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Regulated Retail Electricity Prices 2014-15 – Interim Consultation Paper

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Queensland Competition Authority's (the Authority) Regulated Retail Electricity Prices (2014-15) Interim Consultation Paper.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 36 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ more than 51,000 people and contribute $16.5 billion directly to the nation's Gross Domestic Product.

The Authority has been tasked with determining regulated electricity prices on an annual basis over the period to 30 June 2016. As noted by the Authority, a key objective of regulated prices is to facilitate the development of competition in the Queensland retail electricity market and to provide a transition to price deregulation. Given the Queensland Government has identified 1 July 2015 as a target date for deregulation in south east Queensland (SEQ) subject to certain conditions being met, it is critical the 2014-15 determination delivers against this key objective.[1]

The Association has consistently advocated for deregulation of the retail energy market to drive the best outcome for consumers. Open, competitive energy markets free from distortions such as retail price regulation naturally encourage prices to be efficient through the development of market offers. Competition in retail electricity markets, as in other sectors of the Australian economy, incentivise businesses to improve service, develop products that meet consumer needs and find ways to lower their costs and to pass these savings onto consumers. This ensures that retail prices are set as low as is sustainably possible while businesses can still make an appropriate return.

Where retail prices continue to be regulated in the lead up to 1 July 2015, an overriding focus on competition is paramount. To this end, the esaa has provided comment on three key issues that should be considered in the context of facilitating a competitive and market driven retail electricity sector in Queensland: delivering cost-

[1] Queensland Government, *Response to the Interdepartmental Committee on Electricity Sector Reform*, June 2013; p. 9; and Minister for Energy and Water Supply, The Honourable Mark McArdle, *Media Release: End of electricity price regulation to improve competition*, 17 June 2013.

reflective retail tariffs; providing for cost pass-through events; estimating wholesale energy costs.

Retail tariffs should be set at cost-reflective levels

To ensure that consumers face efficient price signals, it is critical that Tariff 11 (the main residential tariff) is transitioned to cost-reflective levels as soon as possible, preferably by 1 July 2014. Holding Tariff 11 (or any tariff) below cost is a blunt and very expensive measure that benefits all energy consumers receiving the discounted rate. Further, while Tariff 11 is not cost-reflective, consumers will have no incentive to consider switching to a cost-reflective time-of-use tariff, which is a more efficient tariff for shaping energy consumption patterns.

To the extent that Tariff 11 is not made cost-reflective by 1 July 2014, the Association considers the second step in the transition to cost-reflectivity should do most of the heavy lifting. This would leave only a small portion of catch-up to be achieved during 2015-16 and coincide with the removal of retail price regulation in SEQ. In implementing any such arrangements, it is important the retail sector is not forced to absorb the costs of the policy decision. Equally, distribution network businesses should not be required to bear the costs of the scheme and should be compensated for any reduction in fixed network charges.

The esaa does not support the Authority's proposed transitional arrangements for existing obsolete tariffs which provide for extended transitional periods. Allowing customers to switch back and remain on obsolete tariffs for extended periods of time is counter intuitive to the reasons as to why those tariffs were initially made obsolete – usually because of the cost inefficiencies of these tariffs. This, like the 2012-13 Tariff 11 price freeze: distorts the economics of the market; introduces potential financial risk for retailers operating in the market; and when assessing which markets to compete in, makes Queensland a more risky state to operate in than other states.

To the extent that cost-reflective prices are considered beyond the capacity of certain customers to pay, the Association considers that such customers should be supported by purposely designed, budget funded measures. These measures need to be appropriately targeted. The state's electricity rebate in its current form fails to adequately protect vulnerable customers, instead smearing payments across a broader group of customers regardless of the need for assistance.

Where assistance (unrelated to welfare needs) is considered appropriate for regional and rural customers, one option to consider is to administer concessions through Ergon Energy's distribution business. As noted by the Authority, competition in regional Queensland could be significantly improved if the community service obligation payment was made at the network level rather than the retail level. Given the Queensland Government is currently considering this issue, the esaa considers the Authority has a role to play in conveying the interrelationship of these factors.

Materiality threshold for cost pass-through

The Association is supportive of implementing a cost pass-through mechanism that allows for the recovery of costs incurred in previous regulatory periods, including differences in small-scale renewable energy scheme (SRES) costs and network charges. Requiring retail businesses to absorb costs that cannot be passed on creates financial pressure and adversely impacts the level of competition within the sector. Providing an opportunity for retailers to recover the efficient costs of uncontrollable events is therefore a prudent approach.

With regard to assessing the materiality of any cost pass-through event, the Association agrees with the Authority's position that no specific materiality threshold should be set. Materiality thresholds are highly subjective, particularly in isolation of other elements to which retailers are exposed. Given any change in costs will influence the ability of retailers to offer discounts below the regulated price to some degree, it is appropriate that applications for cost pass-through are assessed on their own merits.

Estimating wholesale energy costs

The esaa acknowledges the difficulties associated with trying to estimate the wholesale energy cost (WEC) component of regulated tariffs. While the Authority's preference for applying a hedging-based approach is noted, the Association maintains the most appropriate approach is one that ensures the WEC component is not less that the long run marginal cost (LRMC) of electricity generation.

As discussed above, regulating prices in potentially competitive markets whereby regulated tariffs may be set below the cost of supply impedes the efficient operation of the market. It creates financial pressure for industry participants forced to absorb costs that cannot be passed on and removes incentives for energy companies to enter the market and compete for small-use customers. Conversely, in the event that prices are set above the cost of supply – including an appropriate retail margin – competition will erode margins back to efficient levels. The risks are thus asymmetric, with greater adverse consequences arising from setting the regulated price too low.

These risks are most effectively addressed by implementing a methodology that takes account of different approaches to procuring wholesale electricity, including recognition of the LRMC of electricity generation. The LRMC floor approach appropriately reflects the asymmetry of setting regulated prices high or low and is consistent with the esaa's view that notified prices should be set at a level that encourages vigorous competition. Such methodologies have been successfully used in New South Wales and South Australia, the latter state recently transitioning to deregulated prices with competition having thrived under a more appropriate regulated price methodology free from regulatory distortion.

In contrast, an approach based purely on prevailing market data will result in greater price volatility flowing from spot and contract markets into the retail price path and ultimately, non-cost-reflective prices. There is a high degree of uncertainty associated with estimating WECs, particularly given the potential for significant changes to carbon pricing policy following the September 2013 Federal election. Retailers use a wide range of options to manage these risks, including purchasing different types of hedging products, long-term power purchase agreements and investing in generation themselves. As such, an assessment of market based costs alone may not necessarily be reflective of the actual costs faced by the retail businesses, potentially exposing them to cost they cannot pass-on.

The Association supports the development of a fully competitive and financially viable retail sector. The 2014-15 price setting process should be regarded as a key gateway toward deregulation of the retail energy market and achievement of these outcomes.

Any questions about our submission should be addressed to Shaun Cole, by email to shaun.cole@esaa.com.au or by telephone on (03) 9205 3106.

Yours sincerely

[redacted]

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