

Mr Gary Henry
Queensland Competition Authority
L19 12 Creek St
Brisbane QLD 4000
SENT BY EMAIL

9 May 2012

Dear Mr Henry,

Re: Draft Determination – Regulated Retail Electricity Prices 2012-13

Thank you for your time last week to discuss our feedback on the Draft Determination of the Regulated Retail Electricity Price Review. In light of the truncated consultation timeframes associated with this process, we have been encouraged by your Chairman to submit a supplementary submission.

As noted previously, QEnergy supports the decision to introduce a new methodology based on a network (N) plus retail (R) cost build-up approach. QEnergy also considers that the draft determination reflects the proposed methodology.

However, QEnergy believes that the cost build-up approach must be implemented in a way that maintains sufficient headroom under which competitive market contracts can be offered – otherwise the QCA risks setting a market price rather than a price cap under which competitive processes deliver reduced prices to customers.

We note your view that the QCA is required under the Electricity Act to set cost reflective prices, however in our view the QCA charter with relation to setting notified prices is broader than that (s90(5)):

- In making a price determination, the pricing entity —*
- (a) must have regard to all of the following —*
 - (i) the actual costs of making, producing or supplying the goods or services;*
 - (ii) the effect of the price determination on competition in the Queensland retail electricity market;*
 - (iii) if QCA is the pricing entity — any matter the pricing entity is required by delegation to consider; and*
 - (b) may have regard to any other matter the pricing entity considers relevant.*

In QEnergy's view, the requirement to consider the impact on competition mitigates against the QCA's view articulated above.

In this regard, QEnergy considers that within the Draft Determination, even though an explicit margin has been allocated for headroom, all other elements of the cost stack have been struck at such low levels that this headroom margin does not even compensate retailers for the real risk that they will not meet the allowable regulated cost.

The only other jurisdiction employing the cost build-up methodology proposed by the QCA is South Australia. On the issue of striking cost levels under this methodology, ESCOSA in their *2010 Review of Retail Electricity Standing Contract Price Path*, p A-37 notes that:

The Commission has not sought to establish the lowest sustainable cost in undertaking this task. Such an approach is inconsistent with the Commission's

objective of facilitating retail competition. This however does not mean that the Commission has built in an explicit allowance for headroom in its initial cost assessment. Rather, it has recognised that, even in establishing a one-year cost forecast, there are still likely to be areas of judgement required, and there is likely to be a range of cost benchmarks that are considered reasonable. The Commission has therefore undertaken its cost analysis with this 'reasonableness' test in mind.

QEnergy is of the view that the levels at which the Draft Determination proposes to implement the methodology fail the 'reasonableness' test.

QEnergy agrees that there is no real room for latitude in striking the price-setting of the 'N' element of the proposed pricing stack. With respect to 'R', however, QEnergy contends that both the wholesale and retail cost components have been struck at unsustainably low levels.

Least cost price setting within the Draft Determination

Within the Draft Determination, the wholesale price ex carbon is struck at \$41.60 / MWh for 2012/13. Even based on market contract data, QEnergy has over the past week reviewed its own position and does not consider that the levels proposed by the QCA are dealable.

In support of this statement, QEnergy has an arrangement with our trading provider which delivers shaped contracts suitable for the NSLP at a fixed multiple of the current flat price. This product is a fair representation of a prudent retailer's hedging strategy, reflecting the costs of shape and ensuring that margins are locked in rather than positions established. The multiple has been built using historical pool and settlements data to take account of the risks of price excursions over different parts of the demand cycle.

When applied to current 2012 /13 contracts of \$34.75 / MWh, this product would be priced at [REDACTED]. Note that current contract prices are also particularly low historically – over the last six months they have traded down from approximately \$36.50 / MWh. At that higher level, the sculpted product would be priced at [REDACTED].

As another example of extreme wholesale cost paring, no risk margin has been allocated for potential changes to environmental certificate requirements (where unexpected increases in cost have been a long-term feature).

When the 2011/12 Determination was made, the Small-Scale Renewable Energy Scheme (SRES) percentage for 2012 was published by ORER at 16.75%, which was downwardly revised by ACIL Tasman to 9% in their calculations on the basis that the scheme was changing. Subsequent announcements as to percentages are given below and there was no makegood to the final figure of 23.96%:

Publication Date	31/03	29/07	16/12	Final
2012 SRES Percentage	16.75	20.87	23.95	23.96

QEnergy has also indicated in our main submission that we felt that data were included in the Large Renewable Energy Certificate price series that were not comparable to the current scheme – and therefore were not dealable – which is the flipside of the issue experienced with the SRES scheme as noted above.

This argument relates only to market contract pricing of wholesale energy costs, and does

not even attempt to take account of Long-Run Marginal Costs which are the prices at which Power Purchase Agreements have been struck to support generation in Queensland. It also does not take account of the cost of reallocation certificates as noted in our main submission, required by the model retailer as they are not vertically integrated.

These latter cost elements simply add further weight to the view that the wholesale component of costs has been struck at unsustainably low levels, and the headroom component is effectively required as a risk margin against that price-setting process.

With respect to the retail component of costs, the Draft Determination is predicated on costs appropriate for a retailer of scale, and so by acknowledgement are set at low levels (as scale benefits have already been accessed).

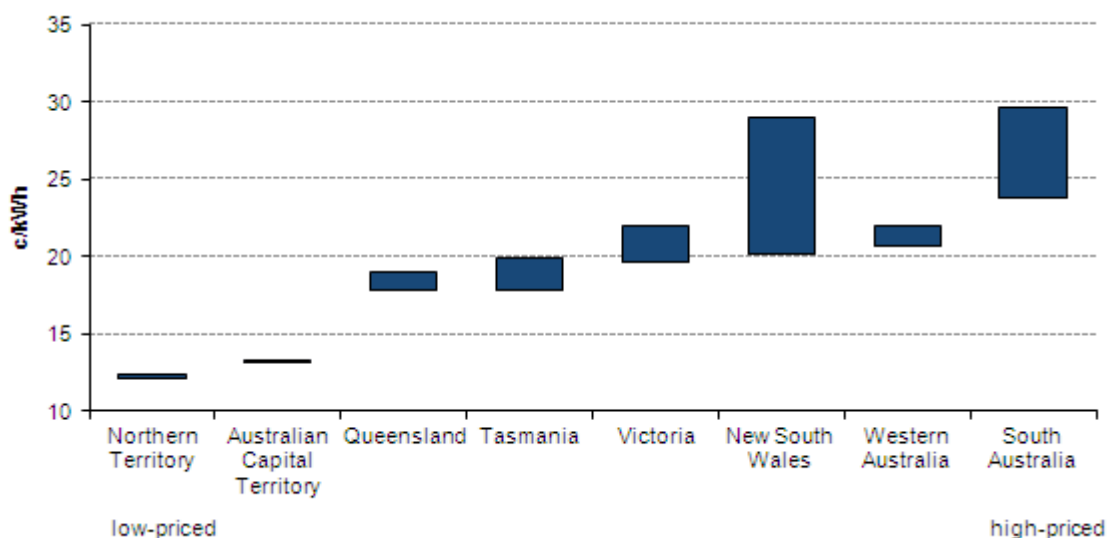
We also understand that the QCA considers the Customer Acquisition and Retention Costs (CARC) to be generous at \$43.27 / customer. This is well below dealable levels in the market, since outsourced or broked customers are costing [REDACTED]

As noted in our main submission, QEnergy does not consider that the QCA addressed the costs of funding prudential requirements to operate in the NEM, nor indeed that the increases on 1 July 2012 as a result of the expected impact of carbon were acknowledged. Once again, QEnergy believes that these costs are at the bottom of a reasonable range.

Cost level unreasonable compared with interstate jurisdictions

An updated chart from the Office of the Tasmanian Economic Regulator, shows that Queensland's prices for residential customers are the lowest of any state where competition has been genuinely introduced, and are lower than those in Tasmania where it has not.

Prices available to residential electricity customers, based on state average consumption, taking into account concessions available in each state or territory, as at 1 January 2012 (OTTER):



These prices are before the Draft Determination which according to the QCA only shifted the cost for the average residential consumer up by 3.9%. By contrast, the IPART determination in NSW shifted the NSW costs up by 16.4%, and South Australia has indicated that its process will likely allow the pass-through of carbon and the increase to ETSA Utilities' distribution determination by way of the gamma decision.

Following those adjustments, the extraordinarily low headroom levels in Queensland are even more starkly demonstrated, and we consider indicate that the QCA’s price setting process fails the reasonableness test.

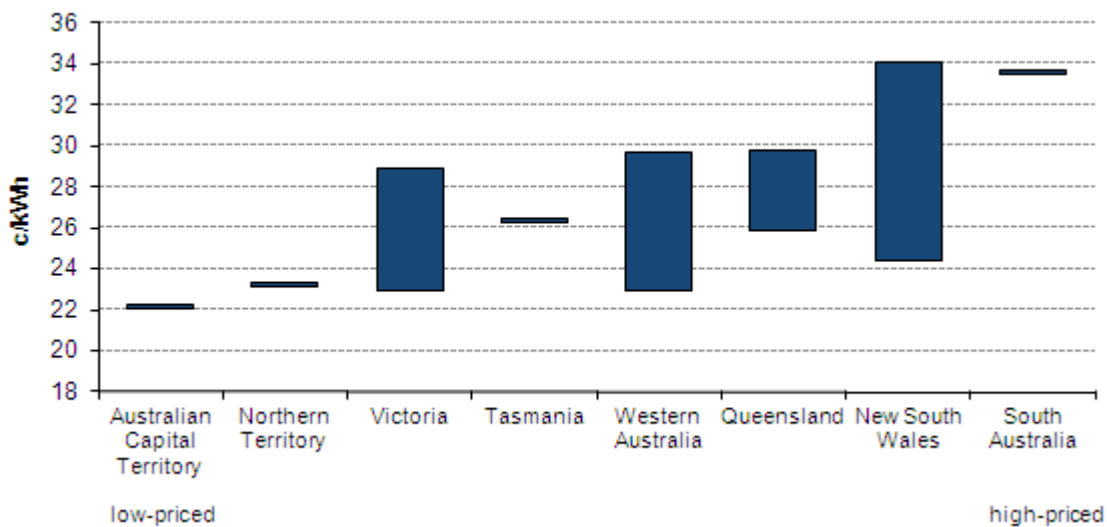
Small business tariffs particularly impacted

QEnergy does not consider that its arguments regarding the need for a higher headroom percentage for small business customers have been acknowledged, let alone considered.

In both submissions to the review process, QEnergy noted that in our experience and commonly across the National Energy Market, business customers require a larger incentive to churn so current market contracts offer discounts of 15% to 20%. This is consistent with the approximately 23% headroom currently in Tariff 20 shown by the QCA’s own chart, but about which no commentary was included. It is also significantly in excess of the allocations put forward in the Authority’s draft determination and suggests that there is absolutely insufficient room for ongoing competition for small business customers under the Authority’s draft determination.

An updated chart from the Office of the Tasmanian Economic Regulator, shows that Queensland’s prices for small business customers prior to the Draft Determination were comparable with other jurisdictions in which competition has been introduced.

Comparison of electricity prices for small businesses consuming 50 MWh per year (1 Jan 2012):



These prices are before the Draft Determination which according to the QCA shifted the cost for most small business customers (who are on Tariff 20) down by 1%. By contrast, the IPART determination in NSW shifted the NSW costs up by 16.4%, and South Australia has indicated that its process will likely allow the pass-through of carbon and the increase to ETSA Utilities’ distribution determination by way of the gamma decision.

This will entirely change the relativity with other states and once again, following those adjustments, the low headroom levels in Queensland is starkly demonstrated, and we consider indicate that the QCA’s price setting process fails the reasonableness test.

QEnergy notes the QCA’s view that available headroom drives market discounts, and that discounts will simply reduce for small business customers in Queensland following the implementation of any Final Determination which included headroom at these levels.

This is not QEnergy's experience based on contacts with thousands of Queensland small business customers – we do consider that there will be no retailer actively participating in the competitive market for small business customers should the Draft Determination be implemented at these levels.

It will also pose a problem for onsellers (for example, owners of strip malls), for there will be no margin for management of an embedded network between market contract rates and small business rates as proposed in the Draft Determination. QEnergy is aware of at least one onseller in Queensland who has been building a business based on this model for over a year but has in light of the Draft Determination announced that they will no longer participate in that market.

Finally, QEnergy notes that we brought competition to regional Queensland businesses and were successful in acquiring 1,500 customers there – all of whom were grateful for the opportunities brought by competition. This process was truncated through the publication of the QCA's Draft Determination, and cannot return at current levels.

This suggests that the maintenance of different headroom levels across customer classes has merit from a competition perspective, but more generally that the argument that headroom needs to be lowered to accommodate the Ergon Energy customers – who by implication have no access to competition – is incorrect, at least in the case of business customers (see Section 6.1 of your Draft Determination).

Further, the suppression of headroom effectively increases the level of the Ergon Energy Community Service Obligation by \$150m – \$250m per annum over current levels, which is concerning as QEnergy does not consider that the QCA has been given a mandate to increase cross-subsidisation of energy prices in Queensland.

QEnergy's position

As noted previously, QEnergy considers that the proposed gazetted tariff prices in the Authority's draft determination do not support the Authority's remit to consider the impacts of the determination on competition, and will lead to a removal of genuine electricity competition in South-East Queensland. As proposed in the draft determination, price allocations are too low and opportunities for non-incumbent retailers to compete by offering attractively priced products into the market are insufficient and are not attractive relative to other markets in which retailers can operate.

This will lead to a re-regulation of South-East Queensland with an effective oligopoly being re-established, driving poor outcomes for consumers in terms of long-run efficient price setting, product innovation and customer service.

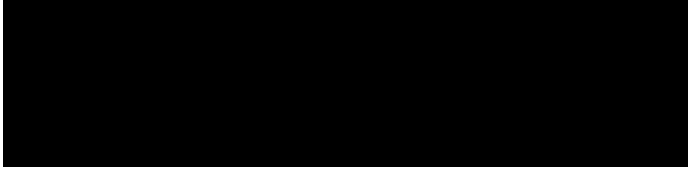
As previously foreshadowed, based on the Authority's draft determination, QEnergy will not actively market to small Queensland customers after the new framework commences if the levels incorporated in the draft determination are left in place. QEnergy will focus instead on growing its business and customer base in other states.

QEnergy considers that these outcomes will be bad for Queensland and bad for consumers, and accordingly QEnergy respectfully suggests that the QCA should either ensure that costs are generally struck higher up in the band of reasonable ranges, or that headroom is increased to a level more consistent with support for ongoing competition. Only with these changes to the Draft Determination can the QCA be certain that Queensland notified prices do not become unreasonably low relative to other states in Australia, stifling competition

and reducing consumer choice.

If you have any queries or comments regarding this letter, please do not hesitate to contact Kate Farrar, Managing Director on (07) 3339 9500.

Yours sincerely



Kate Farrar
Managing Director