Review of Regulated Retail Electricity Prices 2013-14 – Interim Consultation Paper

AGL submission to the Queensland Competition Authority

Date: 23 October 2012

Table of Contents

Executive Summary

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

In the past year heavy-handed regulatory and Government intervention in the setting of notified electricity prices has raised significant uncertainty about the future of the retail electricity market in Queensland. The current Ministerial Delegation provides an opportunity for the Authority to move away from prescriptive regulation of small customer electricity prices so that the retail market can be deregulated by the end of the proposed pricing period. AGL is hopeful that the Authority will take this opportunity to minimise the regulatory risk in determining regulated electricity prices on a year-on-year basis by setting the framework for a sustainable price path.

2013-14 Notified Price Framework

- The Delegation to the Authority has changed compared with previous Delegations from the Minister:
    - The Delegation applies for three years from 1 July 2013 to 30 June 2016, instead of one year. In each tariff year the Authority is to calculate the notified prices and publish an annual price determination; and
    - The Terms of Reference (***ToR***) within the Delegation provide the Authority with much broader discretion to develop a pricing approach which meets the general requirements of the Delegation.
- The Delegation and ToR describe 'transitioning' from current pricing arrangements over three years to rebalance the fixed and variable components of Tariff 11 so that the components are cost reflective by 1 July 2015. AGL supports the principle that the components of tariffs should be cost reflective so that any cross-subsidies between customer groups are eliminated prior to deregulation.
- The Authority has recognised that the new requirements of the Delegation "might warrant some changes to the approach used in the 2012-13 Determination". AGL suggests that a number of changes should be made to the current pricing methodology employed by the Authority to reflect the requirements of the Delegation.
- AGL believes that this Review provides the Authority an opportunity to set a framework for setting notified prices that can provide price certainty for the industry, and consumers alike. By promoting retail competition as a sustainable approach to setting 'efficient' retail prices the Authority can best achieve the goals of "managing short-term price shocks…..and assist in the longer term investment in the sector".

2013-14 Notified Price Consultation

- AGL is concerned that the Consultation Paper does not provide any policy principles, regulatory framework or pricing methodology which the Authority is considering in setting the 2013-14 notified prices. This will severely limit the effectiveness of any consultation carried out at this stage because stakeholders will not be able to provide feedback on specific proposals.

Setting the Retail Component

- In light of the changes to the Delegation, AGL is firmly of the view that the Authority should adopt a principle of setting the elements of the R component at no less than the long-term cost faced by a retailer operating in the Queensland small customer retail market. Using this approach AGL suggests:
    - The wholesale energy cost (***WEC***) should not be less than the long run marginal cost (***LRMC***) of electricity generation;
    - If no consideration of the LRMC of generation is included in the WEC (i.e. purely market-based energy purchase cost) the WEC should include costs of long-term hedging arrangements i.e. PPAs;
    - To promote competition, AGL encourages the Authority to consider if defining the retailer to be a "new entrant retailer" to fully account for the costs of acquiring customers, may be more appropriate; and
    - Retail margin & headroom should be set to appropriately promote retail competition.

1. Background

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

Queensland Retail Electricity Market and 2012-13 Notified Prices

In the past year heavy-handed regulatory and Government intervention in the setting of notified electricity prices has raised significant uncertainty about the future of the retail electricity market in Queensland. The current Delegation from the Minister provides an opportunity for the Authority to move away from prescriptive regulation of small customer electricity prices so that the retail market can be deregulated by the end of the proposed pricing period. AGL is hopeful that the Authority will take this opportunity to minimise the regulatory risk in determining regulated electricity prices on a year-on-year basis by setting the framework for a sustainable price path.

The process to determine notified prices for 2012-13 represented a significant departure from previous determinations made by the Authority. The change in the Minister's Delegation to the Authority created significant uncertainty for retailers and many consumers. The change in the Delegation had the main effect of freezing the price for Tariff 11 at the 2011-12 price plus an allowance for the carbon pricing mechanism. This in turn meant the dismissal of the proposed network pricing approach from Energex and energy purchase cost (***EPC***) approach taken by the Authority to set the most widely used tariff (i.e. Tariff 11).

In terms of the Retail Component of the notified prices the freezing of Tariff 11 plus the carbon allowance made a minor difference to the price of the usage rate of the tariff. However, the methodology used to set the elements of the 2012-13 Retail Component changed significantly from the 2011-12 approach to setting notified prices. Specifically, the Authority made significant changes to the wholesale energy cost (***WEC***) allowance in 2012-13 and included a specific allowance for 'headroom' to promote retail competition.

Recent wholesale electricity market changes

Figure 1 below shows the changes in Cal2013 QLD Base contract prices since October 2011 which cover the period when the 2012-13 Final Determination was developed and finally released in May 2012. The change in contract prices shown in the graph highlights the risk inherent in using a market-based EPC approach to set the WEC allowance. The market-based EPC approach assumes that the cost of servicing an additional customer can be met by hedging this customers load in the short-term market. If the market moves beyond the price set in the Determination then the hedging cost might not be recovered in the regulated tariff. AGL remain of the view that using a long-term approach to setting the WEC allowance would minimise the risk of this occurring.

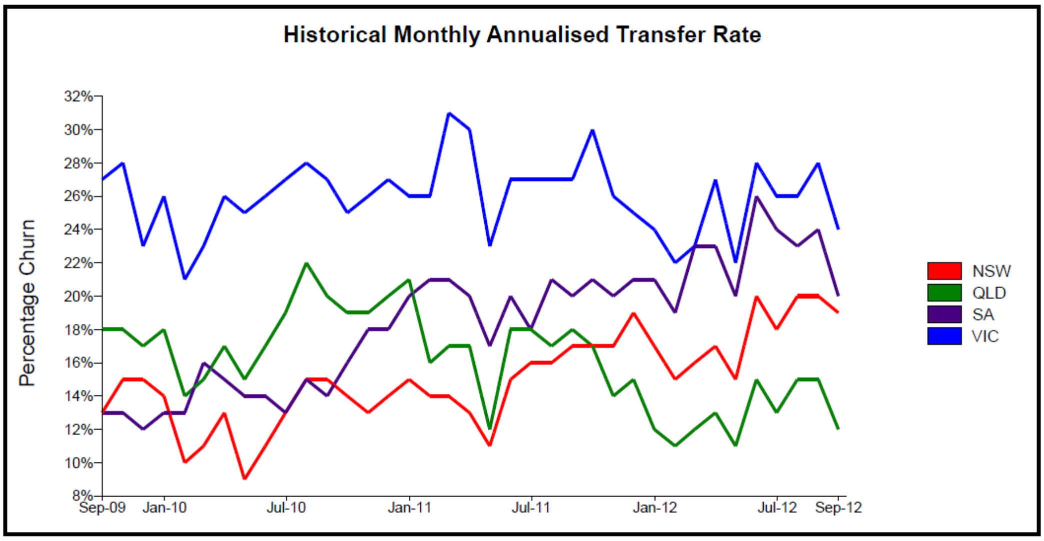
Figure 1 – d-cypha Cal2013 QLD Base Contract Prices

Source: d-cypha Trade website QLD Base Cal2013 – accessed 18 October 2011)

Impact on retail competition

Figure 2 shows the monthly transfer rates for electricity customers in the NEM broken down by State. While the transfer rates include all customer types in the NEM this data provides the most useful benchmark for the trend in switching of retail customers.

Figure 2 – Historical Transfer Rates for NEM States



Source: AEMO NEM monthly retail transfer statistics, Sep 2012

Figure 2 highlights:

- Current Queensland transfer rate is at its lowest level in three years. Since July 2012 the transfer rate in Queensland has reduced further and remains the lowest of any State in the NEM; and
- Queensland transfer rates improved briefly in August 2012 likely due to public interest in the Queensland Government decision to freeze Tariff 11, the

introduction of the carbon pricing mechanism and media interest on retail market contract rates.

AGL is also of the view that the Queensland transfer rate demonstrates the retail market reaction to the increased risks for retailers that result from significant year-on-year adjustments in the regulated price settings. By setting the notified price based on a consultant's view on the efficient WEC the Authority narrows the band within which retailers can develop a strategy to manage their price risk. While the Authority would argue that as part of their Delegation from the Minister they are required to set prices based on a representative retailers' 'efficient costs' there is significant uncertainty in defining this 'efficient cost'.

In submissions to the Authority's Draft Determination, Regulated Retail Electricity Prices 2012-13 (March 2012) (***2012-13 Draft Determination***) stakeholders highlighted that the consultant ACIL Tasman had in October 2011 provided the AEMC with projections of the WEC faced by retailers in various jurisdictions, including Queensland, for a period including 2012-13. ACIL Tasman addressed this issue in their 2012-13 Final Report to the Authority and discussed the different assumptions used in the Draft Decision which resulted in a "$9.00/MWh decrease in the modelled time weighted price between the AEMC report and the report for the Draft Determination".[1] The fact that regulators, such as the Authority, rely on pricing forecasts that can vary so significantly serves to reinforce the risks faced by retailer entering into a market where effectively a 'cap' price is reset each year.

Community Service Obligation Payments

The Queensland Government's Uniform Tariff Policy provides that "wherever possible, non-market customers of the same class should have access to uniform retail tariffs and pay the same notified price for their electricity supply, regardless of their geographic location".[2] In practice this means that in the Ergon supply area that customers whose network tariffs are greater than the total retail tariff then the Government subsidises the retailer (i.e. Ergon Energy) for the difference. In 2012-13 the subsidy paid to Ergon Energy is estimated to be ~$600 million.[3] This amount can be expected to expand if the long term costs of the Government retailer are not recovered.

Retail competition and deregulation

In the context of the commitment to phase out retail price regulation set out in the Australian Energy Market Agreement,[4] AGL is firmly of the view that the objective of the three year Delegation should be to set notified prices in a manner that will best facilitate a move to full retail market deregulation.

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[1] ACIL Tasman Ltd, Estimated energy purchase costs for Final Determination, Prepared for the Queensland Competition Authority, May 2012. Page 18

[2] Queensland Competition Authority, Interim Consultation Paper, Regulated Retail Electricity Prices 2013-14, September 2012, Appendix A: Ministerial Delegation and Covering Letter. Page 8.

[3] Estimate based on Queensland Budget Paper No.2 Community service obligation payments for 2012/13 to the Energy Sector.

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

2. 2013-14 Notified Price Framework

The Delegation to the Authority has changed compared with previous Delegations from the Minister. AGL supports a number of specific changes and notes that the Terms of Reference (***ToR***) within the Delegation provide the Authority with much broader discretion to develop a pricing approach which meets the general requirements of the Delegation.

AGL supports the use of a three year Delegation combined with an annual determination of notified prices. By providing a three year framework this will give greater certainty to the industry and customers alike. It also provides the Authority with a significant opportunity to ensure that the pricing approach used will not impede the move to a deregulation of electricity prices in the future. By promoting retail competition as a sustainable approach to setting 'efficient' retail prices the Authority can best achieve "managing short-term price shocks…..and assist in the longer term investment in the sector".[5]

Minister's Delegation and Terms of Reference 2013-14

The Authority sets out in the Consultation Paper that in accordance with section 90(5)(a) of the Electricity Act, the Delegation requires that the Authority have regard to the following in making its price determination:

a) the actual costs of making, producing or supplying the goods or services;

b) the effect of the price determination on competition in the Queensland retail electricity market; and

c) the matters set out in the Terms of Reference.

The Delegation applies from 1 July 2013 to 30 June 2016. The Delegation also includes a Terms of Reference (ToR) which requires that the Authority consider a number of specific matters, including:

a) basing each annual price determination on a N + R cost build-up approach;

b) the Queensland Government's Uniform Tariff Policy (UTP)

c) basing the network cost component for:

   i. small customers on the network charges to be levied by Energex; and

   ii. large customers on the network charges to be levied by Ergon Energy.

d) transitional arrangements for the standard residential tariff (Tariff 11) and the existing obsolete tariffs

The Authority notes that there are some new requirements in the Delegation which might warrant some changes to the approach used in the 2012-13 Determination. However, the Authority goes on to highlight that the underlying legislative requirements for the Determination has not changed.

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[5] Queensland Competition Authority, Interim Consultation Paper, Regulated Retail Electricity Prices 2013-14, September 2012, Appendix A: Ministerial Delegation and Covering Letter. Page 5

2012-13 Delegation and ToR and changes in 2013-14

In previous price determinations, in particular 2012-13, AGL has been concerned with the way that the Authority has interpreted the wording of the Delegation and ToR to justify the approaches taken to set the different components of the notified prices.[6] Whilst AGL acknowledges that the function of the Delegation and ToR is to provide a framework within which the Authority is to determine prices the interpretation of the wording has been a key factor in justifying the approaches taken for components such as the wholesale energy cost (***WEC***) allowance.

If the Authority is to be consistent in its application of the wording of the Delegation and ToR to the price determination it is necessary to consider the way in which the requirements of the Delegation and ToR were used in 2012-13. The Authority has recognised that the new requirements of the Delegation "might warrant some changes to the approach used in the 2012-13 Determination".[7] AGL suggests that a number of changes should be made to the current pricing methodology employed by the Authority to reflect the requirements of the Delegation.

AGL note the following specific issues for consideration:

Wholesale energy cost allowance

In the Final Determination, Regulated Retail Electricity Prices 2012-13, May 2012 (***2012-13 Final Determination***) the Authority noted:

> *"The Delegation requires that the energy cost component of each regulated retail tariff should include the cost of purchasing energy, environmental and renewable energy costs, energy losses and NEM fees."*[8]

The Authority used this reference to "the cost of purchasing energy" to specifically justify the use of a market-based approach to calculate the WEC. This reasoning was made clear in the Authority's discussion of an 'LRMC as floor' approach for the WEC allowance which was suggested by a number of stakeholders.[9] The Authority used advice from its consultants, ACIL Tasman, to support this approach.[10] Furthermore, ACIL Tasman went on to highlight the importance of the inclusion of "purchasing energy" to determine the approach for setting the 2012-13 WEC allowance:

> *"The use of LRMC of generation was rejected as an approach by ACIL Tasman and the Authority in both the Draft Methodology Paper and the Draft Determination. This was on the basis that market prices were a more efficient and cost reflective measure of the cost of purchasing energy. Furthermore the Ministerial Delegation stated that:*

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[6] AGL Energy Ltd, Review of Regulated Retail Electricity Tariffs and Prices – Draft Methodology Paper. AGL submission to the Queensland Competition Authority (12 December 2011). Page 4.

[7] Queensland Competition Authority, Interim Consultation Paper, Regulated Retail Electricity Prices 2013-14, September 2012. Page 2.

[8] Queensland Competition Authority, Final Determination, Regulated Retail Electricity Prices 2012-13, May 2012. Page 19

[9] Ibid. Page 23.

[10] In the Final Determination 2012-13, the Authority note "ACIL also advised against using LRMC on the basis that it does not account for prevailing market conditions and therefore is unlikely to reflect actual wholesale energy purchase costs faced by retailers, as required in the Delegation."

The energy cost component of each regulated retail tariff should include the cost of purchasing energy,………Importantly, the Delegation did not make reference to the cost of making or producing electricity."[11]

Clearly, ACIL Tasman gave significant weight to this form of words, and particularly the omission of a reference to 'making or producing electricity' when dismissing 'LRMC as a floor' as a valid approach.

It must therefore be considered highly significant that clause 3(a) of the ToR states that the:

> *"QCA must have regard to the following: a) the actual costs of making, producing or supplying the good or services".*

This now aligns with the requirement of Section 90 (5)(a)(i) of the Electricity Act 1994. AGL suggests that as the absence of a reference to "making or producing" electricity was deemed to be largely determinative of the EPC approach previously, this change in the Delegation must require the Authority to review their approach to incorporate generation costs in some way in the WEC.

AGL again encourages the Authority to adopt an 'LRMC as a floor' approach, for the reasons previously articulated by AGL and now because the change to the Delegation appears to require this.

Retail costs

The 2012-13 Delegation to the Authority stated:

> *In determining the retail cost component of each regulated retail tariff, the authority must consider the retails costs that would reasonably be incurred by an efficient representative retailer, the characteristics of which should be determined by the Authority. The Authority is also required to determine an appropriate retail margin giving consideration to any risks not compensated for elsewhere.*

On this basis the Authority developed a set of defined characteristics for a "representative retailer" which were set out in the 2012-13 Final Determination:

> *the Authority considers that the representative retailer is one that:*
>
> a) *is an incumbent retailer of sufficient size to have achieved economies of scale;*
>
> b) *serves small and large retail customers in Queensland and other jurisdictions across the NEM;*
>
> c) *has a mix of market and non-market customers;*
>
> d) *retails electricity on a stand-alone basis; and*
>
> e) *is not vertically integrated with an electricity generator.*

The 2013-14 Delegation and ToR does not include a similar requirement defining an approach for estimating the retail cost component to be included in regulated prices. In addition to having regard to the *"actual costs of making, producing or supplying the goods or services"* the Authority must have regard to "the effect of the price determination on competition in the Queensland retail electricity market". To promote competition, AGL encourages the Authority to consider if defining the retailer to be a "new entrant retailer" to fully account for the costs of acquiring customers, may be more appropriate.

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[11] ACIL Tasman, Estimated energy purchase costs for Final Determination, Prepared for the Queensland Competition Authority, May 2012. Page 10.

Transitional arrangements for Tariff 11

The ToR requires the Authority to consider:

> *Implementing a three-year transitional arrangement to rebalance the fixed and variable components of Tariff 11, so that each component (fixed and variable) of Tariff 11 is cost reflective by 1 July 2015.*

The specific requirement to rebalance the fixed and variable components of Tariff 11 is a new requirement for the Authority and due to the difference between the current fixed component and a cost reflective fixed component the change will likely impact on customers bills. AGL is keen to work with the Authority, the Government and Energex to ensure that these changes are appropriately introduced over the course of the price path, and clearly and carefully communicated to customers.

Principles for setting notified prices

As noted earlier, the 2013-14 Delegation provides the Authority with the opportunity to set a notified pricing framework for the coming three years which balances the objectives of managing short-term volatility and providing long-term sustainability for the Queensland retail electricity market. AGL wish to highlight a number of key principles which in our experience should be addressed in balancing these objectives:

- **Industry impact of notified prices**

As noted earlier, in the past the Authority has been clear to point out that its approach to determining notified prices is limited by the terms of the Delegation from the Minister. The Delegation typically focuses on issues specifically related to setting the notified prices and is not concerned with the functioning of the broader electricity industry. By amending the specific nature of the Delegation AGL suggests that this provides greater scope for the Authority to consider the role that notified prices have in the efficient functioning of the Queensland electricity industry.

AGL has discussed, at length, in previous submissions the link between the need for a sustainable notified pricing framework in order to ensure the ability of credit worthy retailers to underwrite new generation plant as required.[12] The move away from developing new power generation by Government-owned corporations further places the onus on the private sector, and primarily credit worthy retailers to invest in new generation.

AGL is firmly of the view that in setting the framework for a three-year price path that the Authority should acknowledge the broad role of notified prices in the electricity supply chain.

- **Retail electricity price regulation as a 'safety net'**

The framework of Full Retail Contestability (FRC) which was introduced by the Queensland Government from 1 July 2007 was set up to encourage competition amongst retailers in Queensland. Maintaining a notified electricity price provides a 'safety net' for customers that are not able to access the benefits of a competitive retail electricity market. Where retailers are able to offer competitive market offers the regulated price acts as a 'price to beat' in the market.

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[12] AGL Energy, Submission to Consultation Paper, Review of Regulated Retail Electricity Tariffs, August 2011. Page 5.

Using regulation to set an efficient price at a point in time pursues a very different objective, and one that is designed for monopoly markets. If a regulator sets an efficient price then this regulatory process effectively determines the allocation of efficiency savings to market participants, thereby bypassing the efficient market mechanism. This is appropriate where there is no competition in the market. However, such an approach is unnecessary, and risks significant detriment in a competitive market – the market mechanism is designed to establish the most efficient price for customers in a market. If a safety net price is set such that it impacts the level at which the market price is set then the usefulness of the market is constrained.

It should also be recognised that setting a single efficient price in a market with a number of standard or default retailers that have an obligation to supply customers is particularly problematic due to the different nature of their obligations and the customer base that they serve.

The 2013-14 Delegation and ToR reaffirms the Queensland Government’s commitment to a Uniform Tariff Policy. AGL acknowledges that the Authority will be mindful to ensure a outcome in line with the Delegation for customers in areas where there is limited access to the benefits of competition. However, AGL highlights that the continued promotion of competition in South-East Queensland in critical to ensure a sustainable retail market.

3. 2013-14 Notified Price Consultation

The Ministerial Delegation and Covering Letter to the Authority notes that the "QCA is required to undertake a rigorous consultation process with all relevant parties and consider all submission received".[13] AGL is pleased that the need for extensive consultation is acknowledged and is hopeful that the Authority can deliver on this requirement of the Delegation. However, brief nature of the Interim Consultation Paper does not provide us with much confidence. By not providing any guidance on the issues under consideration by the Authority in relation to the notified pricing framework the efficacy of this stage of consultation is undermined. It is not unreasonable to expect that stakeholders are given some indication of the issues which the Authority deems to be under consideration so that stakeholders can provide specific feedback.

AGL also notes the important role played by consultants and their projections as to the costs likely to be incurred by retailers from 2013-16. As part of any "extensive" and "rigorous" consultation process it is essential for those consultants' economic models, results and inputs to be made available and their findings to be subject to consultation and debate. AGL is extremely concerned that if the next step in the current consultation process is the Authority's Draft Determination, the opportunity for robust consultation on the consultant's approach and findings is significantly reduced, as they will already form part of a publicised Draft Determination.

AGL is of the view that the following amendments to the consultation process are necessary in order to appropriately give effect to the requirements of the Delegation:

- The Authority to publish the brief/scope of work which consultants are engaged to provide the Authority. This will assist stakeholders in understanding the basis on which the consultant has come up with a particular recommendation or methodology. This practice is carried out by regulators in other jurisdictions[14];
- The Authority's consultant to release their Draft Report for consultation prior to the planned 'Workshop on energy and retail costs' in December/January. This would include the publication of comprehensive explanations of their economic models and the full data sets used in their modelling, and produced by their modelling, in order to ensure a meaningful process in which all stakeholders can have confidence; and
- Following consultation on the consultant's Draft Report, the Authority would be able to consider additional comments from stakeholders prior to the release its Draft Determination.

This process was used successfully in the Authority's 2012-13 price review. While this does include an additional step in the process, AGL is firmly of the view that this is warranted given this is a process on which a three year price path will rest. The process of consultation for the 2011-12 notified prices did not provide the level of information on which AGL could have confidence and estimate with any certainty the outcomes that the modelling might deliver.

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[13] Queensland Competition Authority, Interim Consultation Paper, Regulated Retail Electricity Prices 2013-14, September 2012, Appendix A: Ministerial Delegation and Covering Letter. Page 6.

[14] In July 2009, IPART published a Notice setting out the basis for engaging consultants as part of the review of regulated retail electricity charges from 2010 to 2013.

4. Retail Component

As noted earlier, it is difficult for AGL to provide specific feedback to the Authority where there is no identification of the issues under consideration by the Authority in developing the Draft Determination. However, AGL notes that in the past there have been a number of issues associated with setting the retail component that AGL suggest the Authority should reconsider.

Wholesale energy costs

AGL continues to advocate the calculation of the wholesale energy cost (***WEC***) using a market-based approach whereby the WEC should not be less than the long run marginal cost (***LRMC***) of electricity generation. As noted above, this change appears to be supported by the change in the terms of the Delegation from the previous year. AGL again notes that adopting this approach within the three year period of the Delegation would limit short-term volatility in retail prices and provide longer-term certainty for the retail industry. AGL has provided a detailed discussion in Annexure 1 of the issues raised by ACIL Tasman in regards to the use of an LRMC approach in setting the WEC allowance for 2012-13 notified prices.

Using this approach the Authority would need to consider approaches for calculating the LRMC of generation to meet the relevant load and a market-based energy purchase cost (***EPC***) to reflect the cost of supplying the relevant load in the NEM i.e. spot and contract markets. The Authority noted in the Consultation Paper that the current approach used in the 2012-13 Final Determination would act as a starting point for setting the methodologies as part of the 2013-14 price and for the remaining years of the price path.[15] AGL is of the view that there are a number of issues which need to be considered when analysing the short-term contract market, and if no consideration of LRMC is included in the WEC allowance then the EPC approach should include costs of long-term hedging arrangements i.e. PPAs.

Market-based EPC approach

As part of the Authority's 2013-13 Final Determination, ACIL Tasman carried out the modelling to determine the market-based EPC allowance for the regulated tariffs. A description of the methodology, the final EPC allowances and a discussion of stakeholders views provided on the Draft Methodology are documented in the report : *Estimated energy purchase costs for Final Determination, May 2012 (**2012-13 EPC Report**)*. AGL has a number of concerns with the application of the market-based EPC approach in determining the energy cost allowance used in the regulated prices.

- **Queensland Futures Market Liquidity**

AGL noted in our submission to the 2012-13 Draft Determination, that the Queensland electricity futures market did not provide a reliable basis on which to calculate the 'efficient cost' faced by a retailer serving a small customer load in Queensland.[16] AGL highlighted that the lack of liquidity in Queensland futures market for different products which would be used by a retailer to hedge their load (i.e. swaps, peak swaps and caps) highlighted that retailers were entering into longer-term hedging arrangements.

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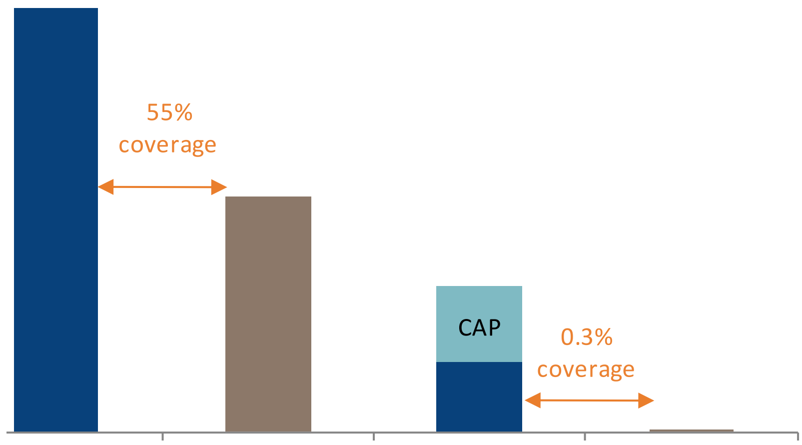
[15] Queensland Competition Authority, Interim Consultation Paper, Regulated Retail Electricity Prices 2013-14, September 2012. Page 2.

[16] AGL Energy Ltd., Draft Determination – Regulated Retail Electricity Prices 2012-13, AGL submission to the Queensland Competition Authority, Date: 16 April 2012. Page 13.

Figure 3 below shows Q3 2013 liquidity in the Queensland futures market for base and peak instruments (i.e. peak combines peak and cap contracts for simplicity) against underlying physical base load demand at the Node, and underlying or physical peak and cap contract demand using the percentiles identified by the Authority and ACIL (i.e. 80th percentile for base demand, 90th percentile for peak demand, and 105% of peak demand for cap demand). Q3 2013 has been chosen to assess liquidity for the regulatory period as this is the closest period to the current date and has the highest level of trades of any quarter during FY14.

Figure 3 - Energex Base Demand vs. d-cypha Trade Reportable Trades



Note: Q3 2013 Reported Trades as at 17 October 2012

Figure 2 demonstrates a lack of liquidity in the futures market to meet both base and peak demand. On this basis AGL maintains that:

- Using thinly traded futures prices which are not representative of retailer costs is not appropriate; and
- Due to the lack of liquidity in this market it is reasonable to assume that retailers will seek other sources of hedge cover such as PPAs.

- **Carbon policy uncertainty impact on contract prices**

AGL is concerned that due to the lack of bipartisan support for the Clean Energy Act 2011 that current FY14 futures market prices may not fully account for the costs of the carbon pricing mechanism on generators. The Leader of the Opposition has published a commitment to abolishing the carbon pricing mechanism as one of the first actions of a Federal Liberal Government.[17] In theory as the contract period approaches, the level of uncertainty relating to the future of the carbon pricing mechanism should reduce and

[17] Liberal Party of Australia, Our plan to abolish the carbon tax. Available at http://www.liberal.org.au/our-plan-abolish-carbon-tax. Accessed on 18 October 2012.

prices will better reflect the whether the carbon price will apply to generators during that period. However, by using current contract prices to set regulated tariffs the Authority risks not allowing for the full recovery of the carbon cost on retailers wholesale energy costs.

- **Pool price modelling assumptions**

AGL remains concerned that any market-based EPC that is reliant on spot price modelling will be heavily influenced by the modelling assumptions which underpin the model. Recently, there have been a number of generators in the NEM that have announced temporary shut downs in response to market conditions e.g. Tarong Power Station has announced plans to withdraw two of its generating units from service in October and December 2012 for at least two years or until wholesale electricity demand improves.[18] In order to ensure acceptance of this type of modelling by stakeholders the Authority and its consultants should clearly set out the assumptions used in any spot price modelling and provide full details of the results.

Consideration of long-term instruments in a market-based EPC approach

As part of AGL's submissions to the 2012-13 Draft Determination AGL provided the Authority with details on two approaches which could be used to calculate the value of a PPA based on a simple and transparent methodology based published inputs and assumptions.[19] As the evidence demonstrates above retailers energy costs are not solely defined by prices in the Queensland futures market and therefore consideration should be given to incorporating long-term hedging costs into a market-based EPC (where no consideration of LRMC is included in the regulated price). AGL also note that the changes in the Delegation (discussed earlier) would not preclude any consideration of long-term hedging costs as part of a market-based EPC approach. In order to incorporate the PPA costs into a retailers' contract hedging strategy assumptions would need to be made as to what extent a retailer would use PPAs to hedge their portfolio. AGL acknowledge that there are a number of issues which would need to be addressed as part of this approach. AGL propose that the details of any such approach could be considered by the Authority through the consultation process for the 2013-14 regulated retail prices.

Green costs

AGL is of the view that the cost allowances to meet other 'green' schemes, such as the RET and the Queensland Gas Scheme, should reflect the long-term cost of compliance rather than short-term market-based costs. This has been recognised by the Authority and it's consultants in determining the 2012-13 allowance for the QLD Gas Scheme. The approach used acknowledges "that retailers have prudently entered arrangements to acquire GEC's which have legitimately added to the EPC".[20]

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

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[18] Stanwell Corporation Ltd. Media release – Stanwell to withdraw Tarong Power Station units from service. 11 October 2012.

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

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

Retail operating costs

In the 2012-13 Final Determination, the Authority decided the retail operating costs (***ROC***) for small customers consuming up to 100 MWh/year to be $130.67/MWh. AGL had previously expressed concern about the "echo chamber" amongst State regulators when determining benchmarks with no inputs considered from retailers who actually operate in the market. Even though large retailers now operate on a national basis, there are still differences in operating costs in various jurisdictions. For example, credit costs, regulatory costs and campaign costs do vary on an average customer basis by state.

The 2012-13 ROC is based on an "efficient, representative retailer". The Terms of Reference requires the Authority to have regard to "the effect of the price determination on competition in the Queensland retail electricity market."[21] To promote competition, the Authority should consider defining the retailer to be a "new entrant retailer" to fully account for the costs of acquiring customers.

However, even with the current definition of an efficient retailer, the 2012-13 ROC understates the operating costs which AGL considers to be appropriate for operating a retail business for small customers in QLD.

Retail margin

The Authority's retail margin in the 2012-13 Final Determination of 5.4% is based IPART's 2010-13 review of regulated electricity prices in NSW. As pointed out previously, the Authority should consider if merely adopting such a benchmark from another jurisdiction is appropriate. The Terms of Reference, despite being for three years, requires a re-determination every year. In NSW, cost pass-through provisions have been included in the price setting framework.

The retail margin cannot be determined in isolation to the other cost components. If the approach to wholesale energy costs has high risk, the retail margin should reflect this risk accordingly. If the WEC or ROC allowances are set too low, the effective retail margin will be lower.

Allowance for headroom

The Authority has established an explicit allowance for headroom in 2012-13 notified prices. The Authority has correctly pointed out that customers able to access a market contract can avoid this additional cost. Competition in the electricity market is based on discounting – without headroom it will be difficult for retailers to induce customers to switch.

AGL do not consider the headroom to be a penalty. QLD users have the right to access the regulated price and can choose to move to market contract at any time (at the next meter read). Market contracts have term and conditions which are different from the regulated tariffs or notified prices. Customers on regulated prices may not identify themselves and retailers with customers on regulated prices have an exposure to uncertain load.

In the 2012-13 Final Determination, the Authority has considered a headroom allowance of 5% to be sufficient for switching to occur. In AGL's experience, a much higher headroom is required to induce customers for switching. One suggestion is to gather

[21] Queensland Competition Authority, Interim Consultation Paper, Regulated Retail Electricity Prices 2013-14, September 2012, Appendix A: Ministerial Delegation and Covering Letter. Page 8.

some evidence, for example, through surveys, to better assess the level of discount which will be effective to induce customers to switch. In any case, there is greater risk in setting prices too low than too high as competition will remove any excess margin.

The Authority had also made no distinction between the headroom allowance for residential and small business customers. AGL considers these two customer groups to be different and a higher allowance is more appropriate for small business customers.

5. Other Issues

Accounting for Unforeseen Events

AGL note that the Delegation to the Authority to determine notified prices does not appear to make any reference to consideration of a cost pass-through mechanism (price adjustments within the tariff year) or a catch-up mechanism (cost impacts from a previous year in the subsequent tariff year). In developing a framework for regulated pricing over the next three years AGL considers that including a mechanism to provide some flexibility within regulated prices to cover unforeseen events is critical. If no mechanism for pass through costs related to unforeseen events, either within the price path or as a 'catch-up' for costs incurred in the previous year, this leaves retailers with an increased level of risk which should be acknowledged within notified prices.

Annexure 1

ACIL Tasman 2012-13 EPC Report – Consideration of LRMC

As part of the Authority's 2013-13 Final Determination, ACIL Tasman carried out the modelling to determine the market-based EPC allowance for the regulated tariffs. A description of the methodology, the final EPC allowances and a discussion of stakeholders views provided on the Draft Methodology are documented in the report : *Estimated energy purchase costs for Final Determination, May 2012 (**2012-13 EPC Report**).*

In this annexure AGL provides a discussion of some of the detailed points raised by ACIL Tasman in the 2012-13 EPC Report used to dismiss an LRMC approach as appropriate to calculate the wholesale energy cost (***WEC***) allowance for the 2012-13 notified prices.

In Section 2.2 of the 2012-13 EPC Report, ACIL sets out in detail the reasons why LRMC of generation was not incorporated into the calculation of the WEC. In the context of the current review, AGL note the following:

- As discussed earlier, ACIL highlight the reference in the Delegation to "the cost of purchasing energy" as not being compatible with using LRMC to calculate the WEC. The change in the wording of the 2013-14 Delegation should prompt the Authority to review the benefits of this the 'LRMC as floor' approach;
- ACIL note that the "LRMC of generation reflects a reasonable annualised cost associated with investing in electricity generation. However, the LRMC of generation implies nothing about the allocative or dynamic efficiency of electricity investment decisions". AGL agrees that the LRMC in itself does not fully account for these efficiencies, however by incorporating this allowance into the regulated retail price cap it allows the forces of competition to allocate this benefit amongst market participants.
- Incorporating the LRMC into the WEC "potentially imposes the consequences of inefficient investment decisions on end-users despite the NEM being designed to pass on the benefits of the competitive market to those end-users". AGL disagrees with this assessment on the basis that:
    - Using a 'stand-alone' LRMC to estimate the 'least-cost' generation mix to meet a particular load does not attempt to account for "inefficient investment decisions" whatsoever, since it is based on optimal plant conditions and applies only as a price cap in the competitive market. It does not in and of itself mean that market participants will recover their full costs – but instead will be determined by the market;
    - While the NEM is designed to "pass on the benefits of the competitive market to end-users" it is retailers that are tasked with ensuring that the competitive market can function properly by managing the price and volume risk of the market. It is the role of retail competition to facilitate efficient pricing to consumers;
    - Market participants throughout the supply chain, from fuel suppliers through to end use customers, make decisions based upon the information available to them at the time. Setting a regulated future price cap based upon a determination of the efficiency of investment decisions after the event assumes perfect hindsight, and that the cost structures of the competitive businesses can be predicted with certainty; and
    - It should not be the role of a regulated retail price cap, set in the context of (what was) an intensely competitive retail market, to set the efficient price in that market. Any inter-temporal underestimation of this price cap

will damage retail competition and innovation, and indeed the long-term sustainability of the market.

In Section 3 of the 2012-13 EPC Report, ACIL consider whether it would be appropriate to incorporate consideration of retailers' exposure to PPAs in determining the WEC. ACIL argue that an efficiently priced PPA should be no higher than purchasing a combination of hedges and pool-priced electricity over the life of the PPA, and therefore "the market price over the term of the PPA would be expected to provide a ceiling to a well priced PPA." It is not clear what ACIL would define as a "well-priced PPA", but it is unreasonable to suggest that a PPA will reflect a year-on-year market price because the buyer is entering into the PPA in order to avoid this year-on-year risk, and in particular, recontracting risks which are assumed away in the ACIL Tasman analysis. As the seller accepts this risk, it will seek an additional premium from what is available in the short-term market.

ACIL go on to argue that there is no policy rationale for including LRMC in the WEC to facilitate timely investment in new generation capacity.[22] ACIL note that as the demand-supply balance tightens, market prices will increase to encourage new generation. The disadvantages of this approach have been addressed in some detail by research which highlights the reliance of the NEM on credit-worth retailers to underwrite new generation capacity in the absence of purely merchant generators.[23] The time required to develop this generation capacity means that while market prices will eventually stimulate investment in new capacity, this would likely result in additional wholesale price volatility, and an unnecessarily heightened cost of capital for new plant. AGL reiterates the view that this scenario would not be in the long-term interests of consumers or the sustainability of the energy market.

[22] ACIL Tasman, Estimated energy purchase costs for Final Determination, Prepared for the Queensland Competition Authority, May 2012. Page 8.

[23] Nelson, James and Simshauser, Paul, Is the Merchant Power Producer a Broken Model. AGL Applied Economic Policy and Research. Working Paper No. 32 – Project Finance.