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Review of Regulated Electricity Tariffs and Prices
Queensland Competition Authority
GPO Box 2257
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REVIEW OF REGULATED ELECTRICTY TARRIFS AND PRICES

Introduction

Alinta Energy (Alinta) appreciates the opportunity to comment on the Queensland Competition Authority (QCA) Issues Paper entitled *Review of Regulated Electricity Tariffs and Prices,* released 24 June 2011.

Alinta currently owns over 2,000MW of generation facilities across Australia and New Zealand. In addition to an existing retail customer base of 600,000 in the WA market, Alinta Energy intends to expand its retail business into the Eastern States.

Summary

The electricity market in Queensland is one of the most competitive in Australia. Given the competitive state of the market, Alinta strongly supports transitioning towards removing retail price regulation in Queensland. However, Alinta recognises that the Queensland Government in the immediate term wishes to continue with price regulation therefore Alinta has limited its comments to the price setting methodologies proposed by the QCA.

In setting the new methodology the QCA should allow:

- tariffs which reflect an efficient new entrant retailer's costs;
- a Wholesale Energy Cost (WEC) component which captures a retailer's exposure to the long run marginal cost (LRMC) of generation;
- a retailer's operating costs which includes an appropriate allowance for customer acquisition costs; and
- a retail margin which reflects the appropriate risks of operating in the market.

In addition, the review process should ensure retailers are provided with price certainty in order for them to make investment decisions.

These issues are discussed further below.

The review process

Alinta is concerned about the timetable for the review as indicated by the QCA in its Issues Paper. The nine month interval between the release of the Issues Paper, and the QCA's Draft Report, followed by a further two

month period before the final report is released, does not provide sufficient timely information for retailers to make commercial decisions in relation to participation in the Queensland market.

The QCA should consider releasing a Draft Methodology Paper between the Issues Paper and the Draft Decision, which would allow further input from stakeholders before a Draft Decision is provided by the QCA. A proposed methodology paper serves two purposes:

- It provides a further opportunity for the QCA to consult with stakeholders, and to consider the views of affected participants; and
- It provides some certainty to retailers for input in developing their market strategy in relation to the Queensland market.

From a new entrant retailer perspective, the lack of information provided between now and the draft report, creates significant risks for the Alinta business regarding its decision to enter the Queensland market. In order to enter a market, Alinta must be able to offer a competitive product. The competitiveness of Alinta's offer is always going to be relative to both the regulated price, and the price offered by market competitors. Potentially, Alinta would be forced to delay entry into the Queensland market if it is not able to determine that the pricing methodology would continue to foster a competitive energy market. Having this information available to comment on prior to the end of the current calendar year would provide greater certainty to stakeholders who are active, or looking to be active, in the Queensland Market.

Future regulated price uncertainty

Currently, the proposed framework allows for the Queensland Government to set Terms of Reference each year for the QCA to set retail electricity prices. Further, Alinta understands the Terms of Reference are unlikely to be prescriptive, therefore the QCA has the option to evaluate the methodology before deciding any annual adjustments to the regulated price caps in future years. Alinta's strong preference is that:

- the regulatory price setting framework be established statutorily, rather than by an annual Terms of Reference approach; and
- the Government establish a price path over 3 years, with a wholesale energy cost allowance reviewed annually.

Alinta believes this approach provides the right balance between providing certainty to those retailers undertaking long-term investment decisions, and allowing the flexibility for prices to adjust to reflect structural movements in any component of electricity prices that may occur within regulatory periods. Further, it provides certainty to both retailers and consumers as to the trajectory of electricity prices over the medium-term. Not only do electricity businesses make long-term investment decisions, but households and businesses make long-term investment decisions that can be better informed from a transparent electricity price path.

In Alinta's case, as a new entrant retailer that ideally would have a presence across all jurisdictions (including Queensland), it influences both the timing of entry and the range of products that it will offer to consumers in the Queensland market. The addition of pricing uncertainty beyond a single-year timeframe adds a further level of complexity into a new entrant positioning its products into a market where customer's decisions to switch are impacted by the level of the regulated price.

Competitive state of the QLD market

The retail electricity market in Queensland has undergone significant structural change since the introduction of Full Retail Contestability (FRC) in 2007. A number of measures indicate the successful functioning of the market currently, with multiple retailers now actively engaging in retailing electricity to customers in South-East Queensland.

As off 31 March 2011, 41.5% of all customers in Queensland were on Market Contracts[1]. Further, AEMO customer switching numbers from June 2011 indicate that currently 18% of customers in Queensland are churning on an annualised basis[2]. Alinta also notes that while higher cost structures, and the current Community Service Obligation directly payed to the Ergon retail electricity business, has resulted in few participants entering the Ergon service area, these overall Queensland figures are likely to underestimate the actual level of competition in the South-East Queensland electricity market.

In the first year of FRC in Queensland, a record number of approximately 350,000 customers on Energex's network were transferred on to market contracts offered by energy retailers[3]. This fact alone indicates that retailers have been more willing to actively target customers with competitive offerings from the beginning of FRC.

Objectives in setting a new methodology

In developing a new price setting methodology, the QCA should ensure:

- The current competitive market is maintained and further promoted, ensuring that retail price regulation does not act as a barrier to entry;
- Ensure that network costs and any movements in network prices over the period of the regulatory period are passed directly through to the regulated retail price (N + R methodology);
- Allow provisions in the framework to ensure that unforseen and uncontrollable costs incurred by retailers are able to be separately passed-through, subject to QCA approval; and
- Consider a clear transitionary path towards price deregulation in the retail Queensland electricity market. A viable transitionary option for the future could be a Relative Price Movement (RPM) methodology as currently adopted in the SA electricity market[4].

Given the Government has indicated it intends to continue with a traditional price setting mechanism for the near future, the new methodology should aim to ensure that regulated prices reflect the costs of an efficient new entrant stand alone retailer, with a reasonably sized customer base. This will ensure a level playing field for all retailers.

In setting regulated tariffs, the QCA should take into account the current Queensland regulatory framework which allows customers who enter into market contracts, to revert back to the regulated price at the cessation of any market contract. The obligation for the retailer to offer the regulated price to continuing customers

[1] Queensland Competition Authority, *Market and Non-Market Customers* March Quarter 2011

[2] Australian Energy Market Operator, *Monthly Retail Transfer Statistics,* June 2011

[3] Energex, AER *Regulatory Proposal,* June 2009

[4] Under the Relative Price Movement (RPM) methodology, standing contract prices are allowed to move in line with changes in market contract prices, subject to prices sitting within a predetermined floor and ceiling individually established by the Essential Services Commission of South Australia.

further reinforces the need for retail tariffs to be fully cost-reflective over the term of the regulatory price setting period.

Alinta also notes in this regard the asymmetrical effect of price regulation. That is, if tariffs are set too low market competitiveness and market entry is reduced negatively impacting competition and therefore consumers in the medium to long-term. In contrast, higher prices will induce competitive offerings below the regulated price to the benefit of consumers in the short and long-term. Therefore, it is imperative to ensure tariffs at least reflect efficient costs.

Wholesale Electricity Costs

Alinta is of the view that the Long Run Marginal Cost (LRMC) must be included in the WEC allowance, preferably as a price floor.

The reasons for this include:

- Retailers' wholesale energy costs are often driven by the LRMC;
- Market prices are volatile and it is a suboptimal outcome for customers to import this volatility into retail prices; and
- Historical market prices will have a carbon cost embedded, however the embedded value of carbon will be impossible identify.

These issues are discussed further below.

<u>LRMC represents retailers' WEC</u>

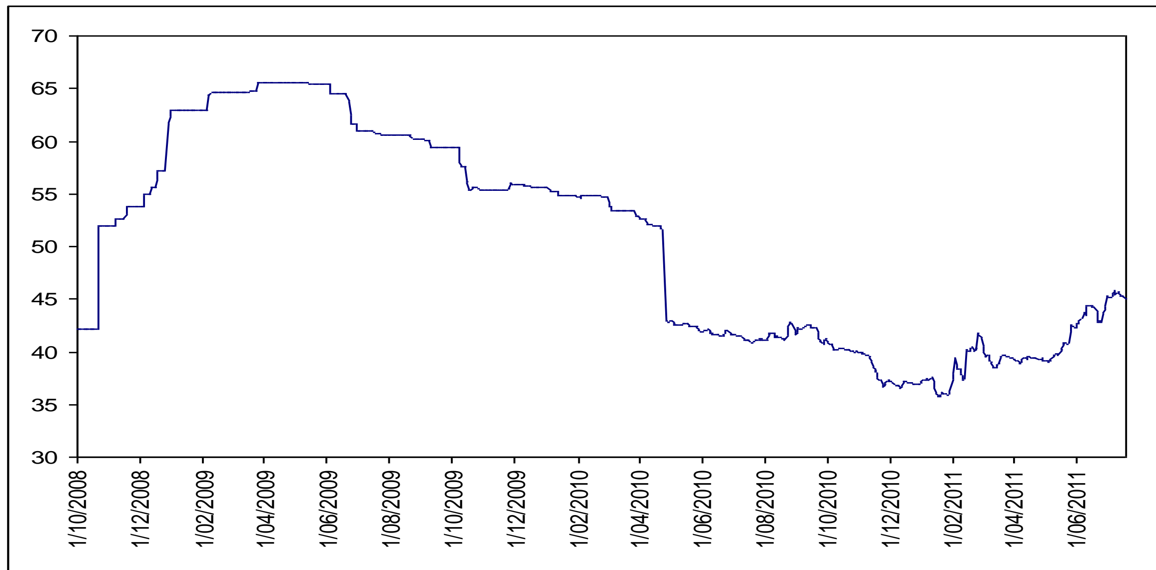
Most retailers in the Queensland market have some degree of vertical integration, or have at least underwritten investment in generation by entering long-term power purchase agreements. This model has thus far proven the most effective way of managing the interaction between wholesale price risk and retail price risk. Accordingly, a retailer's efficient WEC will reflect, at least in part, the LRMC of electricity generation.

In addition, as significant investors in generation capacity, retailers must have the ability to recover their investment costs through retail prices in order to continue to invest in both the generation and retail markets.

<u>Volatility of market prices</u>

Alinta is concerned about the QCA importing the volatility in wholesale market prices into the retail market. As shown below, even for a single calendar year contract, the weighted average price across all NEM jurisdictions can vary significantly over time.

Figure 1: National Power Index (Calendar 2012 Contracts)



Source: D-Cypha Trade

Figure 1 demonstrates that contract prices can increase and decrease significantly over time. The National Power Index for calendar year 2012 contracts has varied by up to 100% over the course of the trading period to date. In contrast to these volatile wholesale electricity prices, the LRMC has been relatively stable over time.

Given the LRMC and wholesale market prices converge over the medium term, the LRMC provides a good outcome for consumers who benefit from stable prices and continued investment and competition in the generation and retail markets. Alinta urges the QCA to take the LRMC of generation into account in its wholesale electricity cost allowance.

<u>Carbon component</u>

The recent Federal Government announcement on the Carbon Tax will need to be factored into the price setting methodology by the QCA. Complicating this process is that the market wholesale price will implicitly contain some level of carbon, however it's impossible to determine at any point the magnitude of the carbon component.

Further, the contracts between retailers and generators for forward purchases of electricity may or may not contain carbon pass through clauses. The exact nature of the pass-through clauses contained in current contracts between retailers and generators are likely to vary between participants, and in any case are confidential.

Alinta believes the difficulty of identifying the carbon component in historical market prices, is a further reason to rely on the LRMC of generation to determine a WEC inclusive of a carbon component.

Retail Operating Costs and Retail Margin

Retail operating costs for electricity tariffs need to be set at a level that allows retailers to fully recover base retail costs in addition to customer acquisition and retention costs. Alinta notes that the retail cost allowance under the current Benchmark Retail Cost Index (BRCI) is a reasonable, albeit conservative, representation of costs faced by an efficient new entrant stand alone retailer.

Retail margins should be set at a level that compensates an efficient electricity retailer in the Queensland market for the systematic risks they are likely to incur over the price-setting period. The risk of setting a retail margin that is too low is that is has the potential to stifle the further development of competition in the Queensland market. As part of the current QCA process, Alinta requests that the previous 5.0% retail margin be revisited, including the methodology underpinning its calculation.

For any inquiries in relation to this submission, please contact me on 08 9486 3762 or at michelle.shepherd@alintaenergy.com.

Yours sincerely

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