Etrog Consulting

REPORT

Prepared for:

Queensland Council of Social Service (QCOSS)

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Regulated Retail Electricity Prices 2014-15: Draft Determination

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This report has been prepared by Etrog Consulting Pty Ltd for Queensland Council of Social Service (QCOSS). It comments on the Draft Determination on regulated retail electricity prices to apply in Queensland from 1 July 2014 to 30 June 2015 which was published by the Queensland Competition Authority (the QCA) on 11 December 2013, inviting submissions from interested parties.

Our main concerns are in the following areas (section references in this report are given in brackets). On other matters, we would be concerned if the QCA were to depart in its Final Determination from its current positions in its Draft Determination.

Introduction

- The QCA must particularly take into account the impacts of price increases on struggling Queensland households and businesses when determining regulated retail electricity prices for 2014-15. (section 1.1)
- We urge the Queensland Government to ensure that its Delegations to the QCA fully reflect its instructions to the QCA, and that important matters should not be included only in the Minister's covering letters. (section 1.1)
- We urge the QCA and the Queensland Government to make available at the earliest opportunity sufficient data to enable modelling of the effects that changes to regulated retail electricity tariffs and prices will have on consumers, particularly disadvantaged and low income consumers, and to release any modelling that they have already undertaken to support any policy decisions that have been made to date. (section 1.2)

Network costs

- The QCA should request and influence the network tariff proposals that Energex makes to the Australian Energy Regulator (AER) to provide the best outcomes for retail tariffs for small customers, to meet the objectives of stakeholders, including the QCA itself, Government, retailers, distributors and consumers. (section 2.1)

Energy costs

- The QCA should use a market-based approach rather than a cost-based approach to estimate the cost of purchasing wholesale energy. (section 3.2.1)
- The QCA should use carbon-inclusive contract prices as the basis for estimating wholesale energy costs for 2014-2015, in accordance with the advice of its consultant, and on the basis of its Delegation to determine notified prices annually, based on the best estimates of costs that are available at the time that the annual prices are determined. (section 3.2.2)
- We support the view that amending the Metrology Procedures is a matter for the Queensland Government to decide and initiate with the Australian Energy Market Operator (AEMO). This is something that the Government should explore further with AEMO in the coming year. The exploration should include cost-benefit analysis of various options for implementation. (section 3.2.3)

- In estimating the cost of Small-scale Technology Certificates (STCs), the QCA should take into account the fact that an active market for STCs has developed outside the clearing house. The market price for STCs has been and continues to be well below the official $40 price. An efficient representative retailer should be expected to be taking advantage of that market and not paying $40 to purchase its STCs. (section 3.3.2)

Retail costs

- No allowance should be made for customer acquisition and retention costs (CARC) in regulated retail electricity prices in Queensland. (section 4.1.3)
- If the QCA is to make an allowance for CARC, it should be at a much lower level than that allowed in the Final Determination for 2013-14. Any allowance should be reasonable rather than generous, and should take into account less costly channels being used to recruit new customers, as against the previous CARC allowance benchmark which was first set when customers were gained primarily through door-knocking. (section 4.1.3)
- The gross retail margin of 5% of total costs that was allowed in the Benchmark Retail Cost Index (BRCI) calculations is realistic, and should not be any higher. Instead, it should be lower, because the retailers will be compensated based on efficient costs, rather than the BRCI mechanism that might have borne no relationship to their actual efficient costs and was not cost-reflective. Under the BRCI, retailers therefore faced higher risks than should be the case under the current framework for setting regulated retail prices. (section 4.2.2)
- In its Final Determination, the QCA should reduce the retail margin commensurate with its view that its revised modelling approach to wholesale energy costs takes into account the majority of risk faced by retailers. (section 4.2.2)

Competition and other issues

- The QCA should make no additional allowance for headroom in notified prices for 2014-15. (section 5.1.5)

1. INTRODUCTION

This report has been prepared by Etrog Consulting Pty Ltd for Queensland Council of Social Service (QCOSS). It comments on the Draft Determination on regulated retail electricity prices to apply in Queensland from 1 July 2014 to 30 June 2015 which was published by the Queensland Competition Authority (the QCA) on 11 December 2013, inviting submissions from interested parties.

At the same time, the QCA also released a report written by ACIL Allen on estimated wholesale energy costs for use by the QCA in setting regulated electricity retail prices for 2014-15, with supporting data from ACIL Allen, and five customer factsheets.[1]

The QCA held workshops for stakeholders in various locations to discuss the QCA's Draft Determination of regulated retail electricity prices for 2014-15 and the QCA's Review of Retail Electricity Price Regulation in Regional Queensland. We were pleased to attend the workshop held in Brisbane on Monday 17 February 2014. We would like to thank the QCA for holding the workshop, which we found very informative and useful.

The QCA has requested that submissions to the Draft Determination should be received by 28 February 2014. This report has been developed in consultation with QCOSS with the understanding that QCOSS is intending to submit this report to the QCA as its response to the Draft Determination.

1.1. DELEGATION FROM THE MINISTER

As stated in Chapter 1 of the QCA's Draft Determination, on 5 September 2012, the Minister for Energy and Water Supply (the Minister) provided the QCA with a Delegation under section 90AA(1) of the *Electricity Act 1994* requiring it to determine notified electricity prices[2] for a three-year period from 1 July 2013 to 30 June 2016.

On 12 February 2013, the QCA received a revised Delegation which changed the date for release of its Draft Determination for 2013-14 from 15 February 2013 to 22 February 2013, while all other content remained the same as the 5 September 2012 Delegation. The Minister's covering letters and Delegations were provided in Appendix A to the Draft Determination.

While the Delegation is for a three-year period, the QCA is still required to set notified prices on an annual basis. The QCA's first price determination was made on 31 May 2013 for the period from 1 July 2013 to 30 June 2014. This submission relates to the QCA's second price determination, which covers the period from 1 July 2014 to 30 June 2015.

1 The QCA's Draft Determination and the ACIL Allen paper and other materials have been published on the QCA's website at www.qca.org.au/Electricity/Consumer/Electricity-Prices/In-Progress/Electricity-Prices-2013-14.

2 Notified electricity prices are the regulated retail electricity prices that a retailer may charge its non-market customers, as defined under section 90 of the *Electricity Act 1994*

Section 1.1 of the Draft Determination outlines various relevant requirements that the *Electricity Act 1994* and the Delegation place on the QCA. However, it does not include the following relevant comment in the Minister's covering letter of 5 September 2012:

> *it is important that the QCA take into account the impacts of price increases on struggling Queensland households and businesses.*

The QCA must particularly take into account the impacts of price increases on struggling Queensland households and businesses when determining regulated retail electricity prices for 2014-15.

We discuss these impacts further in section 6 of this report in relation to transition arrangements involving re-balancing the fixed and variable charges in Tariff 11. Our comments there include the following:

- We support the implementation of transitional arrangements for any changes to tariff structures that will have a significant impact on some consumers' costs.
- The proposal to rebalance the fixed and variable components of Tariff 11 to cost-reflective pricing will have an adverse impact on the lowest consuming households. Many low-consuming households are vulnerable consumers who are least likely to be able to adapt to significant price increases. We support a staged approach to minimise the immediate bill shock for consumers.
- A transition period is essential in order to assess the impact of the changes on different customer groups and for this information to influence improvements to government policy. In particular, the shift to greater cost reflectively will necessitate changes to government concessions to ensure they are adequate and well-targeted alongside the new tariff structure. Further, the transitional timeframe provides an opportunity for consumer education to be rolled out over time to assist consumers understand and adjust to the new pricing structures.
- We prefer a smooth transition to cost reflective pricing in order to minimise bill shock for consumers who may be adversely affected. The effect on consumers should be a key consideration when determining the form of transitioning.
- The QCA should undertake substantial analysis to provide an assessment to identify the expected impacts of tariff arrangements on a range of consumer groups with varying consumption patterns, including pensioners, large working families, low-income tenants and other vulnerable households. This analysis should take into the account the existing electricity concessions available in Queensland.
- Significant changes to tariff arrangements will necessitate changes to the existing energy concessions and support arrangements, to ensure they are well-targeted and equitable for Queensland consumers.

The QCA has accepted previously that it is reasonable for submissions such as this to include comments to the Queensland Government on matters that may be outside the QCA's scope. On that basis, we note that the QCA consistently appears to place weight on the Delegations that it receives from the Minister that it does not also apply to the Minister's covering letters. We understand that this has some basis in the fact that the legislation refers specifically to the Delegation rather than to its covering letter. We believe this is somewhat anomalous, and that important matters in the covering letter should be given weight by the QCA.

> We urge the Queensland Government to ensure that its Delegations to the QCA fully reflect its instructions to the QCA, and that important matters should not be included only in the Minister's covering letters.

1.2. THE EFFECTS THAT CHANGES TO REGULATED RETAIL ELECTRICITY TARIFFS AND PRICES WILL HAVE ON QCOSS' CONSTITUENCY

QCOSS represents the interests of residential consumers, with a particular focus on low income and other vulnerable consumers.

Some low income customers are supported by a range of concessions and other measures in line with the Queensland Government's social policy objectives. In the process of tariff reform, the existing measures may be adequate or may prove highly inadequate to be effective at assisting low income consumers in future. Major restructuring of the concessions framework may be required, and it is better that this is known sooner rather than later, so that appropriate changes can be made to the concessions framework before new regulated tariffs and prices are implemented. Financial counsellors and others who advise these consumers also need prior information on how any new tariffs will affect their clients, so that they can give them appropriate advice on their use of electricity, their budgeting, and any assistance that may be available to them.

> We urge the QCA and the Queensland Government to make available at the earliest opportunity sufficient data to enable modelling of the effects that changes to regulated retail electricity tariffs and prices will have on consumers, particularly disadvantaged and low income consumers, and to release any modelling that they have already undertaken to support any policy decisions that have been made to date.

1.3. THE REVIEW PROCESS TO DATE

On 31 July 2013, the QCA released an Interim Consultation Paper advising interested parties of the commencement of the review. The QCA received 25 submissions in response, which included a response from QCOSS. QCOSS' response discussed a small number of issues in detail, and included the statement that QCOSS retained the views that it expressed on the Draft Determination for 2013-14. Those views should have been taken into account by the QCA in its Draft Determination for 2014-15.

For example, the Draft Determination states that submissions in response to the QCA's consultation paper were broadly in favour of retaining an approach for 2014-15 that included using the clearing house price of $40 to estimate the costs of small-scale technology certificates (STCs).[3] QCOSS' position for 2013-14 was not to retain that approach, and QCOSS' position was retained for 2014-15.

1.4. Structure of this report

The remainder of this report comments on various matters in the QCA's Draft Determination, and largely follows the same structure as the Draft Determination.

- Section 2 covers network costs.
- Section 3 covers energy costs.
- Section 4 covers retail costs.
- Section 5 covers competition and other issues.
- Section 6 covers transitional arrangements.
- Section 7 covers the overall draft determination.

3 Draft Determination, page 26

2. NETWORK COSTS

Chapter 2 of the Draft Determination sets out the QCA's proposal on how to incorporate network costs in regulated retail electricity prices for 2014-15 in Queensland. It is divided into the following sections:

- Section 2.1 includes background information;
- Section 2.2 covers network tariffs for residential customers, small business customers and unmetered supplies;
- Section 2.3 covers network tariffs for large business customers and street lighting;
- Section 2.4 covers network tariffs for very large customers;
- Section 2.5 covers alignment of retail and network prices; and
- Section 2.6 covers network prices for 2014-15 notified prices.

Our comments here cover only network tariffs for residential customers, alignment of retail and network tariffs, and network prices for 2014-15 notified prices.

Network costs include the costs associated with transporting electricity through the transmission and distribution networks and typically account for around 50% of the final cost of electricity for small customers.

Retail electricity prices comprise three main cost components – network costs, energy costs and retail costs. Network costs are the largest of these, and include the costs of transporting electricity from generators to customers, which requires the use of transmission and distribution networks. Transmission networks transport electricity at high voltages across the state and interstate while distribution networks distribute electricity at lower voltages from transmission connection points to households and businesses.

In Queensland, the main transmission network service provider is Powerlink and the two main distribution network service providers are Energex and Ergon Energy. Energex's network services south-east Queensland, while Ergon Energy's network extends across the remainder of the state.

As regulated monopoly businesses, Powerlink, Energex and Ergon Energy all earn regulated revenues that are determined by the Australian Energy Regulation (AER). In addition to recovering their own distribution network costs, Energex and Ergon Energy pass Powerlink's costs on to customers in network prices that are also approved by the AER.

The Delegation requires the QCA to adopt a cost-reflective N+R pricing model under which the network costs (N) are to be passed through to customers.[4]

4 Draft Determination, page 12

2.1. Network tariffs for residential customers

The setting of network tariffs is a matter for the Australian Energy Regulator (AER), and not for the QCA. Nonetheless, as shown above, the network tariff component is a significant part of the retail tariffs, and network costs are passed through directly into regulated retail tariffs.

> The QCA should request and influence the network tariff proposals that Energex makes to the Australian Energy Regulator (AER) to provide the best outcomes for retail tariffs for small customers, to meet the objectives of stakeholders, including the QCA itself, Government, retailers, distributors and consumers.

Two areas that may be of particular concern in network tariffs are as follows:

- The allocation of fixed and variable charge components in network tariffs; and
- The allocation of costs between peak and off-peak components in network tariffs.

2.1.1. The allocation of fixed and variable charge components in network tariffs

As mentioned in section 1.2 above, QCOSS represents the interests of residential consumers, with a particular focus on low income and other vulnerable consumers. Many low income and vulnerable consumers are relatively small users of electricity, because they do not have the high-usage electrical equipment that more affluent households may have, such as swimming pool pumps and large air conditioning systems.

That is not to say that all low income households are low users of electricity. Indeed there are also low income householders who support large families, and there are those who are high users of electricity because of medical requirements or poor quality housing and inefficient appliances. People who are home during the day may also be using more electricity because they require cooling throughout the day, while others may be able to switch off cooling when they are out during the day and rely instead on the cooling systems provided by others, such as their employers. Customers with low income who have high consumption of electricity for reasons outside their control may be particularly in need of concessions in the form of a package of support outside any tariff mechanism.

Given different tariffs that in total are revenue neutral, i.e. they bring in the same revenue when applied across the customer base, tariffs which have higher fixed charges and lower variable charges have an adverse impact on lower usage consumers as compared with tariffs which have lower fixed charges and higher variable charges. Conversely, higher usage customers would benefit from tariffs with lower variable charges and higher fixed charges.

Higher fixed charges and lower variable charges also do not provide as much of a price signal to customers to avoid inefficient usage of electricity as compared to lower fixed charges and higher variable charges. In the latter case, the higher variable charges provide more incentives to reduce unnecessary usage of electricity and to use electricity more efficiently. This is unlike the first case where the higher fixed charges are not reduced no matter how efficiently the consumer uses their electricity.

2.1.2. The allocation of costs between peak and off-peak components in network tariffs

The differential between peak and off-peak needs to be significant if it is to give customers incentives to use electricity at off-peak times rather than at peak times, and thereby contribute to more efficient use of the electricity network and generation capacity and infrastructure. In particular, the Delegation states that "QCA must consider whether its approach to calculating time-of-use tariffs can strengthen or enhance the underlying network price signals and encourage customers to switch to time-of-use tariffs and reduce their energy consumption during peak times".

It is generally understood that peak usage is a significant cost driver for the electricity supply industry as a whole, as peak usage has to be met through investment in generation and network capacity. Less peaky load shapes are less costly to serve, and make more efficient use of the generation and network infrastructure. We are therefore concerned that when the allocation of costs between peak and off-peak components in network tariffs are passed through in retail tariffs, they should continue to provide appropriate incentives to customers to use electricity at off-peak times rather than at peak times. For residential customers, our concern relates to Tariffs 12 (time of use), 13 (PeakSmart), 31 (super economy controlled load) and 33 (economy controlled load).

2.2. Alignment of Retail and Network Prices

Once Energex and Ergon Energy have proposed network tariffs to the AER, after they have taken into account stakeholder views, the approval of the tariffs is then a matter between the AER and the distributors.

The best option would be for the notified prices to reflect the actual network tariffs and prices after they have been approved by the AER. However, we understand that there is a timing issue whereby the AER may not have finalised its decision on tariff approval by the time the QCA needs to publish its Final Determination. If that is the case, then we concur with the proposal of the QCA "to continue using preliminary network prices provided by Energex and Ergon Energy for the Draft Determination and proposed network tariffs submitted by the distributors to the AER for the Final Determination".[5]

The QCA states further: "In the event that the final network prices approved by the AER differ from those used in the Final Determination, we will consider using the pass-through mechanism discussed in Chapter 5 to adjust for any material difference."

Our views on the pass-through mechanism are contained in section 5 of this report.

2.3. Network Prices for 2014–15 Notified Prices

We support the QCA's draft determination to base regulated retail tariffs for residential customers across Queensland in 2014-15 on Energex network tariffs and charges for residential customers.

5 Draft Determination, page 16

3. ENERGY COSTS

The second main component of retail electricity prices is the cost a retailer will incur, either directly or indirectly, in supplying energy to cover the load of its customers.

For 2014-15, the QCA has decided to maintain a hedging-based approach to estimating wholesale energy costs.[6]

3.1. BACKGROUND

Under the Delegation, the R component of each retail tariff is to include appropriate allowances for energy and retail costs.

Energy costs are those a retailer will incur, either directly or indirectly, in supplying energy to cover the load of its customers. As in previous decisions, the QCA has included allowances for a range of energy costs, which can be broadly broken into three categories:

- Wholesale energy costs;
- Other energy costs, including green schemes and market fees; and
- Energy losses.

3.2. WHOLESALE ENERGY COSTS

Wholesale energy costs relate to the costs incurred by a retailer in supplying electricity to cover the load of its customers. While this electricity is purchased from the National Electricity Market (NEM) (the spot market), there is a range of measures that a retailer can take in order to reduce its exposure to volatile prices in the spot market, including purchasing financial derivatives (futures, swaps, options etc.), entering longer-term power purchase agreements (PPAs) with generators, and investing in generation assets.[7]

3.2.1. Potential approaches for 2014-15

We concur with the view of the QCA that it is more appropriate to use a market-based approach rather than to use a Long Run Marginal Cost (LRMC) based approach. This view is based on the reasons given by the QCA in its Draft Determination and in its previous papers and determinations on the subject. On that basis, we have chosen not to repeat the many arguments we have previously given in support of this view. Should the QCA consider a change to that view in its Final Determination, it should refer to our previous submissions on the subject, and to the QCA's own publications for reasons as to why its view should not be changed in this respect.

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6 Draft Determination, page 19

7 Based on Draft Determination, pages 19-20

Following release of the QCA's 2012-13 Final Pricing Determination, Origin Energy made an application for Judicial Review of aspects of the QCA's approach to estimating energy costs in that decision. On 19 December 2012, the Supreme Court dismissed Origin Energy's application. The reasons for the judgment have been published.[8] Our reading of that judgment supports the use of a market-based approach rather than to use a LRMC based approach.

The AEMC also endorses the hedging-based approach as the best-practice method for estimating wholesale energy costs for retail prices.[9]

The QCA should use a market-based approach rather than a cost-based approach to estimate the cost of purchasing wholesale energy.

3.2.2. Dealing with carbon uncertainty under a hedging-based approach

Since the carbon tax was introduced in 2012-13, and previously under the Benchmark Retail Cost Index methodology, the QCA has used energy cost estimates provided by ACIL Allen that are based on carbon-inclusive energy contracts traded through the Sydney Futures Exchange (SFE). We have consistently endorsed this practice.

Market expectations

In previous years, when market participants expected the carbon tax to remain in place for the entire year, the price of carbon-inclusive contracts aligned very closely with the price of carbon-exclusive contracts plus the carbon pass-through.

Carbon-inclusive energy contracts for 2014-15 no longer include the full amount of costs that would be associated with the carbon tax if it was expected to be in place for the full year. This is consistent with the market expectation that the carbon tax will be in place only for part of the year.[10]

Using best estimates of energy costs in accord with the Delegation from the Minister

The Delegation requires the QCA to set regulated prices to apply for the entire year. Using carbon-inclusive contracts would be the correct approach for the QCA to take, because they represent the market's best estimate of expected energy costs for the year, during which the carbon tax is expected to apply for only part of the year. This concurs with the advice that the QCA has received from its own consultant ACIL Allen.

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8 *Origin Energy Electricity Ltd & Anor v Queensland Competition Authority & Anor* [2012] QSC 414 (12/5527) Brisb Jackson J 19/12/2012, available at www.sclqld.org.au/qjudgment/2012/QSC/414

9 AEMC, *Advice on Best Practice Retail Price Regulation Methodology – Final Report*, September 2013

10 Draft Determination, pages 20-21

ACIL Allen gave its advice in accordance with the Delegation and its terms of reference, under which its task is to provide expert advice to the QCA on the energy costs to be incurred by a retailer to supply customers on notified prices for 2014-15 *taking into account the uncertainty over the carbon price and any other uncertainties*.[11]

Consistency of approach to other cost elements that change during a Determination period

The costs of compliance with small scale and large scale renewable energy targets change by calendar year rather than by retail price Determination period (which is 1 July to 30 June). Similarly when Gas Electricity Certificates (GECs) formed part of a retailer's cost base, the costs of compliance with the GEC scheme changed by calendar year. In no case has the QCA determined retail prices for a period from 1 July to 30 June with a step-change at 1 January to reflect changes in costs. Rather it has smoothed those costs across the determination period. It would be consistent to handle carbon costs in the same way, rather than to attempt a step-change part way through the period from 1 July 2014 to 30 June 2015.

The QCA's proposal not to use the market's best estimate of energy prices

The QCA has chosen not to take the advice of its consultant. Instead it proposes to set notified prices that include the full impact of the carbon tax, to apply for as long as it remains in place. The QCA suggests that a separate set of prices that do not include any carbon tax costs could then be implemented after the carbon tax is removed, but the QCA has no apparent remit to change notified prices during the year.

Rather than use energy cost estimates that reflect the real world uncertainty over the carbon price, the QCA has instead decided to base its Draft Determination on two scenarios where the status of the carbon price is assumed to be known. In the QCA's Draft Determination methodology, the two scenarios assume that there is no uncertainty with respect to the future of the carbon price in each case. In one case, the carbon price is known to continue, and in the other case it is known to be repealed. Neither case reflects reality. Neither case should be the basis for setting notified prices.

The QCA justifies its Draft Determination in regard to carbon pricing on two sets of arguments:

1. Under the approach that we believe is the correct approach, there would be no change to electricity prices if the carbon tax is removed. This would be at odds with the expectation of customers that electricity prices would likely decrease if the tax is removed.
2. Concerns about risks that might result from the use of carbon-inclusive contract prices to set retail prices once to apply for the entire year.

We suggest that these objections to following the QCA's consultant's advice are easily overcome.

11 *Estimated energy costs*, 2014-15 retail tariffs, ACIL Allen report to the QCA, 21 November 2013, for use by the QCA in its Draft Determination on retail electricity tariffs

Customer expectations

We agree that it is good for customers' expectations to be met. We applaud the view of the QCA that it should take customers' expectations into account in its decision making process. We look forward to seeing more instances of the QCA taking account customers' expectations in its regulatory decision making processes. In order to ensure that customers' expectations are met, it will be incumbent on the QCA if and when it follows its consultant's advice to explain to Queensland consumers the decision that it has made. This will include explanation of the fact that customers will have already seen from 1 July 2014 the effect of the removal of the carbon tax, which is why there is no further reduction when the tax is removed.

Handling of risks due to uncertainty as to when the carbon tax will be removed

Regarding risks that might result from the use of carbon-inclusive contract prices to set retail prices once to apply for the entire year, in fact ACIL Allen has set out the risks the other way. The risks apply if the QCA adopts its preferred approach, rather than follow ACIL Allen's recommendation:

> ACIL Allen notes that regulated retail prices based on energy cost estimates with and without carbon will result in an increased risk of under-estimating retailer energy costs if the carbon price is repealed and over-estimating retailer energy costs if the carbon price is not repealed. This is because current pricing is trading on a risk adjusted basis and retailers are likely incurring actual costs at these risk adjusted prices regardless of whether the carbon price is repealed or not. On this basis, ACIL Allen recommends that the QCA use ACIL Allen's best estimate based on the risk adjusted carbon price allowance.[12]

The actuality of setting prices too high

The QCA recognises that its approach will set prices at 1 July 2014 that are too high. This is not just a risk; it is a certainty.

> Taking this approach means setting an initial set of prices that we acknowledge are too high to apply for the entire year, given market expectations that the carbon tax will be repealed mid-year.[13]

Lack of power to change retail prices mid-year

The QCA does not have the power to change retail prices mid-year. In order to do so, the QCA would require a new delegation from the Minister for Energy and Water Supply if and when the carbon tax is removed. Alternatively, the Minister could choose to make a new price determination using the carbon-exclusive notified prices calculated by the QCA. This would make the implementation in the notified prices of the removal of the carbon tax much more complex than is necessary. This complexity can be avoided if the QCA follows its consultant's advice regarding treatment of carbon pricing.

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12 *Estimated energy costs*, 2014-15 retail tariffs, ACIL Allen report to the QCA, 21 November 2013, for use by the QCA in its Draft Determination on retail electricity tariffs, page 7

13 Draft Determination, page 22

While the Minister may take one of the suggested actions, this is not certain to occur. This is a further risk inherent in the QCA's approach that can and should be avoided by following ACIL Allen's advice, rather than relying on new actions from the Minister which the Minister may not take.

The QCA should use carbon-inclusive contract prices as the basis for estimating wholesale energy costs for 2014-2015, in accordance with the advice of its consultant, and on the basis of its Delegation to determine notified prices annually, based on the best estimates of costs that are available at the time that the annual prices are determined.

3.2.3. Enhancing time-of-use signals

The Delegation requires the QCA to consider whether its approach to estimating energy costs could strengthen or enhance the underlying network price signals and provide greater incentives for customers to switch to time-of-use tariffs and reduce their energy consumption during peak times.

In previous reviews, the QCA considered developing energy cost estimates that would include time-of-use signals to consumers. However, retailers pointed out that this did not reflect the way in which they are charged for electricity by the Australian Energy Market Operator (AEMO), which is based on the relevant distributor's net system load profile (NSLP).

To resolve this issue, the Queensland Government has to propose amendments to AEMO's Metrology Procedures to align Queensland's procedures with those of other states.[14]

We support the view that amending the Metrology Procedures is a matter for the Queensland Government to decide and initiate with the Australian Energy Market Operator (AEMO). This is something that the Government should explore further with AEMO in the coming year. The exploration should include cost-benefit analysis of various options for implementation.

3.3. OTHER ENERGY COSTS

In addition to wholesale energy costs, there are a range of other energy costs including those relating to:

- The large-scale renewable energy target (LRET) scheme;
- The small-scale renewable energy scheme (SRES);
- NEM participation fees and ancillary services charges; and
- Prudential requirements.

14 Draft Determination, page 23

The inclusion of a mechanism to address any new compulsory scheme that imposes material costs on retailers is considered in Chapter 5.[15]

3.3.1. Large-scale Renewable Energy Target (LRET) costs

The LRET scheme sets annual targets for the amount of electricity that must be generated by large-scale renewable energy projects like wind farms. Retailers must purchase a set number of large-scale generation certificates (LGCs) that is determined on the basis of achieving the annual target, which increases annually toward the ultimate goal of 41,000 GWh by 2020.

For the 2013-14 Determination, ACIL Allen estimated LRET costs using the 2013 renewable power percentage (RPP) for the first half of the pricing period and the 2014 LRET target for the second half of the pricing period, as the 2014 RPP was not published at the time of the Final Determination. To estimate the cost of meeting these targets, ACIL Allen used LGC prices published by the Australian Financial Markets Association (AFMA).

ACIL Allen has proposed to retain its previous approach for estimating LRET costs, on the basis that there were no new or persuasive arguments in submissions.

The QCA has considered, and decided against, adopting a Long Run Marginal Cost (LRMC) approach for estimating LRET costs in previous pricing determinations. The QCA has a preference for market-based approaches to estimating costs rather than proxies such as LRMC on the basis that they are more transparent and more likely to reflect the costs incurred by a retailer in any given year. On this basis, the QCA has accepted ACIL Allen’s advice on this matter

We support the use of market-based data to estimate the costs of LGCs. We agree with the QCA that a market-based approach is more likely to reflect the costs to retailers of complying with various environmental schemes and that it is superior to an LRMC based approach for a range of reasons.

3.3.2. Small-scale renewable energy scheme (SRES) costs

The SRES covers small-scale technologies such as solar panels and solar hot water systems installed by households and small businesses. Retailers have an obligation to purchase small-scale technology certificates (STCs) based on expected rates of STC creation, which are determined by the Office of Renewable Energy Regulator’s (ORER) Small-scale Technology Percentage (STP).

For the 2013-14 Determination, ACIL Allen estimated SRES costs using the binding 2013 small-scale technology percentage (STP) target for the first half of the pricing period and the non-binding 2014 target for the second half of the pricing period as the binding target was not published at the time of the Final Determination. To estimate the cost of meeting these targets, ACIL Allen used the clearing house price of $40, on the basis that it expected any difference between market prices and the clearing house price to diminish over time.

15 Draft Determination, page 25

We concur with estimating SRES compliance requirements for 2014-15 using the binding 2014 STP target for the first half of the pricing period and the non-binding 2015 target for the second half of the pricing period. This is consistent with how compliance costs were estimated for 2013-14.

Should the QCA consider a change in its Final Determination to move away from using the binding 2014 STP target for the first half of the pricing period and the non-binding 2015 target for the second half of the pricing period, it should refer to our previous submissions on the subject, and to the QCA's own publications for reasons as to why its view should not be changed in this respect.

ACIL Allen has proposed to retain its previous approach for estimating SRES costs, on the basis that submissions were generally supportive of the approach. However, QCOSS was not generally supportive of continuing to rely on the ORER's Clearing House price of $40 to estimate the costs to an efficient representative retailer of purchasing its STCs for 2014-15. As previously, we remain concerned that in its Draft Determination the QCA continues to rely on the ORER's Clearing House price of $40 to estimate the costs to an efficient representative retailer of purchasing its STCs for 2014-15.

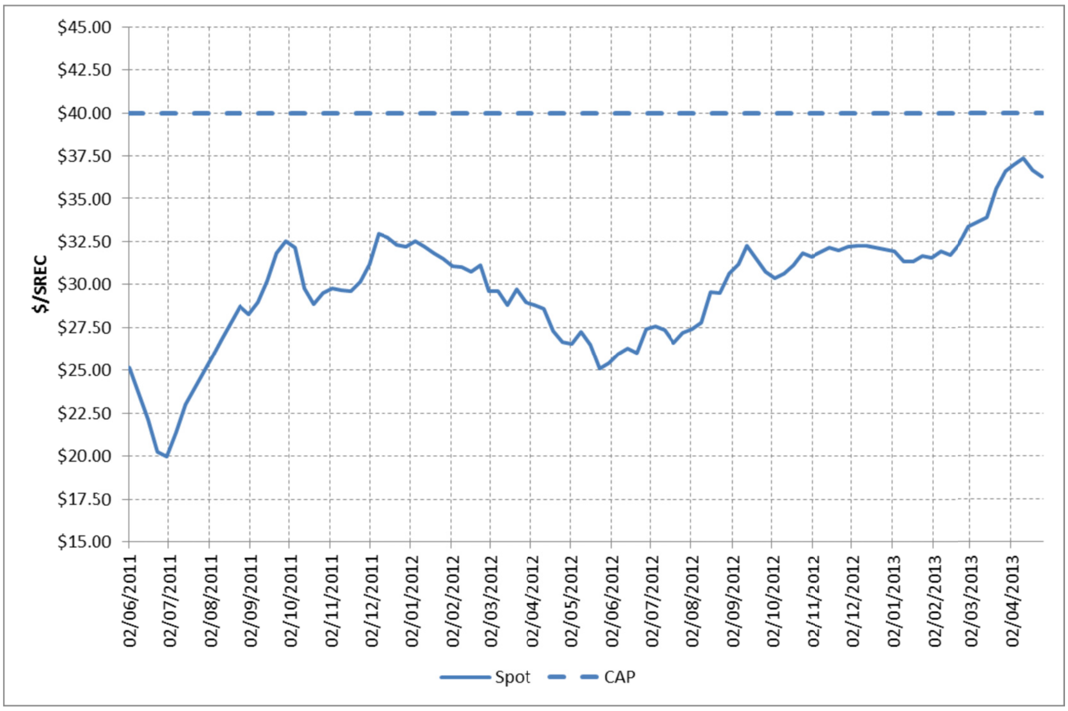
This is notwithstanding the facts that:

- The QCA and ACIL Allen have previously both acknowledged that STCs are being purchased based on market prices that are readily available, and continue to acknowledge that there is an active market for STCs outside the Clearing House.
- ACIL Allen has previously stated that the secondary market STC price has been between $25 and $33.[16]
- Previous STC prices are illustrated in Figure 1 below which ACIL Allen sourced from AFMA and which we have copied from the previous ACIL Allen report.[17]

16 ACIL Allen report 2013-14, page 47

17 ACIL Allen report 2013-14, page 54

Figure 1: Small-scale Technology Certificate (STC) prices



- We acknowledge that future market prices may not be the same as historic prices. As ACIL Allen suggests, prices could be $40 in future. Equally they might continue to be a lot lower. We see no reason why the Clearing House price should be the best indicator of future market prices, and we commend market prices as the best indicator, as for other commodities which are market traded.
- The Independent Competition and Regulatory Commission (ICRC) of the ACT has used market prices for STCs in its Final Determination of regulated retail prices for 2012-14.[18]
- The Climate Change Authority has stated that: “To provide clarity to scheme participants, the QCA recommends that the clearing house be amended to a ‘deficit sales facility’, whereby certificates are only allowed to be entered in the clearing house when the clearing house is in deficit (that is, only when regulator-created certificates have been issued to liable entities). This would allow the continued operation of the clearing house as a price cap, while making it clear that it is unable to guarantee a set price of $40 per certificate in a timely fashion. Such a change would also allow the clearing house price to be more easily amended as there would be no need for transitional arrangements for certificates on the transfer list.”[19]

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18 *Retail prices for franchise electricity customers 2012-14*, Final report, Report 4 of 2012, June 2012, ICRC, pages 13-15, available at www.icrc.act.gov.au/energy/electricity

19 See *Renewable Energy Target Review*, Climate Change Authority, Final Report, December 2012, available at www.climatechangeauthority.gov.au/ret

- That same report from the Climate Change Authority reveals that: "While the clearing house has provided an effective price cap, it has failed to deliver a set subsidy of $40 per STC to owners of small-scale systems (or their agents). The clearing house is a voluntary mechanism and liable entities have chosen to acquire certificates outside the clearing house where STC spot prices are around $25 to $32. This has meant the clearing house transfer list has not cleared for 18 months (the last sale was on 25 February 2011)."
- The Climate Change Authority report refers to the fact that "the existence of the clearing house has created an expectation among some non-expert participants that a $40 set price per STC is obtainable". It is clear from this that only "non-expert participants" expect STCs to trade at $40; the QCA and its consultant should not be in this category.
- This all further undermines the relevance of $40 as the price at which STCs trade.

In this submission, and in our previous submissions, we have responded to all of the concerns raised by the QCA and ACIL Allen in regard to using market prices for STCs. We have shown that there is a liquid market, and that prices are readily available. We propose that market prices are the best indicator of prices, as for other commodities which are market traded, rather than the clearing house, where it has been reported by the Climate Change Authority that the last sale was on 25 February 2011. As stated by ICRC: "there is a robust case for the use of market data to estimate the costs of STCs". We commend this approach to the QCA.

We also note that the AEMC has stated: "Provided that there is sufficient liquidity in the market for SRES certificates, future prices should be used (i.e. a market based method)".[20]

> In estimating the cost of Small-scale Technology Certificates (STCs), the QCA should take into account the fact that an active market for STCs has developed outside the clearing house. The market price for STCs has been and continues to be well below the official $40 price. An efficient representative retailer should be expected to be taking advantage of that market and not paying $40 to purchase its STCs.

3.3.3. NEM participation fees and ancillary services charges

Given that changes in NEM participation fees and ancillary services charges are relatively stable from year to year, we agree with the QCA that it is reasonable to use historical data in forecasting these costs.[21]

20 AEMC, *Advice on Best Practice Retail Price Regulation Methodology – Final Report*, September 2013

21 Draft Determination, page 26

3.3.4. Prudential capital

The Draft Determination stated that submissions raised no objections to the methodology used for 2013-14, with the exception of QEnergy.[22] However, this is another example of an area where QCOSS raised objections to the methodology in its submission to the Draft Determination for 2013-14, and retains those objections for 2014-15.

In particular:

- While there may be a case for separate itemisation of costs of prudential capital in setting regulated retail prices, the case is far from proven by the QCA. We believe that before these costs are separately itemised, there should be stronger case made as to why this should be so.
- There is no reported analysis of how other regulators treat such costs.
- ACIL Tasman assumes a future risk-weighted mean pool price of $54.37, without any indication of the source of that figure.[23]
- The applicability of the approved WACC for Energex is unclear. The WACC which is used for network determinations by the AER has characteristics that are specific to those determinations, and the historic way in which the underlying assets that are assessed for WACC were valued when the current form of regulation was implemented. It is unclear on what basis a WACC from a network pricing determination relating to network assets should be relevant to a retailer in assessing the costs of prudential capital.

3.4. Energy Losses

A retailer must purchase sufficient energy to supply its customers and allow for the distribution losses that will be incurred, and the transmission losses from the reference node.

We agree that the QCA should apply transmission and distribution losses published by AEMO to all energy cost components.

22 Draft Determination, page 26

23 ACIL Allen, page 53

4. RETAIL COSTS

In setting the R component of notified prices, the QCA makes an allowance for retail costs, which comprise retail operating costs and the retail margin. Retail operating costs are the costs associated with services provided by a retailer to its customers. The retail margin is the reward to investors for a retailer's exposure to systematic risks associated with providing customer retail services.

4.1. RETAIL OPERATING COSTS

Retail operating costs relate to the costs of the services provided by an electricity retailer to its customers and typically include customer administration (including call centres), corporate overheads, billing and revenue collection, IT systems, and regulatory compliance.

In the past, the QCA has also considered retail operating costs to include customer acquisition and retention costs (CARC), which include costs associated with marketing, advertising and sales overheads.

4.1.1. Approach to estimating retail operating costs

There are two generally accepted approaches to estimating retail operating costs:

- A bottom-up approach, which requires detailed information on each cost component; and
- A benchmarking approach, which relies on publicly available information and is therefore less data intensive.

The two approaches can also be used together, with benchmarking used to assess the reasonableness of costs estimated under a bottom-up approach. Regulators in other jurisdictions tend to use a combination of a bottom-up analysis and benchmarking.

We support the use of benchmarking to determining the retail operating cost allowances, subject to the following issues. Besides the arguments set out in the Draft Determination,[24] there is now not sufficient time available for the QCA to consult on a bottom-up approach for the estimation of retail operating costs for 2014-15.

4.1.2. Implementing the benchmarking approach

We support the QCA's Draft Determination that the estimation of retail operating costs should be based on the costs of large retailers that are likely to have achieved economies of scale, consistent with the QCA's representative retailer definition.

4.1.3. Customer Acquisition and Retention Costs (CARC)

We continue to believe that there is no justification for including an allowance for CARC in retail operating costs.

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24 Draft Determination, page 29

Treatment of CARC in other Australian jurisdictions

Customer acquisition costs and retention costs were originally included in retail price determinations in NSW in 2007 when IPART was required to consider a mass market new entrant, and this approach was then copied in other Australian jurisdictions.

Not all jurisdictions accepted this approach.

Victoria

There was never any allowance for customer acquisition costs or retention costs in any of the regulated retail tariffs that were set in Victoria, and competition still thrived. Victoria was still then considered to be the most competitive electricity market with the highest rates of customer churn and transfer anywhere in the world. This shows that an allowance for customer acquisition costs or retention costs is not required in order for competition to develop and thrive.

ACT

In the ACT, ICRC has consistently refused to include an allowance for CARC in its regulated retail prices, and has only allowed instead for “sales and marketing, being primarily the costs of communicating the TFT [Transitional Franchise Tariff] arrangements” as efficient costs.[25]

For example, in a previous determination, ICRC countered arguments that an allowance for CARC needed to be included in regulated tariffs to encourage competitive behaviour, by stating the following:[26]

> *… the Commission considers that a ‘regulated’ franchise tariff, where franchise customers are able to benefit from ActewAGL Retail’s economies of scale and where customer acquisition costs are not included in the franchise tariff, is likely to provide greater benefits to customers than a notional ‘competitive’ tariff that is determined by the Commission.*

We concur with this view of ICRC. CARC has no place in regulatory tariff determinations that have appropriate terms of reference.

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25 *Final determination: Investigation into retail prices for non-contestable electricity customers in the ACT*, ICRC, May 2003, section 4.7, available at http://www.icrc.act.gov.au/__data/assets/pdf_file/0009/16677/finaldeterminationretailpricesmay2003cw.pdf – and quoted in later ICRC determinations ever since

26 *Final Decision: Retail prices for non-contestable electricity customers 2010–12*, Report 7 of 2010, ICRC, June 2010, page 54, available at http://www.icrc.act.gov.au/__data/assets/pdf_file/0018/194310/Report_7_of_2010_11_June_2010.pdf

Proposed treatment of CARC in Queensland

The regulated retail electricity tariffs apply to customers that have not chosen a competitive market offer, and to customers that specifically request to be put on a regulated tariff. There are no customer acquisition costs or retention costs involved in offering regulated retail electricity tariffs, and no allowance should be made for such costs in the regulated tariffs. While some jurisdictions have included these costs in their calculations on setting regulated retail tariffs, this was because their Terms of Reference required them to do so.

> No allowance should be made for customer acquisition and retention costs (CARC) in regulated retail electricity prices in Queensland.

We note that the previous inclusion of CARC by the QCA in Queensland explicitly allows for marketing to support a competitive market. It implicitly recognises that there is effective competition in the electricity market in the Energex area, because an efficient representative retailer would only be expending any funds on customer acquisition and retention if that was the case. Because of the Queensland Government's Uniform Tariff Policy (UTP), it also has the side effect that Ergon Energy customers are paying for the costs of customer acquisition and retention, even where there is no effective competition, and therefore no funds are being expended on those activities.

Our previous submissions have noted that the QCA has in the past characterised its CARC allowance as being "generous".

Any allowance for CARC should be reasonable, not generous.

If there has to be an allowance for CARC in Queensland, it should instead be much lower, given that only a proportion of customers in Queensland are reasonably open to contestability, as against all customers in other states against which the CARC allowance has been benchmarked.

The Draft Determinations states:[27]

> QCOSS and the Queensland Consumers' Association considered that, if a CARC allowance continues to be included, it should be lowered because some retailers have stopped door-to-door marketing. Our allowance is not based on any particular form of marketing and we consider that it is set at a reasonable level. We propose to maintain the 2013-14 CARC allowance in real terms.

We agree that the allowance was set based on retailers using a mix of marketing methods. However, when the CARC allowance benchmark was first set, customers were gained primarily through door-knocking. But since then:

27 Draft Determination, page 31

- EnergyAustralia announced in February 2013 that it would no longer use door-to-door sales to sign up potential customers by the end of March, and called on other energy retailers to follow EnergyAustralia's lead and discontinue unannounced doorknocking.[28]
- AGL withdrew from door-knocking in Queensland and South Australia in October 2012, and announced in February 2013 that it would now cease unsolicited door-to-door sales activity to residential customers across New South Wales and Victoria.[29]
- Origin Energy has been reported to have distributed more than three million "Do Not Knock" stickers so customers would not be disturbed.[30]

Given these initiatives, it would be prudent that any CARC allowance would be lowered to account for less costly channels now being used to recruit new customers.

If the QCA is to make an allowance for CARC, it should be at a much lower level than that allowed in the Final Determination for 2013-14. Any allowance should be reasonable rather than generous, and should take into account less costly channels being used to recruit new customers, as against the previous CARC allowance benchmark which was first set when customers were gained primarily through door-knocking.

4.1.4. Regulatory fees

We agree that it is appropriate to make some adjustments to account for jurisdictional differences where reliable information on the individual cost components exists, but we continue to caution that with substantial adjustment up or down, the benchmark approach will lose its validity, as it will morph into an actual costs approach that is not properly thought through. We do not believe that an additional explicit allowance should be made to cover regulatory fees, unless it is shown that regulatory fees are materially different in Queensland as against in other jurisdictions. If they are materially different, then it is the difference and not the full amount that should be added to or subtracted from the retail operating costs allowance.

4.2. Retail margin

The retail margin represents the reward to investors for committing capital to a business and for accepting risks associated with providing retail electricity services.[31]

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28 *Knock Knock...Who's there? Not EnergyAustralia*, EnergyAustralia, 25 February 2013, available at www.energyaustralia.com.au/about-us/media-centre/current-news/knock-knock

29 AGL withdraws from unsolicited door-to-door sales, AGL, 26 February 2013, available at www.agl.com.au/about/ASXandMedia/Pages/AGLwithdrawsfromunsoliciteddoor-to-doorsales.aspx

30 See for example www.abc.net.au/pm/content/2013/s3699798.htm and www.heraldsun.com.au/news/victoria/electicity-and-gas-supplier-energyaustralia-axes-intrusive-door-knockers-after-customer-complaints/story-e6frf7kx-1226584788982. The stickers are available from https://www.originenergy.com.au/sticker.

31 Draft Determination, page 34

4.2.1. Approach to estimating the retail margin

In previous BRCI decisions and the 2012-13 and 2013-14 Determinations, the QCA set the retail margin on an earnings-before-interest, tax, depreciation and amortisation (EBITDA) basis which meant that an allowance for depreciation and amortisation was implicitly included and the retail margin was calculated as a percentage of total costs.

There are generally two alternative approaches to estimating the retail margin:

- Undertaking an extensive and detailed financial analysis of the appropriate retail margin, such as a bottom-up and/or expected returns approach; or
- Assessing the appropriateness of the current retail margin by benchmarking it against margins adopted in other jurisdictions.

We support the QCA's benchmarking approach. Besides the arguments set out in the Draft Determination,[32] there is now not sufficient time available for the QCA to consult on a bottom-up approach for the estimation of retail operating costs for 2014-15.

4.2.2. Implementing the benchmarking approach

We do not believe that it was appropriate to increase the margin from 5% to 5.4% in 2012-13 or from 5.4% to 5.7% in 2013-14. The justification for the increase in 2012-13 seemed to be that 5.4% was the mid-point of the reasonable range of 4.8% to 6% found by consultants in NSW.[33] That justification was made notwithstanding that the current retail margin of 5% fell within the reasonable range. The QCA itself said that "the current 5% margin in Queensland is not unreasonable" and "the new pricing approach being established in this determination should reduce the risks faced by retailers in Queensland relative to the previous BRCI approach, including better alignment of the cost structure and price structure and the pass through of network costs".[34]

This being the case, the allowed margin in 2012-13 should have been lower, and certainly not higher, than the previous 5% level under the BRCI.

The 2013-14 was again based on a decision in NSW, without apparent consideration of whether the previous margin allowed in Queensland remained reasonable for Queensland.

The QCA stated: "The QCA also notes that, unlike IPART, it has included a specific allowance for head room of 5% which, in combination with the margin, means that the potential gap over total allowed costs available to retailers is close to 11% in total."[35] This is far in excess of any such allowance in other Australian jurisdictions.

32 Draft Determination, page 34

33 Final Determination for 2012-13, pages 74-75

34 Final Determination for 2012-13, pages 74-75

35 Final Determination for 2012-13, page 75

> The gross retail margin of 5% of total costs that was allowed in the Benchmark Retail Cost Index (BRCI) calculations is realistic, and should not be any higher. Instead, it should be lower, because the retailers will be compensated based on efficient costs, rather than the BRCI mechanism that might have borne no relationship to their actual efficient costs and was not cost-reflective. Under the BRCI, retailers therefore faced higher risks than should be the case under the current framework for setting regulated retail prices.

We have noted previously that the QCA has not reflected elsewhere its view that its revised modelling approach using the 95th percentile of hedged outcomes takes into account the majority of risk faced by retailers. The Final Determination should take this into account in the retail margin, where the return expected should now be lower because of the minimised risk.

> In its Final Determination, the QCA should reduce the retail margin commensurate with its view that its revised modelling approach to wholesale energy costs takes into account the majority of risk faced by retailers.

5. COMPETITION AND OTHER ISSUES

5.1. COMPETITION CONSIDERATIONS

In its Final Determinations for 2012-13 and 2013-14, the QCA decided to include an additional allowance for headroom of 5% of cost-reflective prices for all tariffs.

We have many concerns regarding these decisions, which we discuss in this section of our report.

5.1.1. The role of competitive activity to derive longer term benefits for consumers

We understand that the Delegation requires that, in making a price determination for each tariff year, the QCA must have regard to the effect of the price determination on competition in the Queensland retail electricity market.

We accept that there is some longer term benefit to be derived by maintaining an actively competitive market rather than pursuing a short term minimum price approach which may stifle or eliminate competition from the market.

However, we have some concerns with the following paragraph in the Final Determination for 2012-13:[36]

> The longer term benefit derives from the downward pressure on prices that competition naturally brings to the market. By setting regulated prices somewhat higher than full cost, retailers will be attracted to enter the market and, as they compete for market share, non-regulated prices will be driven down. The more active the competition, the closer retailers will reduce prices to their individual, efficient costs of supply. While regulated prices will be unaffected, customers should be able to access lower priced market offers from competing retailers. Consumers should also benefit from improved service quality and choice.

It may be true that “by setting regulated prices somewhat higher than full cost, retailers will be attracted to enter the market and, as they compete for market share, non-regulated prices will be driven down” in the shorter term. But the best way to achieve longer term benefits for consumers is not to attract retailers because there is an artificial extra margin in the supply chain for them to exploit. Rather, retailers should be attracted to a market because they can operate more efficiently and innovatively, and provide better customer service than the incumbents. That is the way to achieve sustainable entry to give longer term benefits.

36 Final Determination for 2012-13, page 82

We are concerned that creating artificial headroom to attract retailers will not encourage efficiency or lower pricing. Rather, there is significant danger that it will attract retailers offering no better service. We do not believe that this contradicts the QCA's comment that regulation is an imperfect substitute for competition.[37] There may be benefit in attracting retailers per se, but it should not require an explicit allowance for headroom to achieve that in an efficient manner.

Following the logic of the QCA, without headroom, competition will be stifled. This means that the QCA thinks that retailers will not compete when regulated prices are set at what the QCA considers to be cost-reflective prices with a reasonable margin. We disagree with that assertion, on the basis that we believe retailers can compete in that scenario, through a combination of offering superior customer service, innovative product development, more efficient and economic purchasing and operations, and perhaps accepting lower margins.

But if the QCA's logic is accepted, then the implication is that headroom will drive down prices no further than the level at which they would have been had no headroom been allowed – because that is the level at which the QCA believes competition is stifled.

5.1.2. The effects of allowing for headroom in regulated electricity prices

The overall effects of adding headroom could thus include:

- No additional longer term benefits in improving customer service or lower prices than would have been achieved without headroom.
- Short term additional costs incurred by all consumers until competition drives prices down to the levels at which they would have been without explicit allowance for headroom.
- Longer term ongoing additional costs for headroom for those customers who through inertia, lack of access to clear comparative information, or other reasons, remain on price-regulated tariffs even though more competitive offers might be available to them.
- Ongoing longer term additional costs for customers in the Ergon Energy area that do not have access to competitive offers. As noted by the QCA, the disparity between the lower market prices available to the majority of customers in SEQ and the higher notified prices customers elsewhere must pay may be inconsistent with and undermining the intent of the UTP. The application of the UTP is being reviewed as progress is made towards deregulation in SEQ. The application of headroom by the QCA further serves to undermine the intent of the UTP.

37 Final Determination for 2012-13, page 83 – based on analysis by the Australian Energy Market Commission

One of the cornerstones of the retention of retail price regulation even after retail competition is introduced is to provide a safety net for those customers who have not yet embraced competition, or are unable or unwilling to do so. Customers who remain on regulated tariffs even after competition is introduced should be assured by the role of the QCA that they are paying a reasonable price based on cost-reflective prices and a reasonable margin. Instead, by advocating for "headroom" of an additional 5% the QCA is essentially proposing to regulate that customers who remain on regulated tariffs pay 5% more than they should be paying.

A further point regarding the regulated tariffs is that the terms and conditions of supply are also set out in regulation, whereas the market offers available to customers may vary those. It may not be possible for customers to obtain competitive offers that have terms and conditions that replicate the standard terms and conditions. Adding headroom will therefore mean that customers who desire to benefit from the standard terms and conditions may only be able to do so at a premium to efficient supply costs, on an ongoing basis. Allowing retailers to charge a premium for standard supply is not justifiable.

5.1.3. No explicit allowance for headroom has been included in any other jurisdiction

As noted by the QCA, "an explicit allowance for headroom has not been included by regulators in setting regulated retail electricity prices in any other jurisdiction to date".[38] For example, IPART has stated in the past:[39]

> A number of stakeholders suggested that the Tribunal should set target tariffs *above* cost-reflective levels for standard retailers, to provide greater encouragement for competitive entry. The Tribunal does not consider this to be appropriate. It considers that charges to customers should be based on the costs of supply *and no more*. It strongly believes that including an allowance in target tariffs for costs that are not incurred by standard retailers is not desirable from an economic efficiency perspective.

5.1.4. The role of the QCA in regard to competition in determining notified prices

The Delegation requires the QCA to base its determination on an N + R cost build-up methodology, where:

- The N (network) cost component is treated as a pass through; and
- The R (energy and retail) cost component is determined by the QCA.

If the QCA makes an additional allowance for headroom, it will have gone outside of the remit of the Delegation by instead basing its determination on an N + R + headroom methodology, where:

38 Draft Determination 2012-13, page 49

39 *NSW Electricity Regulated Retail Tariffs 2004/05 to 2006/07*, Final Report and Determination, IPART Determination No 1, 2004, June 2004, page 8, available at www.ipart.nsw.gov.au/files/d8cd67c3-b819-4497-b5d0-9f4f010fafd8/Det04-1.pdf.

- The N (network) cost component is treated as a pass through;
- The R (energy and retail) cost component is determined by the QCA; and
- An additional allowance is determined by the QCA for headroom – which is not a component that is specified in the Delegation.

In its Final Determination for 2012-13, the QCA countered this argument as follows:[40]

> QCOSS suggested that the QCA was going beyond its Delegation because head room was not explicitly mentioned in the Delegation. However, as noted above, the QCA is required by the Delegation (and the Electricity Act) to have regard to the effect of its determination on competition in the Queensland retail electricity market. Under the Electricity Act, the QCA may also have regard to any other matter it considers relevant.

The equivalent wording in the current Delegation is that the QCA must have regard to the effect of the price determination on competition in the Queensland retail electricity market. We do not dispute that there are several matters to which the QCA may or must have regard. But that does not change the fact that the paragraph 5(c) of the Delegation sets out that the QCA must base its determination on an N + R cost build-up methodology, and not an N + R cost build-up + headroom methodology

In its Draft Determination for 2013-14, the QCA countered this argument as follows:[41]

> QCOSS and Queensland Consumers Association also argued that the QCA has gone outside the remit of the Delegation by including headroom because this means that it has not based its determination on an N+R methodology. However, the QCA considers that the N+R framework is intact, but in setting the R component it is not precluded from including headroom to satisfy the requirements of the Electricity Act and Delegation that it must consider the effect of its determination on competition in the Queensland retail electricity market.

Our response to that is that the Delegation sets out that the R component comprises "energy and retail **cost**". Headroom is not a cost. The Final Determination for 2012-13 was very clear: cost-reflective tariffs and prices were shown in Chapter 5. The final determined tariffs and prices in Chapter 7 of the Final Determination for 2012-13 were not the same as the cost-reflective tariffs and prices in Chapter 5, because the determined tariffs and prices included headroom. The determined tariffs and prices were thus clearly shown not to be cost-reflective.

In the Draft and Final Determinations for 2013-14, the QCA presented its draft and final determined tariffs and prices without the same clarity. Chapter 7 of the Draft and Final Determinations for 2013-14 did not separately set out cost-reflective vs. determined prices.

In the QCA's own words:

- Headroom represents "excess profit" in prices.[42]

40 Final Determination for 2012-13, page 83

41 Draft Determination for 2013-14, pages 50-51

- "We propose to continue to include an allowance for headroom, above our estimate of the efficient costs of supply"[43]

Tariffs that include "excess profits" for retailers and tariffs which are set "above our estimate of the efficient costs of supply" are <u>not</u> cost reflective tariffs. They are tariffs set at levels above the levels at which cost reflectivity would be exhibited.

We note the final report published by the Independent Competition and Regulatory Commission (ICRC) of the ACT on 8 June 2012, which stated:[44]

> It is also important to note that the Commission's remit is the preparation of a price direction for the next two years and that this is a fundamentally different task to the establishment of a competitive market. The decision to remove the regulated tariff is a decision that rests with the ACT Government. The Commission considers it appropriate under the current legislative framework to continue to base the efficient costs on those that would be incurred by an incumbent retailer receiving a reasonable retail margin.

5.1.5. Quantification of headroom allowance

As stated above, the Final Determinations for 2012-13 and 2013-14 included an additional allowance for headroom of 5% of cost-reflective prices for all tariffs.

Our view is that no additional headroom allowance is warranted for 2014-15. It should therefore be obvious that if the QCA nonetheless includes an additional headroom allowance in its Final Determination, it should be set as low as possible, and fully justified.

The QCA should make no additional allowance for headroom in notified prices for 2014-15.

5.2. ACCOUNTING FOR UNFORESEEN OR UNCERTAIN EVENTS

The application of cost pass-through or catch-up should be strictly limited to events that would be wholly outside an efficient representative retailer's control. The circumstances that might trigger a cost pass-through or catch-up mechanism should be capable of adjusting prices up or down; they should definitely not be one-way. The trigger should not be dependent on retailer initiation, which might be actioned only if the mechanism would be likely to put prices up, and not down.

The QCA has decided to retain the approach to cost pass-throughs it established in the 2013-14 Determination and will therefore consider adjusting 2014-15 notified prices to account for differences in small-scale renewable energy scheme (SRES) costs, where the amounts allowed for in the 2013-14 notified prices are found to be ***materially under- or overstated***.

42 Draft Determination, page 38

43 Draft Determination, page 39

44 *Retail prices for franchise electricity customers 2012-14*, Final report, Report 4 of 2012, June 2012, ICRC, page 6, available at www.icrc.act.gov.au/energy/electricity

The QCA maintains its view that it is not necessary to prescribe a fixed materiality threshold, and will consider each event on its merits, in conjunction with other relevant factors.[45]

We believe that it would have been better had the QCA already defined the materiality threshold for applying the catch-up mechanism. It is now unclear on what merits and in conjunction with what other relevant factors each event will be considered. Had the materiality been defined in advance of knowing whether the outturn is under- or over-recovery, it would have provided transparency on the decision on materiality.

45 Draft Determination, page 45

6. TRANSITIONAL ARRANGEMENTS

We support the implementation of transitional arrangements for any changes to tariff structures that will have a significant impact on some consumers' costs. As outlined by the QCA, the proposal to rebalance the fixed and variable components of Tariff 11 to cost-reflective pricing will have an adverse impact on the lowest consuming households. Many low-consuming households are vulnerable consumers who are least likely to be able to adapt to significant price increases. We support a staged approach to minimise the immediate bill shock for consumers.

We support the QCA's interpretation of the Minister's Delegation as requiring the QCA to implement a stepped approach. The covering letter to the Delegation recommends the QCA "... fully utilise the three-year delegation period ..." and that this approach is suggested so the QCA can "... take into account the impacts of price increases on struggling Queensland households and businesses" and "ensure that Queensland households experience a smooth transition from the freeze".

A transition period is essential in order to assess the impact of the changes on different customer groups and for this information to influence improvements to government policy. In particular, the shift to greater cost reflectively will necessitate changes to government concessions to ensure they are adequate and well-targeted alongside the new tariff structure. Further, the transitional timeframe provides an opportunity for consumer education to be rolled out over time to assist consumers understand and adjust to the new pricing structures.

Consumer education will be critical in ensuring a smooth transition to new pricing arrangements over time and reducing bill shock for consumers. A sustained campaign of consumer education over time is likely to be more successful than quickly rolling out consumer education ahead of significant change prior to 1 July 2014. Consumers should be given time to adjust and understand the implications of the reforms.

We prefer a smooth transition to cost reflective pricing in order to minimise bill shock for consumers who may be adversely affected. The effect on consumers should be a key consideration when determining the form of transitioning.

The QCA does not control the underlying network charges that are taken as costs that are to be reflected in "cost-reflective" tariffs. Non-smooth changes in network costs outside the QCA's control could materially undermine the QCA's best efforts to put in place smooth transition of retail tariffs.

The level of the Energex fixed network charge to retailers for residential customers on Tariff 11 has a material impact on the mismatch for low usage customers between the current charges in Tariff 11 and the cost-reflective levels. It will therefore be necessary for the QCA to have close regard to changes in the structure and level of the underlying network charges in designing the particular form of transitioning of retail tariffs that the QCA implements.

The Minister's covering letter to the September 2012 Delegation states that "it is important that the QCA take into account the impacts of price increases on struggling Queensland households and businesses". To meet this expectation, the QCA should undertake substantial analysis to provide an assessment to identify the expected impacts of tariff arrangements on a range of consumer groups with varying consumption patterns, including pensioners, large working families, low-income tenants and other vulnerable households. This analysis should take into the account the existing electricity concessions available in Queensland.

To date, the QCA's analysis of different customer types seems to amount to typifying various consumption levels,[46] without regard to the customers' concessions entitlements. Concessions are separately listed in the Draft Determination,[47] but are not linked to bill impacts. This is no substitute for actual socio-economic, demographic (and firmographic) analysis which takes account of those customers' concessions entitlements.

For example, the QCA has typified a "frugal single elderly person" as using 2200 kWh per annum, and shows this person's bill impacts without regard to their concessions. What is required is analysis of the range of bills of single elderly persons and their distribution. This analysis needs to take into account the impacts that concession entitlements have on the percentage changes and the actual dollar amounts by which bills will change when tariffs become more cost-reflective. This might result in findings that are quite different from the QCA's finding that a "typical increase" for such a customer based on the Draft Determination would be 19% or $164 per annum (including carbon).

While we appreciate that the QCA has no jurisdiction over government policy, the QCA must consider the impact of regulated retail tariffs as a whole to undertake effective assessment of the impact of price changes on consumers. Using information from other jurisdictions to inform calculations without considering the different concession arrangements provides a skewed snapshot of what is really going on in households struggling with energy affordability in Queensland. It is our strong view that significant changes to tariff arrangements will necessitate changes to the existing energy concessions and support arrangements, to ensure they are well-targeted and equitable for Queensland consumers.

The QCA's analysis of the impact of price increases on consumers will be an important input to the Queensland Government's own policy assessment and implementation. It will provide the Queensland Government with information to enable it to model the extent to which concessions are providing adequate and equitable outcomes across customer segments, and to make appropriate adjustments to the concessions framework, alongside the changes to the tariffs that are delegated to the QCA.

46 Draft Determination, Tables 19 and 20, page 66-67

47 Draft Determination, Appendix C, page 77

7. DRAFT DETERMINATION

Chapter 7 sets out the QCA's Draft Determination of regulated retail electricity prices (notified prices) to apply from 1 July 2014 to 30 June 2015, as well as expected customer impacts.

We are concerned at the magnitude of the residential customer impacts set out in section 7.2 of the Draft Determination. We again draw attention to The Minister's covering letter to the September 2012 Delegation which states that "it is important that the QCA take into account the impacts of price increases on struggling Queensland households and businesses".

We also wish to point out a minor typographical error in Note 2 of the Draft Tariff Schedule for gazettal later this year. This Note states that the Tariff Schedule replaces the previous version that was published in the Queensland Government Gazette on 29 June 2012.[48] The previous version would however have been published in 2013.

48 Draft Determination, page 98