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Mr Gary Henry
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

via email electricity@qca.org.au

Dear Mr Henry

RE: Draft Methodology Paper – Regulated Retail Electricity Prices 2012-13

TRUenergy welcomes the opportunity to provide comments on the Draft Methodology Paper – Regulated Retail Electricity Prices 2012-13 (the Methodology Paper). We appreciated the opportunity to provide input at the public forum the QCA hosted on 25 November 2011 and this submission expands on the comments we made at the forum.

A competitive electricity market?

TRUenergy notes that the Queensland Competition Authority (QCA) has said that it considers that “all customers will be best served by a well functioning competitive electricity market”.¹ Also the Minister’s Delegation to the QCA notes that Queensland “consumers, wherever possible, have the opportunity to benefit from competition and efficiency in the market place.”² TRUenergy agrees with both of these statements and believes that a key retail pricing objective, over the long term, must be to enable more Queenslanders to access competitive retail electricity prices.

Given this context, it is disappointing that the Methodology Paper does not include any vision of what the QCA considers an appropriate level of competition going forward, or how the proposed methodology will help deliver this. The Methodology Paper notes that the QCA’s “task is to set prices that will sustain an appropriate level of competition in the market in order to place downward pressure on prices”³ but does not outline what the QCA considers an appropriate level of competition.

Other stakeholders have examined the impact of the Methodology Paper on competition. Citi Investment Research & Analysis noted that the new methodology “will likely make it difficult for second tier retailers to compete.”⁴ Macquarie Securities (Australia) Limited noted that the current churn rate in Queensland is 24% but forecast that “NSW churn was 8% in 2006, and we would expect Queensland will quickly go back to this level.”⁵ We are unaware of any stakeholder who believes that the proposed methodology will deliver a well functioning competitive electricity market.

We urge both the QCA and the Queensland Government to consider what level of competition they consider appropriate for the future and to factor this in when setting all elements of the regulated prices. As it stands the proposed methodology is likely to lead to a severe downturn in competition in

¹ QCA, *Final Report: Review of Electricity Pricing and Tariff Structures - Stage 2*, November 2009, page i

² The Hon. Stephen Robertson MP. Minister for Energy, *Electricity Act 1994 Section 90AA(1) Delegation*, September 2011, page 1

³ QCA, *Draft Methodology Paper- Regulated Retail Electricity Prices 2012-13*, November 2011, page 13

⁴ Citi Investment Research & Analysis, *Utilities: QLD Tariff Review*, November 2011, page 1

⁵ Macquarie Securities (Australia) Limited, *AGK Flashnote*, November 2011, page 1

Queensland and it is difficult to believe that this is not contrary to the policy objectives of both the QCA and the Queensland Government.

Representative Retailer

The Methodology Paper examines the current state of play, noting that “if the level of competition in the market were seen as adequate, then a definition based on an incumbent retailer should ensure that prices are sufficient to maintain the current level of competition.”⁶ The logic behind this assertion is flawed. As the Methodology Paper also notes, the previous BRCI was an index not a cost build up approach as the new methodology will be. Critically, under the BRCI the “actual level of costs incurred by the representative retailer did not form part of the tariff”⁷ but under the new methodology it will. So the fact that the BRCI used an incumbent, standalone Queensland electricity retailer as the representative retailer is not particularly relevant to the current task. And to conclude that the current market is competitive and that will continue if the BRCI definition continues to be used is asserting a cause and effect relationship that does not exist.

As the Methodology Paper outlines, in South Australia ESCOSA adopted a new entrant retailer focus to ensure that electricity retailers are able to compete in the market and deliver the benefits of competition to consumers. Conversely, in the ACT an incumbent electricity retailer definition was adopted. It is noteworthy that competition in SA is strong but in the ACT it is virtually non-existent.

The costs incurred by an incumbent retailer will be lower than those incurred by a second tier retailer already operating in Queensland or entering the market for the first time. If the proposed methodology is implemented it will lead to retail cost allowances that are below the real costs of second tier retailers. This will directly impact on competition.

If the QCA wants the new methodology to deliver a well functioning competitive electricity market then we recommend a new entrant, standalone retailer of small or moderate size be used as the representative retailer.

Network Tariffs

Where network structures and tariffs change, as they will be for 2012/13, it is essential that the timing of the finalisation of the new or amended network tariffs and the setting of retail tariffs be aligned to ensure that retailers are able to implement any necessary system changes and recover reasonable costs. This will also enable retailers to develop and offer retail products that best suit customer needs and complement not disrupt network tariff pricing objectives.

Energy Costs

As the Methodology Paper outlines, setting energy costs in the current environment is a challenge. Long Run Marginal Cost (LRMC) has its drawbacks and the lack of liquidity in the futures market due to the introduction of a carbon tax makes it very difficult to use a hedging-based approach (Method 2) similar to that used to calculate the BRCI.

The annual price distribution (Method 3) proposed by ACIL Tasman is designed to address the lack of data but in doing so creates a raft of new problems. One of Method 2’s weaknesses is that it is a “black box” approach - it is based on forward market prices but has a theoretical framework around the timing and volumes used for hedging. However, Method 3 is effectively a “double black box” in that there is no link to actual forward market prices and hence even more problematic. To forecast contract prices based on predicted spot outcomes is unwise as the two are not closely linked. If prices in the futures contract market were closely related to modelled future spot outcomes then forward contracting would be a simple task, but this is not the case.

⁶ QCA, *Draft Methodology Paper- Regulated Retail Electricity Prices 2012-13*, November 2011, page 9

⁷ QCA, *Draft Methodology Paper- Regulated Retail Electricity Prices 2012-13*, November 2011, page 8

Past BRCI data shows that the correlation between forward contract prices and actual spot outcomes is low. The table below shows the allowances for forward contract prices allowed in BRCI decisions and actual spot price outcomes.

Flat	Q3 Fwd	Q3 Spot	Premium	Q4 Fwd	Q4 Spot	Premium	Q1 Fwd	Q1 Spot	Premium	Q2 Fwd	Q2 Spot	Premium
2007-08	\$ 37.00	\$ 53.35	-\$16.35	\$ 40.03	\$ 51.70	-\$11.67	\$ 55.77	\$ 67.94	-\$12.17	\$ 32.51	\$ 36.36	-\$3.85
2008-09	\$ 42.66	\$ 34.39	\$8.27	\$ 50.26	\$ 36.98	\$13.28	\$ 65.35	\$ 34.60	\$30.75	\$ 33.74	\$ 30.00	\$3.74
2009-10	\$ 36.51	\$ 25.05	\$11.46	\$ 44.66	\$ 46.82	-\$2.16	\$ 70.96	\$ 39.77	\$31.19	\$ 36.09	\$ 21.57	\$14.52
2010-11	\$ 36.92	\$ 21.12	\$15.80	\$ 45.12	\$ 19.93	\$25.19	\$ 66.80	\$ 57.37	\$9.43	\$ 39.03	\$ 25.96	\$13.07
2011-12	\$ 30.88	\$ 28.06	\$2.82	\$ 36.16			\$ 50.62			\$ 33.83		
Peak	Q3 Fwd	Q3 Spot	Premium	Q4 Fwd	Q4 Spot	Premium	Q1 Fwd	Q1 Spot	Premium	Q2 Fwd	Q2 Spot	Premium
2007-08	\$ 49.65	\$ 68.96	-\$19.31	\$ 58.51	\$ 70.47	-\$11.96	\$ 96.31	\$ 96.75	-\$0.44	\$ 42.64	\$ 44.29	-\$1.65
2008-09	\$ 59.30	\$ 43.53	\$15.77	\$ 76.94	\$ 52.26	\$24.68	\$108.12	\$ 47.87	\$60.25	\$ 45.66	\$ 38.84	\$6.82
2009-10	\$ 47.02	\$ 29.17	\$17.85	\$ 64.86	\$ 78.16	-\$13.30	\$106.51	\$ 64.97	\$41.54	\$ 45.86	\$ 24.52	\$21.34
2010-11	\$ 50.47	\$ 23.31	\$27.16	\$ 66.18	\$ 23.16	\$43.02	\$110.39	\$ 96.19	\$14.20	\$ 47.59	\$ 28.17	\$19.42
2011-12	\$ 44.56	\$ 31.97	\$12.59	\$ 56.66			\$ 90.30			\$ 46.91		
Caps	Q3 Fwd	Q3 Spot	Premium	Q4 Fwd	Q4 Spot	Premium	Q1 Fwd	Q1 Spot	Premium	Q2 Fwd	Q2 Spot	Premium
2007-08	\$ 6.52	\$ 1.14	\$5.38	\$ 7.86	\$ 12.35	-\$4.49	\$ 24.20	\$ 36.74	-\$12.54	\$ 5.38	\$ 0.94	\$4.44
2008-09	\$ 4.66	\$ 2.45	\$2.21	\$ 8.51	\$ 5.22	\$3.29	\$ 33.77	\$ 2.60	\$31.17	\$ 4.82	\$ 1.44	\$3.38
2009-10	\$ 4.49	\$ 0.55	\$3.94	\$ 10.48	\$ 16.18	-\$5.70	\$ 34.31	\$ 13.15	\$21.16	\$ 4.92	\$ 0.15	\$4.77
2010-11	\$ 4.58	\$ -	\$4.58	\$ 10.06	\$ 0.56	\$9.50	\$ 25.21	\$ 20.78	\$4.43	\$ 4.56	\$ -	\$4.56
2011-12	\$ 3.98	\$ 0.41	\$3.57	\$ 9.16			\$ 17.86			\$ 3.13		

Just looking at the flats, the correlation between the BRCI allowances and the actual spot outcomes is 0.44. Also of note is that the difference between the mean and the median of the spot outcomes is only \$2.52, but on average the BRCI forward price was \$7.84 higher than the spot outcome, over 200% higher than the mean/median differential. This suggests that Method 3's approach is likely to underestimate real world forward premiums by a significant amount.

Even if ACIL was able to forecast future spot prices well, adoption of Method 3 would mean that if current forward contracts were an "above average" year relative to ACIL's inputs then retailers would simply not be able to hedge at the prices forecast by ACIL under Method 3. Given current uncertainties such as carbon, the GenCo restructure and gas developments, adoption of Method 3 is a high risk approach.

Other stakeholders have noted the problems that Method 3 would create. Macquarie notes that "such an approach causes some potential unintended consequence for the smaller players, bankruptcy!!!"⁸

Given all these problems with Method 3, we recommend the QCA reconsider its decision to abandon LRMC, at least for 2012/13. Method 3's link to actual retailer hedging costs is weaker than LRMC, which at least links back to the new build generation cost. Beyond 2012/13 there is likely to be a strong case to put more reliance on Method 2. However for 2012/13 Method 2 has data issues and Method 3 as currently proposed cannot be used with any confidence. As the market operator is predicting generation shortfalls in Queensland by 2013/14, it is reasonable to expect market prices to rise to at least LRMC in the near future. The Minister's letter asks the QCA to "balance the long term need for maintaining pricing stability with ensuring customers are not subjected to unnecessary price volatility in the short term."⁹ TRUenergy believes LRMC best delivers this for 2012/13.

All market participants agree that new generation will be required in Queensland sometime between 2014 and 2016. The 2008-09 Major Economic Statement reconfirmed a policy position of encouraging "private sector investment in and ownership of economic infrastructure"¹⁰ including new electricity generation. In the 2010 review of the Government Owned Corporation Generators (GOCs) the government confirmed that the GOCs "would not engage in expansionary business development activities relating to investment in new generation."¹¹ It is clear that the new generation required will only be built if the private sector is willing to invest.

⁸ Macquarie Securities (Australia) Limited, *AGK Flashnote*, November 2011, page 1

⁹ The Hon. Stephen Robertson MP, Minister for Energy, *Letter to the QCA*, September 1 2011, page 1

¹⁰ Queensland Government, *Major Economic Statement: Mid Year Fiscal and Economic Review*, December 2008, page 27

¹¹ Queensland Government, *Shareholder Review of Queensland Government Owned Corporation Generators*, November 2010, page 12

Setting an energy cost allowance below LRMC will make retailers unwilling to enter long-term forward contracts at LRMC. This in turn will diminish the willingness of private capital to invest in the new generation capacity that Queensland clearly requires. As a potential investor in new generation, we again urge the QCA to reconsider creating further investment uncertainty and instead utilise LRMC as a floor price.

Small-scale Renewable Energy Scheme (SRES)

Estimating the Small-scale Technology Percentage (STP) is a challenge, further complicated by the fact that in May the QCA must estimate what the STP will be for the following calendar year, yet the actual STP is not set until much later. ACIL Tasman are now recommending that the official STP estimate be used by the QCA. This seems a wise approach, especially given the inaccuracy of ACIL's forecast in May this year.

Dealing with uncertainty

A mechanism to deal with unforeseen events that a retailer could not reasonably be expected to manage is good regulatory practice. Without one, we will at some stage see a repeat of the unacceptable situation when the Jan-Jun 2011 costs of the then-new SRES were never factored in to regulated prices by the QCA. This situation is set to occur on a material scale again Jan-Jun 2012. If an effective pass through mechanism is not included this increases the risks associated with energy retailing, and in turn increases the required returns to account for this risk. IPART has defined cost pass through provisions to cover changes in legal and tax obligations such as the SRES. These provisions should be considered a minimum pass through standard.

The QCA has acknowledged this issue in the Methodology Paper and concluded that "it would appear appropriate to include some form of mechanism to account for the material impacts of unforeseen events."¹² However, the QCA has identified that it may not be able to include a pass through mechanism under the current delegation.

We re-iterate that without a robust pass-through mechanism the risks of retailing increase materially and is an unlikely outcome. We will discuss this issue with the government and request that the QCA also does so to ensure technicalities concerning the specifics of the delegation do not lead to sub-optimal outcomes for Queenslanders.

Retail costs

The QCA needs to set the retail cost allowance to cover all reasonable retail costs of supplying a customer in south east Queensland. Further, the QCA needs to set the cost allowance at a level that leads to a well functioning competitive electricity market. As noted above, we recommend that in order to maintain a reasonable level of competition, a new entrant, standalone retailer of small or moderate size be used as the representative retailer.

Retail Margin

The retail margin must be set at a level that reflects the reasonable costs and risks of operating a retail business. TRUenergy notes that IPART, in their Final Decision for regulated retail electricity tariffs for 2010-2013, provided a retail margin of 5.4% and this margin received considerable attention in the Methodology Paper.

TRUenergy believes retail regulatory risks will be significantly greater under the proposed model in Queensland than under the current model in New South Wales. This is due to factors such as:

¹² QCA, *Draft Methodology Paper- Regulated Retail Electricity Prices 2012-13*, November 2011, page 9

- NSW has a more stable and predictable process with retail costs and margin set for three years, network tariffs as a pass through and annual reviews of the wholesale cost under a set methodology;
- NSW has an LRMC floor which greatly reduces the risk that a retailer cannot hedge for an amount equivalent to the wholesale cost allowance; and
- NSW has well defined cost pass through provisions to cover changes in legal and tax obligations such as the SRES.

As the delegation notes, when setting the retail margin the QCA is required to consider “any risks not compensated for elsewhere.”¹³ If the risks above are not compensated for elsewhere, then it is appropriate that the retail margin is increased to account for them. If this does not happen, then it is unlikely that the proposed methodology will lead to a well functioning competitive electricity market.

We again highlight the risk asymmetry in the setting of retail margins. If the margin is overstated then this will encourage significant retail competition that will quickly erode these excess margins away. However, if the margin is understated this will block competition, stifle innovation and discourage investment, none of which are in the long term interest of Queensland electricity customers.

Conclusion

TRUenergy is a second tier retailer in Queensland and would like to grow its customer base. However we are concerned that because the proposed methodology does not seek to promote competition, the likely outturn prices and associated risks will mean that we will struggle to offer customers competitive market offers.

Over the longer term, customers will be better off if retail energy prices are disciplined by effective competition than they will be if prices are based on regulatory estimates. Where price regulation is considered necessary, an approach that sets reasonable costs and returns will foster the development of a competitive and efficient retail electricity market. An approach that adopts cost estimates at the low end of reasonable ranges for a variety of inputs may lead to lower regulated prices in the short term, but will lead to a less effective market which is not in the long term interest of Queensland electricity customers.

We are concerned that the proposed methodology will see Queensland head down the same path that NSW did following IPART’s decision in 2007. Effective competition ceased, customers moved from market offers back to the regulated rates and, most importantly, resulted in competitive offers that deliver real savings to customers drying up. We urge the QCA to not send Queensland down this path.

Should you wish to discuss or clarify any of this before then please feel free to give me a call on (03) 8628 1120.

Yours sincerely,



Andrew Dillon
Regulatory Pricing Manager

¹³ The Hon. Stephen Robertson MP. Minister for Energy, *Electricity Act 1994 Section 90AA(1) Delegation*, September 2011, page 2