Review of Regulated Retail Electricity Prices 2013-14 – Consultation Paper: Cost Components and Other Issues

AGL submission to the Queensland Competition Authority

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Executive Summary

AGL welcomes the opportunity to provide feedback on the Consultation Paper, Regulated Retail Electricity Prices 2013-14, Cost Components and Other Issues (***Consultation Paper***). AGL looks forward to continuing to work closely with the Queensland Competition Authority (***the QCA***) through the next stages of the process to set the 2013-14 notified prices.

General Comments

AGL understands that the QCA is planning to follow the approach for setting energy costs that was used in its regulated price determination in 2012-13.

AGL remains concerned that this approach does not deliver the optimal long-term policy settings for consumers and industry. The recent weakening of competition in the Queensland retail electricity market, as highlighted by the lower switching rates for customers compared to other jurisdictions, is a result of this.

Energy Costs

AGL firmly believes the calculation of the wholesale energy cost (***WEC***) using a market-based approach needs to ensure that the WEC is not less than the long run marginal cost (***LRMC***) of electricity generation. AGL again notes that adopting this approach within the three year period of the Delegation would limit short-term volatility in retail prices and provide longer-term certainty for the retail industry.

However, AGL understands that the QCA is reluctant to move away from its current market-based approach for 2013-14, and for the remaining years covered by the Delegation. AGL has significant concerns with the proposed market-based approach, in particular that the way in which the load and spot prices have been simulated is flawed. AGL has therefore attempted to identify areas within the proposed methodology which need to be improved including:

- development of load traces that better capture historic weather variability;
- ensuring the scaling of system and settlement loads to match AEMO forecasts does not flatten the simulated load shapes and therefore underestimate hedging costs;
- the derivation of contract prices from periods where carbon was not incorporated and accounting for the impact of limited liquidity in the Queensland futures market; and
- that the modelling results over the 462 year simulation need to produce a realistic range of outcomes. Based on the preliminary results presented by ACIL Tasman on 19 December 2012:
    - ACIL seems to suggest that the average cost under a hedging position will fall below the average cost of a retailer exposed to the simulated spot market. Reducing risk comes at a cost so it is nonsensical to suggest that it is cheaper to do so; and
    - The suppressed variability in the NSLP load (resulting from the load scaling methodology) combined with the contract strategy used has ensured that a retailer would not suffer any significant exposure to spot prices in a single one of the 462 cases modelled. While the contract strategy might be considered conservative, the observed historic variability in the NSLP load means that the EPC results appear unrealistic and this leads AGL to question the reasonableness of the ACIL methodology.

Due to the issues identified in ACIL's preliminary results, it is critical that stakeholders have the opportunity to fully understand the modelling approach used. AGL has set out the information which should be provided by QCA/ACIL to ensure that stakeholders can conduct a detailed analysis of the results in the Draft Determination.

AGL has also provided comments on the other components of the energy cost including green schemes and other fees and charges.

Retail Costs, Margin and Headroom

AGL supports the QCA benchmarking framework. However, AGL has publicly reported a number of measures of operating costs per customer, and on a fully allocated basis the cost is higher than the current QCA benchmark.

Similarly, the retail margin of 5.4% is based on the decision by IPART in the 2010 review of regulated retail electricity prices, but AGL still considers that this underestimates the risk in Queensland based on the current method used by the QCA to estimate the WEC. A higher margin should be allowed unless the QCA reverts to using 'LRMC as a floor' to the WEC as was the case in the IPART 2012 review of regulated retail electricity prices.

As well as retail margin, the level of headroom in the retail tariffs needs to be maintained at a minimum of 5 per cent to ensure a sustainable level of competition. Any reduction in headroom or increase in risk will continue to erode retail competition and run the risk of undermining the reforms to the Queensland energy market.

To reduce some of the risk inherent in the current framework, AGL encourages the QCA to introduce a cost pass through mechanism to allow costs, such as the under-recovery in SRES costs that seems to occur on an annual basis, to be recovered by retailers.

AGL looks forward to working with the QCA during this consultation process to ensure the 2013-14 notified prices are cost-reflective and facilitate the further development of competition in the Queensland market.

1. General Comments

AGL Energy Ltd (***AGL***) welcomes the opportunity to provide comments to the Queensland Competition Authority (***the QCA***) on the Interim Consultation Paper, Regulated Retail Electricity Prices 2013-14, Cost Components and Other Issues (***Consultation Paper***).

Retail competition and deregulation

In the context of the commitment to phase out retail price regulation set out in the Australian Energy Market Agreement,[1] AGL is firmly of the view that the objective of the three year Delegation should be to set notified prices in a manner that will best facilitate a move to full retail market deregulation.

AGL notes that since the release of the Consultation Paper the South Australian Government has announced the removal of the regulated retail electricity price from 1 February 2013. AGL considers that it is imperative that the QCA ensures that through the period of the Determination (i.e. 2013-2016) that prices are set to promote competition in line with the Delegation.

Importance of the regulated price in a competitive market

Following the outcome of the Judicial Review application by Origin Energy regarding the cost of energy approach used by the QCA in making its 2012-13 Regulated Retail Pricing Determination, AGL understands that the QCA does not intend to change its current approach for setting energy costs used in the regulated price. AGL remains concerned that the current approach does not deliver the optimal long-term policy settings for consumers and the industry alike.

Having said this, it is important that regulatory policy settings are predictable and transparent so as to minimise regulatory uncertainty, which in turn will allow retailers to plan for the medium to long-term. They are critical in ensuring the sustainability of competition in the retail energy market. As noted by the QCA, and other regulators, regulated prices alone cannot protect consumers from electricity price increases, however retail competition can provide consumers with greater choice and in turn ensure that prices are restrained by competitive pressures.

Structure of Submission

In this paper, AGL has responded to the Consultation Paper in the following structure:

- Section 2 discusses network costs;
- Section 3 considers the range of issues in establishing the energy purchase cost allowance;
- Section 4 discusses the retail operating cost allowance and retail margin; and
- Section 5 comments on retail competition in the Queensland electricity market and other considerations.

[1] Standing Council on Energy and Resources, Australian Energy Market Agreement (As Amended) Clause 14.11.

2. Network Costs

In light of the Queensland Government's uniform tariff policy it is appropriate that small customer tariff pricing is based upon Energex's network tariffs.

AGL also notes that currently the timing of the confirmation of network prices can pose difficulties for the QCA in setting regulated retail tariffs. AGL support the changes to the National Electricity Rules (NER) recently proposed to the AEMC by IPART. For 2013-14, AGL agrees with the QCA proposal to use the Energex and Ergon network tariffs as proposed to the AER in April. If these network tariffs were to change between their submission to the AER and the publishing of regulated prices, AGL would suggest that the QCA should update its retail prices accordingly.

Of course, if the Queensland distribution networks are planning to make any structural or other such significant changes to its network tariffs in 2013-14 then AGL would expect it to provide immediate notice to the QCA and market participants as it may have serious consequences on the QCA's price determination process.

3. Energy Costs

Wholesale energy costs

AGL continues to advocate for the calculation of the wholesale energy cost (***WEC***) using a market-based approach whereby the WEC should not be less than the long run marginal cost (***LRMC***) of electricity generation. AGL again notes that adopting this approach within the three year period of the Delegation would limit short-term volatility in retail prices and provide longer-term certainty for the retail industry.[2] The QCA suggested that other regulators and Governments are showing a preference for a market-based approach. AGL would highlight that recently regulators and Governments have also moved to reduce the impact of retail price regulation with the South Australian Government removing price regulation from 1 February 2013 and IPART proposing an 'opt-in' model for regulated retail prices for the 2013-16 Determination period – a short-term approach to setting regulated retail electricity prices is at odds with this trend.

However, AGL understands that the QCA is reluctant to move away from its current market-based approach for 2013-14, and for the remaining years covered by the Delegation. The QCA has noted in the Consultation Paper that "it is open to suggestions from stakeholders on how that framework might be improved". AGL has reviewed the report by ACIL Tasman *Estimated energy costs for use in 2013-14 electricity retail tariffs, December 2012* (***ACIL Draft Report***) and the presentation entitled *Energy cost estimates – Approach and preliminary results* (***ACIL Workshop Slides***) presented at the Workshop on 19 December 2012.

AGL has significant concerns that the preliminary results provided in the ACIL Workshop Slides demonstrate that the proposed methodology is flawed and will not adequately represent a retailers 2013-14 energy purchase costs. In this section AGL has detailed a number of specific issues with the modelling and a number of questions for the QCA and ACIL Tasman so that AGL can better understand the methodologies being employed.

Market based approach assumptions

AGL notes that there are a series of critical assumptions which underpin the proposed market-based approach to calculating a retailers energy costs. In setting a credible energy cost for retailers these assumptions should be tested to determine whether they reflect the reality faced by retailers operating in the NEM.

2013-14 futures contract liquidity in Queensland

AGL has highlighted in its last two submissions made to the QCA (i.e. 2012-13 Draft Determination and 2013-14 Interim Consultation Paper) that due to liquidity concerns AGL does not agree that futures prices provide a reliable estimate of the 'efficient cost' faced by retailers serving a small customer load in Queensland. It would appear that due to a lack of any other wholesale electricity contract market data which could be used in the market-based approach the QCA and ACIL have ignored the concerns raised by AGL.

[2] In previous submissions to the QCA AGL has advocated that the energy cost should be calculated based on the LRMC of generation using a 'standalone or greenfields' basis to meet the relevant load. ACIL anticipate that the LRMC for 2013-14 would equal the marginal cost of the lowest cost of an existing generator. This assumes calculating the LRMC incorporating the existing generation fleet i.e. 'incremental or brownfields' approach. AGL does not consider an incremental approach suitable for calculating the cost of energy for a regulated retail electricity price.

In the ACIL Draft Report, ACIL argued that other hedging arrangements entered into by retailers do not warrant consideration when setting the energy purchase cost for one year because a prudent hedging strategy using published contract prices with forecast spot prices will provide the 'efficient cost' for that period (i.e. because these contracts are available, the hedging strategy can be prosecuted and the spot prices represent a reasonable forecast, then this cost is available to all retailers). Therefore using any other approach would be inefficient and result in a misallocation of resources. This approach is based upon the assumption that the contract market is completely liquid and therefore all retailers can access these prices for their entire load.

As AGL has shown in our previous submissions, the trading levels of QLD contracts on the d-cypha Trade platform have not indicated that historically the market is completely liquid and AGL does not expect 2013-14 to be any different. In addition, if a single large retailer, let alone all retailers, sought to hedge their loads using these contracts then the prices for these contracts would be significantly affected. ACIL has not attempted to estimate what the forward contract prices would be under this situation but simply assumes that the contract prices of a small sample of incremental trades will be representative. The result is that contract prices do not reflect a price which would be available to retailers under the conditions modelled by ACIL. One approach to address this issue would be to include a liquidity risk premium as part of the EPC (discussed in further detail later in the submission).

Also AGL has previously highlighted that long-term hedging arrangements mean that the conditions which are being hedged are by their nature more uncertain. Option theory and practice supports the view that instrument valuations increase as the tenor of the instrument increases. Accordingly, it is most unlikely that such instruments, by reducing retailer risks, could somehow be cheaper. ACIL has effectively ignored prudent retailer practice of diversifying price and volume risk through a number of different hedging arrangements.

In addition, at the recent Workshop, AGL queried whether ACIL considered liquidity levels (i.e. volume traded or open interest at a point-in-time) of d-cypha Trade contracts to confirm whether the price can be deemed 'efficient'. ACIL noted that the efficacy of the pricing is judged against data on historical OTC trades which ACIL acquire from a broker. AGL does not believe that a comparison of illiquid contract prices against a limited selection of futures contract trades addresses the liquidity concerns and the increased cost of long-term hedging arrangements described above.

Lack of transparent PPA information

ACIL argued that information on PPAs is not in the public domain and therefore ACIL do not have access to such information.[3] AGL provided a submission to the QCA on the 2012-13 Draft Determination dated 8 May 2012 in which AGL presents two methodologies for calculating the theoretical price of a PPA equivalent to a base or peak swap.[4] AGL notes that this approach could provide an option for consideration PPA costs of retailers as part of the EPC allowance. AGL requests that the QCA/ACIL give this approach further consideration, and provide feedback why this type of approach should not be included in estimating a retailer's EPC.

[3] ACIL Tasman, Estimated energy costs for use in 2013-14 electricity retail tariffs, December 2012. Page 12.

[4] AGL Energy Ltd. Regulated Retail Electricity Prices 2012-13 (March 2012) - Supplementary Information, 8 May 2012.

Market-based approach methodology

The QCA proposed two changes to the methodology employed by ACIL in 2012-13, in summary:

a) Changing the data source for demand forecasts; and

b) Use of the 95th percentile of the distribution of energy purchase cost (EPC) estimates to better reflect "volume risk faced by retailers in this period of high volume uncertainty".

AGL does not in principle oppose these changes to the EPC methodology. However, AGL does have a number of specific concerns with the methodology described in the ACIL Draft Report and the preliminary results in the ACIL Workshop Slides. AGL has listed out these concerns below and highlighted a number of specific questions which AGL requests that the QCA/ACIL provide a response to as part of the Draft Determination:

1) Development of simulated load traces

In their proposed methodology, ACIL has described their process for constructing 39 simulated load traces for each NEM region and settlement class. This is done by selecting daily load profiles from actual load data in the three years 2009-10 to 2011-12, based upon a comparison of daily temperature profiles from 2009-10 to 2011-12 with the corresponding temperature data for 39 simulation years. The actual load data is then normalised to the 2011-12 demand levels so that the 42 load traces represent levels in line with 2011-12.

By using an approach which relies on a limited number of years of actual data to represent 42 years of loads, AGL is concerned whether this type of methodology adequately represents the historic variability in the load over the years. In ACIL's approach, given that 42 simulation years are derived from only 3 years of actual demands, it is reasonable to assume that demands from particular historical days are replicated multiple times across the various load traces. This becomes of particular importance for historical days where the temperature is greater than the maximum temperature in the actual data years. For example, if the maximum demand day in 2 out of the 39 year traces (e.g. 1980 and 1981) are taken from the same historical day (i.e. maximum temperature day in actual data years), but these two years have different maximum temperatures (e.g. 40.4 and 39.1 respectively), these days will still have the same demand.

Q. Is there any mechanism in ACIL's methodology to differentiate historical days with hotter or milder weather? If not, does this reduce the range of the historical weather variability?

2) Scaling of system and settlement loads

AGL notes that the historical years used as the basis for NSLP and system loads, i.e. from July of 2009 to 30 June of 2012 were a period in which the summer weather of Queensland was relatively mild. Furthermore, the flooding that occurred in 2011 around Brisbane also resulted in reduction of electricity consumption for a significant period in the 2011 summer. Therefore the approach used to scale these demands is of critical importance. AGL has two major concerns with the scaling approach used:

i) The variability in maximum demands is suppressed

ACIL has attempted to simulate demand conditions over a 42 year history of weather conditions, which should give the full range of weather conditions that might be expected to occur over that length of time. However, AGL notes that the actual approach fails to represent the variability in maximum demands that might be expected over time. Firstly,

as discussed above the 42 years of weather data are mapped onto only 3 years of genuine demand data. Secondly, the 1 in 10 year maximum system demand has artificially been taken to be the extreme point of the 42 year simulation, whereas in fact at least 4 years (44 simulation cases) should have a demand at this level or higher.

ii) Additional variability of NSLP loads is not represented

In order to ensure that they are representative of the forecast 2013-14 load, the simulated load traces are adjusted to match the 2013-14 demand and energy forecasts from the AEMO 2012 National Electricity Forecast Report (NEFR). Adjusting the loads is an important step of the proposed methodology because scaling historical loads (which vary during the period in question) based on a number of individual parameters and/or on a particular mapping method can affect the shape of the load (over the period in question), and in turn the cost of hedging this load.

At the December 2012 workshop, AGL requested clarification of the approach used to scale NSLP (as opposed to system) maximum demands. ACIL suggested that descriptions of this process in previous ACIL documents would address any queries. On this basis, AGL has reviewed the descriptions in ACIL's 2013-14 Draft Report (December 2012), 2012-13 Draft Report (March 2012) and the 2012-13 Final Report (May 2012). In the 2012-13 Draft Report, ACIL provided a more detailed discussion of the approach used to scale the loads (page 15), including:

> *"Using a non-linear transformation the 41 years of load data are adjusted to match the AEMO 2011 ESOO forecast for each NEM region…The matching 41 years of load traces for Energex total, Energex NSLP and the individual tariff load traces are also adjusted by the same amounts to provide consistent load traces to represent 2012/13."*

This appears to state that NSLP maximum loads have only been scaled in line with system demand loads. AGL is concerned that this approach does not adequately reflect the additional volatility in the NSLP compared to the QLD system load. This effect can be seen very starkly in recent years:

Table 1: Historical Maximum Load (QLD System vs. Energex NSLP)

	Maximum QLD system load	**Maximum Energex NSLP load**
FY08	8,116MW	2,386MW
FY09	8,683MW	2,582MW
FY10	8,931MW	2,785MW
FY11	8,846MW	2,528MW
FY12	8,714MW	2,521MW

Over the last 5 years system demands have peaked at 8,658MW on average, but reached 8,931MW on one occasion (in FY10). This 273MW variation represents around 3% of the total. By contrast over the same period the Energex NSLP varied from 2,560MW to 2,785MW, or 9% of the total.

On this basis AGL is of the view that the majority of the variability in the QLD load is in the NSLP load, meaning that where system demands are scaled by 100MW, the entire 100MW should be attributed to the Energex and Ergon NSLP and CLP components.

Q. Can ACIL provide a more detail explanation of the process applied to scaling the different loads used in the market-based approach?

3) Contract prices and trading costs

In *Step 8* of the market-based approach, ACIL has described that the futures price data for 2013-14 will be taken from d-cypha Trade and a set of prices will be developed by averaging the prices using a traded volume weighting. In 2011-12 ACIL developed a methodology for sampling traded futures prices acknowledging that periods of electricity futures prices traded on the d-cypha Trade platform occurred while there was significant uncertainty regarding the commencement of the Commonwealth Government's 'carbon pricing scheme'. If futures prices up to 2 years prior to the start of the determination period (i.e. 1 July 2011) are used, it is likely that some of the traded volume used to calculate the contract prices will not reflect the impact of the carbon pricing scheme.

Q. How does ACIL propose to trade-weight contract prices i.e. over what period to minimise any impact of carbon price uncertainty while maintaining sufficient liquidity?

As noted earlier, the market-based approach proposed by ACIL carries with it a liquidity risk that contracts are not available at a 'reasonable' price. Typically there is a significant spread between the prices proposed by buyers (bid price) and sellers (offer price). If a retailer wishes to purchase contract volumes to hedge their retail load they would be forced to pay the higher offer price, which is generally only a small volume on d-cypha Trade, hence the retailer will be required to pay the next best offer in the market for additional volume. Therefore, the proposed contract prices should be increased to reflect an estimated liquidity risk premium on d-cypha Trade for a retailer contracting their load.

AGL also notes that retailers incur additional costs associated with hedging through the futures market which should be acknowledged in the EPC i.e. exchange fees, broker fees and margining requirements.

4) Preliminary results - Market Risk to Retailers

The ACIL Workshop Slides presented on 19 December 2012 included a set of preliminary results for the 2013-14 EPC across the different settlement loads. Apart from the estimates themselves, AGL notes that the graphs in Slide 5 provided some insights into the range of energy purchase cost outcomes in the preliminary ACIL modelling. These figures have been reproduced below as Figure 1 and Figure 2. AGL has major concerns about the results as they are shown, as discussed below.

Figure 1 – ACIL Workshop Slides (Slide 5 – Market Simulations, Low Growth)

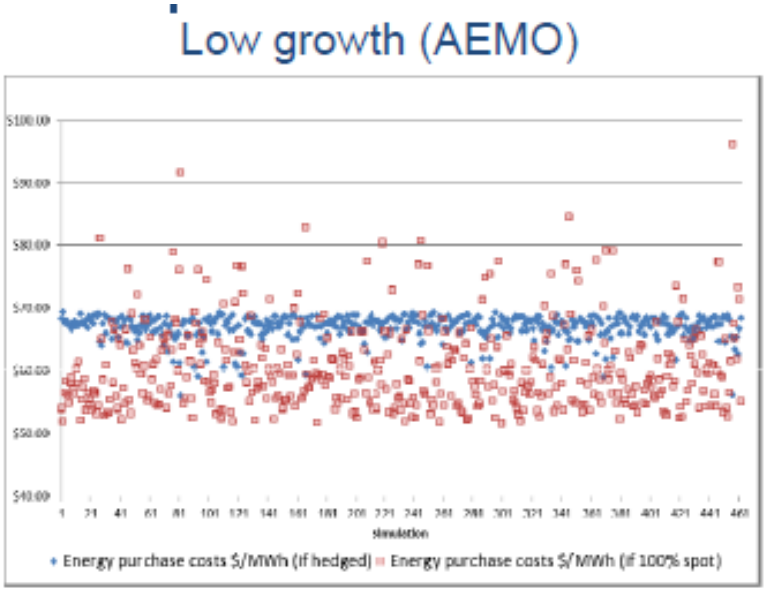
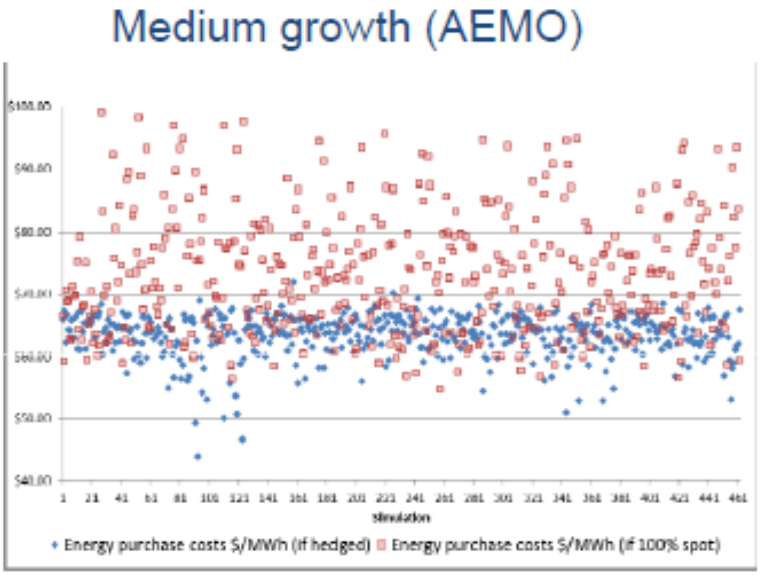


Figure 2 – ACIL Workshop Slides (Slide 5 – Market Simulations, Medium Growth)



i) Retailer risk exposure

In Figure 1, the results for the EPC (hedged) are generally higher than the results for the EPC (100% spot) for the Low Growth scenario. At the same time, the spread/risk of the EPC (hedged) results is much lower than the EPC (100% spot) results. This is consistent with the expectation that a retailer can reduce price risk by hedging, but this will result in a higher cost.

In Figure 2, the EPC modelled using the Medium Growth scenario shows the opposite which is that a retailer can reduce its price risk by hedging but at a lower cost than being fully exposed to spot market price risk. At the workshop ACIL explained that the nature of the hedging strategy being employed meant that in the Medium Growth scenario there were higher spot prices and therefore the contract strategy resulted in windfall gains for the retailer, and therefore a range of lower EPC results.

ACIL seems to suggest that the average cost under a hedging position will fall below the average cost of a retailer exposed to the simulated spot market. Reducing risk comes at a cost so it is nonsensical to suggest that it is cheaper to do so.

ii) Range of EPC Results

In Figure 1 and Figure 2, the results for EPC (100% spot), as expected, show a considerable degree of variability. The EPC (hedged) results show considerably less variability, also as expected. AGL is concerned that even with significant variability in the EPC (100% spot) results the EPC (hedged) results appear to put a 'ceiling' on the retailer's costs. For example, it is remarkable that in Figure 2 there is only one case shown with an EPC that exceeds around $70. This could only be the case if the retailer was fully hedged against all incidences of high prices.

The modelled hedging strategy is to hedge to 5% above the 50% POE maximum load. On the surface this appears conservative. However due to the reality of extremely volatile NSLP loads modelled this strategy would certainly be insufficient in high demand years. As discussed previously, in FY10 the maximum NSLP demand was 9% higher than in the average year. It follows that over the modelled 42 years one would expect a significant number of occurrences where demands exceed the 5% buffer in the contract position. In each such case the retailer would be exposed to any high spot prices that occur, and under such circumstances high spot prices are almost inevitable due to the unusually high demands.

Figures 1 and 2 reproduced above seem to tell a very different story, wherein the retailer has not suffered any significant exposure in a single one of the 462 cases modelled. AGL is not convinced that this is a credible forecast of a retailers risk exposure and requests more detail on the modelling results to better understand this outcome.

On the basis that the contract strategy assumed by ACIL is sound, this leads AGL to question the reasonableness of the spot prices/loads used to generate this distribution of EPC results. AGL suggests two possible explanations could be:

i) The process of scaling the loads (discussed earlier) may have reduced the variability of the mass market loads i.e. Energex NSLP; and

ii) The model does not realistically represent pool price volatility

AGL requests that the QCA/ACIL address these concerns in order to confirm the reasonableness of the assumptions which underpin the EPC modelling.

It should be noted that AGL does not advocate increasing the hedge level modelled as this strategy would generally incur prohibitive contracting costs. However these conditions are an inescapable feature of electricity retailing and must be fairly represented.

5) Retailer volume risk – move to 95th percentile EPC

AGL supports the change proposed by the QCA in relation to the choice of EPC from the distribution of simulated results i.e. from median to 95th percentile of the EPC distribution. ACIL acknowledged the suitability of this change because their proposed approach does

not fully account for "other uncertainties….and…. residual market volume or price risk"[5]. However, as noted earlier in relation to ACIL's approach, the apparent reduction in the variability of the loads, and therefore the spot prices, which will be used means that the distribution of EPC results is narrower than AGL would otherwise expect i.e. the difference between the median EPC and the 95th percentile is lower than anticipated. If the distribution of load, spot price and therefore EPC results better reflected the variability that AGL would expect to see then the EPC distribution would be greater.

AGL anticipates that by publishing the data related to the distribution of EPC results, loads and spot prices in the Draft Determination a more detailed analysis of these results will be possible.

6) Transparency of spot price modelling

ACIL's proposed approach relies on a 'black box' model of pool prices as well as a complex simulation methodology involving 462 iterations at a half-hourly level. In each simulation the modelled EPC will depend on the volatility of spot prices, coincidence of high demand with high prices and effectiveness of hedging.

To mitigate the lack of transparency inherent with the approach, AGL believe it is imperative that full details of the inputs and outputs to the model are made available to allow stakeholders to gain confidence and understanding in the model.

AGL requests that for each simulation half hourly pool prices, half hourly NSLP loads, contract volumes for base, peak and cap contracts, and details of the outages modelled are made available. This information is essential to deriving the EPC outcomes.

AGL also notes that no details have been provided of the system loads (half hourly), bids or outages modelled and request that further details of both are made available.

Enhancing time of use signals

AGL supports the use of time-of-use pricing to provide consumers with better price signals driven by the costs of supplying their energy at different times. However, in setting regulated retail prices AGL is of the view that the wholesale energy costs should be modelled on the same basis that retailers settle the energy costs in the wholesale market.

Green costs

Queensland Gas Scheme

AGL is of the view that the cost allowances to meet other 'green' schemes, such as the RET and the Queensland Gas Scheme, should reflect the long-term cost of compliance rather than short-term market-based costs. This has been recognised by the QCA and it's consultants in determining the 2012-13 allowance for the QLD Gas Scheme. The approach used acknowledges "that retailers have prudently entered arrangements to acquire GEC's which have legitimately added to the EPC".[6]

LRET

AGL is of the view that in determining the cost allowance for LRET compliance the QCA should consider the range of costs that would be experienced by a retailer sourcing LGCs

[5] ACIL Tasman, Estimated energy costs for use in 2013-14 electricity retail tariffs, December 2012. Page 16

[6] ACIL Tasman, Estimated energy purchase costs for Final Determination, Prepared for the Queensland Competition Authority, May 2012. Page 22.

not only from the market. Therefore AGL is of the view that in setting the allowance for a retailer's cost of compliance with the LRET scheme using the LRMC of compliance is the most appropriate approach in setting a regulated retail electricity price.

The QCA has dismissed this approach and proposes to continue with using a market-based approach as used in 2012-13. AGL requests that the QCA make the data available on LGC prices and any assumptions for the RPP clear and transparent as part of the Draft Determination.

SRES

AGL notes that the nature of the SRES makes it very difficult for regulators to accurately forecast an accurate SRES allowance for a future period. While acknowledging recent recommended changes to the STC Clearing House made by the Climate Change Authority, AGL does not support the use of market prices to set a future cost of scheme compliance for retailers. AGL notes that numerous changes in the market and other regulatory decisions have meant that fundamentals of the STC market have changed over time, and this could continue over the coming years.

AGL remains of the view that the cost allowance for SRES compliance should be based upon the clearing house STC price (i.e. $40/STC) and the most recent estimate of the STP for the years in question.

NEM fees and ancillary services charges

AGL supports the continuation of the approach the QCA used in previous determinations to assess the NEM fees and ancillary service charges.

4. Retail Costs

Retail operating costs

In the 2012-13 Final Determination the QCA assessed the retail operating costs (ROC) for small customers consuming up to 100 MWh/year to be $130.67/MWh. This ROC amount is based on an "efficient, representative retailer". Although AGL supports the QCA's approach in taking into account regulatory fees which are specific to QLD, AGL continues to be concerned about the practice of state-based regulators referencing each other's benchmarks without inputs from retailers.

To provide a guide to the possible level of retail operating costs on a per customer basis, AGL refers to its publicly reported costs. In announcements to the market, AGL has published details of its financial performance in an ASX Appendix 4E report. For the financial year ended 30 June 2012, AGL has reported the information below in section 4.1.4.2 Cost to Serve Analysis:

Table 2: Cost to Serve Analysis

		Year ended 30 June 2012	Year ended 30 June 2011
Net operating costs	$million	321.7	290.8
Net operating cost per account	$	95.38	89.34

These amounts represented costs which are directly related to the retail business and do not include operating costs related to Merchant Energy involved in managing the wholesale energy portfolio and Corporate Costs. They also do not fully reflect the direct cash outlays for customer acquisition incurred during the year as these costs are amortised.

In 2011-12, Corporate Costs or Centrally Managed Expenses which can be allocated to Retail Energy amounted to $55.8 million but there is a further $94.5 million which remained unallocated (section 4.5 of ASX Appendix 4E report).

When operating costs related to Merchant Energy and Corporate (including a re-allocation of the unallocated amount), as well as the reversal of capitalised costs and amortisation of campaign costs, are considered, the cost per customer would be around $45 per customer higher for 2011-12. The adjusted net operating cost per customer which includes acquisition and retention costs incurred during the year would be about $140. This is an average across electricity and natural gas customers.

Therefore, under the current definition of an efficient retailer, the 2012-13 ROC of $130.67 is lower than the actual operating costs which AGL incurred in 2011-12. If costs are re-allocated on the basis of fuel (electricity or natural gas), the operating costs relating to small electricity customers overall will be even higher, predominantly due to higher bad debts costs as electricity bills are significantly larger than natural gas bills.

As AGL is one of the largest retailers in south east Australia, AGL's costs reflect some economies of scale. The current benchmark for operating costs is therefore unlikely to facilitate competition. In addition, the QCA should consider re-defining the retailer to be a "new entrant retailer" to fully account for the costs of acquiring customers.

In relation to the allocation of ROC, AGL agrees that it is appropriate to allocate 100% of ROC to the fixed component of each retail tariff with the exception of controlled load tariffs

and unmetered tariffs. As suggested by the QCA, retail costs are unlikely to vary with consumption.

Retail margin

The current retail margin of 5.4% is based on the decision by IPART in the 2010 review of regulated retail electricity prices. In the Consultation Paper, the QCA has referred to the arguments which AGL and other retailers have put forward that the risk of retailing in QLD is higher than in NSW due to the lack of a LRMC floor in the cost of energy. AGL considers that this continues to be a valid point. Although it is difficult to establish a retail margin which can be easily verified, some acknowledgement of the higher risk should be allowed. In addition, as AGL had previously submitted, the retail margin cannot be determined in isolation to the other cost components. If wholesale energy costs and retail operating costs are set too low, the effective retail margin will be lower.

The QCA also referred to the Government's query as to whether the retail margin should be applied to all cost components, given that network costs are treated as a pass-through cost. AGL agrees with the QCA's point that network costs are not necessarily a costless pass-through and where a customer does not pay their bills, a retailer will not recoup all relevant network costs.

In relation to the application of the retail margin to tariffs, AGL agrees with the QCA's approach of applying the retail margin equally to each component of each retail tariff.

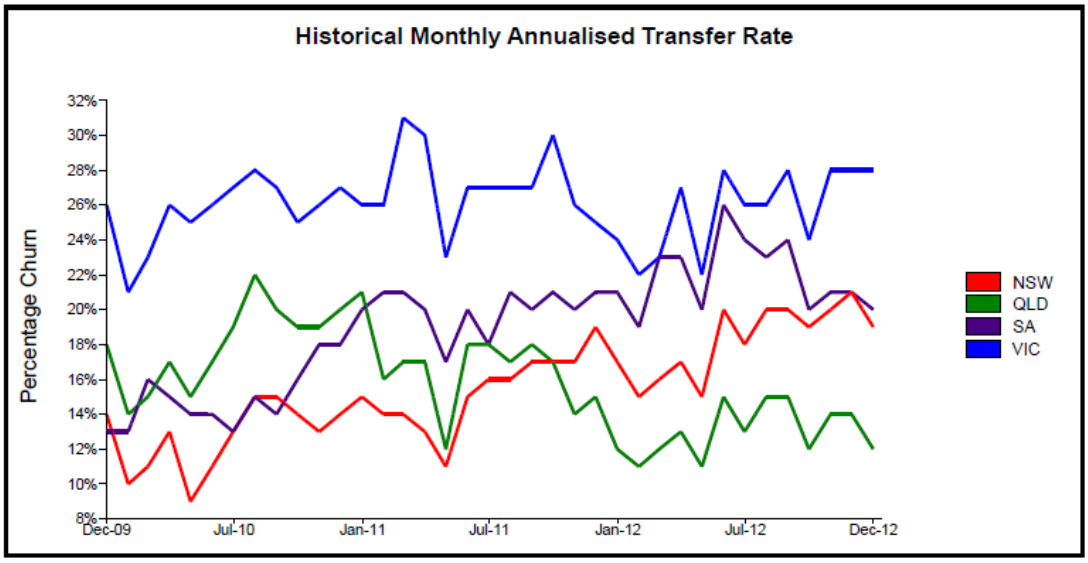
5. Competition and Other Issues

Competition Considerations

The QCA has claimed that neither the 2012-13 Determination nor the Tariff 11 freeze has negatively impacted competition. AGL does not agree with this.

Although there are other types of information which could be relevant, the switching or transfer rate such as those published by AEMO (Monthly Retail Transfer Statistics) is a simple but useful guide to assess the level of competitive activity. There are changes in switching rates from month to month and there are lags between marketing activity and customer transfers. However, it is clear that despite the switching rate stabilising in October and November 2012 as noted by the QCA, the switching rate in QLD has remained well below that of the other states in the NEM (see Figure 3 below). AGL contends that this is strongly suggests that competition is relatively weak compared with other jurisdictions.

Figure 3: AEMO NEM monthly retail transfer statistics, Dec 2012



In relation to the market offers available, it should be noted they do vary from time to time. In addition, the types of products offers vary from a discount off the total bill to offers with a number of components with a separate discount for direct debit and payment on time. An offer with a 10% discount provides a higher effective discount that an offer which has components which could add up to 10% e.g. a guaranteed 6% plus 2% for direct debit and another 2% for payment on time.

It should also be recognised that new entrant retailers may be prepared to incur losses to establish a customer base, considering the losses as a marketing expense. Therefore, comparing current offers by new entrant retailers with previous offers by established retailers is not a valid way to assess the changes in level of discounts offered. In AGL's case, the level of discounts offered has been reduced since June 2012. Up to June 2012, AGL had offers of 10 to 15% discount off usage rates, but current offers are based on a maximum discount of up to 9% based on a guaranteed 5% plus 2% for direct debit plus

2% for payment on time. In addition, AGL also cut back on its marketing resources in Queensland during 2012 as a direct result of the level of prices set by the QCA.[7]

Allowance for headroom

As submitted previously, in AGL's view, the allowance for headroom needs to be at least 5% to enable retailers to compete and provide incentives for customers to switch. In the Consultation Paper, the QCA's own analysis has supported this:

- The QCA estimated that, on average, the level of headroom was around 6% for Tariff 11 but much higher in most other common tariffs, ranging between 12% and 23%; and
- The maximum discount off Tariff 11 is currently 15%.

In AGL's view, the level of headroom in the tariffs needs to, as a minimum, be maintained to ensure a sustainable level of competition. Based on the indicators of competition discussed in the previous section the QCA should be mindful that further reductions in the regulated price will continue to erode retail competition and runs the risk of undermining market reforms to date.

The QCA has concerns about the lack of customer engagement with a possible option to involve an advertising campaign to encourage customer to shop around. Retailers have been active in providing information to customers about the ability for them to take up market contracts or to switch their energy provider. About two thirds of customers in SEQ have already taken advantage of this opportunity. It is therefore important that strong competition is fostered by the QCA as retailers will be more effective in engaging with customers.

Accounting for unforeseen or uncertain events

Given that the Delegation is for a three year period, it is appropriate that the QCA consider a cost pass through or catch up mechanism to cover unforeseen or uncertain events. This risk has not been recognised in the QCA's benchmark for retail margin. Over the past two price determinations, there has been significant under-recovery of the allowance for SRES.

In NSW, IPART has provided cost pass through mechanisms for regulatory and taxation changes. Regulatory change events include:

- Changes in relation to green energy and efficiency schemes;
- Changes in relation to govern imposed hardship policies;
- Unforeseen AEMO charges such as reserve trader or direction event; and
- Retailer of last resort event.

Taxation events include income and capital gains tax, penalties, licence fees or other items which are in the nature of taxation.

AGL considers that IPART's approach to be reasonable. AGL favours an approach which is flexible, not prescriptive, in relation to the types of events which a pass-through mechanism can work with.

Given that the QCA will be reviewing retail prices on an annual basis, it should be straightforward for the QCA to consider and include any relevant and material pass-

[7] AGL Energy Ltd. 2013 Earnings Guidance. Available at: http://svc001intranet.dmoss15.server-web.com/about/ASXandMedia/Pages/2013EarningsGuidance.aspx

through amounts in the following year's notified prices. This mechanism could be constructed as an explicit part of the QCA's determination process.

If so, AGL believes it may also provide the QCA the opportunity to rectify the SRES under-recoveries in 2012-13 within its determination of retail prices for 2013-14.

Obsolete Tariffs

AGL has provided a separate submission on the QCA's Consultation Paper on Transitional Issues.

AGL agrees with the QCA's view that it is not appropriate to allow new large customer to access the obsolete tariffs as it will allow customer to be placed on tariffs which are not cost reflective and create a large group of customers who would eventually need to be transitioned to more appropriate cost reflective tariffs. The obsolete tariffs should remain closed to new customers.

The QCA has raised the issue of allowing customers who have shifted from an obsolete tariff prior to 1 July 2012 to switch back due to the price differential. In AGL's view, as a general principle, prices should be set at cost reflective levels as soon as possible. Since price signals are considered critical for resource allocation, this mispricing could provide incorrect incentives to consume energy. The number of customers on tariffs which are not cost reflective should be reduced over time. If the obsolete tariffs are reset to cost reflective levels as soon as possible, this issue will resolve itself.