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6 September 2013

Mr Mark Gray
Chief Executive Officer
GPO Box 2257
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Dear Mr Gray Mark

Re: Submission on the Regulated Retail Electricity Prices for 2014-15: Interim Consultation Paper

Ergon Energy Queensland Pty Ltd welcomes the opportunity to provide comment on the Queensland Competition Authority's Interim Consultation Paper Regulated Retail Electricity Prices for 2014-15.

Should you wish to discuss this submission, or require any further information on the issues raised, please contact me on (07) 3851 6395.

Yours sincerely

Mark Easton
Group Manager Retail Strategy and Market Solutions

Encl: Ergon Energy Queensland's Submission

Ergon Energy Queensland Pty Ltd

Submission on the *Regulated Retail Electricity Prices for 2014–15: Interim Consultation Paper*

Queensland Competition Authority

6 September 2013

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Queensland Competition Authority
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This submission, which is available for publication, is made by:

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1 INTRODUCTION

Ergon Energy Queensland Pty Ltd (EEQ) welcomes the opportunity to provide comment on the Queensland Competition Authority's (the Authority) *Interim Consultation Paper Regulated Retail Electricity Prices for 2014-15* (Interim Consultation Paper).

EEQ supports the Minister for Energy and Water Supply's (the Minister) Delegation to the Authority to determine the regulated retail electricity prices (or notified prices) for 2013–14 to 2015–16 based on a network (N) plus retail (R) cost build-up methodology. The move to an N+R cost build-up methodology has allowed for greater transparency of the underlying costs of supplying electricity to customers and presented distributors with an opportunity for improving network price signals in order to manage the on-going impact that network costs have on customer affordability.

As the largest retailer by customer number in regional Queensland, EEQ is cognisant of the unique circumstances of regional Queensland customers and strongly supports the continuation of transitional tariffs for Large and farming customers. We also believe that retail tariffs must not unduly penalise customers who have little alternative to accessing the notified prices.

Further, it is important to note that the Queensland Government has indicated that the Authority will continue in its role of setting notified prices for regional Queensland while the Government continues its reform agenda. The Queensland Government identified in its response to the Interdepartmental Committee (IDC) on Electricity Sector Reform (p9) that the proposed reforms to remove electricity price regulation by 1 July 2015 only relate to south east Queensland and only if consumer protection and engagement in the market are judged to be adequate.

In addition, the current delegation to the Authority provides that the Authority will set regulated retail electricity prices for the three year delegation period 2013-14 to 2015-16. While the Delegation can be amended, in light of the Government's proposed reforms it is reasonable to assume that the Authority will continue to set the notified prices in 2015-16 for, at a minimum, regional customers. The Authority must therefore consider this reality when reviewing its current approaches to determining energy costs, retail operating costs and the retail margin. These critical matters must not be considered a single year issue only, especially for regional Queensland customers.

EEQ strongly supports the continued investigation and refinement of the pricing methodology.

In its Interim Consultation Paper, the Authority has invited comments on the Authority's review of notified prices for 2014-15, the second year in the three-year delegation. In response, EEQ has provided general comments in Section 2 and detailed comments in relation to the specific questions posed by the Authority in Section 3.

EEQ is available to discuss this submission, or provide further detail regarding the issues raised, should the Authority require.

2 GENERAL COMMENTS

As the Authority is aware the determination of energy cost, in particular the wholesale energy costs, has been the subject of extensive consideration with many stakeholders and experts having a significant difference of opinion. EEQ is of the view that continued constructive consideration on the determination of the wholesale energy costs is essential to ensure that an equitable price is allowed for this important element.

Importantly, the consideration to date has predominately centred on whether a market-based versus LRMC methodology should be used. Whilst there have also been significant discussion and improvements made to the market-based methodology used by the Authority, EEQ is if the view that further improvements are required, especially in the current market conditions.

Whilst there have been many arguments and counter-arguments on each particular issue, which in isolation to each particular issue may have a valid base, the net effect is that in EEQ's view the current market based-approach for wholesale cost of energy is not providing an equitable price and therefore needs refinement. EEQ considers improvements must be made in 2014-15 to:

- Ensure competitive retailers that are not currently active in the south east Queensland market re-engage. This is particularly important if the Queensland Government is considering de-regulation of retail prices for south east Queensland from 1 July 2015; and
- Improve the pricing of the risk faced by retailers, while acknowledging the significant improvements in the 2013-14 determination (i.e. the move to the 95th percentile).

In this light, EEQ strongly supports the Authority seeking stakeholder's views on the determination of the energy costs for 2014-15.

EEQ considers that it would be in the interests of all stakeholders that the Authority, with ACIL Allen[1] (ACIL), conducts a workshop on energy costs prior to the Draft Determination to ensure that these issues can be constructively considered. This would assist the Authority and ACIL to finalise the 2014-15 Draft Determination for the energy costs component.

EEQ has provided comment below on methodology improvements for pricing of the risk premium to account for contract price movements following the Final Determination. EEQ is continuing further consideration and analysis of a number of the other issues raised by the Authority and proposes to submit supplementary papers to assist the Authority and ACIL with further consideration of these issues for its Draft Determination. We ask that the Authority give consideration to any supplementary papers on these matters, which we aim to provide prior to any energy costs workshop.

[1] Throughout this document "ACIL" refers to ACIL Allen Consulting, which commenced trading on 2 April 2013, and its predecessor ACIL Tasman.

3 DETAILED COMMENTS

3.1 Network Costs

The transition to the N+R cost build-up approach for notified prices presents network businesses with an opportunity to further refine network pricing signals in order to manage the on-going impact network costs have on customer affordability. Affordability remains a key priority for EEQ and its customers, who continue to expect the electricity industry to operate in a manner that provides them with access to cost efficient electricity that meets their changing needs.

It is critical that customers receive pricing signals that inform them and provide appropriate value for shifting load to different times. This can, in turn, reduce peak demand impacts on the network and defer the need for expensive network construction and upgrades thus putting downward pressure on the network component of the total costs of electricity to the end user.

In recognition of the critical importance of appropriate network price setting for the future of the electricity industry, and in particular its impact on customer affordability, EEQ supports continuation of the distributor reviews of network tariff strategies in consultation with customers, retailers and other key stakeholders. We also recognise the important role retailers will play in assisting distributors with demand management and the development of appropriate price signals.

The inclusion of network tariffs in the notified prices must recognise the need for further refinement of price signals and ensure that customers can access transitional retail tariffs where the price signalling is more appropriate (e.g. continued access to time-of-use tariffs). The Authority must also provide for appropriate transitional arrangements where customers would experience price shocks from a straight pass-through of network costs (discussed later in paper).

3.1.1 Network Tariffs for Small Customers

The Authority seeks stakeholders' views on the following

(a) the suitability of Energex's network tariffs as the basis of retail tariffs for residential and small business customers;

EEQ supports the continuation of Energex network tariffs as the basis for retail tariffs for residential and small business customers i.e. notified prices for customers that are classified as 'Small' (consuming less than 100 megawatt hours (MWh) per annum).

Where Energex is considering changing the structure of its network tariffs adequate notice must be provided to the industry in order for retailers to identify impacted customers, educate customers on upcoming changes and modify systems and processes to provide for the alternative structures.

It is also highly preferred that Energex consult retailers, customers and other key stakeholders before any alternative structures or new tariffs are introduced to ensure optimal structure and pricing.

3.1.2 Network Tariffs for Large Customers

The Authority seeks stakeholders' views on the following

(a) the suitability of Ergon Energy's network tariffs as the basis of retail tariffs for large customers and, in particular:

(i) whether notified prices for large customers should be based on network charges in Ergon Energy's East pricing zone, Transmission Region 1 and, if not, what should they be based on?

(ii) what better options, if any, are there for network charge(s) to be used as the basis for notified prices for very large Ergon Energy customers?

As noted by the Authority[2] around 90% of Ergon Energy's Large customers are based in the Ergon Energy East pricing zone. The remaining Large customers are located across the West pricing zone, Mt Isa or isolated systems. As the costs of network tariffs relating to these areas are typically significantly higher than the East zone, it is preferred that the Authority base notified prices for Large customers on Ergon Energy's East pricing zone transmission region one.

With respect to pricing the 'very large' notified price (i.e. Tariff 48) it is appropriate to continue using the same network tariff (for high voltage demand customers) on which Tariff 47 is based. The Authority should not pre-empt the outcomes of the Queensland Commission of Audit Taskforce's investigations into the IDC's recommendation of removing notified prices for very large customers. It would be appropriate for this investigation to consider appropriate transition pathways for customers to manage the significant increases in their annual electricity costs should retail prices be based on site-specific network charges. As such, EEQ recommends that no changes be made to the N component for very large customer pricing for 2014-15.

3.1.3 Unmetered Supply and Street Lighting

The Authority notes that it will consult with distributors on the Queensland Government's decision to develop a price path to recover non-energy street lighting charges from Ergon Energy customers, giving consideration to individual customer needs, and will reflect any necessary changes through regulated retail tariffs if required[3]. As the potential changes to street lighting tariffs identified in the IDC report will affect EEQ customers, it is appropriate for EEQ to be involved in the discussion regarding price paths.

[2] QCA 2013, *Interim Consultation Paper Regulated Retail Electricity Prices for 2014-15*, p. 6.
[3] *Ibid*. p. 9.

3.1.4 Maintaining Alignment of Retail and Network Tariffs

The Authority seeks stakeholders' views on how best to maintain or improve alignment between network and retail tariffs for the purposes of setting notified retail prices.

EEQ supports the Independent Pricing and Regulatory Tribunal (IPART) proposed rule change to the Australian Energy Market Commission (AEMC) to provide for network prices to be approved earlier in order to allow for earlier notification of network price changes. This would reduce the risk of misalignment between network and retail tariffs for the purposes of setting notified prices. In the absence of a regulatory change, there appears to be little option but for the Authority to rely on draft prices with the continued inclusion of a catch-up mechanism should there be material deviation between draft and final network tariffs.

ERGON ENERGY

3.2 Energy Costs

3.2.1 Wholesale Energy Costs

The Authority seeks stakeholders' views on the following:

(a) What improvements might be made to ACIL Allen's hedging-based approach for 2014-15?

(b) Is there any new information available to suggest an alternative approach might be better than the hedging-based approach for 2014-15?

(c) What factors should ACIL Allen take into account when determining modelling inputs such as customer load forecasts, plant outage scenarios, hedging strategies and spot price forecasts?

(d) How best should the Authority account for carbon price uncertainty and the resultant potential lack of contract trading data?

Determining an appropriate treatment of carbon price uncertainty in setting retail tariffs for 2014-15 is both important and difficult. The current regulatory uncertainty surrounding carbon prices for the 2014-15 financial year is very high with a significant range of possible outcomes. EEQ is giving this complex matter further consideration, and intends to submit a supplementary paper on question 3.2.1(d) for the Authority's consideration and to support discussion of the issue at the proposed energy costs workshop.

Potential Changes in Contract Prices post Final Determination

In Origin Energy's supplementary submission in response to the Authority's Consultation Paper on Cost Components, Origin raised the issue of the ACIL hedging methodology assuming that retailers have completed all hedging for the coming financial year by the preceding May (assuming that final contract prices used in the Determination are updated in May 2013). Ergon Energy also raised a similar issue in its response to the Authority's Draft Determination 2013-14.

Origin identified that:

> *"ACIL Tasman's methodology implies a retailer will have completed all hedging for the coming financial year by the preceding May, yet Futures trading volumes indicate that this is not the case in practice. To the extent a retailer does not follow this theoretical hedging strategy in structure or timing, there are material risks which are not accommodated within the proposed tariff."* [4]

ACIL's response to the Origin issue was that a prudent retailer would have a reasonable proportion of load hedged just prior to the commencement of the quarter. As a result any significant increase in contract prices in a quarter would be limited to the unhedged proportion of load and, providing the remaining three quarters do not experience the same level of change in contract price, then the cost of the price rise would be marginal if spread across the year[5].

[4] Origin Energy 2013, *Supplementary Submission on the Queensland Competition Authority's Regulated Retail Electricity Prices 2013-14 Cost Components and Other Issues Consultation Paper,* p. 3.

[5] ACIL Tasman 2013, *Draft Report: Estimated Energy Costs for 2013-14 Retail Tariffs*, pp. 11-12.

While EEQ agrees that it is a prudent risk management strategy to hedge a reasonable proportion of load prior to the commencement of the quarter, retailers still take on the risk on price volatility (i.e. price could adversely move against the retailer) and load forecast risk (i.e. load forecast could adversely move against the retailer, including change in customers numbers, weather, shape etc.) due to the time between the close of assumptions for the Authority tariff determination process (i.e. April/May) and the start of a particular quarter. This is because retailers hedge to their revised load forecasts up to the commencement of the quarter, as evidenced by the trades occurring in the market. This risk is greater for Quarters 1 and 2 being the furthest in time from when tariffs are set.

An illustration of this disconnect is provided in the figure 1 below.

<u>Figure 1 – Queensland Competition Authority R Price Setting process – Timing Issues</u>

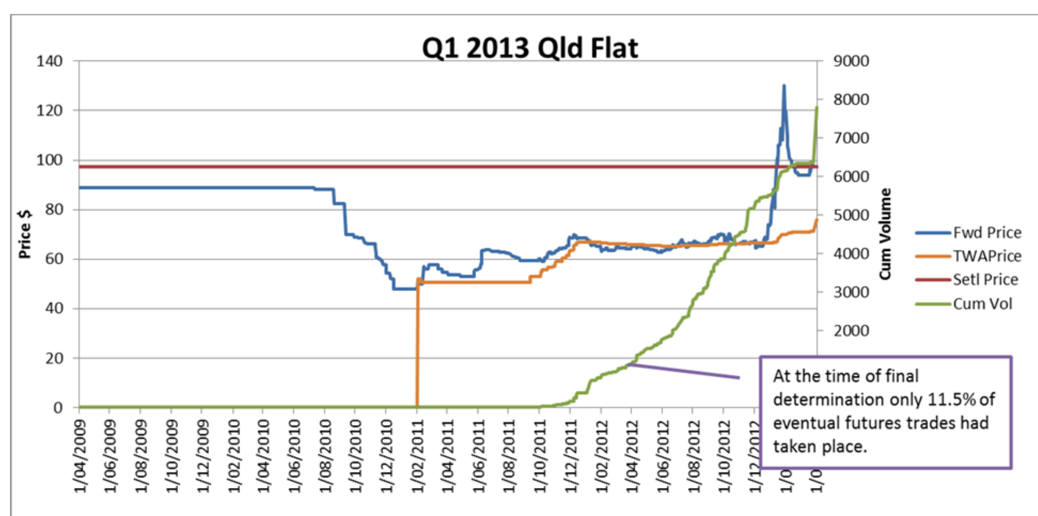
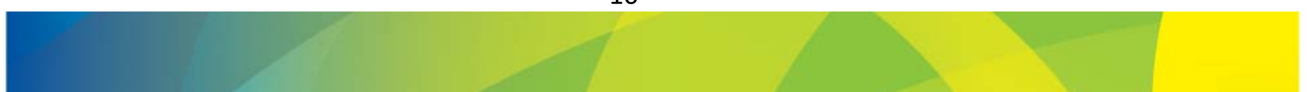


Figure 1 shows the cumulative volume of flat futures trades for Queensland for Q1 2013 together with the movement over time of the forward price and the time weighted forward price. It can be seen that, at the time of calculating the Q1 2013 contract price to be used in the final tariff determination, only 11.5% of the eventual total of futures trades for that quarter had taken place.

There is clearly a risk that the contract price used by the Authority in its determination could vary substantially from the contract price available to retailers leading up to the commencement of the quarter and from the final settled price at the end of the quarter. In this example the contract price remained relatively stable up until the start of the quarter, then the high pool prices which occurred in January 2013 lead to the final settled price being some $30 above the contract price assumed by the Authority. Further examination of historical outcomes will demonstrate that this is a constant and inevitable issue arising from the need to fix an annual price while retailers manage their risks more dynamically and, typically, on a quarterly basis.

Instead of introducing an annual catch-up mechanism the following year to account for the realisation of a price volatility or load forecast risk, it is considered appropriate that the above risks are compensated for in the wholesale energy allowance (ex-ante) and that a catch-up mechanism is only used for unusual events (e.g. similar to the impact on the drought in 2007 on electricity prices or potentially dramatic unforseen increases in gas prices following the commissioning of the liquefied natural gas (LNG) trains currently under construction in Queensland).



EEQ has previously suggested modelling the potential price movements as an option because options volatility is well understood and can be modelled using market based inputs. The Black-76 model was put forward as a possible model to describe the forward movement. An excerpt from our submission on this topic is provided at Attachment A.

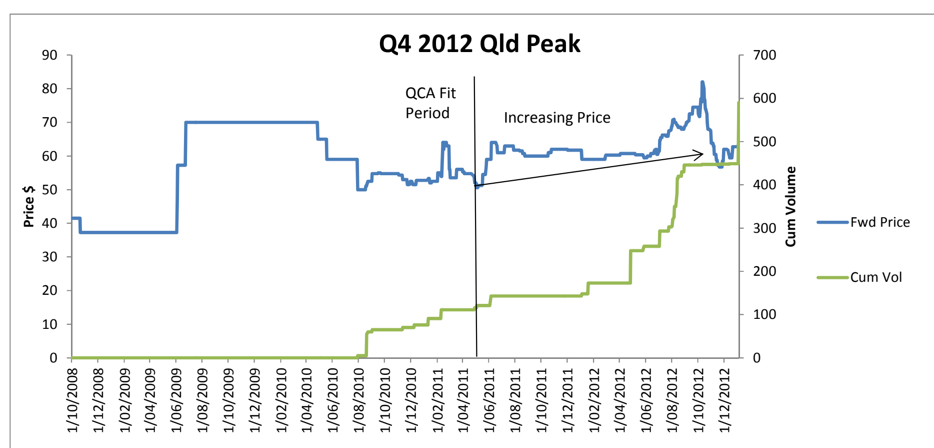
Whilst ACIL appears to accept the validity of the concern, ACIL considered that the futures contracts used in the methodology would already include the option value associated with the length of time to expiry:

> *"Ergon Energy have argued for a forward volatility premium to be added to the WEC to reflect hedge price uncertainty between the time that modelling is completed and the time when retailers might finalise their hedge arrangements for each quarter of 2013-14. The futures contracts used in the methodology would be expected to include the option value associated with the length of time to expiry. Therefore in our view the methodology already reflects any volatility premium."*[6]

ACIL should reconsider its position on this issue for the following reasons:

1. An at-the-money futures call option will always have a positive premium. The asymmetry of forward price necessitates this. This indicates that the risk associated with price change over the remaining time to expiry is not captured in the futures price;
2. It is unreasonable to expect a representative retailer would lock in all of its volume up to three quarters of a year from maturity. As well as liquidity issues limiting the ability to contract this far in advance, the capability of a retailer to position and reposition up to maturity is a key element in managing the price and volume risks of energy purchasing; and
3. ACIL's statement infers reduction in the time-to-maturity should result in a natural attrition of futures price over time (all else held equal). If so, this should at least be observed statistically and this has not been observed by EEQ. The following graph for Q4 2012 shows quite the opposite.

Figure 2 – Historical Futures Prices for Q4 2012



[6] ACIL Tasman 2013, *Final Report: Estimated Energy Costs for 2013-14 Retail Tariffs*, p. 32.

In summary EEQ's view is that the current Authority pricing methodology does not capture the risk in the remaining time to maturity for each of the quarters and that this risk must be priced and included in the determination of the wholesale black energy price for 2014-15.

Whilst EEQ considers the option valuation approach outlined in our submission to the Draft Determination 2013-14 (refer to Attachment A) is a reasonable method for capturing and pricing this risk, EEQ also considers other option instruments (e.g. Asian options) to be valid in pricing this risk. EEQ intends to make a supplementary submission on the pricing methodologies as soon as possible to ensure the Authority and ACIL have sufficient time to consider this issue in the preparation of the Draft Determination and to optimise discussion at the proposed energy costs workshop.

Way Forward

As noted above, EEQ currently intends to submit supplementary papers to the Authority as soon as possible on the following issues, and requests that the Authority accepts them for consideration:

- Options for pricing of risk premium to account for contract price movements from data of final determination to commencement of a traded quarter; and
- The matters raised in question 3.2.1(d).

3.2.2 Enhanced Renewable Energy Target Scheme

The Authority seeks stakeholders' views on the following:

(a) What improvements might be made to ACIL Allen's approach to estimating SRES costs for 2014-15?

(b) What improvements might be made to ACIL Allen's approach to estimating LRET costs for 2014-15?

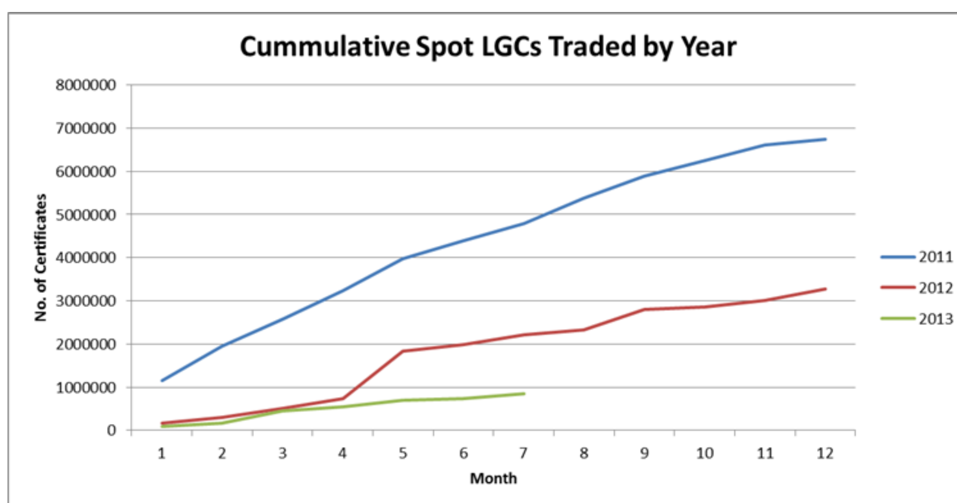
(c) Is there any new information available to suggest alternative approaches might be better at estimating SRES and LRET costs for 2014-15?

The approach undertaken by ACIL to estimate Small-scale Renewable Energy Scheme (SRES) costs for the 2013-14 Final Determination is supported by EEQ.

With respect to the approach for estimating Large-scale Renewable Energy Target (LRET) costs for 2014-15, EEQ suggests extending the book build period to four years, while continuing to use the current weighted approach. It is considered that the two year book build period will not truly be representative of the cost of hedging environmental liability for a large retailer due to falling liquidity and the expectation that following the possible repeal or modification of the current carbon legislation that the Large-scale Generation Certificates (LGC) price will rally.

As can be seen from the chart below (figure 3), the cumulative spot volumes of LGCs traded, as per trades reported by TFS, have been significantly decreasing even though the RPP has been increasing. In our view large retailers with large LRET obligations will not seek to meet their LGC surrender requirements by relying on the spot market over a relatively short term period. Retailers would have used the liquid years such as 2011 to build up their bank of LGCs as well as entering into longer term off take agreements with renewable energy generators. EEQ is of the belief that by extending the book build period to 4 years the QCA will more accurately reflect a retailer’s costs of meeting their LGC obligations.

Figure 3 - Cumulative Spot Volumes of LGCs Traded



Even though the methodology is not trade weighted, EEQ believes that the longer build period is more representative as this covers a longer period of time when more representative volumes of LGCs traded or quoted in the market. Therefore the price at which these were traded or quoted in the market better represented the true appetite of the market.

Further, given there has been such uncertainty over the future of carbon legislation and Mandatort Renewable Energy Target (MRET) this has impacted on the number of LGCs coming to market and the decision to hedge exposure is delayed until more regulatory certainty is obtained. This is an anomaly which has been limited to the last 12 to 18 months. Should more certainty be gained around the future of the schemes the price could be markedly different.

Various scenarios have been considered regarding possible future carbon legislation and MRET changes which have all indicated that the price of LGCs are likely to increase above current price levels experienced over the past two years as there still exists a significant shortfall in the target and given that renewable energy generators will not receive a carbon portion of the electricity price (if carbon legislation is repealed) or would receive a lower carbon price (if the current carbon price is transitioned to a fully flexible price under an emissions trading scheme) a higher LGC price would be required in order for projects to be made commercial.

Scenarios considered, included:

- Repeal of carbon legislation and MRET is maintained;
- Repeal of carbon legislation and MRET modified to 20% of actual demand; and
- Transition of MRET to an emissions trading scheme for 1 July 2014.

Renewable energy generators are reluctant to sell LGCs at the current market price and can see the same changes in the regulatory environment that might lead to higher LGC prices. This is a contributing factor to the current low level of LGC liquidity.

Also EEQ considers that greater transparency is gained into the LGC market by utilising TFS for pricing observation rather than AFMA as AFMA contributions have been limited. TFS maintain market data dating back to 2009 on daily basis.

3.2.3 Other Energy Costs

EEQ offers no comment in relation to the calculation of NEM Participation Fees, Ancillary Services Charges, Prudential Capital or Energy Losses Allowances.

3.3 Retail Costs

Throughout the Retail Costs section of the Interim Consultation Paper the Authority makes reference to the Queensland Government's commitment to "increasing retail competition and removing price controls in South East Queensland by 1 July 2015 providing it can be demonstrated that customers can benefit, and adequate customer protections are in place"[7]. The Authority argues that in light of the proposed reforms it may only perform the role of retail price regulator for one more year and therefore it is questionable whether to change its current approach to calculating the retail cost allowances[8].

As the Authority notes later in its paper[9] the Government proposed reforms refers to removing electricity price regulation for south east Queensland customers by 1 July 2015 and the current role of the Authority in setting notified prices will be retained for regional Queensland while the Government continues its reform process. As the Authority will continue to regulate prices for regional electricity customers, any decision to change or retain methodology should be based on the appropriateness of the approach. If a change in approach is valid, it should not be avoided because it may only have a short-term application in south east Queensland.

3.3.1 Retail Operating Costs

The Authority seeks stakeholders' views on the following:

(a) Are there any compelling reasons why the benchmarking approach should not be used for 2014-15?

(b) Is there any evidence to suggest that retail operating costs have changed materially, making the 2013-14 values irrelevant?

(c) Is the Authority's 2013-14 approach to allocating the ROC allowance to retail tariffs cost-reflective?

(d) If not, what would be a more cost-reflective approach, and why?

For the 2013-14 Final Determination the Authority continued with a benchmarking approach by adopting the Retail Operating Costs (ROC) allowance for small customers from IPART's draft determination, with a small adjustment to add back late payment fees and account for inflation, and uplifting the 2012-13 large and very large customer ROC allowances in line with inflation[10].

EEQ notes that the Authority has indicated that it will continue with the benchmarking approach subject to the identification of any compelling reason to modify its approach.

While there is merit in undertaking a bottom-up approach to setting the ROC allowance, EEQ acknowledges that there is difficulty in obtaining detailed confidential information from multiple retailers, especially where information may be classified differently between retailers making comparisons difficult.

[7] State of Queensland 2013, *Queensland Government Response to the Interdepartmental Committee on Electricity Sector Reform*, p. 9.
[8] QCA 2013, *Interim Consultation Paper*, pp. 19-20.
[9] *Ibid*. p. 22.
[10] QCA 2013, *Final Determination Regulated Retail Electricity Prices 2013-14*, pp. 43-47.

As undertaken in previous determinations, the Authority should consider any Queensland specific issues that may impact on a retailer's operating costs and adjust the benchmark accordingly. In addition to the absence of late payment fees in Queensland, another issue that warrants consideration is the combination of rising electricity supply costs and the implementation of retail tariff reform in Queensland, which has resulted in higher retail costs due to:

- Updating systems and processes to provide for new retail tariffs and structures, such as three part time-of-use;
- Increased call centre work load due to increased complexity in tariff choice, higher electricity costs and greater need for payment plans or hardship support; and
- Higher debt levels and longer debt carrying times (caused by customer affordability issues stemming from higher electricity prices).

3.3.2 Retail Margin

The Authority seeks stakeholders' views on the following:

(a) Are there any compelling reasons why the benchmarking approach should not be used for 2014-15 (for the retail margin)?

(b) Is there any evidence to suggest that the retail margin the Authority adopted for 2013-14 is not applicable for 2014-15?

In previous determinations the Authority has adopted a benchmarking approach to determine the retail margin and looked for recent determinations in other jurisdictions that may have been applicable for Queensland. The Authority adopted the IPART retail margin for the setting of notified prices in 2013-14.

While EEQ notes the merits of applying a benchmark approach to determine retail margin, EEQ is concerned about the application of the retail margin to different customer segments. As discussed in previous submissions to the Authority on the setting of notified prices, EEQ supports the use of a differentiated retail margin for each customer segment. It is our view that this approach is consistent with the philosophy the Authority has adopted for calculating other components of the retail tariff cost stack. Over the last two years the Authority has differentiated between small, large and very large customers for network, wholesale energy, energy losses and retail operating cost allowances in recognition of the variances between supplying different customer segments.

In the Authority's Draft Determination 2013-14 the Authority acknowledged "that there may be justification for applying different margins to different customer groups, for instance on the basis of differences in risk, however, it would be highly subjective process and Ergon Energy did not suggest how the different margins could be estimated"[11]. In light of the Authority's continued role in price regulation for regional customers where significant numbers of large customers are on notified prices, it is EEQ's view that the Authority should seek expert advice (for example through ACIL) to determine an appropriate retail margin for each customer segment.

[11] QCA 2013, *Draft Determination Regulated Retail Electricity Prices 2013-14*, p. 46.

The Authority seeks stakeholders' views on the following:

(a) Is the Authority's 2013-14 approach to applying the retail margin to retail tariffs appropriate to use for 2014-15?

(b) If not, what would be a more appropriate approach and how would it be applied in practice?

The Authority proposes to continue to apply the retail margin equally (on a percentage basis) to each component (fixed, variable and demand) of each retail tariff. EEQ is supportive of this approach.

3.4 Competition and Other Issues

3.4.1 Level of Competition

The Authority seeks stakeholders' views on the following:

(a) What is the impact of the Authority's 2013-14 Determination on competition in:

(i) SEQ in relation to residential and small customers; and

(ii) Regional Queensland, particularly in relation to large customers.

(b) How could the Authority improve its assessment of the state of competition in SEQ?

(c) What information could assist the Authority in assessing the level of competition in regional Queensland for large customers?

(d) What impact are factors other than the Authority's price determination having on competition in SEQ and regional Queensland?

The Authority has noted that the provision of a headroom allowance in notified prices should balance the promotion of competition in south east Queensland while recognising that customers outside the south east have limited or no access to competition. EEQ supports the continuation of this philosophy in the setting of notified prices for 2014-15.

3.4.2 Accounting for Unforeseen or Uncertain Events

The Authority seeks stakeholders' views on how the Authority should apply a cost pass-through mechanism, and whether there is a need to apply such a mechanism when setting notified prices for 2014-15?

EEQ is supportive of the continuation of a catch-up mechanism in the setting of notified prices for 2014-15 where there has been a material change in the actual costs of supply during the year. It is possible that a catch-up mechanism may need to be implemented in the Determination for 2015-16 to account for significant unpredictable movements in carbon price and/or carbon legislation during 2014-15.

3.5 Transitional Arrangements

EEQ welcomes the continuation of the seven year transition period for customers on transitional tariffs and the two year transition period for customers on Tariffs 41 (large) and 43 (large) from 1 July 2013. The transition period will allow customers time to adjust to the price rises and alternative tariff structures associated with the cost-reflective retail tariffs.

3.5.1 Transitional Arrangements for Tariff 11

The Authority seeks stakeholders' views on whether there are any compelling reasons not to continue with the approach to transitioning Tariff 11 that was established in the 2013-14 determination.

We support transitioning domestic customers on Tariff 11 to cost-reflectivity over a three year period.

3.5.2 Transitional Arrangements for Tariffs Made Obsolete in 2012-13

The Authority seeks stakeholders' views on the following:

(a) How should obsolete and transitional tariffs be increased towards cost-reflectivity, given the 10% increase applied in 2013-14?

(b) Any other suggestions on how customers might be transitioned to cost-reflective prices over the remaining six years of the transition period.

As noted by the Authority, recent market developments will need to be taken into account when setting transitional prices for 2014-15. Ergon Energy Corporation Ltd (EECL) has begun consultation on its network tariff strategy review, which has highlighted that changes to Large customer tariff structures are likely to occur in 2015-16. Changes to Large customer tariff structures and pricing will influence the difference between the transitional tariffs and the cost-reflective tariffs for Large customers and consequently the required transition path.

In addition, the Queensland Government is progressing consideration of recommendations by the IDC regarding removal of price controls in south east Queensland and improving competition in the EECL distribution area.

This changing environment makes it difficult to establish a set transition path for transitional tariffs because the cost-reflective tariff price and structure which customers are transitioning to over the next six years is unknown. It may be helpful for the Authority to engage with the distributors regarding price trends forecast for the next distribution regulatory period (2015 to 2020) to assist with the establishment of price escalators for 2014-15 and beyond.

The Authority has suggested two options for setting transitional prices for 2014-15. One option is to increase prices to the level they would have been had the Queensland Government not intervened and capped the price increase for transitional and obsolete tariffs at 10%, before applying the same escalation method as used for 2013-14. The second option is to forgo the 'catch-up' and apply the 2013-14 escalation method to the lower capped prices.

EEQ does not support a 'catch-up' of transitional tariffs as it would negate the benefits gained by the Government decision to cap prices in 2013-14 and may impose unnecessary financial strain on businesses, especially in light of the uncertainties regarding the structure and price of the notified prices into the future. The second option to apply the 2013-14 escalation method to the lower capped prices is therefore supported.

3.5.3 Allowing New Large Customers Access to Transitional Tariffs

The Authority seeks stakeholders' views on whether access to transitional arrangements should remain open to all eligible customers.

It is EEQ's view that all business customers should continue to have access to transitional tariffs, subject to the individual tariff terms and conditions. This will allow for equitable outcomes amongst business customers and will help mitigate the risk of customers experiencing unreasonable and unnecessary price increases in the short-term.

Short-term price shocks may lead to financial hardship or business closure, which is of particular concern in remote communities or where the business is the largest employer in the community. As the ultimate 'end point' of retail tariffs over the full transitional period is unknown it is preferable to continue to allow all business customers access to the transitional tariffs.

Attachment A

Excerpt from Ergon Energy Submission on the Regulated Retail Electricity Prices 2013-14 Draft Determination Queensland Competition Authority 22 March 2013, pp. 5-7

2. SPECIFIC COMMENTS

2.1. Energy Costs

2.1.2. Wholesale Energy Costs – Forward Volatility Premium

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

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

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

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

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

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

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

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

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

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