Mr Gary Henry
Director Electricity and Gas
Queensland Competition Authority
SENT BY EMAIL

4 August 2011

Dear Mr Henry

QEnergy Comments on Review of Regulated Retail Electricity Prices and Tariffs

Thank you for the opportunity to respond to your Issues Paper of June 2011 regarding QEnergy's views on the review of Regulated Retail Electricity Prices and Tariffs. This letter contains QEnergy's comments on the issues, which will be addressed as asked in the paper.

Background

QEnergy is a Queensland electricity retailer specialising in providing retail electricity to businesses of all sizes. A public unlisted company, QEnergy is owned by a small number of highly successful energy and financial services business owners across Australia and was established by the two founders of the well-known business electricity retailer Powerdirect Pty Ltd to offer choice to businesses in areas with limited competition.

Whilst QEnergy is a relatively new retailer, it has grown exponentially over the last six months with around 3,700 customers across Queensland. QEnergy differentiates itself through our focus on providing competitive rates to customers in previously uncompeted regions, and through our individualised service ethic. QEnergy is the only electricity retailer offering a range of market contracts to small customers in regional Queensland, and as such is in a unique position to comment on the potential impacts of this tariff review.

QEnergy notes that the Issues Paper assumes that there is no competition outside south-east Queensland. This is not correct – QEnergy's unique approach has opened up competition from Toowoomba up the Queensland coast to Townsville for small customers. Through this process, QEnergy has found excellent responsiveness from customers to the prospects offered with choice.

QEnergy therefore respectfully submits that it is important that the Issues Paper consider the ongoing promotion – and indeed increase – of competition outside South-East Queensland, alongside impacts in that more populous and competed region. The maintenance of appropriate levels of competition will ensure that any headroom under the Regulated Retail Price will be competed away, to the benefit of customers and the State.

Issue: Section 2.3 ENERGEX Network Tariffs

QEnergy supports a transitioned approach to the tariff changes recommended by this review – individual customer impacts could be significant should change be abrupt which would be problematic for both customers and the industry.

QEnergy considers that the slightly amended network tariff structures proposed by ENERGEX in their letter dated 7 July 2011 are consistent with this transitioned approach. ENERGEX also demonstrates that the mapping of their proposed network charge structures is broadly consistent with a rationalised set of existing tariff structures. So in particular:

- QEnergy supports the consolidation of the 8500 and 8600 network codes, as well as the 8700 and 8800 network codes, to allow the business tariffs to more appropriately reflect the true structure of the network costs whilst not discriminating against customers in the consumption band just above 25 MWh per annum.
- QEnergy does not support the removal of tariff code 8200, particularly given that large customers in the South-East Queensland region will not have access to tariffs after 1 July 2012. The introduction of a new structure for these larger demand customers simply adds to the analytical complexity of taking these customers into the market, particularly as the new thresholds and levels will not be known until shortly before the implementation date.
- QEnergy supports the establishment of a Peak / Shoulder / Off-Peak mapping for domestic Time of Use periods which mirror National Electricity Market settlement times, however does not support the proposed different mapping for business Time Of Use as this is confusing for small businesses (all of whom have domestic accounts as well).

QEnergy has also noted that Ergon Energy's network tariff structures have not been considered in this review. Whilst we understand that the Regulated Retail Prices will be based on ENERGEX's proposed network structures, we have demonstrated above that competition in regional Queensland does exist and is of importance to customers.

Consequently the structure of Ergon Energy's network tariffs relative to the Regulated Retail Prices is of importance not only to Government with relation to the provision of the Community Service Obligation, but also to ourselves as providers of competition in that area, and to customers as recipients of both current and future competition.

QEnergy agrees with the QCA's view that:

In Queensland, the simplest way for the Government to implement its decisions regarding the subsidised cost of electricity for consumers in difficult situations would be to provide its subsidy at the network level because the distributors are wholly owned by Government.

QEnergy believes that this would be in the long-run best interests of customers, the industry and the Government because it would allow regional Queensland to be opened up to more traditional and extensive competition than is currently the case.

Whilst we understand that this is outside the scope of this review, it is imperative that this long-run objective be supported through ensuring that Ergon Energy's network tariffs are structured in a similar way to those proposed by ENERGEX, even though they clearly will not be at the same levels.

This in particular is important for large customers, who in regional Queensland (as opposed to South-East Queensland) will have the choice of remaining on the tariff or moving to a market contract. The establishment of a network tariff structure mirrored across distributors

for large customers will greatly facilitate analysis of the benefits or otherwise for customers in regional Queensland to take up their option, assisting with alleviating the inevitable tensions that will arise on this issue between the regions.

The QCA asks retailers to comment on the ability of retailers to pursue our own demand management objectives in an N+R model, where R is not structured to support market demand objectives but N is devised to support network demand management.

QEnergy supports this model from a customer perspective because at present the key cost driver for customers has been the increase in network capital costs, and consequently any ability to curtail network critical peak demand will be beneficial to everyone. The use of an N+R model does not constrain retailers from establishing their own market contract mechanisms to drive retail demand management where and when commercially appropriate.

Retailers could also provide demand management aggregation services to networks to avoid network upgrade requirements should there be appropriate incentives in place for the provision of that service.

Issue: Section 2.4 Process for passing through network costs

As noted above, QEnergy considers that the Community Service Obligation accruing to regional Queensland customers should be paid through the Ergon Energy network business. In the short run, ensuring that Ergon Energy's network tariffs are structured in a similar way to those proposed by ENERGEX, even though not at the same levels, at least makes the level of subsidy more transparent, as well as ensuring that there are no barriers to the ultimate implementation of more uniform competition.

QEnergy considers that the separation of retail and network charges as mandatory items on the bill will cause confusion to customers and significant disruption to the industry. The network and retail contributions are already separated on large interval-metered bills, and this causes significant confusion when customers move into the market from tariff prices. If these sophisticated consumers find the separation confusing, it is hard to imagine that it would not be even more so for domestic customers.

QEnergy also agrees with previous retailer submissions that there would be significant additional cost and disruption which would need to be borne by the industry and, ultimately, customers, if the requirement for separate identification of the network and retail components of the bill were mandatory.

There is certainly not sufficient time between the release of the final report in March 2012 and the implementation of this structural review in July 2012 for this to be a requirement, particularly given the other systems changes being implemented at the same time. These include changes to accommodate compliance with the National Electricity Consumer Framework and also the proposed introduction of a Carbon Tax.

QEnergy supports the QCA proposal to inform customers of the cost of the network components of their bill through the publication of the separate N and R components in the tariff schedule. This could then form the basis for retailer communications to customers

through our annual repricing communications, rather than requiring the introduction of a new framework for communication in an already cluttered communication landscape.

Issue: Section 2.5 Maintaining alignment of retail and network tariffs

QEnergy agrees with the Authority that the timing of the release of ENERGEX network charges later than the required gazettal of Regulated Retail Prices is a matter of concern for retailers. QEnergy does not support the implementation of new N+R structures on 1 July and then their reimplementation on say 1 August as this will add significant additional cost and disruption which would need to be borne by the industry and, ultimately, customers.

QEnergy also does not support the Authority adjusting retail tariffs once the Australian Energy Regulator has approved ENERGEX's network tariffs as we agree that it would leave insufficient time for the amendment of the retail tariff structure or for retailers to incorporate the new retail tariffs into their billing systems in time for the start of the new financial year.

The Authority could consider adopting a different year – for example, August to July or September to August – to allow for this timing inefficiency which will be an ongoing issue.

If this is not possible, then the structure whereby the Authority makes any required adjustments as promptly as it can is a second-best alternative, albeit one significantly poorer than the adoption of a different timetable by the Authority.

Issue: Section 3.2 Estimating Energy Costs

QEnergy believes that over the long-run, LRMC pricing will be delivered by the Queensland electricity market since this is the rational approach to electricity generation pricing. We do not support the adoption of a solely market-based approach to estimating energy costs, chiefly because this would significantly add to year-on-year volatility for customers. The volatility would in some periods be beneficial for customers, and in some periods punitive, but would always make forward budgeting uncertain and more complex.

As noted by IPART (Changes in Regulated Electricity Retail Prices from 1 July 2011 – draft report April 2011 p.31):

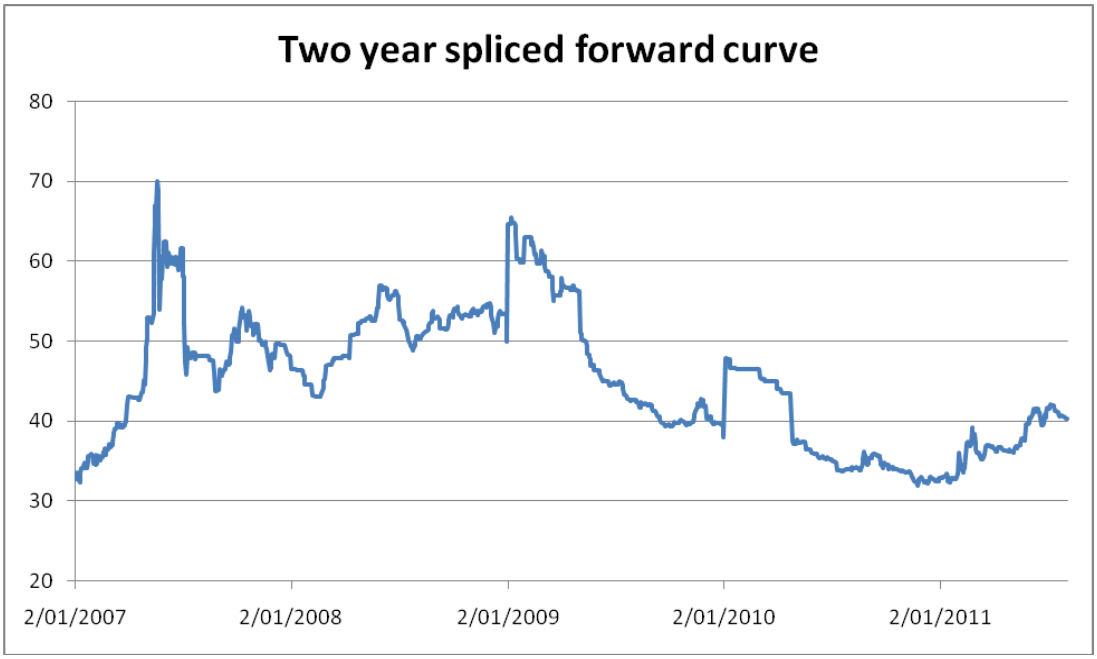
The market-based cost is sensitive to the supply-demand balance and can move significantly from year to year. As a result for some years the market price can be significantly above the LRMC of generation, for example, during the tightening of the supply-demand balance ... Over the longer term we would expect the market price to reflect the LRMC of generation.

By way of background, the Australian electricity market is currently experiencing an oversupply of generation and an abundance of gas as a fuel, as coal-seam wells are ramped up towards the commissioning of the proposed Liquified Natural Gas trains in Gladstone. This is being reflected in relatively low market prices.

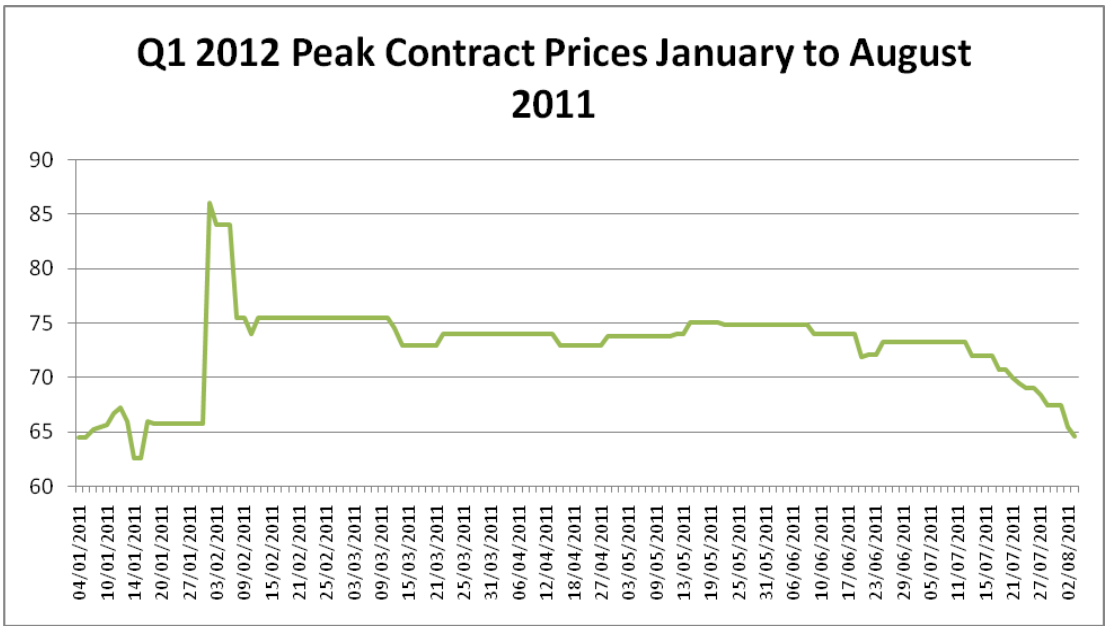
In Queensland, this is an abrupt change from 2007, when a lack of water required the withdrawal of capacity and sent forward contract prices to extraordinary levels. The history of forward contract prices over the last five years is shown overleaf, demonstrating that

prices which went into 2007 at $30/MWh, rose to $70 / MWh later that year, and have remained similarly volatile ever since.

If the Authority had been undertaking the review using market contracts to benchmark energy prices at this time, the energy component in 2007 would have doubled going into the 2008 determination, a more than 40% increase in the Regulated Retail Price (energy makes up around 40% of the overall tariff rate).



Within one year there can also be significant volatility as is demonstrated in the graph below, when prices spiked because of lack of supply during Queensland's floods.



This drives the requirement for a volatility premium on top of base prices since effectively by setting a single price which is open for a year, the Authority is requiring retailers to sell customers an option which is over for the entire gazettal period.

From a risk-management perspective, then, retailers sell at the Regulated Retail Price to customers – a fixed price – in quantities set by the customer not the retailer, and buy their hedges to cover their forecast load at a variety of prices throughout the year. Further, they are subject to significant risks such as load volatility which can change the cost of provision of supply to customers even once the customer is hedged.

As a starting point, it is therefore important to realise that the prices which are visible in the market – and which are the basis of these charts – are flat, Peak or Off-Peak contract prices which do not contain any risk premia for the market risks that retailers take in making their offerings to customers. Those prices therefore represent only the base level upon which the Authority can commence to apply premia to cover these and other risk aspects of retailing.

Further, because the electricity market is a semi-perfect (and somewhat illiquid) market, the prices are only a representation of dealable levels, and may have significant buy/sell spreads around them. This means they can be extremely misleading as market price indicators.

Finally, whilst an R based on current wholesale market prices would no doubt initially be lower than one based on LRMC approaches, it would move sharply upwards over the next few years as the coal seam gas is extracted for compression and export.

For this reason, QEnergy supports a continuation of the LRMC based approach to estimating energy costs. If however the Authority is intent on pursuing a market-based approach to estimating energy costs, QEnergy would recommend a blend of LRMC and market-based approaches to assist in smoothing out this volatility. This appears to be IPART's preferred model.

If a market-based component is adopted, determination of the nature of a representative retailer will be key to establishing the appropriate risk level which drives the hedging strategies (and hence price). Given that a core objective is to promote competition in the South-East Queensland market, it would seem sensible to use the new entrant retailer as a model on which to base cost estimation.

New entrants typically have a lower risk appetite than incumbent retailers, and consequently the more conservative approach to risk adopted by the Authority in its last review is appropriate.

It is not, however, appropriate to represent that risk appetite through over-hedging a book. New entrant retailers are far more conscious of daily and weekly cashflows than incumbent retailers, and for this reason, steadily losing money through being long to the pool and paying the difference payments is not an appealing strategy despite offering the comfort of protection in the event of a price excursion. It is analogous to 'death by a thousand cuts' as opposed to the alternative of 'death by beheading' (where the retailer has a short position during a price excursion).

For this reason, the new entrant retailer will generally seek to match its expected load volume and shape with shaped hedging contracts rather than the block contract methodology reviewed by the Authority in its previous examination.

This makes sourcing the appropriate data for market contract benchmarking not easy to achieve. Whilst core Flat, Peak and Off-Peak swap and cap prices are readily available for the Queensland market, as noted by the Authority this does not reflect the actual cost of hedging. If some visible market portfolio is adopted as a base point, then a variety of risk premia must be added to the contract price in order to achieve truly cost reflectivity:

- The cost of an NSLP shaped hedge is not observable through traded prices, although a premium can be inferred through bilateral contract transaction levels.
- A liquidity premium must also be included since the volumes acquired on a monthly basis are traditionally smaller than ordinary tradeable market parcels.
- Because retailers traditionally hedge as load is acquired (ie regularly throughout the year), a premium would need to be added to any market-based contract proposal to allow for price volatility over the annual period. This premium can be estimated using historical data on contract price volatility over an annual term.
- For the same reason, a seasonally volume-weighted approach to estimating the full-year cost would be required by the representative new entrant retailer, since one-twelfth of the final load would be in place for the full year; one-eleventh for eleven months; one-tenth for ten months; and so on. This however is directly opposite to the incumbent retailer profile, where the full franchise load is in place for the entire year. Perhaps a balance between the two would be appropriate.
- It would also be necessary to include a premium for load variability, which can be estimated using standard simulation packages.

On balance, none of these pricing elements are easily observable, so if the Authority is to pursue this approach it will need to invite stakeholder confidential feedback on their specific bilateral costs, compare them to the observable market to determine appropriate premia, and then make a qualitative determination of costings from that point. It may be appropriate to engage a consultant to undertake this work on behalf of the Authority.

With respect to wholesale spot price forecasts, it is not necessary to use spot price forecasts as a component of the modelling process even for energy market contracts, because retailing as a margin business does not allow for the establishment of short positions to pool – this is a trading activity, is not compensated in the Regulated Retail Price structures, and is better thought of a separate, unrelated profit-making activity.

With respect to the timing of purchasing, as noted above, the representative retailer is as averse to being long to the pool as it is to being short because of the cashflow consequences. Hence, the Authority's view that retailers will purchase load in advance of customer recruitment is not borne out in practice.

Whilst QEnergy agrees that using a rolling dataset to estimate market prices is less volatile than using a point-in-time estimate, it is imperative that these rolling prices be forward rather than backward looking. This could be established by using, as noted above, a traditional volatility premium to add to the point-in-time estimates or could be based on a simulated forecast contract prices forecasted by an expert.

As noted previously, a seasonally volume-weighted approach to estimating the full-year cost would be required by the representative new entrant retailer, although the incumbent retailer would require a more full-year profile. For this reason QEnergy suggests a balance between the two.

QEnergy considers that the ENERGEX NSLP shape is the appropriate shape to use when costing the sculpted load. Historical data without adjustment should be used as the basis on which to estimate this shape.

Issue: Section 3.3 Use of LRMC as a price floor

As noted above, QEnergy is supportive of an approach of combining the LRMC and market-based costs when establishing energy contract rates. Failing this, it would be imperative to introduce an LRMC price floor into the calculation to smooth market volatility and to ensure that retailers are not forced to take the risk of being required to sell to customers at a rate that is unsustainably low for a fixed period of time.

Issue: Section 3.4 Accounting for energy losses

QEnergy does not support the Authority's approach to accounting for energy losses in the calculation of price. When pricing a large customer – and as price-setter for aggregate small customers the Authority is effectively assuming the role of a large customer – load is taken at meter and then the price is accreted for both distribution and transmission loss factors.

Small customers billed on tariff arrangements are not subject to the application of distribution or transmission loss factors, and are billed based on metered load. Consequently the tariff rate must include an uplift in pricing to take account of average combined distribution and transmission loss factors, which in ENERGEX's area average around 8% (but can be significantly more across the rest of the State). This is clearly an important margin component if not included in the pricing.

Issue: Section 3.5 Cost associated with environmental schemes

QEnergy does not support the unaltered use of market contract data to estimate the costs of environmental credits, because the issues associated with using market data for 'black' energy costs also apply to these other markets. The cost estimate for GECs in the 2010/11 BRCI fell significantly from the previous year, which was not representative of the costs of compliance for retailers selling to small customers.

If the Authority chooses to use observable market contract data as the basis for pricing environmental schemes, then the following premia must be added to contract prices to truly be cost-reflective:

- A liquidity premium, since the volumes acquired by the representative new entrant retailer would be traditionally smaller than ordinary tradeable market parcels.
- A premium for price volatility over the annual period would be required, which can be estimated using historical data on contract price volatility over an annual term.
- A seasonally volume-weighted approach to estimating the full-year cost would be required by the representative new entrant retailer, although this is opposite to the

requirements of the incumbent retailer profile, where the full franchise load is in place for the entire year. Again, a balance between the two would be appropriate.

Because the volume associated with environmental compliance is annual not half-hourly, the risks are not as concentrated as they are in the case of 'black' energy.

These premia would apply similarly to the other environmental schemes within the Expanded Renewable Energy Target scheme.

With respect to Carbon Pricing, QEnergy considers that the legislative environment is still sufficiently uncertain to comment on an appropriate mechanism to price the tax into electricity.

Issue: Section 3.6 Costs associated with market participation

QEnergy supports the use of historical costs to estimate NEM participation fees and ancillary services charges incurred by retailers.

Issue: Section 4.2 Retailer characteristics

QEnergy considers that the appropriate retailer should be a new entrant retailer in order to support the continuation of vibrant competition in Queensland.

Consolidation has been a feature of the electricity market landscape over the past few years, and with the sales of the electricity businesses in NSW to the two Queensland incumbents AGL and Origin Energy, a flourishing competitive environment is dependent entirely on new entrant participation. This should be reflected through the price-setting framework with respect to Regulated Retail prices.

QEnergy considers that the business should be standalone providing only electricity retail services in Queensland, largely because most of the new entrants currently participating in other states and likely to enter to support competition in Queensland are structured in that way. Gas retailing is not a viable startup business in Queensland because of the limited numbers of customers, so consequently standalone electricity retail businesses are the most appropriate from a market environment as well.

If the Authority wished to consider that the business was vertically integrated, then it would need to use the LRMC approach to estimating energy costs in the Regulated Retail prices, since this is the cost that applies to those businesses.

QEnergy considers that operating costs should be benchmarked across the market as competition forces a competitive cost structure on all participants.

Issue: Section 4.3 Retail operating costs.

QEnergy supports the current list of retail operating costs reviewed by the Authority under the BRCI, and also supports the methodology used to date in calculating those operating costs, including the CARC.

Issue: Section 4.4 Retail margin

QEnergy supports the methodology used by the Authority in calculating the retail margin in BRCI reviews to date, as well as the 5% margin.

Issue: Section 5.2 Allocating R costs to customer groups

QEnergy considers that except for tariff classes applicable to large customers in the Ergon Energy area – tariffs 41, 43 and 66 – there is limited difference in the application of tariff structures across classes. This is particularly because the specific consumption pattern of an individual customer is not material to the establishment of a cost-reflective R since all customers are settled based on the Net System Load Profile.

Issue: Section 5.3 Allocating R costs through individual retail tariffs

QEnergy considers that in general, operating costs are driven by customer numbers – each customer must be acquired, transferred, billed, serviced and have their debt collected regardless their size. Therefore QEnergy advocates for Retail operating costs to be included in a Fixed-rate R component, whilst energy trading costs (including the costs of environmental compliance) are clearly applicable on a variable basis.

QEnergy considers that the inclusion of the Retail Margin as a fixed cost would drive retailers to educate customers to reduce their consumption rather than grow it as would be the case if the retail margin was variable. The same argument applies should a variable Retail Margin be applied in the Time Of Use tariffs for domestic and business customers – it would need to be either equivalent across Peak and Off-Peak components or more targeted towards Off-Peak components in order to ensure that retailers were appropriately incented to drive Off-Peak consumption.

Issue: Section 5.4 Transitional issues

As noted at the outset, QEnergy supports a transitioned approach to the changes in tariff structures recommended out of this review. This means that QEnergy considers that changes from current tariff structures and levels should be constrained at an aggregate level to ensure that no individual customer is shocked or has too much of a windfall price gain.

In this sense, QEnergy supports that a phased transition does support the determination of prices for customers on a less than cost-reflective basis in the first year simply by managing the deviation of prices from the current level extremely tightly. In particular, ENERGEX's network pricing will need to take this into account when establishing the rates for each of the steps in the domestic tariff as the inclining block structure is new for domestic customers and clearly will have the largest impact by customer numbers.

The most significant impact for individual customers transitioning off obsolete tariffs will likely be the small consumption Tariff 21 sites, since most significant electricity consumers who were on this tariff have already been placed onto a Tariff 20 structure. However many of these sites are adjuncts in part of a larger portfolio of business sites, and so QEnergy does not consider it will cause undue hardship. Similarly, Tariff 37 is generally found in

combination with another business tariff and so is unlikely to impose large-scale hardship through obsolescence.

The two farm tariffs – 63 and 64 – are different and merit the special attention directed towards finding an appropriate farm solution. Whilst these might seem to be solely a problem in regional Queensland, they are also found in significant numbers across nurseries and agricultural facilities in the ENERGEX rural areas.

Issue: Section 6.1 Accounting for unforeseen events

As noted in the Issues Paper, regulatory events have occurred, particularly associated with environmental schemes, which have adversely impacted retailer margins during a gazettal year, and which have not been able to be passed through.

QEnergy considers that the maintenance of a price reopening mechanism in the price setting framework is imperative, although this could apply only to the energy cost component – including in particular the renewable energy schemes – which contains the significant business and regulatory risks which retailers accept as part of our business.

QEnergy considers that changes to law and regulatory disruption should be included in this mechanism. These might include the introduction of the Carbon Tax for example, or any changes to the percentage allocations to any of renewable energy schemes, which have an extremely material impact on the costs for retailers in providing supply to customers.

Conclusion

QEnergy welcomes the work undertaken by the Authority in delivering a more cost-reflective set of tariffs for Queensland customers. In particular, QEnergy supports the intention to promote competition, both within South-East Queensland and outside of this area over the long-run. In this regard, we consider it is imperative that Ergon Energy's network structures do not diverge from those proposed by ENERGEX, which appear appropriate when allocated against the current tariff set.

QEnergy also supports a transitioning approach to customers, and the avoidance of price shock both short-term and over the long run. In this regard, QEnergy strongly supports the retention of some sort of LRMC mechanism in the setting of wholesale energy costs, since this will tend to ensure that price volatility is smoothed out relative to a mechanism which is reliant solely on market pricing.

Thank you again for the opportunity to comment on these issues.

Yours sincerely

Kate Farrar
Managing Director