



Mr Gary Henry
Queensland Competition Authority
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Brisbane QLD 4000
SENT BY EMAIL

Dear Mr Henry

***Re: Regulated Retail Electricity Prices 2013-14
Draft Determination***

This is Qenergy Limited's (QEnergy's) response to the Queensland Competition Authority's (the Authority's) Draft Determination February 2013 (the Paper) for setting regulated retail electricity prices for 2013-14. QEnergy is grateful for the opportunity to respond to this paper and in particular to add our perspective on ACIL Tasman's (ACIL's) approach to estimating energy costs for use in setting 2013-14 notified prices.

QEnergy is an established national electricity retailer with 12,000 customers in Queensland, South Australia, New South Wales and the Northern Territory, specialising in providing retail electricity to small businesses.

QEnergy addresses specific sections of the Paper below in turn.

Section 3. Energy Costs

As noted in our previous submission, QEnergy believes that over the long-run, Long Run Marginal Cost (LRMC) pricing will be delivered by the Queensland electricity market since this is the rational approach to electricity generation pricing. QEnergy therefore does not support the adoption of a solely market-based approach to estimating energy costs.

However, given that ACIL have ruled out using LRMC, we would like to reiterate our concern with their methodology which in our view still falls short of an acceptable approach to estimating electricity costs.

First, QEnergy considers that ACIL's proposed reliance on a single source of pricing information as a proxy for hedging costs – the closing prices from d-Cypha trade – is unduly restrictive and does not reflect the actual way that retailers hedge their load nor the prices arising from those decisions.

For example, it is not correct to say, as ACIL does, that *'the PPA price would not be expected to exceed the cost of purchasing energy through a combination of the electricity pool and electricity hedges over the life of the PPA.'* There are many reasons why a retailer might need to adopt a conservative hedging structure that leads to higher short-term costs than simple reliance on over-the-counter contracts, few of which are acknowledged by ACIL.

For example, Power Purchase Agreements (PPAs) or structured hedges – particularly those that are both load-following and reallocated – provide cashflow hedging as well as financial hedging to the retailer. ACIL at no point acknowledges retailer challenges in accessing the volumes of capital needed to participate in the National Energy Market (NEM), let alone the cost impacts of any decisions they might make to manage those challenges.

For example, in January 2013 when extraordinarily high demand coincided (and promoted) high pool prices, the settlements exposure of many Queensland retailers breached their Maximum Trading Limits, triggering a requirement for effective prepayment of their forward costs to the Australian Energy Markets Operator (AEMO).

Managing the potential for this type of cash call requires having in place an unused overdraft facility – which is not included in the Retail Operating Costs calculation by virtue of its benchmarking against an IPART retailer which is vertically integrated and consequently fully reallocated – or alternatively (or in combination) over-reallocating the underlying exposure to include coverage of expected GST payments in order to avoid a call to AEMO.

If a retailer were hedged entirely using ACIL's methodology, then the load flex and GST call alone in January would have meant a substantial drain on the retailer which is not costed into the Retail Operating Costs. It would also have placed significant stress on the business in both a cash and an operating sense.

On the other hand, if a retailer had been at least partially hedged using reallocated load-following hedges, the impact would have been significantly mitigated (particularly if the retailer were over-reallocated). For this reason, a retailer will logically pursue this hedging strategy, despite it causing them to incur higher costs. This element is not costed into the d-Cypha hedge approach, and is one of a number of examples demonstrating that ACIL's simplified approach to hedging does not include all costs.

As suggested by QEnergy in our previous submission, actual prices of structured hedges should be utilised in order to establish the wholesale energy cost. QEnergy provided confidential pricing data in our earlier submission to which we redirect ACIL and the Authority.

A further issue relates to the volumes transacted through the hedge contract market, which are in no way commensurate with the volumes of load requiring to be hedged. Should the market operate in the way assumed by ACIL for modelling purposes – that is, with the entire load dealt through straightforward vanilla hedges – then offer levels would increase. Retailers counter this by purchasing over-the-counter products, many of which are shaped or structured in a way to closely reflect the underlying load exposure. ACIL, however, continues to ignore the real costs for retailers associated with this more genuine form of hedging.

QEnergy acknowledges that ACIL has recommended attempting to deal with the additional cost premia through using the 95th percentile of price outcomes rather than last year's 50th percentile, which was unbearably low. Whilst QEnergy supports this improvement, we still have a concern with the forecasting of demand which in our view would tend to underforecast the right-hand tail of the pricing distribution yielded by ACIL's model. This will then tend to underforecast the average price outcome of the model as well.

In developing the 42 simulations of load traces each representing 2012/13, ACIL has used the historic temperature outcomes for 39 years from 1970/71 to 2011/2012. They have then mapped these days based on closest match profiles to the daily temperature / demand outcomes from 2009/10 to 2011/12.

This 'day-at-a-time' approach does not account for extended high temperature outcomes over consecutive summer days where a day of 30°C in Brisbane may be the end of a five day period of temperatures above 32°C. In this case, the mapping process used by ACIL could retrieve a relatively normal day's demand outcome whereas in reality the actual demand outcome may have flexed considerably.

So, ACIL's simulation of a day with 30°C temperatures would have been mapped to a like day in the past three years, however if the day was the last of a five day heatwave then the true load

would have been more reflective of a 34⁰C day and indeed more, given the observed kneebone in demand after consecutive days of hot weather.

At the Authority's March workshop in Brisbane, ACIL stated on numerous occasions that they had not seen in their simulations the type of load flex attested by retailers. Retailers observed load flex in the Net System Load Profile (NSLP) load trace in Queensland during December 2012 and January 2013 of as much as 25% above the day-type / period average during periods of peak demand, or 9% above maximum demand as highlighted by AGL. Contrast this with ACIL's maximum observed flex of 4%, which makes an enormous difference to the number of extreme demand and hence price observations seen in ACIL's model, and has a disproportionate impact on average prices.

QEnergy recommends that actual load traces are used rather than constructed load traces, as we are aware that ENERGEX is well able to provide many years' of data to ACIL. We understand that this means that solar and air conditioning penetration corrections are required to more data, however in our view this additional effort is appropriate given the severity of the outcome to both individual retailers and the industry as a whole if (as we believe) the pricing outcomes generated by ACIL are inappropriately low.

Additionally, ACIL has indicated to us that they use seasonal rather than monthly profiles, and have a less granular approach to day-type modelling than we consider good practice, averaging Saturdays and Sundays. Many of the most extreme price events over the last five years have taken place on a Saturday when load levels look increasingly like a weekday whilst supply levels look like a weekend, and during January when many NSLP premises are occupied over the school holidays. This suggests that ACIL's profile averaging practice is having a dampening effect on the pricing outturns within the ACIL model.

Indeed, ACIL indicated at the March Brisbane workshop that when they had backcast demand through their model, actual pricing outturns were mirrored. This suggests that the problem with ACIL's price modelling underrepresenting achievable costs lies with the *ex ante* demand modelling rather than the price-setting process itself.

The risk profile of extended demand days has been exacerbated by the withdrawal of significant load from the market and the emergence of an increased sensitivity of the network to constraints, coupled with recent changes to generator bidding behaviour. Because of this, it has become prudent for stand-alone retailers – who like the model retailer are not vertically integrated – to hedge against the worst (rather than expected) case scenario given the impact these high demand / high pool price events have on profit and prudential / capital requirements.

So the observed flex outcomes and subsequent correlation to periods of very high pool pricing (as witnessed in the NEM during December 2012 and January 2013) are not taken into account in ACIL modelling. It would be more reflective of actual price outcomes if ACIL was to either model the outcomes of extended heat and as such demand flex, or alter the generic hedging strategy from 90% of maximum peak to 100% of maximum peak, with caps over the top. This is a more prudent hedging strategy given the increased demand and pool price volatility as witnessed over recent months.

ACIL states that using the 95th percentile of the 462 simulated annual hedged prices should account for any residual volume and price risk, however should a more suitable modelling of the load flex and impact of high pool prices be employed, the spread between the median and 95th percentile hedge price will widen and the 95th percentile will be more reflective of actual risk in the market.

Another issue with the pricing of hedges is demonstrated through the Authority's response to concerns from Origin Energy about dealing with recent volatility in the electricity market. The Authority states that *prudent retailers would not be hedging for the first quarter 2012 in January 2012, but would have undertaken their hedging over a number of years up to the quarter*. This ignores the fact that in times of significant pricing stress retailers must respond, and do so by issuing balance of quarter or short-term deals just to protect the cash position (as noted above).

For example, during the January high demand days, retailers undertook hedging to cover up the significant flex that we saw as noted above. Transactions for balance of quarter or for smaller time parcels were undertaken above what would be their estimated value within prepurchased full quarter hedges. This indicates that any estimate of prices must contain a risk buffer to allow conditions (such as market or demand expectations) to change dynamically. In all fairness, ACIL cannot take a market-based approach and then not use the full suite of market instruments.

Finally, the SFE market has risen significantly since the issuance of the Draft Determination on the back of pool volatility. Given ACIL's stated reliance on market prices, it is imperative that ACIL capture this rise for reflection in the Authority's Final Determination.

QEnergy also has concerns with ACIL's estimated costs for provision of prudentials (although we are grateful to have had this cost element recognised for the first time in this Determination). Specifically, ACIL states that each 1MWh of AEMO prudentials in fact covers 42MWh by virtue of the fact that it applies for a rolling 42 days. This is not correct, because every day, for every 1MWh consumed for that day, the forward 42 days of roll is required, and on any given day for every MWh, the entire volume of prudentials (or over-reallocations) is required. Hence QEnergy stands by our original cost estimates in this item.

Section 4. Retail Costs

As noted above, the fact that the model retailer in this determination is not vertically integrated – as evidenced by the disappearance of LRMC from the energy costs calculations – means that either the retailer must have excess prudentials on hand with AEMO in order to ensure that cash calls in extreme events are not required, or must have access to an overdraft.

In either case, the amount of 'excess capital' required to hedge the retailer's cash position can be calculated by running the same sorts of simulations required under the calculations for financial (hedge) protection, but taking into account actual cashflow obligations (including GST). QEnergy has done this for our own circumstances and would be glad to discuss calculations in our specific case with the Authority and ACIL in order to allow a more generalizable formula to be determined for the purposes of the determination.

Again, as noted above, this cost is not included in the Authority's Retail Operating Costs.

Section 5. Competition

QEnergy strongly supports the arguments of the entire industry that competition has been significantly negatively impacted in Queensland as a result of the Authority's decision for 2011/12, a position not greatly improved in 2012/13. For the best statement of this position, please see the paper submitted jointly between the Energy Retailers Association of Australia and the Energy Supply Association of Australia.

This impact on competition can also be seen as the inverse of the withdrawal of capital from a market in the face of unacceptably low returns.

In their half-yearly performance outcomes, AGL announced that the QCA decision had by itself reduced interim earnings for 2012/13 by \$29 million, and Origin Energy indicated an impact of \$58 million. Further, the market volatility in Queensland (and notably, in no other state) will

further impact AGL's full-year earnings by approximately \$10 million, and Origin's by \$30 – \$35 million.

Extrapolating these results to a full-year basis, this is a decrease of around 20% in return to the retailers, a clearly unsustainable position and hugely disproportionate to the relative penetration of Queensland customers in their respective overall positions. Second-tier retailers such as QEnergy have also borne the impact of this reduction and as noted we have ceased actively retailing in the Queensland market – our home market – as a result. Nothing in the current Draft Determination settings would encourage that to change.

In this context, it is worth noting statements made at a recent IIR conference in Sydney, *Energy 2013*, by Jason Steed of JP Morgan regarding a consideration of the value of equity investment in energy retailers generally, but those participating in Queensland in particular. His view was that net retail equity returns to the Queensland market were around 3%, compared with an equity expectation of around 12% (given the opportunity costs). His view, consistent with that of any retailer attempting to determine where to put time and resources (and consequently, equity capital), was that this was simply insufficient to justify participation in that market through the mechanism of an operating injection of capital.

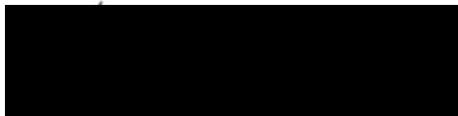
QEnergy strongly urges the Authority to consider this matter as the withdrawal of capital from a sector – operating or investment – can do long-term damage to an industry and its health.

In Queensland's case, the outcomes have been further significantly compromised by the errors made in forecasting environmental allowances in prior years, and the lack of any regulatory makegood model. QEnergy respectfully requests that the makegood model proposed for the period going forwards – which we support and for which we are grateful – be extended backwards over the past two years to capture this series of profit hits below the recommended price by the Authority that retailers were simply forced to accept and which is driving operating capital away from the market.

This is a particularly draconian outcome in a market where the regulatory model requires all retailers to offer tariff prices to premises for which is it financially responsible, regardless whether they have any profit associated with them or not.

QEnergy hopes that this input is of use in the Authority's deliberations. As is the case for all matters, QEnergy remains open to discuss or clarify any matter relating to this request. I look forward to future dealings as we work towards a regime that rewards participation for industry participants, as well as diversity, choice and service for customers over time.

Yours sincerely

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Kate Farrar
Managing Director