urge the Queensland Government to ensure that its Delegations to the Authority fully reflect its instructions to the Authority, and that important matters should not be included only in the Minister's covering letters. (section 1.1)

- We urge the Authority and the Queensland Government to make available at the earliest opportunity sufficient data to enable modelling of the effects that changes to regulated retail electricity tariffs and prices will have on consumers, particularly disadvantaged and low income consumers, and also to release any modelling that they have already undertaken to support any policy decisions that have been made to date. (section 1.2)

Network costs

- The Authority should request and influence the network tariff proposals that Energex makes to the Australian Energy Regulator (AER) to provide the best outcomes for retail tariffs for small customers, to meet the objectives of stakeholders, including the Authority itself, Government, retailers, distributors and consumers. (section 2.1)

Energy costs

- The Authority should use a market-based approach rather than a cost-based approach to estimate the cost of purchasing wholesale energy. (section 3.3.1)

- The Authority should consult separately on enhancing time of use signals in the R component of regulated retail electricity prices. The consultation should include cost-benefit analysis of various options for implementation. (section 3.3.2)

- Wholesale energy costs for setting regulated retail electricity prices should be modelled based on actual costs given the reality of the Queensland electricity industry and the legislative, regulatory and market environment in which it operates. This includes the reality of a carbon tax. If other scenarios are modelled, the results of that modelling should not be published without clear explanation of their limitations. (section 3.3.3)

- The cost of the Queensland Gas Scheme should be based on 15% cover and an averaging of Gas Electricity Certificate (GEC) prices from AFMA. The length of time over which they are averaged should be the same as the length of time over which the purchasing of contracts occurs for hedging of wholesale energy costs. (section 3.4.1)

- In estimating the cost of Small-scale Technology Certificates (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 its STCs. (section 3.4.2)

Retail costs

- No allowance should be made for customer acquisition and retention costs (CARC) in regulated retail electricity prices in Queensland. If the Authority is to make an allowance for CARC, it should be at a much lower level than that allowed in the Final Determination for 2012-13. (section 4.2.2)

- The gross retail margin of 5% of total costs that was allowed in the Benchmark Retail Cost Index (BRCI) calculations is realistic, and should not be any higher in the new tariffs. Instead, it should 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. (section 4.3)

Competition and other issues

- The Authority should make no additional allowance for headroom in notified prices for 2013-14. (section 5.1.5)

- The gazetted prices should not be adjusted via a cost pass-through during the tariff year, or via a catch-up mechanism in a subsequent tariff year. One exception to the above may be if a change of Government policy requires the Authority to make changes to regulated pricing during the tariff year. In that case, we would expect the Government to provide the necessary Delegation to the Authority so that the Authority would have the capacity to implement the required changes. (section 5.2)

1. INTRODUCTION

This report has been prepared by Etrog Consulting Pty Ltd for Queensland Council of Social Service (QCOSS). It comments on the Consultation Paper on Cost Components and Other Issues in regard to regulated retail electricity prices to apply in Queensland from 1 July 2013 to 30 June 2014. The Consultation Paper was published by the Queensland Competition Authority (the Authority) on 12 December 2012, inviting submissions from interested parties in relation to the three cost components – network, energy and retail – and other matters relevant to this review that the Authority is required to consider.

At the same time, the Authority also released a report written by ACIL Tasman on estimating energy purchase costs for use by the Authority in setting regulated electricity retail prices for 2013-14, and ACIL Tasman's terms of reference.

The Authority held a workshop for stakeholders on transitional issues, cost components and other issues relevant to the review of regulated retail electricity tariffs, in Brisbane on Wednesday 19 December 2012, which we were pleased to attend. We would like to thank the Authority for holding the workshop, which we found very informative and useful.[1]

The Authority has requested that submissions to the Consultation Paper should be received by 7 January 2013. 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 Consultation 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 19 December 2012.

1 The Authority's Consultation Paper and the ACIL Tasman paper and terms of reference have been published on the Authority's website at www.qca.org.au/electricity-retail/NEP/ConsultPaperCostComp.php, along with slides from presentations made by the Authority, ACIL Tasman, Energex and Ergon Energy at the workshop that was held on 19 December 2012.

1.1. DELEGATION FROM THE MINISTER

As stated in Chapter 1 of the Authority's Consultation Paper, on 5 September 2012, the Minister for Energy and Water Supply (the Minister) provided the Authority with a Delegation under section 90AA(1) of the *Electricity Act 1994* requiring it to determine notified electricity prices[2] for a three-year period from 1 July 2013 to 30 June 2016. However, while the Delegation is for a three-year period, the Authority is still required to set notified prices on an annual basis, with the first determination to apply from 1 July 2013 to 30 June 2014 (the 2013-14 Determination). The Minister's covering letter and Delegation were provided in Appendix A to the Consultation Paper.

Section 1.1 of the Consultation Paper outlines various relevant requirements that the *Electricity Act 1994* 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:

> *it is important that the QCA take into account the impacts of price increases on struggling Queensland households and businesses.*

The Authority must particularly take into particular account the impacts of price increases on struggling Queensland households and businesses when determining regulated retail electricity prices for 2013-14.

The Authority accepted at the workshop on 19 December 2012 that it was reasonable for submissions such as this to include comments to the Queensland Government on matters that may be outside the Authority's scope. On that basis we note that the Authority consistently appears to place weight on the Delegations that it receives from the Minister that it does not also apply to the Minister's covering letters. We understand that this has some basis in the fact that the legislation refers specifically to the Delegation rather than to its covering letter. We believe this is somewhat anomalous, and that important matters in the covering letter should be given weight by the Authority.

We urge the Queensland Government to ensure that its Delegations to the Authority fully reflect its instructions to the Authority, and that important matters should not be included only in the Minister's covering letters.

2 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*

1.2. THE EFFECTS THAT CHANGES TO REGULATED RETAIL ELECTRICITY 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.

Some low income customers are supported by a range of concessions and other measures in line with the Queensland Government's social policy objectives. In the process of tariff reform, 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.

> We urge the Authority and the Queensland Government to make available at the earliest opportunity sufficient data to enable modelling of the effects that changes to regulated retail electricity tariffs and prices will have on consumers, particularly disadvantaged and low income consumers, and also to release any modelling that they have already undertaken to support any policy decisions that have been made to date.

1.3. STRUCTURE OF THIS REPORT

The remainder of this report comments on various matters in the Authority's Consultation Paper, and largely follows the same structure as the Consultation Paper.

- Section 2 covers network costs.
- Section 3 covers energy costs.
- Section 4 covers retail costs.
- Section 5 covers competition and other issues.

2. NETWORK COSTS

Chapter 2 of the Consultation Paper sets out the Authority's proposal on how to incorporate network costs in regulated retail electricity prices for 2013-14 in Queensland. It is divided into the following sections:

- Section 2.1 covers Network Tariffs for Small Customers;
- Section 2.2 covers Tariffs for Large Customers; and
- Section 2.3 covers Maintaining Alignment of Retail and Network Tariffs.

Our comments here cover only network tariffs for small customers, and maintaining alignment of retail and network tariffs.

2.1. NETWORK TARIFFS FOR SMALL CUSTOMERS

The Authority has noted: "Network costs include the costs associated with transporting electricity through the transmission and distribution networks and typically account for around 50% of the final cost of electricity for small customers."[3]

The Delegation sets out: "QCA must use the Network (N) plus Retail (R) cost build-up methodology when working out the notified prices and making the price determination, where N (network cost) is treated as a pass-through and R (energy and retail cost) is determined by QCA."

We recognise that the setting of network tariffs is a matter for the Australian Energy Regulator (AER), and not for the Authority. Nonetheless, as shown above, the network tariff component is a significant part of the retail tariffs, and network costs are passed through directly into regulated retail tariffs.

> The Authority should request and influence the network tariff proposals that Energex makes to the Australian Energy Regulator (AER) to provide the best outcomes for retail tariffs for small customers, to meet the objectives of stakeholders, including the Authority itself, Government, retailers, distributors and consumers.

Two areas that may be of particular concern in network tariffs are as follows:

- The allocation of fixed and variable charge components in network tariffs; and
- The allocation of costs as between peak and off-peak components in network tariffs.

3 Consultation Paper, page 5

2.1.1. The allocation of fixed and variable charge components in network tariffs

As mentioned in section 1.2 above, QCOSS represents the interests of residential consumers, with a particular focus on low income and other vulnerable consumers. Many low income and vulnerable consumers 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 who have high consumption of electricity for reasons outside their control 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 benefit from tariffs with lower variable charges and higher fixed charges.

Higher fixed charges and lower variable charges also do not provide as much of a price signal to customers to avoid inefficient usage of electricity as compared to lower fixed charges and higher variable charges. In the latter case, the higher variable charges provide more incentives to reduce unnecessary usage of electricity and to use electricity more efficiently. This is unlike the first case where the higher fixed charges are not reduced no matter how efficiently the consumer uses their electricity.

2.1.2. The allocation of costs as between peak and off-peak components in network tariffs

The differential between peak and off-peak needs to be significant if it is to give customers incentives to use electricity at off-peak times rather than at peak times, and thereby contribute to more efficient use of the electricity network and generation capacity and infrastructure. In particular, the Delegation states that “QCA must consider whether its approach to calculating time-of-use tariffs can strengthen or enhance the underlying network price signals and encourage customers to switch to time-of-use tariffs and reduce their energy consumption during peak times”.

We therefore support the statement that "the Authority encouraged Energex to review its network tariffs to ensure they are sending appropriate pricing signals to customers regarding the differential network costs associated with their time of use".[4] We note that the Authority made this comment specifically in relation to small business tariffs. We believe that this comment should also apply to residential tariffs.

2.2. MAINTAINING ALIGNMENT OF RETAIL AND NETWORK TARIFFS

We concur with the view of the Authority that "the best option for setting 2013-14 prices will most likely be to proceed as for last year and request Energex and Ergon Energy to supply the Authority with proposed network tariffs and prices when they are submitted to the AER in April and using these as the basis for notified prices to apply from 1 July".[5]

4 Consultation Paper, page 6

5 Consultation Paper, page 10

3. ENERGY COSTS

3.1. INTRODUCTION

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

3.2. JUDICIAL REVIEW

The Authority stated that at the time its "Consultation Paper was prepared, the Authority had not received the Supreme Court's decision in relation to a Judicial Review application by Origin Energy regarding the cost of energy approach used by the Authority in making its 2012-13 Regulated Retail Pricing Determination. The case was heard by the Supreme Court in early December 2012. The results of that review may require changes to be made to the approach to be used in 2013-14."[6]

We note that the decision has now been made, and the reasons for the judgment have been published.[7] Our reading is that the judgment does not require changes to be made to the approach to be used in 2013-14.

3.3. WHOLESALE ENERGY COSTS

Wholesale energy costs relate to the costs incurred by a retailer in supplying electricity to cover the load of its customers. While this electricity is purchased from the National Electricity Market (NEM) (the spot market), there are a range of measures that a retailer can take in order to reduce its exposure to volatile prices in the spot market, including purchasing financial derivatives (futures, swaps, options etc.), entering longer-term power purchase agreements (PPAs) with generators, or investing in generation assets.

3.3.1. Potential approaches for 2013-14 to 2015-16

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. This view is based on the reasons given by the Authority in its Consultation Paper and in its previous papers and determinations on the subject. On that basis, we have chosen not to repeat the many arguments we have previously given in support of this view. Should the Authority consider a change to that view in its Draft Determination, it should refer to our previous submissions on the subject, and to the Authority's own publications for reasons as to why its view should not be changed in this respect.

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6 Consultation Paper, page 12

7 *Origin Energy Electricity Ltd & Anor v Queensland Competition Authority & Anor* [2012] QSC 414 (12/5527) Brisb Jackson J 19/12/2012, available at www.sclqld.org.au/qjudgment/2012/QSC/414

Our reading of the recent judgment to which we refer in section 3.2 above also supports the use of a market-based approach rather than to use a LRMC based approach.

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

We note that the Authority has stated that ACIL Tasman is considering whether it should use the median of its 462 cost estimates (as it used for 2012-13), or whether a higher percentile might better reflect the volume risk faced by retailers in this period of high volume uncertainty.[8] ACIL Tasman also stated that the 95th percentile is suggested "in recognition that there are other uncertainties not specifically accounted for in the process and to minimise any residual market volume or price risk".[9]

Any change in the methodology will need to be explained and justified fully. We welcome consideration of such a change if it will mean that the minimisation of risk in the portfolio will allow for reductions elsewhere, such as in the margin, where the return expected should now be lower because of the minimised risk.

3.3.2. Enhancing time of use signals

The Delegation states that "QCA must consider whether its approach to calculating time-of-use tariffs can strengthen or enhance the underlying network price signals and encourage customers to switch to time-of-use tariffs and reduce their energy consumption during peak times". We have already discussed this in section 2.1.2 in regard to the allocation of costs as between peak and off-peak components in network tariffs. Here we discuss the potential allocation of costs as between peak and off-peak components in the energy cost component of retail tariffs.

The Consultation Paper states: "At the outset of the 2012-13 Review, the Authority considered developing energy cost estimates that could provide suitable time of use signals to consumers on time of use tariffs. However, while it was possible to calculate time of use costs under the Authority's wholesale energy cost approach, these costs did not reflect the way in which retailers are charged for electricity by AEMO which is based on the relevant distributor's net system load profile (NSLP)."[10]

8 Consultation Paper, page 14

9 ACIL Tasman report, page 16

10 Consultation Paper, page 14

We support the view that the correct way to model energy costs in the determination of regulated retail electricity prices is to match the way in which the electricity retailer settles for that energy. The Authority suggests that allowing for time of use signals in wholesale energy costs requires smart meters.[11] We agree that smart meters would allow for those signals. However, as an alternative to smart metering we believe the Authority should investigate what changes to the Metrology Procedure would be required to allow for time of use periods to be accounted for separately in wholesale settlement, and hence for differentiated wholesale energy costs in the determination of regulated retail electricity prices.

We note that in its submission to the Interim Consultation Paper, the Queensland Government stated: "The Government requests QCA to separately consult on whether the R component can strengthen or enhance the ToU signals of the underlying network tariffs. This is particularly important for Tariff 22 given the sub-optimal outcome that occurred during 2012-13. It is also important for Tariff 12 and other relevant transitional tariffs."[12] We agree the status quo is "sub-optimal". We suggest that the Authority's consultation should include a cost-benefit analysis that compares the status quo against smart metering rollout as one option, and changes to the Metrology Procedure without roll-out of smart metering as another option.

We note that the Queensland Government submission also states: "Government has had feedback from different stakeholders that it is possible to send ToU price signals whilst also using the (Energex or Ergon Energy) NSLP." The Authority should consult with the Government to ascertain what that feedback is and what other methods may achieve this outcome, and should consider including those methods as further options in its cost-benefit analysis and separate consultation.

> The Authority should consult separately on enhancing time of use signals in the R component of regulated retail electricity prices. The consultation should include cost-benefit analysis of various options for implementation.

3.3.3. Carbon costs

The Consultation Paper states: "When estimating wholesale energy costs for 2012-13, ACIL ran two modelling scenarios, one with carbon costs and one without, to estimate how the carbon tax would affect the costs faced by retailers. The difference between the two scenarios was used as the cost allowance for carbon. In its preliminary report, ACIL has proposed to adopt the same approach to estimate carbon costs for 2013-14."[13]

11 Consultation Paper, Table 3.1, page 15

12 Submission page 15, available at www.qca.org.au/files/ER-QLDGov-Submission-InterimConsultationPaper-1112.pdf

13 Consultation Paper, page 15

We understand that given that a carbon tax has been implemented in Australia, the only modelling scenario that actually is used for determining the regulated retail electricity prices is the one including carbon costs. The scenario without carbon pricing is purely theoretical, and is undertaken because the Delegation requires the Authority's Draft and Final Determinations to "specify the carbon cost allowances for the relevant tariff year".

In the Final Determination for 2012-13, the Authority reported that in order to run its modelling scenario excluding carbon costs ACIL Tasman had "re-run its spot price and hedging models excluding carbon tax costs. To estimate quarterly swap contract prices without carbon, ACIL continued to apply the AFMA ACB addendum methodology and has used the quarterly NEM emissions factors between 0.89 and 0.91 as projected for 2012-13 in its Powermark Model for 2012-13."[14]

We have previously pointed out that the Australian Carbon Benchmark (ACB) Addendum to which the Authority has referred was published by the Australian Financial Markets Association (AFMA). AFMA published four versions, in December 2008, December 2009, March 2010 and August 2010. Each version was made available to be built into other trade documentation between contracting parties. It was a means by which parties to contracts (who may be carbon-emitting or non-carbon emitting generators or banks or other financial institutions) could choose to specify payment obligations between them in different circumstances. It is not an agreed legislative or regulatory calculation of carbon tax impact. The full "pass through" from generators to retailers (and to consumers) of the average carbon price ($/t$CO_2$-e) for the year multiplied by the average NEM carbon intensity (tCO_2-e/MWh) has also been contested.

Once carbon pricing was contemplated in Australia, as an emissions trading scheme or as a tax, the generation mix in Australia was irreversibly affected. Investment decisions and market behaviour for many years were strongly influenced based on the contemplation, expectation and final certainty of the carbon pricing scheme that was eventually influenced, and the previous considerations of other schemes that were not actually implemented. Retailers also made their own decisions on wholesale energy purchasing, contracting and hedging, based on what they observed and analysed, and their predictions for the future.

Further decisions on market behaviour and on investment and on plant closure have been made since the carbon tax has been introduced, based on the fact of its introduction, and the views of those making the plant investment and closure decisions as to the future of carbon pricing in Australia among many other factors and predictions in complex modelling. Retailers have similarly continued to purchase electricity based on the actions of generators and the behaviour of the wholesale market, as well as their own modelling, and this in turn drives bidding behaviour and the market.

14 *Regulated Retail Electricity Prices 2012-13 – Final Determination*, Queensland Competition Authority, May 2012, pages 35-36, available at www.qca.org.au/electricity-retail/NEP/NEP1213/FinalDet.php

For all these reasons, it should not be thought that the calculation now of wholesale energy costs without carbon costs really represents what wholesale energy costs would have been had the carbon tax not been contemplated or implemented. Nor would it represent what wholesale energy costs would be if the carbon tax were removed now or at any time in the future.

Provided the modelling scenario without carbon costs is not used to determine regulated retail electricity prices, we do not see an issue here. But we also believe that the Authority should not just publish figures for the carbon cost allowances without making very clear the limitations of the validity of those figures.

> Wholesale energy costs for setting regulated retail electricity prices should be modelled based on actual costs given the reality of the Queensland electricity industry and the legislative, regulatory and market environment in which it operates. This includes the reality of a carbon tax. If other scenarios are modelled, the results of that modelling should not be published without clear explanation of their limitations.

3.4. OTHER ENERGY COSTS

3.4.1. Queensland Gas Scheme

We note that ACIL Tasman has stated: "The cost of the Queensland Gas Scheme will be based on 15% cover and an average of the Gas Electricity Certificate (GEC) prices over the past four years from AFMA."[15]

We concur that the cost of the Queensland Gas Scheme should be based on 15% cover and an averaging of Gas Electricity Certificate (GEC) prices from AFMA. We propose that the length of time over which they are averaged should be the same as the length of time over which the purchasing of contracts occurs for hedging of wholesale energy costs. We see no basis for an extended period for contracting for GECs as against wholesale energy.

Should the Authority consider a change in its Draft Determination to move away from using market prices to estimate the cost of GECs, it should refer to our previous submissions on the subject, and to the Authority's own publications for reasons as to why its view should not be changed in this respect.

> The cost of the Queensland Gas Scheme should be based on 15% cover and an averaging of Gas Electricity Certificate (GEC) prices from AFMA. The length of time over which they are averaged should be the same as the length of time over which the purchasing of contracts occurs for hedging of wholesale energy costs.

15 ACIL Tasman report, page 16

3.4.2. Enhanced Renewable Energy Target scheme

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.

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 Large-scale Generation Certificates (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 a Long Run Marginal Cost (LRMC) based approach for a range of reasons.

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 concur with estimating SRES compliance requirements using the binding 2013 STP target for the first half of the pricing period and the non-binding 2014 target for the second half of the pricing period. This is consistent with how compliance costs were estimated for 2012-13.

Should the Authority consider a change in its Draft Determination to move away from using the binding 2013 STP target for the first half of the pricing period and the non-binding 2014 target for the second half of the pricing period, it should refer to our previous submissions on the subject, and to the Authority's own publications for reasons as to why its view should not be changed in this respect.

As previously, we would be concerned if the Authority were to continue to rely on the ORER's Clearing House price of $40 to estimate the costs to an efficient representative retailer of purchasing its STCs for 2013-14. We note that the Authority and ACIL Tasman have previously both acknowledged that a proportion of STCs are being purchased based on market prices that are readily available.

"For the 2012-13 Determination, the Authority … calculated the cost of meeting these targets using the clearing house price of $40, after ACIL advised that at that time it would be difficult to estimate the proportion of STCs that were being traded outside the market. ACIL also expected the difference between market prices and the clearing house price to be short term and diminishing over time."[16]

We do not accept this approach. Essentially in taking this approach the Authority 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.

Even if the difference between market prices and the clearing house price is diminishing over time, that is not a valid reason to reject usage of market prices, and anyway the Authority's own analysis suggests this may not be correct: "ACIL also expected the difference between market prices and the clearing house price to be short term and diminishing over time. However, the latest survey data from AFMA indicates that STCs are still being traded at a 20% discount to the clearing house price."[17]

The Authority is now required to make the best estimate it can of the proportion of STCs likely to be traded in 2013-14 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".[18]

The market prices are known. Again in the words of ACIL Tasman: "The current market price (as at February 2012) for STCs is around $31".[19] According to the Clean Energy Council (CEC), the current market price at 10 April 2012 was $28.90. As at 4 January 2013, the current market price is $32.15.[20] ICAP Energy Australia also posts frequent updates to STC prices on its blog.[21]

These prices are consistent with references in the current Consultation Paper as quoted above to STCs being traded at 20% to 25% discount to the clearing house price.

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16 Consultation Paper, pages 18-19

17 Consultation Paper, page 19

18 ACIL Tasman report accompanying the Draft Determination 2012-13, page 54

19 ACIL Tasman report accompanying the Draft Determination 2012-13, page 54

20 Source: www.cleanenergycouncil.org.au. It may be possible to obtain historic price data from the CEC, or from TFS Green from whom the CEC sourced its data – see www.cleanenergycouncil.org.au/cec/resourcecentre/REC-prices/STC-further-info

21 See www.icapenergy.com.au/blog

All that remains is to estimate the proportion of STCs being traded. The proportion is not zero. If ACIL Tasman and the Authority cannot provide a more appropriate estimate, we will provide one. According to a newspaper report in February 2012:[22]

> The oversupply of certificates has pushed down the market price to about $31, meaning trade on the government registry is virtually paralysed with a backlog of more than $280 million worth of certificates.
>
> "It does mean that if people took at face value they would get $40 and put them in the (government) clearing house, they will wait a long time," said John Grimes, chief executive of the Australian Solar Energy Society. "The message to those people is that really there is no guarantee that those certificates will ever be cleared out of there. I certainly don't see the price of certificates rising to $40."
>
> The delay is also hitting installers, who often take the certificates off the buyer's hands in return for an up-front discount. One major firm, which did not want to be named, told The Age it was pulling its certificates out of the government registry and selling them on the market at an estimated drop in value of $1 million.

On that basis, we propose an estimate that the percentage being purchased through the clearing house is zero, and the percentage being traded at market prices is 100%.

We note that this would be consistent with the final report published by the Independent Competition and Regulatory Commission (ICRC) of the ACT on 8 June 2012, which stated:[23]

> In the draft report, the Commission proposed a shift away from the clearing house price to a market-based approach. The Commission developed this approach based on its preference to where possible rely on market-data and to ensure consistency with the approach applied to the calculation of LGC prices.
>
> …
>
> The submission from ActewAGL Retail argued that SRES costs should be based on the CER's clearing house price. This was the approach adopted in the 2011-12 price reset. A liquid secondary market has developed in STCs since their inception in January 2011, and consequently the Commission now has available from ICAP a daily reference price for STCs. These prices reflect the levels at which STCs are being traded in the market.

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22 *Cloudy outlook for solar rebates*, David Wroe, 6 February 2012, available at http://www.theage.com.au/opinion/political-news/cloudy-outlook-for-solar-rebates-20120205-1qztn.html

23 *Retail prices for franchise electricity customers 2012-14*, Final report, Report 4 of 2012, June 2012, ICRC, pages 13-15, available at www.icrc.act.gov.au/energy/electricity

> Moreover, the Commission has investigated the volumes of certificates available in the market and is of the view that at this time there is sufficient liquidity available to comfortably service the ACT's regulated load. The Commission believes there is a robust case for the use of market data to estimate the costs of STCs and is of the view that ICAP daily STC reference price is the most relevant source.

We have hereby responded to all of the concerns previously raised by the Authority and ACIL Tasman in regard to using market prices for STCs. We have shown that there is a liquid market, and that prices are readily available. As stated by ICRC: "there is a robust case for the use of market data to estimate the costs of STCs". We commend this approach to the Authority.

In estimating the cost of Small-scale Technology Certificates (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 its STCs.

3.4.3. NEM participation fees and ancillary services charges

Given that changes in NEM participation fees and ancillary services charges are relatively stable from year to year, we agree with the Authority that it is reasonable to use historical data in forecasting these costs.[24]

3.5. ENERGY LOSSES

We agree that the Authority should apply transmission and distribution losses published by AEMO to all energy cost components. We note that as AEMO publishes its Distribution Loss Factors and Marginal (transmission) Loss Factors in September of each year, the Authority's 2012-13 determination relied on the losses for the 2011-12 year as these were the most recent available at the time. Similarly, the Authority will be required to use 2012-13 losses in its 2013-14 Determination.[25]

24 Consultation Paper, page 19

25 Consultation Paper, page 20

However, there are not single distribution and transmission loss factors published by AEMO to cover the whole of Queensland. There are different factors applying across the State, and they vary considerably, and the Consultation Paper did not set out in more detail which factors would be used. We refer the Authority to its previous documentation for some of the additional details,[26] and expect more detail will be set out in the Draft Determination for 2013-14.

For example, if averages are to be applied, how will they be applied? If different loss factors are to be applied to different tariffs, that should also be explained.

26 See for example the Final Determination for 2012-13, pages 43-44

4. RETAIL COSTS

4.1. INTRODUCTION

The Delegation requires that the Authority must use the Network (N) + Retail (R) cost build-up methodology when working out notified prices. Chapter 4 of the Consultation Paper discusses retail costs and sets out stakeholders' views on an appropriate allowance for retail operating costs and an appropriate retail margin, as well as some preliminary observations from the Authority.

4.2. RETAIL OPERATING COSTS

Retail operating costs relate to the costs of the services provided by an electricity retailer to its customers and typically include customer administration (including call centres), corporate overheads, billing and revenue collection, IT systems, and regulatory compliance.

In the past, the Authority has also considered retail operating costs to include customer acquisition and retention costs (CARC), which include costs associated with marketing, advertising and sales overheads.

We support the use of benchmarking based on the Authority's 2012-13 approach to determining the retail operating cost allowances, subject to the following issues.

4.2.1. Adjustments to benchmarks

We agree that it is appropriate to make some adjustments to account for jurisdictional differences where reliable information on the individual cost components exists, but we continue to 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.

4.2.2. Customer Acquisition and Retention Costs (CARC)

We believe that there is no justification for including an allowance for CARC in retail operating costs.

Treatment of CARC in other Australian jurisdictions

Customer acquisition costs and retention costs were originally included in retail price determinations in NSW in 2007 when IPART was required to consider a mass market new entrant, and this approach was then copied in other Australian jurisdictions.

Not all jurisdictions accepted this approach.

Victoria

There was never any allowance for customer acquisition costs or retention costs in any of the regulated retail tariffs that were set in Victoria, and competition still thrived. Victoria was still then considered to be the most competitive electricity market with the highest rates of customer churn and transfer anywhere in the world. This shows that an allowance for customer acquisition costs or retention costs is not required in order to create "headroom" for competition to develop.

ACT

In the ACT, ICRC has consistently refused to include an allowance for CARC in its regulated retail prices, and has only allowed instead for "sales and marketing, being primarily the costs of communicating the TFT [Transitional Franchise Tariff] arrangements" as efficient costs.[27]

For example, in a previous determination, ICRC countered arguments that an allowance for CARC needed to be included in regulated tariffs to encourage competitive behaviour, by stating the following:[28]

> *… the Commission considers that a 'regulated' franchise tariff, where franchise customers are able to benefit from ActewAGL Retail's economies of scale and where customer acquisition costs are not included in the franchise tariff, is likely to provide greater benefits to customers than a notional 'competitive' tariff that is determined by the Commission.*

We concur with this view of ICRC. CARC has no place in regulatory tariff determinations that have appropriate terms of reference.

Proposed treatment of CARC in Queensland

The regulated retail electricity tariffs apply to customers that have not chosen a competitive market offer, and to customers that specifically request to be put on a regulated tariff. There are no customer acquisition costs or retention costs involved in offering regulated retail electricity tariffs, and no allowance should be made for such costs in the regulated tariffs. While some jurisdictions have included these costs in their calculations on setting regulated retail tariffs, this was because their Terms of Reference required them to do so.

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27 *Final determination: Investigation into retail prices for non-contestable electricity customers in the ACT*, ICRC, May 2003, section 4.7, available at http://www.icrc.act.gov.au/__data/assets/pdf_file/0009/16677/finaldeterminationretailpricesmay2003cw.pdf – and quoted in later ICRC determinations ever since

28 *Final Decision: Retail prices for non-contestable electricity customers 2010–12*, Report 7 of 2010, ICRC, June 2010, page 54, available at http://www.icrc.act.gov.au/__data/assets/pdf_file/0018/194310/Report_7_of_2010_11_June_2010.pdf

No allowance should be made for customer acquisition and retention costs (CARC) in regulated retail electricity prices in Queensland.

We note that the previous inclusion of CARC by the Authority in Queensland 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.

We are particularly concerned regarding the statement of the Authority in its Final Determination that it "will maintain the current, perhaps generous, CARC component going forward".[29] This was presented without any further analysis.

Any allowance for CARC should be reasonable, not generous. Analysis of Table 4.3 on page 58 of the Final Determination shows clearly that the Queensland allowance for CARC is above that allowed in NSW and South Australia, and in other jurisdictions no allowance for CARC was given. If there has to be an allowance for CARC in Queensland, it should instead be much lower, given that only a proportion of customers in Queensland are reasonably open to contestability, as against all customers in those other two states. We propose that if there is to be an allowance for CARC in Queensland, it should be set at a rate benchmarked against NSW and South Australia, with an adjustment for the proportion of customers in those areas of Queensland where there is effective competition.

If the Authority is to make an allowance for CARC, it should be at a much lower level than that allowed in the Final Determination for 2012-13.

4.3. 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".[30]

29 Final Determination 2012-13, page 58

30 Draft Determination for 2012-13, page 63

We do not believe that it was appropriate to increase the margin from 5% to 5.4% in 2012-13. The justification for the increase seemed to be that 5.4% is the mid-point of the reasonable range of 4.8% to 6% found by consultants in NSW.[31] The justification was made notwithstanding that the current retail margin of 5% also falls within the reasonable range. The Authority itself said that "the current 5% margin in Queensland is not unreasonable" and "the new pricing approach being established in this determination should reduce the risks faced by retailers in Queensland relative to the previous BRCI approach, including better alignment of the cost structure and price structure and the pass through of network costs".[32]

This being the case, the allowed margin in 2012-13 should have been lower, and certainly not higher, than the previous 5% level under the BRCI.

The arguments on page 75 of the Final Determination for 2012-13 regarding an LRMC floor are also not relevant to the retail margin since those are not systematic risks. If a LRMC floor were appropriate, it would have been incorporated in the energy costs. The Authority rightly did not include LRMC in energy costs, and the retail margin is not the place to add something extra to offset a good decision elsewhere in a pricing determination.

The Authority also stated: "The Authority also notes that, unlike IPART, it has included a specific allowance for head room of 5% which, in combination with the margin, means that the potential gap over total allowed costs available to retailers is close to 11% in total."[33] This is far in excess of any such allowance in other Australian jurisdictions.

The gross retail margin of 5% of total costs that was allowed in the Benchmark Retail Cost Index (BRCI) calculations is realistic, and should not be any higher in the new tariffs. Instead, it should 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.

31 Final Determination for 2012-13, pages 74-75

32 Final Determination for 2012-13, pages 74-75

33 Final Determination for 2012-13, page 75

5. COMPETITION AND OTHER ISSUES

5.1. COMPETITION CONSIDERATIONS

In its Final Determination for 2012-13, the Authority decided to include an additional allowance for head room of 5% of cost-reflective prices for all tariffs.

We have many concerns regarding this decision, which we discuss in this section of our report.

5.1.1. The role of competitive activity to derive longer term benefits for consumers

We understand that the Delegation requires that, in making a price determination for each tariff year, the Authority must have regard to the effect of the price determination on competition in the Queensland retail electricity market.

We also accept that there is some longer term benefit to be derived by maintaining an actively competitive market rather than pursuing a short term minimum price approach which may stifle or eliminate competition from the market.

However, we have some concerns with the following paragraph in the Final Determination:[34]

> The longer term benefit derives from the downward pressure on prices that competition naturally brings to the market. By setting regulated prices somewhat higher than full cost, retailers will be attracted to enter the market and, as they compete for market share, non-regulated prices will be driven down. The more active the competition, the closer retailers will reduce prices to their individual, efficient costs of supply. While regulated prices will be unaffected, customers should be able to access lower priced market offers from competing retailers. Consumers should also benefit from improved service quality and choice.

It may be true that "by setting regulated prices somewhat higher than full cost, retailers will be attracted to enter the market and, as they compete for market share, non-regulated prices will be driven down" in the shorter term. But the best way to achieve longer term benefits for consumers is not to attract retailers because there is an artificial extra margin in the supply chain for them to exploit. Rather, retailers should be attracted to a market because they can operate more efficiently and innovatively, and provide better customer service than the incumbents. That is the way to achieve sustainable entry to give longer term benefits.

34 Final Determination for 2012-13, page 82

We are concerned that creating artificial headroom to attract retailers will not encourage efficiency or lower pricing. Rather, there is significant danger that it will attract retailers offering no better service. We do not believe that this contradicts the Authority's comment that regulation is an imperfect substitute for competition.[35] There may be benefit in attracting retailers per se, but it should not require an explicit allowance for headroom to achieve that in an efficient manner.

Following the logic of the Authority, without headroom, competition will be stifled. This means that the Authority thinks that retailers will not compete when regulated prices are set at what the Authority considers to be cost-reflective prices with a reasonable margin. We disagree with that assertion, on the basis that we believe retailers can compete in that scenario, through a combination of offering superior customer service, innovative product development, more efficient and economic purchasing and operations, and perhaps accepting lower margins.

But if the Authority's logic is accepted, then the implication is that headroom will drive down prices no further than the level at which they would have been had no headroom been allowed – because that is the level at which the Authority believes competition is stifled.

5.1.2. The effects of allowing for headroom in regulated electricity prices

The overall effects of adding headroom could thus include:

- No additional longer term benefits in improving customer service or lower prices than would have been achieved without headroom.
- Short term additional costs incurred by all consumers until competition drives prices down to the levels at which they would have been without explicit allowance for headroom.
- Longer term ongoing additional costs for headroom for those customers who through inertia, lack of access to clear comparative information, or other reasons, remain on price-regulated tariffs even though more competitive offers might be available to them.
- Ongoing longer term additional costs for customers in the Ergon Energy area that do not have access to competitive offers.

35 Final Determination for 2012-13, page 83 – based on analysis by the Australian Energy Market Commission

One of the cornerstones of the retention of retail price regulation even after retail competition is introduced is to provide a safety net for those customers who have not yet embraced competition, or are unable or unwilling to do so. Customers who remain on regulated tariffs even after competition is introduced should be assured by the role of the Authority that they are paying a reasonable price based on cost-reflective prices and a reasonable margin. Instead, by advocating for "headroom" of an additional 5% the Authority is essentially proposing to regulate that customers who remain on regulated tariffs pay 5% more than they should be paying.

A further point regarding the regulated tariffs is that the terms and conditions of supply are also set out in regulation, whereas the market offers available to customers may vary those. It may not be possible for customers to obtain competitive offers that have terms and conditions that replicate the standard terms and conditions. Adding headroom will therefore mean that customers who desire to benefit from the standard terms and conditions may only be able to do so at a premium to efficient supply costs, on an ongoing basis. Allowing retailers to charge a premium for standard supply is not justifiable.

5.1.3. Other regulators' views on headroom

There are reasons – as set out above – why all energy regulators in other jurisdictions have refused to be swayed by retailers' arguments requesting "headroom". Rather than fill this report with quotes from regulators on this issue, we provide just one, from IPART:[36]

> A number of stakeholders suggested that the Tribunal should set target tariffs *above* cost-reflective levels for standard retailers, to provide greater encouragement for competitive entry. The Tribunal does not consider this to be appropriate. It considers that charges to customers should be based on the costs of supply *and no more*. It strongly believes that including an allowance in target tariffs for costs that are not incurred by standard retailers is not desirable from an economic efficiency perspective.

This strong belief articulated by IPART has been similarly articulated in many other regulatory decisions, in the electricity industry and in other industries. It is a bold move for the Authority to depart from the existing economically sound principles on which regulated pricing of electricity and of other products and services is based.

36 *NSW Electricity Regulated Retail Tariffs 2004/05 to 2006/07*, Final Report and Determination, IPART Determination No 1, 2004, June 2004, page 8, available at www.ipart.nsw.gov.au/files/d8cd67c3-b819-4497-b5d0-9f4f010fafd8/Det04-1.pdf.

In its Final Determination for 2012-13, the Authority countered this statement as follows:[37]

> QCOSS also argued that the Authority would be radically departing from accepted practice by including head room in regulated prices. However, this is contrary to the acknowledgement by QCOSS that head room is implicitly included in current (2011-12) notified prices.

Given this comment from the Authority, we should clarify that the departure is in approving specific allowance for headroom, rather than allowing competing retailers to find their own headroom through their own efficiencies.

5.1.4. The role of the Authority in regard to competition in determining notified prices

The Delegation requires the Authority to base its determination on an N + R cost build-up methodology, where:

- The N (network) cost component is treated as a pass through; and
- The R (energy and retail) cost component is determined by the Authority.

If the Authority makes an additional allowance for headroom, it will have gone outside of the remit of the Delegation by instead basing its determination on an N + R + headroom methodology, where:

- The N (network) cost component is treated as a pass through;
- The R (energy and retail) cost component is determined by the Authority; and
- An additional allowance is determined by the Authority for headroom – which is not a component that is specified in the Delegation.

In its Final Determination for 2012-13, the Authority countered this argument as follows:[38]

> QCOSS suggested that the Authority was going beyond its Delegation because head room was not explicitly mentioned in the Delegation. However, as noted above, the Authority is required by the Delegation (and the Electricity Act) to have regard to the effect of its determination on competition in the Queensland retail electricity market. Under the Electricity Act, the Authority may also have regard to any other matter it considers relevant.

37 Final Determination, page 83

38 Final Determination, page 83

The equivalent wording in the current Delegation is that the Authority must have regard to the effect of the price determination on competition in the Queensland retail electricity market. We do not dispute that there are several matters to which the Authority may or must have regard. But that does not change the fact that the paragraph 5(c) of the Delegation sets out that the Authority must base its determination on an N + R cost build-up methodology, and not an N + R cost build-up + headroom methodology

The Consultation Paper states at the outset that "the Authority considers that, while having regard to costs is important in setting notified prices, a key aim is to provide a transition to effective competition and eventual price deregulation, particularly in SEQ".[39] Similar wording later in the Consultation Paper states that "while having regard to costs is important in setting notified prices, the Authority considers that a key objective of notified prices is to provide a transition to effective competition and eventual price deregulation, particularly in SEQ".[40]

The Consultation Paper further states: "Notified prices should also encourage customers to exercise market choice and seek out the best deal in the competitive market."[41]

We have read carefully the Delegation, the covering letter to the Delegation, and the Government's submission to the Interim Methodology Paper, and we do not see anywhere that notified prices should be set at a level that encourages customers to seek out other better deals. Nor do we see it stated that a key objective is to transition to price deregulation. This is notwithstanding "the Government's policy objective that consumers, wherever possible, have the opportunity to benefit from competition and efficiency in the market place".[42]

Rather, we read the reason why the Authority is still regulating prices as being that "the Government is not convinced that residential and small business customers are adequately protected from the effects of a move to a fully deregulated market in order for price regulation for this customer segment to be removed at this time."[43]

We sense some tension between the Government on the one hand seeing regulated retail prices as a means to protect customers from the effects of a move to a fully price-deregulated market, while the Authority sees regulated retail prices as a means of transition to price deregulation.

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39 Consultation Paper, page 2

40 Consultation Paper, page 26

41 Consultation Paper, page 26

42 Government Submission to the Interim Consultation Paper, page 16, available at www.qca.org.au/files/ER-QLDGov-Submission-InterimConsultationPaper-1112.pdf

43 Government Submission to the Interim Consultation Paper, page 7

We note the final report published by the Independent Competition and Regulatory Commission (ICRC) of the ACT on 8 June 2012, which stated:[44]

> It is also important to note that the Commission's remit is the preparation of a price direction for the next two years and that this is a fundamentally different task to the establishment of a competitive market. The decision to remove the regulated tariff is a decision that rests with the ACT Government. The Commission considers it appropriate under the current legislative framework to continue to base the efficient costs on those that would be incurred by an incumbent retailer receiving a reasonable retail margin.

The Authority should be similarly clear regarding its remit.

5.1.5. Quantification of headroom allowance

As stated above, the Final Determination for 2012-13 included an additional allowance for head room of 5% of cost-reflective prices for all tariffs.

The figure of 5% was provided apparently without any supporting justification, and without any apparent attempt to quantify what headroom might already be in the cost-reflective tariffs. Nor did the Authority quantify what benefits customers might see from this additional allowance. It is our view that a radical departure from accepted practice such as creating an additional explicit allowance for headroom should at least be accompanied by regulatory cost-benefit and other regulatory impact analysis. A range of figures should be presented in such analysis, and the most appropriate one chosen, based on the analysis.

This is all notwithstanding our view that there should be no such additional headroom allowance in the tariffs.

Our view is that no additional headroom allowance is warranted for 2013-14. It should therefore be obvious that if the Authority nonetheless includes an additional headroom allowance in its Final Determination, it should be set as low as possible, and fully justified.

The Authority should make no additional allowance for headroom in notified prices for 2013-14.

5.2. ACCOUNTING FOR UNFORESEEN OR UNCERTAIN EVENTS

In its 2012-13 Determination, the Authority considered that it would be appropriate to include some form of mechanism to account for the material impacts of unforeseen or uncertain events on retailers' costs.

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44 *Retail prices for franchise electricity customers 2012-14*, Final report, Report 4 of 2012, June 2012, ICRC, page 6, available at www.icrc.act.gov.au/energy/electricity

However, the Authority considered that it did not have the capacity to include a within-year cost pass-through mechanism in its determination because it was only delegated the task of determining prices for one year and had no ongoing role in administering the determination. It also considered that it would not be possible for it to commit to some form of catch-up mechanism which would allow for unforeseen cost impacts from one year to be accounted for in setting prices for the following tariff year, because the Authority had only been delegated the function of setting notified prices for the 2012-13 tariff year and the Minister could have decided not to delegate the function to the Authority in the following year, making any commitment potentially worthless.

The Authority notes that other regulators commonly include cost pass-through mechanisms in their multi-year price determinations. While the Authority has now been delegated the task of determining prices for a three-year period, it is still required to make annual price determinations. While this suggests that a within-year cost pass-through mechanism is still not possible (as the Authority is required to set prices once each year, for the year in prospect), the Authority will seek to clarify whether it can include a catch-up mechanism (allowing for unforeseen cost impacts from one year to be accounted for in setting prices for the following tariff year).[45]

It is our view that it is generally not appropriate to revise tariffs 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, it has previously been 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. 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.

The gazetted prices should not be adjusted via a cost pass-through during the tariff year, or via a catch-up mechanism in a subsequent tariff year. One exception to the above may be if a change of Government policy requires the Authority to make changes to regulated pricing during the tariff year. In that case, we would expect the Government to provide the necessary Delegation to the Authority so that the Authority would have the capacity to implement the required changes.

45 Consultation Paper, pages 28-29

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.

5.3. TERMS AND CONDITIONS FOR NOTIFIED PRICES

If changes are to be made to the terms and conditions for notified prices, they should be undertaken in an open consultative process.

5.4. OTHER ISSUES

We support the view that competition in regional Queensland could be significantly improved if the Community Service Obligation (CSO) payment to subsidise electricity costs in regional Queensland was made at the network level rather than the retail level. However we understand there could be other implications associated with this, and that it would require comprehensive analysis and consideration before any changes are made.

There should be benefits to customers in the Ergon Energy area from having access to full retail competition, but giving customers access to retail competition does not guarantee that the competition will be effective, particularly in regional and rural areas.[46]

46 See for instance *Choice? What Choice? – a study of consumer awareness and market behaviour in the electricity market in five regions of New South Wales: Cooma, Lismore, Bourke, Wagga Wagga and Orange*, Public Interest Advocacy Centre (PIAC), 15 June 2011, available at www.piac.asn.au/publication/2011/06/choice-what-choice