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5 August 2011

Mr John Hall
Chief Executive
Queensland Competition Authority
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BRISBANE QLD 4001

Email: electricity@qca.org.au

Dear Mr Hall

RESPONSE TO THE QCA'S ISSUES PAPER: REVIEW OF REGULATED RETAIL ELECTRICITY TARIFFS AND PRICES

Ergon Energy Corporation Limited and Ergon Energy Queensland Pty Ltd, collectively referred to as Ergon Energy, welcome the opportunity to provide a response to the Queensland Competition Authority's Issues Paper: Review of Regulated Retail Electricity Tariffs and Prices.

Should you require further information, please contact Carmel Price, Group Manager Regulatory Affairs on (07) 4121 9545.

Yours sincerely

[redacted]

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Ergon Energy Corporation Limited

and

Ergon Energy Queensland Pty Ltd

Response to the Queensland Competition Authority's Review of Regulated Retail Electricity Tariffs and Prices Issues Paper

5 August 2011

Review of Regulated Retail Electricity Tariffs and Prices – Issues Paper

Submission

Queensland Competition Authority

5 August 2011

This submission, which is available for publication, is made by:

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1. INTRODUCTION

Ergon Energy welcomes the opportunity to provide comment to the Queensland Competition Authority (QCA) on its Issues Paper on the Review of Regulated Retail Electricity Tariffs and Prices June 2011 (Issues Paper).

Ergon Energy is dedicated to maintaining a reliable and secure electricity supply throughout regional Queensland. It seeks to do this while minimising its impact on rising electricity prices and responding to customers' interests in choice, value and affordability. By combining customer focus, new technologies and demand management, along with efficiency and productivity improvements, Ergon Energy is aiming to limit growth in network charges to less than the Consumer Price Index over the long term. By 2015 Ergon Energy aims to defer or avoid 100 megawatts (MW) of network investment – the equivalent electricity demand of around 20,000 houses.

Considered in this broader strategic context, Ergon Energy considers retail tariff reform can contribute to two of its strategic objectives:

- Managing peak demand growth; and
- Delivering better choice for customers.

While electricity prices are rising due to multiple and complex factors, a significant driver of recent increases has been due to more homes and businesses using more energy at peak times. This has driven record network expansion and put pressure on electricity prices. Retail tariff reform that delivers appropriate price signals to customers offers potential to help reduce growth in electricity use during peak times. This in turn will slow future network expansion and may lessen price pressures in the long term.

In the nearer term, giving domestic customers greater choice in how they manage their electricity usage is one way that may help them manage their electricity costs. For example, domestic customers that are able to move their electricity use outside peak times may find a voluntary time-of-use tariff to their advantage. Education will be critical to ensuring customers are informed about the opportunities and effects of any new tariffs.

In addition to the above areas, Ergon Energy has an interest in seeing that appropriate transitional arrangements are considered. The impacts of tariff reform will vary between different customer segments and even within these segments. Identifying the potential customer outcomes and developing appropriate transition paths and education programs will be important to ensure the success of any tariff reform implementation.

About this submission:

In this submission Ergon Energy has focused on providing general comments in relation to the tariff reform process and provided detailed comment on each of the QCA's specific questions, where Ergon Energy considers it is relevant to comment.

This submission is provided by:

- Ergon Energy Corporation Limited (EECL), in its capacity as a Distribution Network Service Provider (DNSP) in Queensland; and
- Ergon Energy Queensland Pty Ltd (EEQ), in its capacity as a non-market area retail entity in regional Queensland.

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

2. GENERAL COMMENTS

Ergon Energy welcomes the Minister's direction to the QCA to investigate and report on an alternative retail electricity pricing methodology and schedule of retail electricity tariffs for Queensland based on a network (N) and retail (R) approach.

Ergon Energy supports the Government's retail tariff reform objectives of providing a more flexible and fairer outcome for all Queenslanders. The reform is important for regional Queensland electricity consumers as regulated retail tariffs represent the only option for many regional customers.

Ergon Energy considers that the establishment of new regulated retail tariffs in Queensland allows for the achievement of two critical aspects of a functional and dynamic retail electricity market - rectification of the issues with the current retail tariffs (identified by the QCA in its 2009 Review) and establishment of a regulatory framework that will allow for the market to respond to emerging issues, such as a carbon price and demand management initiatives.

Ergon Energy supports the N+R framework as it will allow for network businesses to send network signals directly to non-market customers. Pricing signals are recognised as an appropriate mechanism to help encourage a change in customer behaviour. Over the long-term as customers respond to pricing signals by shifting their consumption or reducing their electricity use there will be flow-on benefits to the electricity market, such as deferring the need to augment the network or build new peaking generation. Therefore, the reflection of network pricing signals in retail tariffs presents a significant opportunity for distribution businesses to achieve improved asset utilisation and, consequently, for managing the long-term growth of electricity costs for customers.

It is anticipated that tariff reform will impact customers in different ways, depending on the customer's unique situation, what tariff they are charged and their associated load profile. Transitional arrangements should be considered as part of this reform process. Residential customers will also have more choice with the introduction of new retail tariffs, which replace the existing domestic tariff. The new inclining block and time-of-use tariffs will provide customers with improved price signals about their impact on the network and may encourage a change in customer behaviour. The pricing and structure of the new set of retails tariffs must be introduced in such a manner that balances simplicity and effectiveness.

One of the benefits of the N+R framework is that there will be improved cost reflectivity in the retail tariffs and therefore there will be stronger signals to encourage energy efficiency and peak demand management. To support customers in this new environment, it is expected that third parties and market participants will be incentivised to develop new complementary products, which will assist both industry and customers in improving their energy efficiency and peak demand management.

The N+R framework should also provide opportunity for further network tariff development allowing distribution entities to send stronger or more targeted price signals to improve asset utilisation and change customer behaviour. As the market evolves and metering sophistication improves, there are further opportunities to manage the electricity supply chain's medium to long term cost outcomes. The ultimate benefit from the tariff reform process is contingent on the market, network businesses, retailers and customers responding to the price signals.

Ergon Energy expects setting the new retail tariff prices based on an N+R framework will improve the current disconnect between the costs incurred by a retailer for supplying electricity to a customer and the amount they are able to recover from that customer through regulated retail tariffs. Under this approach, it is imperative that the network and retail tariffs have alignment. To this end, the network tariff structure should influence the number and structure of the retail tariffs and the eligibility rules for network tariffs should direct the eligibility of the associated retail tariff.

To support its maximum uniform tariff policy the Queensland Government has indicated that the N component should be equal to the approved Energex network price. While Ergon Energy considers that the Energex network tariffs can be applied for determining regulated retail tariffs for the vast majority of our small customers, there are some specific circumstances where the Energex network tariffs are not appropriate, for example, Ergon Energy's Individually Calculated Customers (ICCs) and Connection Asset Customers (CACs). It is Ergon Energy's view that where unique situations exist, the intent of the Government's policy should be applied but in a flexible manner. Ergon Energy has detailed specific issues in this submission and would welcome the opportunity to discuss these issues further with the QCA and Government.

Ergon Energy believes that the R component should be set by a robust, reliable and transparent price-setting methodology. It should be priced to allow for economically efficient competition to prosper but it should not be priced in such a way as to penalise customers who have little alternative to accessing the regulated retail tariffs. Further, it is critical the price-setting methodology does not override the existing supply/demand signals of the wholesale energy market regarding the need for new generation. Ergon Energy's views on how the energy and retail costs should be calculated are detailed in this submission.

Our specific comments on the questions raised are contained in the remainder of this submission.

3. SPECIFIC COMMENTS

3.1 Treatment of Network Costs

3.1.1 Energex's Network Tariffs (Issues Paper s 2.3)

The QCA has sought stakeholder views on a number of issues raised in its Issues Paper about the suitability of the Energex tariff structure as a basis for meeting retail pricing objectives.

***Issue**: The tariff structure at the network level must include all the tariff types that one wishes to see reflected at the retail level. If there is no network tariff for a particular class or category of customer/consumption, there can be no retail tariff for that group of customers.*

Ergon Energy supports the view that any consideration of alternative tariff structure options for retail pricing must take into account the underlying network tariff structures. As stated in submissions to the QCA during the 2009 Review, Ergon Energy considers that the eligibility for retail tariffs should primarily be based on the customer's network tariff. That is, the eligibility rules for network tariffs should determine the eligibility of a customer for the retail tariff.

Ergon Energy would prefer that the tariff structure at the network level determine the number and structure of the retail tariffs. That is, there is a one-to-one relationship between network tariffs and retail tariffs. An example of this approach is the draft Energex tariff structure maps its unmetered network tariff (NTC 9600) to three of the current regulated retail tariffs – tariffs 71, 81 and 91. Ergon Energy would prefer to see only one regulated retail tariff for each network tariff. However, if there are to be multiple "Rs" to one network tariff it is critical that the "N" is the foundation of the retail tariff and that the customer must meet the network tariff eligibility (at a minimum) to be eligible for the retail tariff.

***Issue**: If some customers are to be supplied at subsidised rates in certain situations (e.g. Rural Subsidy Scheme), the extent of the subsidy has to be determined and enshrined at the network level.*

Ergon Energy supports the view of the QCA that decisions regarding the Rural Subsidy Scheme and drought relief, or other public policy issues, are matters for governments to decide, not private sector electricity retailers. However, it is Ergon Energy's preference that targeted special purpose schemes, such as drought relief, should be provided for outside the regulated retail tariffs and outside network tariffs. This retail tariff reform process presents an opportunity for the Government to consider harmonising the application of drought relief support (Tariff 68) in regional Queensland with the approach taken for drought relief in South East Queensland (i.e. Government provides a direct subsidy to affected customers).

***Issue**: If the Energex tariffs are to be the basis for charging across the State, the Energex tariff structure will have to also adequately cater for any particular circumstances in the Ergon Energy distribution area that are not encountered by Energex.*

The Government has directed that the network costs should be treated as a pass through to customers and that the N cost component of each tariff should be equal to the approved Energex network price for the relevant tariff year. While this approach is considered reasonable for the majority of Ergon Energy's domestic and small business customers, we are concerned about how an Energex network tariff can be applied to the regulated retail tariffs for our Large Customers (greater than 100 Megawatt hours (MWh) per annum), our Embedded Generators (EG), our card-operated meter customers in remote communities and our street lighting customers.

Large Customers

Large customers in South East Queensland will only be eligible for market contracts from 1 July 2012. Accordingly, only non-market Large Customers in regional Queensland will be eligible for regulated retail tariffs from 1 July 2012.

Ergon Energy is still considering the complex issues associated with reform process for Ergon Energy's ICC, CAC and Standard Asset Customer (SAC) Large Customers. Ergon Energy would welcome the opportunity to discuss this matter further with the QCA and the Government.

Embedded Generators

Presently, there is no regulated retail tariff specific to EGs. However, as Energex levies an EG specific network tariff for its generator customers with a generation capacity over 1 megawatt, under an N+R tariff framework, it is expected the gazetted Retail Tariff Schedule will provide for retail tariffs with an N component based on the Energex EG network tariffs. As the EG network tariffs include site-specific fixed charges, Ergon Energy would welcome the opportunity to discuss with the QCA options for how this EG retail tariff could apply to non-market EG customers in regional Queensland.

Card-operated Meters in Remote Communities

The gazetted Retail Tariff Schedule (part 3) includes a section for card-operated meters in remote communities. Currently, domestic customers whose electricity is measured and charged by means of a card-operated meter are levied rates broadly in line with the domestic tariffs (Tariff 11, 31 and 33). Business customers on a card-meter are charged the Tariff 20 consumption rates and a weekly service fee (broadly in line with the Tariff 20 monthly service fee). The draft Energex network tariff structure indicates a flat business network tariff will continue beyond 1 July 2012. Given this, there should be no structural issues with card-metered business customers. However, there are issues with applying the proposed new domestic tariffs to card-operated meters.

Card-operated meters are a prepaid meter. Therefore, as a customer consumes electricity, the tariff rate is applied by the meter to the credit in the card. The proposed new standard domestic tariff structure – an inclining block tariff – is not suitable for card-operated meters because an inclining block tariff is applied to consumption over a period of time (one month, a quarter etc), not instantaneously as is done with a card-operated meter.

The other domestic tariff intended to be available from 1 July 2012 will be a voluntary time-of-use tariff. This presents a variety of concerns:

- It is not considered appropriate to mandate that a time-of-use tariff be applied to all domestic customers on card-operated meters as the Government has directed that this tariff will be voluntary for domestic customers.
- The Queensland Government has decided that Queensland's card-operated meters should be exempt from the pre-payment meter requirements specified in the National Energy Customer Framework (NECF). Should Ergon Energy's card-operated meters need to be replaced to support a time-of-use tariff there is a risk that it will affect the exemption of Queensland's card-operated meters from the NECF pre-payment meter requirements.
- There are significant costs associated with replacing/reprogramming the card-operated meters to support a time-of-use tariff due to the isolation of our remote communities. It would not be practical to switch a customer's card-operated meter to time-of-use on an ad hoc basis (i.e. as customers voluntarily choose to switch to the time-of-use tariff).

Ergon Energy would prefer that the Retail Tariff Schedule retain a unique section for card-operated meters in remote communities and that an alternative flat tariff for residential customers on card-operated meters in remote communities be set. Ergon Energy would welcome the opportunity to discuss this matter further with the QCA and the Government.

Street Lighting Customers

In South East Queensland street lighting customers are no longer eligible for regulated retail tariffs. Therefore, street lighting retail tariffs are only applicable to non-market street lighting customers in regional Queensland.

In the Distribution Determination for the 2010-15 period, the Australian Energy Regulator (AER) decided that the element of Ergon Energy's activities relating to the installation, operation and maintenance of street light assets would be classified as an Alternative Control Service, the costs of which would be funded through AER-approved separate charges levied on those who utilise the service i.e. not part of their network tariff. This contrasts with previous regulatory arrangements where Ergon Energy funded street light assets as part of its Standard Control Service revenue cap and recovered the cost from all street lighting customers through a 'bundled' network tariff.

From 1 July 2010, Ergon Energy has two types of distribution charges associated with street lights:

- Unmetered Supply Network Tariff – these charges recover costs associated with the use of the distribution and transmission networks to convey electricity to a street light installation. These services are classified by the AER as Standard Control Services.

- Daily Street Lighting Charge ($ per day per light) – these charges recover costs associated with the installation, operation and maintenance of street lighting assets which are owned by Ergon Energy. These services are classified by the AER as Alternative Control Services.

Presently EEQ does not pass through the Daily Street Lighting Charge to its non-market street lighting customers because the wording in the gazetted Retail Tariff Schedule states that the costs associated with the installation, operation and maintenance of street lighting assets are incorporated into the street lighting regulated retail tariff. However, as stated above, these costs are no longer included in Ergon Energy's underlying network tariff due to a reclassification of street lighting services by the AER. Therefore, the street lighting regulated retail tariff requires significant amendment.

Ergon Energy proposes that under an N + R approach the new 'street lighting' retail tariff be based on Energex's unmetered network tariff 9600 plus an R component. This tariff's N component would relate to the use of the distribution and transmission networks to convey electricity to the street light installations.

Ergon Energy considers the gazetted Retail Tariff Schedule should also be amended to allow for the costs of installing, operating and maintaining street lighting assets (i.e. the distributors' Alternative Control Service Daily Street Lighting Charge) to be passed through to customers by the retailer. This approach is not dissimilar to the current approach applying to watchman lighting (Tariff 91) in the Retail Tariff Schedule, which recognises that the regulated retail tariffs are only based on electricity supplied, and that the customer will incur additional charges for any installation and maintenance activities associated with the lighting asset. It is also consistent with what retailers are entitled to do for any other Alternative Control Service charge (or *distribution non-network charges*) under the regulatory framework i.e. levy the Alternative Control Service charge in addition to any applicable regulated retail tariffs for the service.

***Issue**: Will Energex's demand management strategies translate directly to the Ergon Energy network or, more fundamentally, does the Energex network tariff structure provide appropriate scope for managing network demand?*

Ergon Energy supports the establishment of a retail electricity price-setting methodology and new set of retail electricity tariffs based on an N+R approach as we consider this approach allows for network businesses to send price signals to manage demand. While recognising that price signals are only one of a suite of strategies to manage demand, the use of a direct incentive to customers is a powerful tool to change customer behaviour.

Ergon Energy and Energex's main demand management strategies are broadly similar (e.g. focus on controlled load for hot water, air-conditioning and pool pumps), but there are nuances within Ergon Energy's distribution business that may require different approaches. It is believed that Ergon Energy's network does not have the same load profile as Energex's network. This can result in times of the day, or times of the year, where different network demand issues exist within Ergon Energy's regional areas in comparison to Energex. Some parts of Ergon Energy's distribution area has different peak time periods to South East Queensland due to the differences in geographic differences (e.g. different daylight hours) across the State. However the pattern of consumption and peak demand for domestic customers (for whom the new inclining block and time-of-use tariffs will apply) are considered to be similar enough to be adopted as an initial arrangement. The focus of demand management strategies for Ergon Energy is on identified constrained areas where there is a high value proposition from deferral of capital.

Ergon Energy considers that the introduction of an N+R approach to retail tariffs establishes the foundation for more flexible, innovative and comprehensive tariff solutions for managing peak demand. Ergon Energy proposes the on-going development of demand management tariff solutions.

***Other considerations:** The Authority is also interested in any other matters concerning the setting of network tariffs which stakeholders consider important to be considered in this review.*

Time-of-Use Domestic Tariff

Ergon Energy supports the passing through of network pricing signals through an N+R approach in order to reduce peak demand. Addressing one of the key drivers of network augmentation will reduce the long-term increases in electricity costs and ultimately benefit customers. However, Ergon Energy is concerned that many customers currently have little to no understanding of retail electricity prices and tariff structures. As such, the introduction of alternative tariff structures (i.e. time-of-use tariffs) will require substantial education, especially of the domestic market that has, to date, not been exposed to complex tariff structures.

Domestic customers in Ergon Energy's distribution area that choose to switch to the domestic time-of-use tariff will require an upgrade of their electricity meter to a time-of-use capable meter (Ergon Energy envisages that this would be an electronic meter without remote communication facilities). Ergon Energy does not intend to charge individual domestic customers for this initial meter upgrade service or the associated system and process changes required to affect the switch to the time-of-use tariff. However, Ergon Energy has a finite operational capacity to perform meter upgrades and is not able to accommodate large quantities of customers wishing to switch to the time-of-use tariff at any point in time. These issues will be further considered throughout the reform process. Ergon Energy welcomes further discussions with the QCA and Government regarding how a transition to time-of-use domestic tariffs may be able to be practically achieved.

Customers may also incur some additional costs in relation to their switch to a time-of-use tariff. These include, but are not limited to:

- The cost of 'making ready' their meter board at their premises including the cost of installing any safety equipment as required by the *Electrical Safety Act 2002*;
- The cost of repairing any work found to be defective in the meter board; and
- Should the customer fail to attend the appointment made with Ergon Energy to install new meters, Ergon Energy is likely to levy a 'wasted truck visit' fee and re-scheduling of the appointment would be required.

Reversion (switching) from one domestic tariff to another

It is not anticipated that further metering work will not be required if a domestic customer who has previously switched from the inclining block tariff to the time-of-use tariff decides to revert to the inclining block tariff. Meter readings will still be able to be taken from the time-of-use meter and converted within Ergon Energy's systems to allow the calculation of the inclining block pricing. Whilst Ergon Energy has no objection to the principle of tariff reversion, it is important to note that additional costs will be incurred if the process is not managed in an orderly manner. Ergon Energy proposes to work with the Queensland Government and the QCA, and having regard to the national laws, to clarify the terms under which a customer can revert at no cost, for example aligning the option to revert to the meter reading cycle at a particular interval.

Traffic Light Tariffs

With respect to the Government direction that the QCA consider an appropriate tariff for electricity supplied to continuously operated traffic lights, Ergon Energy supports the use of Energex's unmetered tariff to be used as the N component for an unmetered retail tariff.

3.1.2 Process for passing through Network Costs (Issues Paper s 2.4)

The Authority seeks stakeholders' views on any issues that should be considered in relation to the pass through of network costs; in particular, should network and retail costs be separately identified on a customer's bill?

Ergon Energy supports the concept of an aggregated retail tariff where 'like' components of network and retail tariffs are bundled (e.g. like fixed network and retail charges are bundled, like variable network and retail charges are bundled etc) and the aggregated retail tariff is presented on the customer's retail bill. Network and retail costs should not be separately identified on customer bills.

The benefits of the aggregated approach include:

- An aggregated retail tariff would be simpler to implement from a system and administration perspective compared to a separately identified network price pass through on customers' bills, which could result in eight or more separate line items representing the separate retail, distribution and transmission cost components appearing on the bill.

- A simpler implementation would result in less additional system costs (costs that would ultimately be worn by customers) and is more achievable in the short timeframe provided by the review.

- An aggregated retail tariff will inform the customer of what elements are controllable by them. The differentiation between any network variable cost and retail variable cost, or any network fixed cost and retail fixed cost is largely a secondary issue for most (in particular small) customers.

- An aggregated retail tariff is less confusing for customers. If there are too many line items (and complexity) on a customer's bill, the important message of what is driving their electricity cost may be missed.

- Consistency with other jurisdictions. Other jurisdictions which have adopted an N+R cost build up approach, aggregate 'like' components for both network and retail to derive a bundled notified price, which is then applied to the customer's bill.

- Information on network charges could be achieved via alternative and potentially more cost effective means.

As part of the QCA's discussion on the pass through of network costs, the QCA commented on the Queensland Government's Community Service Obligation (CSO) policy and its application to Ergon Energy. The electricity CSO policy gives effect to the Government's uniform tariff policy – that regional Queenslanders should pay a similar price for electricity compared with similar customer classes in South East Queensland. That is, it enables EEQ to supply non-market customers in regional Queensland at the regulated retail tariffs. As the regulated retail tariffs do not provide enough revenue to recover the costs of supply in regional Queensland (overall) the Government makes a CSO payment to EEQ for the difference between revenue received and allowable costs.

The underlying policy intent for both the CSO and uniform tariff policies is to ensure regional Queensland is not disadvantaged due to the geographical supply cost differences between South East and regional Queensland. Ergon Energy understands that both the CSO and uniform tariff policies, including the delivery mechanisms, are not under review.

3.1.3 Maintaining Alignment of Retail and Network Tariffs (Issues Paper s 2.5)

The Authority seeks stakeholders' views on maintaining alignment of retail and network tariffs.

Ergon Energy supports the QCA's view that there should be a formal process to ensure the ongoing alignment of network and retail tariffs. Under the N+R approach to retail tariffs, the network and retail tariffs become intrinsically linked because the tariff structure at the network level influences the number and structure of the retail tariffs.

Changes to the underlying network tariff structures can have a significant impact on retailers' operations. A major change to tariff structures can have more impact on a retailing business than simply having to upgrade billing systems. Retailers also need to train call centre staff and key customer managers, introduce new processes, educate customers about tariff changes, update published material and website, and determine the impact on metering etc. If a meter change or reprogram is required this will further impact on timeframes as distribution entities will need to undertake site visits to complete this work. This can be time-consuming, especially in regional and remote areas. Structural changes to the tariff schedule require around a six months lead time for retailers to amend systems and update processes. However, the more the new tariff structure deviates from existing structures, the more lead time is required (around 9-12 months is preferred).

Minor amendments to network tariffs (i.e. new prices for existing tariffs) that can be accommodated by retailer system and processes do not require significant prior notice. However, under NECF (to take effect in Queensland from 1 July 2012) retailers must publish variations of standing offer prices at least 10 business days prior to the prices taking affect. While the usual one month notice provided by the QCA under the current Benchmark Retail Cost Index (BRCI) process to update retail tariff schedules is preferred, Ergon Energy acknowledges that there is a high risk that the Energex network tariffs may not be approved and published in time for the QCA to gazette the regulated retail tariffs by 31 May each year. There may need to be further consultation with other bodies, such as the AER, on this issue.

With respect to QCA's possible solution for this issue to gazette retail tariffs by 31 May each year and then gazette the adjusted retail tariffs (following the approval of the network tariffs) in June/July, this is not feasible due to the National Energy Retail Law (which gives effect to NECF) which stipulates that variations to standing offer prices (i.e. the regulated retail tariffs in Queensland) can only be made once every six months.

3.2 Energy Cost Component of Retail Tariffs

3.2.1 Estimating Energy Costs (Issues Paper s 3.2)

3.2.1.1 Determining a Suitable Hedging Strategy

The Authority seeks stakeholders' views on the following:

- **Is a hedging-based model the most appropriate way to estimate energy costs given complexities and risks involved in the Queensland electricity market?**

  Ergon Energy agrees with the QCA's conclusion in the 2009 Review that a market-based approach using a hedging-based model is the most appropriate in setting the wholesale energy costs in retail tariffs because:

  - It is important to base it on transparent products that can be monitored;
  - It is accessible and tradable by all entities participating in the retail market (regardless of whether they are new entrant or incumbent);
  - Setting wholesale energy costs using a theoretical Long Run Marginal Cost (LRMC) may not be cost reflective of most retailers' wholesale energy costs in Queensland; and
  - Running 100% to pool introduces unacceptable volatility for both retailers and their customers.

  Although it is recognised that there will be participants in the retail electricity mass market in Queensland who have a mixture of financial hedges and access to a physical generation portfolio, it is considered that physical generation effectively acts as a "hedge" for the retailer (be it base load or peaking plant) to secure its wholesale energy costs.

  Further, customers most likely to be on the regulated retail tariffs are mass market (domestic and small-medium enterprises) below 100 MWh customers who will be settled on the Energex Net System Load Profile (NSLP). Since any single retailer cannot actively influence the shape of the NSLP, it would be prudent for the retailer to hedge their exposure to wholesale energy costs rather than other more risky options.

  Therefore, Ergon Energy recommends that a hedge-based volume weighted average (VWA) model be used to estimate energy costs. The VWA approach is discussed further in section 3.2.1.3.

- **What mix of hedging contracts would be appropriate to include in the hedging strategy?**

  Similar to what has been suggested in section 3.2 of the QCA Issues Paper, a mix of vanilla hedging products should be used in order to remain transparent. However, Ergon Energy considers that the hedge levels set under the BRCI methodology have some limitations in that it will have a tendency to over-hedge the overnight and shoulder periods due to setting flat hedge levels based on off-peak maximum loads. That is, if demand is forecast to remain high at 10:01 pm, or on a weekend (i.e. non working week day), the BRCI methodology would be forced to purchase base flat contracts far in excess of what would necessarily be required for an overnight period.

  Although this hedging strategy was deliberate in order to minimise the exposure of extreme pool events, it must be noted that over-hedging still does not fix the hedge costs. The Contract for Difference (CFD) cost of the over-hedged periods is considered to be an unnecessary cost to mitigate risk and may potentially overstate the hedging cost in the retail tariff.

  Therefore, Ergon Energy considers that a revised product mix strategy be used that attempts to shape, where possible, within the load profile in order to prevent the significant over-exposure of overnight periods, and overlay cap cover to mitigate extreme pool events.

  An example of an alternative hedge levels are:

  - 85 percent of quarterly minimum off peak contracted with flat contracts;
  - 90 percent of quarterly average peak with 7-day peak contracts – after deducting the flat contract volume; and
  - 115 percent of quarterly maximum with flat $300 strike caps – after deducting the flat and 7 day peak contract volume. This is to accommodate for flex and extreme pool events.

  The fundamental shifts of the above hedge levels when compared to the BRCI approach are:

  1. The base flat contracts are determined by the minimum off-peak level to ensure that the base load is covered, but not so much as to over-hedge overnight periods;
  2. The use of 7-day peak contracts to ensure that weekend peaks are still covered. The pricing of these contracts can be derived by calculating the ratio of the historical quarterly time weighted average (TWA) pool outcomes for the overnight periods to the historical quarterly TWA pool outcomes for the flat periods, then apply this ratio to the quarterly flat contract rate used to determine the flat contract level costs; and
  3. An increase in the use of cap cover (to roughly 25%) to mitigate the cost of extreme pool events for the unhedged periods and accommodate load flex.

  Whilst the above approach does not completely remove the risks of being exposed to extreme pool events, it aims to balance the risk of being exposed to pool prices, cost of hedging and cash flow volatility.

- **How (if at all) should the Authority take account of bi-lateral hedging contracts between generators and retailers?**

  Bi-lateral contracts are typically not publicly available. However, if the retail tariffs adopt a market-based VWA approach, parties to the bi-lateral hedging contracts may instead consider broadcasting their contracts through brokers to ensure that their hedging costs are considered in the retail wholesale energy cost. That is, they would still have the ability to enter into bi-lateral contracts, but would then run the risk of the retail tariffs not being reflective of their costs.

- **Are there any other factors the Authority should consider in relation to this issue?**

  No comment.

3.2.1.2 Wholesale Spot Price Forecasts

The Authority seeks stakeholders' views on the following:

- **What are the likely advantages and disadvantages of using proprietary electricity market simulation models that are capable of simulating spot prices for every half hour trading interval as would occur in the NEM?**

  The main advantage of using a proprietary model that simulates the half hourly spot prices is that the risk of short term high pool prices and changes in correlation between these and load can be modelled. The issue is that most of these models are fairly "black box" and there are many inputs that can be fairly subjective.

  Ergon Energy considers that the value of having a spot price forecast easily outweighs the disadvantages associated with using a proprietary model.

- **Are there any simpler modelling alternatives, such as the historical spot price approach adopted by the ICRC, that the Authority could rely on to forecast future wholesale spot prices in the NEM?**

  Although historical spot prices can be used to forecast future spot prices and a trend analysis basis, they generally do not reflect structural changes in the market. This introduces a danger of providing an inaccurate and irrelevant spot price forecast that may be using spot prices from a historic period when the market was structurally different or does not have enough data points (since the structural change) to reflect the flex risk.

  It is noted though that most proprietary models base a lot of their assumptions on historical information but can generally model forward assumptions as well. Therefore, Ergon Energy does not believe that a simple historical spot price approach is an appropriate alternative.

- **Are there any other factors the Authority should consider in relation to this issue?**

  Continued monitoring of the performance of any spot price simulation is critical (regardless of method chosen). Ergon Energy acknowledges that the QCA currently monitors this annually under the BRCI and would like to ensure that this process continues into the N+R tariffs.

3.2.1.3 Source of Forward Contract Prices

The Authority seeks stakeholders' views on the following:

- **What source(s) of data should the Authority use to estimate the cost of forward contract prices?**

  Ergon Energy is advocating an actual market VWA approach to estimate the cost of forward contracts.

  Ergon Energy agrees with the QCA that the source data must avoid market bias, market manipulation and liquidity issues. Forward contract prices and actual traded volumes must be collected from a range of reliable and industry accepted sources such as:

  - actual trades on Sydney Future Exchange (SFE) (including block trades) Dcypha;
  - actual Over the Counter (OTC) brokered trades; and
  - OTC – Tradition Financial Services (TFS) and ICAP to cover bilateral contracts.

- **Are there any other factors the Authority should consider in relation to this issue?**

  Ergon Energy acknowledges that an abnormal market situation has arisen as a result of the uncertain nature of carbon pricing to retailers. Essentially, the existence of carbon pass-through and clean contracts for the same period of cover makes using a VWA approach far more difficult.

  Ergon Energy considers the least difficult way to address this is to only include traded clean contracts in the VWA calculation. Although Ergon Energy recognises that this will limit the validity of the VWA calculation by cutting out the carbon pass-through contracts, it is considered that the difficulties (i.e. required debate and complexity) associated with agreeing a derived carbon price to put on these pass-through contracts to compare them to clean contracts will outweigh the limitations of only referencing clean contracts.

  It is also important to note that the issue raised about treatment of carbon pass-through contracts are only temporary until the true cost of carbon to retailers is certain. Once that occurs, that price will automatically be priced into the market, as well as knowing for certain the amount that will be "passed-through" on the pass-through contracts.

3.2.1.4 Timing and Treatment of Forward Contract Prices

The Authority seeks stakeholders' views on the following:

- **What assumptions should be made about the timing of contract purchasing for a representative retailer?**

  Stipulating a specific book build period of cover in a straight line buying pattern, as per the previous BRCI methodology, can lead to illiquidity, data quality, and price manipulation issues. These issues become even more prevalent when the book build period is lengthened.

  Most participants would agree that a two year straight line book build is too short to commence hedging for mass market customers. However, as the period extends, liquidity (and hence data quality) becomes more of an issue. That is, when the market is not liquid, there may not be any market activity (and hence data) available on a specific day, but a straight line buying pattern assumes that cover is attainable.

  Furthermore, in the case of a commonly used data source (SFE) when no market data is observed for a day, the closing price from the previous day is simply carried forward. The issue with this rule is that in long periods of illiquidity and uncertainty, these "dry" data points can influence a large portion of the final cost of energy estimate because they hold the same weighting as any other (liquid) day.

  There is also opportunity to manipulate this rule by trading a small volume at a premium price during a dry period, and have that premium price carried forward until another trade occurs.

  Therefore, Ergon Energy considers that a viable alternative to this approach is to adopt a VWA of market trades that have occurred via a range of reliable and industry accepted sources. That is, the timing of contract purchasing for the representative retailer will mirror the market trading volumes, and hence remove the need to set a book build period.

- **Should the Authority consider using a volume-weighted average in determining contract prices for its market-based energy purchase cost allowance?**

  Yes. A VWA will provide a transparent representation of market-based contracts as well as addressing the timing issues of when to purchase in market.

  Another advantage is that it removes potential price manipulation by minimising the impact of small volume trades by allocating a much larger weighting to when the majority of volume is traded within the market.

- **Are there any other factors the Authority should consider in relation to this issue?**

  No comment.

3.2.1.5 Customer Load Forecasts

The Authority seeks stakeholder views on the following:

- **Would Energex's NSLP data be suitable for estimating the consumption profile of customers on retail tariffs in Queensland?**

  Energex's NSLP does not reflect the consumption profile of customers in Ergon Energy's distribution area. In general, the two key differences are:

  - The Energex NSLP will have more peaks and be more extreme than the profile in Ergon Energy's area as the concentration of customers in South East Queensland will be subjected to the same weather patterns (and hence are more likely to respond as a collective), rather than the diverse and spread out nature of Ergon Energy's area. That is, an extreme weather event in regional Queensland will have less of an impact on Ergon Energy's profile when compared to a similar extreme weather event in South East Queensland; and

  - Customers that contribute towards the Energex NSLP are typically mass market customers that consume less than 100 MWh per annum since the vast majority of the large customers have moved to market (and hence interval meters). This is compared to a large amount of load from large customers on accumulation meters (who have not moved to market) in Ergon Energy's area will tend to flatten out the shape of Ergon Energy's NSLP.

  With these differences in mind, it is likely that basing the retail tariffs on a combined NSLP for Queensland will result in the dampening of the profile for retailers participating in South East Queensland and potentially create an unnecessary deviation from their actual (Energex NSLP) wholesale costs for mass market customers.

  Ergon Energy acknowledges that the Energex NSLP is a publicly accessible robust calculation method. Ergon Energy considers that using Energex NSLP will provide a satisfactory proxy for regional mass market customers for the proposed N+R approach while not adding an unnecessary barrier to competition in South East Queensland.

- **Are there any other sources of load demand forecasts, other than AEMO's annual ESOO publication forecasts, that the Authority should consider in forecasting the customer load?**

  Ergon Energy recommends that a historical trend analysis approach should be adopted to forecast the Energex NSLP. The main reasoning behind this is that the annual ESOO publication tends to overstate the increase in demand. This view is based on the fact that every year the most likely forecast (50% chance of exceeding) has overstated Queensland demand.

  Considerations when conducting the historical trend analysis will be the lag indicators that result from:

  - Permanent customer usage changes – i.e. domestic solar photo voltaic penetration;

  - Population increases; and

  - Abnormal usage events – i.e. cyclones, floods, heat waves.

- **Are there any other factors the Authority should consider in relation to this issue?**

  No comment.

3.2.2 Use of LRMC as a Price Floor (Issues Paper s 3.3)

The Authority invites stakeholders' comments on the following:

- **Should energy costs include an LRMC floor price?**

  Ergon Energy does not support the notion that LRMC should be included as a floor of the energy costs. The main argument used in the past is that LRMC should be part of the tariffs to allow investment in generation assets. Ergon Energy does not believe that the retail tariffs are the appropriate mechanism for promoting effective investment in generation.

  Adopting LRMC as a floor of the retail tariff will tend to overstate the cost of energy estimate, with consumers on notified prices effectively subsidising overcapacity. Although an oversupplied generation market will result in lower wholesale energy costs for retailers, the setting of an LRMC floor would mean that those lower costs would not flow through to customers in the retail tariffs.

  In addition, the Australian Energy Market Operator (AEMO) already has a process whereby it assesses the supply/demand balance of generation and ensures that there is sufficient potential in the spot market to accommodate new generation into the market as it is needed. AEMO recently demonstrated this function through a recalculation of the maximum National Energy Market (NEM) spot price to ensure the supply/demand balance of generation.

- **If so, how would retailers and customers share the risks as well as benefits from any short-term price fluctuations in wholesale energy costs?**

  Ergon Energy notes that using LRMC as a floor at a time when the price of wholesale energy is low will lead to tariffs that are higher than the costs faced by the retailers.

  If the representative retailer is stand alone and not vertically integrated and will be compensated for the risk of not being vertically integrated (via the market), it does not make sense that it should also have protection if it wants to secure new generation.

  Ergon Energy believes that the forward prices currently reflect an element of the supply/demand balance into the future and if there is a need for new generation, the market will factor it in.

  Using a market based approach will also give the QCA a transparent cost of energy which allows consumers to benefit when the prices are low and allow adequate compensation for retailers when the prices are high.

- **Are there any other factors the Authority should consider in relation to this issue?**

  No comment.

3.2.3 Accounting for Energy Losses (Issues Paper s 3.4)

The Authority seeks stakeholder's views on any issues associated with the incorporation of energy losses in its energy cost estimate.

Ergon Energy is of the view that loss factors should be incorporated into the energy cost estimate because retailers are billed for the energy sent out from the generator but can only charge for energy consumption at the customer's meter. Therefore the energy cost used in setting retail prices should account for these losses.

Ergon Energy considers that the loss factors as approved and published by AEMO should be used in the QCA's calculation. As AEMO is required to publish the distribution and transmission loss factors that are to be applied for the next financial year by 1 April each year, there should be no timing issues with using AEMO as a source for loss factors.

Only one transmission loss factor (TLF) can be incorporated into the energy cost estimate (per retail tariff). Therefore, Ergon Energy suggests that the highest TLF in Energex's area be used as the proxy for South East Queensland mass market customers.

The distribution loss factor (DLF) incorporated into the energy cost estimate for each tariff should be based on the Energex DLFs that are applicable to the customer type that would be on the tariff. For example, the DLF applicable to a low voltage (LV) line connected customer should be used for domestic tariffs because residential customers are supplied off a LV line.

3.2.4 Cost of Meeting Obligations under Environmental Schemes (Issues Paper s 3.5)

3.2.4.1 Queensland Gas Scheme

The Authority seeks stakeholders' views on the following:

- **How should a retailer's cost of complying with the Queensland Gas Scheme best be estimated?**

  Ergon Energy considers that the appropriate approach for estimating Gas Electricity Certificate (GEC) costs is to use a 12 month average price. However, as there is extreme lack of liquidity in GEC spot prices for Calendar 2012 and Calendar 2013, Ergon Energy considers a representative approach is to use the average of the past 24 months GEC spot prices for estimating the price of GECs for the 2012-13 retail price determination.

- **What data source(s) should the Authority use in modelling the Queensland Gas Scheme?**

  Ergon Energy agrees with the QCA that the estimated costs should be based on reliable market data available from the Australian Financial Markets Association (AFMA) or ICAP.

- **Are there are any other issues that should be considered in estimating this cost component?**

  No comment.

3.2.4.2 Renewable Energy Target Scheme

The Authority seeks stakeholders' views on the following:

- **How should the Authority estimate retailers' costs of complying with the ERET scheme?**

  Ergon Energy considers it prudent to separate the compliance costs of the Enhanced Renewable Energy Target (ERET) between the Small-scale Renewable Energy Scheme (SRES) and the Large-scale Renewable Energy Target (LRET). Similar to the GECs approach, Ergon Energy considers that a 12 month average AFMA/ICAP price methodology for the appropriate compliance year certificate can be used to price Large-scale Generation Certificates (LGCs).

  However, due to the unique nature of participants in the SRES market, Ergon Energy considers that the $40 per Small-scale Technology Certificate (STC) (as was used to forecast SRES compliance in the BRCI 2011-12) would be most reflective. It is preferred to maintain consistency with last year's price calculation given the market for STCs are so new, volatile and prone to regulatory change.

- **What factors should be considered in forecasting the REC costs likely to be incurred by retailers in the SRES and LRET markets?**

  Both the SRES and LRET markets are based on a retailer's customer load. The QCA should use the Queensland load and factor the Small-scale Technology Percentage for the SRES and the Renewable Power Percentage for the LRET.

Forecasting the cost of the LRET is more straightforward because of the following attributes:

- Market participants are fewer;
- Projects are larger and more reliable;
- Development of projects can be easily tracked;
- Projects are generally reported; and
- Lifetime of the scheme can provide historic prices, historic demand and a forecast of the scheme targets.

Forecasting the costs for retailers under the SRES is more complex because of the following reasons:

- There are a large number of new market participants that do not understand the scheme completely and are struggling to come to terms with how the market works;
- There are new participants including households and newly established businesses;
- There are numerous installation companies that are not required to register; and
- The lag time between applications, physical installations and certificate registration distorts supply and demand signals.

- **Are there are any other issues that should be considered in estimating this cost component?**

  No comment.

3.2.4.3 Carbon Pricing

The Authority seeks stakeholders' views on the following:

- **Is it reasonable to expect the market to effectively price in the carbon tax? If not, how should the Authority estimate retailers' costs of complying with a carbon price?**

  Ergon Energy believes that it is reasonable to expect the market to effectively price in the carbon tax because the current market tends to react promptly to changes in news regarding carbon and the carbon tax. So far as we have seen, the contracts that have been traded seem to reflect prudent hedging due to an increase in the number of carbon pass-through contracts being traded at times when carbon policy has been more uncertain.

- **What factors should be considered in forecasting future carbon price costs likely to be incurred by retailers?**

  The cost impact that a retailer faces from a carbon tax is largely a higher cost of energy, which should translate into a higher pool price forecast and higher future market hedging costs. Both of these cost impacts would be adequately addressed, and hence compensated for, in the suggestions outlined earlier.

- **Any other issues?**

  No comment.

3.2.5 NEM Participation Fees and Ancillary Services Charges (Issues Paper s 3.6)

The Authority seeks stakeholders' views on the following:

- **How should the Authority estimate both the NEM participation fees and ancillary services charges incurred by retailers?**

  <u>NEM Participation Fees</u>

  As AEMO NEM participation fee charges are unlikely to be available in time for the setting of regulated retail tariffs on 31 May each year, Ergon Energy has no issues with the QCA using the previous year's fees, possibly escalated by the Consumer Price Index.

  <u>Ancillaries</u>

  Ergon Energy has no issues with the QCA maintaining the previously adopted approach under the BRCI and using historical average costs.

- **Are there are any other issues that should be considered in estimating this cost component?**

  No comment.

3.3 Retail Costs

3.3.1 Retailer Characteristics (Issues Paper s 4.2)

The Authority seeks stakeholders' views on the following:

- **Should the build-up of retail costs be modelled on a representative retailer or an actual retailer in the Queensland market?**

  Ergon Energy agrees with the issues raised by the QCA and acknowledges that they are comprehensive. We concur with the QCA's statement that since there is no standard retailer in Queensland from which to readily source information, a representative retailer would be the most appropriate basis to determine costs.

  However, a limitation of this approach is that a representative retailer will need to build up its retail costs from transparent information. Accordingly, a constraint that must be considered in framing the characteristics of a "representative retailer", and also in determining the retail costs, is what public information actually exists.

  The Independent Pricing and Regulatory Tribunal (IPART), New South Wales (NSW) and its consultants considered this issue in determining NSW's last two retail pricing determinations:

  - In its 2007-10 retail pricing determination, IPART[1] was required to determine an allowance for retail operating costs of a mass market, new entrant rather than those of the Standard Retailers who supply regulated customers in NSW.

    > *"The terms of reference do not define a mass market new entrant. However, they do note that it should be a new market entrant that is of sufficient size to achieve economies of scale. The Tribunal accepts that mass market new entrant retail costs include both retail operating costs and costs to acquire new customers."*

    Frontier Economics considered that the retail operating costs reported by Standard Retailers in NSW can be used as a guide to determining the retail operating costs that would be incurred by a mass market new entrant. IPART accepted Frontier Economics interpretation of a mass market new entrant in calculating retail costs.[2]

  - In its 2010-13 retail pricing determination, IPART[3] determined the base retail operating costs of a Standard Retailer from the actual historical costs supplied by the three (then) Government owned retailers in NSW.

    > *"The terms of reference for the 2010 determination require us to set an allowance to recover the efficient costs a Standard Retailer is likely to incur in providing these functions for small customers on regulated tariffs. In doing so, we are required to:*
    >
    > - *take account of information from the NSW Standard Retailers and other available information on retailers' efficient operating costs (rather than consider the efficient costs of a mass market new entrant, as required for the 2007 determination)*

[1] IPART, Regulated Electricity Retail Tariffs and Charges for Small Customers 2007 to 2010*, Final Report and Final Determination*, June 2007 refer Section 7.
[2] Frontier Economics, *Mass Market New Entrant Retail Costs and Retail Margin: Public Report prepared for IPART*, March 2007
[3] IPART, *Review of Regulated Retail Tariffs and Charges for Electricity 2010-2013, Final Report*, March 2010, refer Section 7.

- *include customer acquisition costs to ensure regulated retail tariffs are set at a level which encourages competition."*

Accordingly, whilst there were different approaches for defining the retailer characteristics the outworking of the approaches resulted in using the historical data of the three Standard Retailers as the starting point. Therefore whilst Ergon Energy supports the representative retailer approach, it is also cognisant that the use of publicly available information will be an important factor in determining the appropriate retailer characteristics. Ergon Energy's view is that the most comprehensive, publicly available data set on retailer characteristics, which is appropriate for the Queensland market, is the IPART retail pricing determinations.

- **Where a representative retailer is preferred:**

  - **Should it be a new entrant or incumbent in the market?**

    Ergon Energy considers, to the extent possible, it is important to find an equitable balance in setting the retail costs of a representative retailer in Queensland since many types of retailers, ranging from new entrants to fully established national incumbents, are already participating in Queensland.

    A good source of recent publicly available information on retail operating costs is IPART's 2010-13 retail pricing determination, where they base their Standard Retailer costs on an incumbent that has achieved economies of scale. Specially, IPART[4] stated:

    "As the terms of reference do not define a Standard Retailer, we adopted the following definition for the purpose of making the 2010 determination:
    - *an incumbent retailer that has achieved economies of scale (i.e., has efficient costs)*
    - *a standalone retailer in NSW that is not vertically integrated into electricity distribution in NSW*
    - *serves retail customers, including small retail customers, in NSW and other jurisdictions across the NEM*
    - *can offer retail customers standard form and negotiated customer supply contracts*
    - *has an existing customer base to defend."*

    Although IPART's determination considers the Standard Retailer an incumbent retailer in NSW, Ergon Energy is of the view that once the retailer costs are split into their two components (being retail operating costs and customer acquisition and retention costs) the retail operating costs of the NSW incumbent retailer is relevant and akin to a Queensland incumbent in that IPART identifies that economies of scale has occurred. Having economies of scale will ensure that retail operating costs are kept to a minimum.

    Also in line with IPART, consideration must be made for effective competition of small customers (in South East Queensland) and therefore the inclusion of customer acquisition and retention costs are necessary.

[4] IPART, *Review of Regulated Retail Tariffs and Charges for Electricity 2010-2013, Final Report*, March 2010, page 112.

- **Should it be a stand-alone business providing only electricity retail services in Queensland or an integrated business involved in other activities including retailing in other jurisdictions?**

  Noting the key differences that the QCA raised between a stand-alone and integrated standard retailer, Ergon Energy believes that generally retailers participating in Queensland are far more likely to be equitably represented by the IPART based stand-alone Standard Retailer.

  As noted above, IPART included in their definition of a stand-alone retailer that the retailer serves retail customers, including small retail customers, in other jurisdictions across the NEM.

- **How many customers should it be assumed to have?**

  Ergon Energy considers that the main assumption that underpins how many customers the representative retailer has is that sufficient economies of scale have been achieved (to leverage a low retail operating cost). As our preference is based on an incumbent retailer using the IPART decision, the minimum size of the retailer should be 700,000 customers across the NEM.

  It should be noted that whilst new entrant retailers operating in Queensland might have a significant lower number of customers than 700,000 these retailers generally look to out-sourcing solutions to ensure that they can properly manage the cost to serve.

- **Where an actual retailer is preferred, which retailer(s) should be included?**

  As noted above, Ergon Energy's preference is for a representative retailer rather than an actual retailer. However, the retail operating costs must be based off publicly available actual costs.

3.3.2 Retail Operating Costs (Issues Paper s 4.3)

The Authority seeks stakeholders' views on which costs should be included in the retail operating cost allowance and how they would best be categorised?

Ergon Energy considers that the QCA should use the same costs as the IPART decision, where retail operating costs are separate from customer acquisition and retention costs.

Ergon Energy can not see a compelling reason to depart from the IPART methodology, given that there were multiple retailers participating in the mass market space and IPART had multiple information sources upon which to base their decision.

The QCA should be aware that applying the IPART decision in Queensland may require some Queensland specific adjustments (e.g. clause 4.9.6 of the Queensland Electricity Industry Code provides that a retailer can charge a late payment fee to customers on a standard retail contract only if the notified prices provide for the charging of a late payment fee).

3.3.2.1 Calculating Retail Operating Costs

The Authority seeks stakeholders' views on the following:

- **How should retail operating costs be calculated?**

  As detailed above, Ergon Energy considers that the IPART decision to be a reasonable basis upon which to set retail operating costs in South East Queensland, being the bottom up and benchmarking methodology used by IPART. Additional adjustments for Queensland specific retail operating costs will then need to be incorporated.

  Ergon Energy considers that the adjusted IPART decision could be compared against any confidential information obtained from other retailers operating in Queensland to ensure they are reflective of costs.

- **What information should be obtained from retailers?**

  The difficulty in obtaining detailed confidential information from multiple retailers is that the information may be classified quite differently between retailers in their management accounts, which will make any comparison difficult for the QCA. Accordingly, it is considered that the QCA may need to undertake the comparison by requesting high level amalgamated costs or simply a lump sum amount for retail operating costs and also the number of customers held by the retailer so that a high level comparison can be made.

- **What other sources of information would assist the Authority in its task?**

  The various sources used by IPART in their decision.

3.3.2.2 Customer Acquisition and Retention Costs

The Authority seeks stakeholders' views on the following:

- **Should CARC be treated the same as other retail operating costs?**
- **If not, how should CARC be calculated?**
- **Are there any other issues related to CARC the Authority should consider?**

As Ergon Energy is not active within the South East Queensland sector and is restricted to selling electricity to its regional customers on non-market contracts at the regulated retail tariff prices, it is not appropriate for Ergon Energy to respond to specific issues on customer acquisition and retention costs.

However, Ergon Energy does acknowledge that a customer acquisition and retention costs allowance is necessary and should be included in addition to the base retail operating costs in order to continue to stimulate competition for small customers in South East Queensland.

3.3.3 Retail Margin (Issues Paper s 4.4)

The Authority seeks stakeholders' views on:

- **What factors should be considered when calculating an adequate retail margin?**

  The retail margin is the return that a retailer requires to attract the risk capital, from equity and debt providers, that is necessary to provide electricity retail services.

  The retail margin has generally been determined on a net margin basis and is represented by regulators (including the QCA and IPART) as a margin over total costs, or a percentage of controllable and uncontrollable costs.

  Ergon Energy considers that an appropriate retail margin should be first calculated for the representative retailer and then be allocated across the different customer segments for the purposes of determining an appropriate risk margin to add to each retail tariff.

  Ergon Energy considers the retail margin for the representative retailer should be determined by assessing an appropriate systematic return (e.g. the analysis undertaken by SFG Consulting for IPART) rather than merely on the basis of benchmarking to decisions from other jurisdictions.

  In regards to allocating the risk margin across different customer segments, there are a range of factors which will influence the required retail margin pertaining to a customer. A retailer may elect to differentiate its retail margin within and between customer segments for a variety of reasons, for example credit risk of a smaller number of large customers versus a large collective of small customers, load shape and also due to the average amount payable by each customer segment.

  Ergon Energy considers a retail margin should be allocated to each Energex network customer class, being (for 2011-12):

  - ICC
  - CAC – 33 kilovolt (kV)
  - CAC – 11kV Bus
  - CAC – 11kV Line
  - EG
  - SAC Demand
  - SAC Non-demand

- **What level should the retail margin be set at?**

  The work undertaken by SFG Consulting for IPART's 2010-13 retail pricing determination decision provides a reasonable basis upon which to base the retail margin for the representative retailer.

3.4 Setting the R Component of Retail Tariffs

3.4.1 Allocating R Costs to Customer Groups (Issues Paper s 5.2)

The Authority seeks stakeholders' views on the following:

- **How should the Authority allocate R costs to each customer group?**

  Ergon Energy agrees with the QCA that "the key to setting efficient tariffs is ensuring that they reflect the costs of supplying each customer group" and to the extent possible, "the R component of tariffs should be set on a fully cost reflective basis".

  To enable an equitable allocation of the costs, the main considerations in allocating the costs to each customer group are:

  - From whose perspective should the cost reflectivity be considered, the customer or the retailer; and

  - The availability and determination of cost reflective allocation information.

  Ergon Energy considers that cost reflectivity is more than cost recovery. That is cost reflectivity ensures that the retail tariffs signal to customers how their consumption and demand profile is driving the growth of the electricity infrastructure (i.e. both network and generation requirements). While cost recovery simply ensures that sufficient revenue is collected to fund the electricity infrastructure.

  Whilst this is the goal of retail tariff reform there are constraints on how cost reflectivity can be outworked. Ergon Energy considers that the preferred interpretation of "cost reflectivity" given the current constraints is:

  - The pricing and relativity of each individual N component (i.e. individual Energex Network Tariff) should reflect more than just current costs. The pricing should, to the extent allowed by the AER Pricing Principles, send appropriate signals to those customers which are driving the peak demand growth and therefore driving the need for network augmentation;

  - The R component must be priced relative to the generic customer load profiles settled by AEMO in Energex's area (i.e. Energex NSLP, Peel Off shapes) for each relevant tariff class. The market settlement profile is more appropriate than an alternative customer load profile (e.g. Energex network profile) as this is how the customer load is settled by the retailer and is therefore cost reflective from a retailer's perspective;

  - A significant part of the R component is the cost of purchasing electricity from the wholesale market, which incorporates future costs into its prices. Therefore the R component inherently incorporates future costs of purchasing electricity; and

  - Retailer costs (i.e. retail margin and retail operating costs) are allocated in accordance with how a retailer would normally allocate such costs across the different customer segments for its market contracts. Retail margin should be allocated to each network tariff class based on systematic risks associated with the customers on those tariffs.

- **What information will the Authority require?**

  The QCA may seek to obtain information from retailers that have similar characteristics to the representative retailer on how they allocate their retail operating costs across their non-market customer base.

- **What other issues should the Authority be aware of?**

  Under the N+R framework the network tariff must be the principal building block for setting retail tariffs in the future. Ergon Energy considers that while the R component should be allocated based on cost reflective principles the R component generally can only support network tariff price signals to the customer, due to limitations within the way retailers settle their load in the wholesale energy market.

3.4.2 Recovering R Costs through Individual Retail Tariffs (Issues Paper s 5.3)

The Authority seeks stakeholders' views on the following:

- **How should the proportions of fixed and variable energy costs be determined?**

  Energy costs, being solely the cost of supplying electricity to the retailer's customers exclusive of the retailer's operational costs and retail margin requirements, has historically been measured and charged by retailers on a megawatt hour basis. Therefore, energy costs have historically been considered solely a variable cost. Ergon Energy considers that the historic view that energy costs are 100% variable should continue to apply.

- **How should the proportions of fixed and variable retail costs (operating costs and margin) be determined?**

  Ergon Energy considers that it is reasonable to proportion retailer costs between fixed and variable components of the retail tariffs.

  Ergon Energy considers that the IPART's 2010-13 retail pricing determination decision should be used as the base given the fixed/variable split was determined from the Standard Retailers in NSW. This is also consistent with Ergon Energy view that IPART's definition of a Standard Retailer should be used as the definition of a representative retailer. In its 2010-13 retail pricing determination, IPART states:

  > *"To set the R values for each retailer and each year, we disaggregated each of the efficient cost allowances into their fixed and variable cost components, and calculated the cost per unit for each group of components.*
  >
  > *The fixed cost components account for 100% of customer acquisition and retention costs and 75% of retail operating costs (after the adjustment for double counting of late payment costs). These costs are expressed in terms of dollars per customer, and are the same for all 3 retailers. Therefore, we set a single fixed R value per year that is common to all 3 retailers.*
  >
  > *The variable cost components include 100% of total energy costs, 25% of retail operating costs (after the adjustment for double counting of late payment costs), and 100% of the retail margin. These costs are expressed in terms of dollars per MWh. These costs vary for each retailer (because the total energy cost allowance and the dollar value of the margin vary by retailer)."*[5]

  The IPART decision should then be adjusted for (if any) Queensland specific conditions. Ergon Energy considers the above approach to be the most effective method to determine the fixed and variable splits.

- **How should the Authority establish a time-of-use R component for residential customers with appropriate metering?**

  Ergon Energy is of the understanding that residential customers that opt to be on the time-of-use tariff will only be eligible if the appropriate metering is installed. However, since the appropriate metering is based on customer billing capability (rather than market settlement capability) the customer's load will still contribute to the NSLP, and therefore be settled by the retailer in exactly the same manner as other residential customers with an accumulation meter that are on an inclining block tariff.

[5] IPART, Regulated Electricity Retail Tariffs and Charges for Small Customers 2007 to 2010, *Final Report and Final Determination*, June 2007, page 141.

Ergon Energy considers it is important that cost reflectivity is considered from a retailer's perspective in setting the time-of-use retail tariff:

- In regards to the N component, the reduction (or increase) in revenue, as a result of the customer changing to a time-of-use tariff, will be exactly compensated (or penalised) by the network time-of-use charge to the retailer.

- In regards to the R component, the retailer will be revenue neutral if the energy costs are priced off the NSLP and overlaid as either:

    - a flat rate to the time-of-use network charges; or

    - by shaping the NSLP energy cost into the corresponding time-of-use parts as per the network time-of-use periods to enhance the signal to the customer. This particular approach would send a stronger signal to the customer.

- **How should the Authority set the R component for customers with accumulation meters?**

  Ergon Energy considers the R component for customers with accumulation meters and on an inclining block tariff should be set with the same considerations as detailed above, noting that it could only be set as a flat rate.

- **What information will the Authority require to set the R component of each tariff?**

  Under our proposal, no network load information is required to be obtained from Energex.

- **What other issues should the Authority be aware of?**

  No comment.

3.4.3 Transitional Issues (Issues Paper s 5.4)

The Authority seeks stakeholders' views on the following:

- **Given that prices will only be determined for one year at a time, how could the Authority mitigate the impact on customers of moving to new tariffs?**

  The readiness of customers to adopt the new tariffs is important to consider and Ergon Energy will work with the Queensland Government to understand what may be appropriate by way of education and transitional arrangements.

  In relation to specific issues affecting Ergon Energy's supply area, such as drought and rural subsidy schemes, Ergon Energy considers it important to maintain cost reflectivity from a retailer's perspective from 1 July 2012. Therefore any transitional arrangements to assist with customer impacts considered appropriate by the Government or the QCA should be provided for through a targeted Government rebate or scheme.

- **Is there any justification for determining prices for any customers on a less than cost-reflective basis in the first year?**

  As stated above, any support mechanism should be provided externally to retail tariffs.

3.5 Dealing with Uncertainty

3.5.1 Accounting for Unforeseen Events (Issues Paper s 6.1)

The Authority seeks stakeholders' views on the following:

- **Is a mechanism required to account for the impact of unforeseen events on the R component of retail tariffs?**

  Ergon Energy considers that a mechanism to account for the impact of unforeseen events should be included to remain in line with the cost reflectivity objective.

  With that in mind, Ergon Energy considers that an adjustment mechanism should only occur if material changes in Federal or State policy are implemented during a determination year (e.g. ERET). When policy changes are adopted as legislative, regulatory, code or rule changes, Ergon Energy suggests that those changes be considered in the R component and implemented as soon as practicable (even if it is mid year), having regard to the NECF constraints (refer below).

- **If so, should the mechanism apply to both the retail operating cost and energy cost components or just the more volatile energy cost component?**

  Ergon Energy considers that the mechanism should apply to all material impacts, whether it relates to energy or retail operating costs.

- **What specific events should be included or excluded?**

  Ergon Energy considers that wholesale market events that occur during the determination period (i.e. a movement in Q113 peak prices after the 2012-13 tariffs have been set) should not trigger an adjustment mechanism because Ergon Energy believes that these market movements would have an immaterial impact on the previously calculated VWA market price.

- **Should a materiality threshold apply? If so, how should it be determined?**

  Although it may be difficult to assess the materiality of a policy change at times, Ergon Energy believes a 10% movement in R costs due to the policy change is appropriate.

- **What other issues should the Authority be aware of?**
  Should a variation occur mid-year, the QCA must give consideration to the requirements of the National Energy Retail Law (NERL) (s 23) which provides that variations to standing offer prices (i.e. regulated retail tariffs in Queensland) can only be made once every six months (note: NERL to take affect in Queensland from 1 July 2012).

3.6 Additional Comments

3.6.1 Timeframe Risks

The NECF will apply in Queensland from 1 July 2012; the same date that the new regulated retail tariffs are to be introduced. Therefore, Queensland electricity retailers and distributors will be making major changes to their operations over the next 12 months to introduce both initiatives concurrently. Retailers require certainty about the structure of the tariffs in order to invest in new systems and processes; therefore it is imperative that the structure of the network and retail tariffs be communicated as early as possible in order for all electricity entities to make the necessary operational changes. This should be done as soon as the *structures* are known, and can not wait until final *prices (or rates)* are calculated and set. Ergon Energy acknowledges that the network tariff structures and prices will not be finalised until the AER approves the distributors' Pricing Proposals, however, early communication of the proposed structures is vital to allow retailers to begin operational readiness.

A further risk to the successful implementation of the new regulated retail tariffs is that resources may be constrained if Queensland experiences more natural disasters over summer 2011-12. Should such a natural disaster occur (e.g. a disaster of the magnitude similar to Cyclone Yasi), Ergon Energy would prioritise resources to restoring power and ensuring the safety of the community, which would significantly impact on Ergon Energy's ability to meet the 1 July 2012 deadline. Should such an event occur, a delay in the introduction of the new retail tariffs may be warranted.

From a customer perspective, provision of education and information will be key to ensuring customers are able to make informed judgements about opportunities and outcomes of the new tariffs. Effects will vary between and even within customer segments, as will customers' readiness for the new tariffs. Ergon Energy will work with the Queensland Government to understand what may be appropriate by way of education and transitional arrangements.

3.6.2 Further Consultation

Ergon Energy welcomes the opportunity to comment on the issues pertaining to establishing a new price-setting methodology and establishing a new set of retail tariffs based on an N+R framework. Ergon Energy is supportive of the QCA continuing with this approach and undertaking on-going consultation on the key issues (e.g. how energy costs are estimated or what constitutes a representative retailer). This will allow electricity entities to comment on the QCA's initial views and provide more comprehensive responses on targeted issues.