Submission to QCA

Interim Consultation Paper
Regulated Retail Electricity Prices 2016-17

20 January 2016

ERGON ENERGY

RETAIL

BACKGROUND

Ergon Energy Queensland Pty Ltd (EEQ) welcomes the opportunity to provide comment on the Queensland Competition Authority's (QCA's) Interim Consultation Paper on Regulated Retail Electricity Prices for 2016-17.

EEQ is a regional Queensland company that provides electricity to more than 700,000 homes and businesses and helps regional Queenslanders manage their energy consumption. It has a team of people servicing regional Queensland customers from contact centres and offices located in Townsville, Rockhampton, Maryborough and Brisbane. It also supports communities by providing regional jobs and engaging in community partnerships with organisations such as the Royal Flying Doctor Service.

EEQ acknowledges the increasing pressure electricity prices are placing on its customers' household budgets and businesses and support activity to create a cost-competitive market.

Customer hardship has become a significant issue for Ergon Retail's customers. Relevant reporting to the QCA between December 2013 and June 2015 shows the number of customers in our hardship program has more than doubled.

Ergon Retail has had a dedicated team assisting customers in hardship since 2006. This team's activity has increased with the demand for the program. Our focus is to assist customers to move out of hardship and into a position where their cost of electricity is sustainable and does not put pressure on family budgets.

This has required significant effort and resources to understand how our customers can better use their electricity and manage their financial circumstances. Funding costs have also increased to cover the extra time customers are now taking to pay their bills.

Beyond direct assistance provided to customers, Ergon Retail has partnered with community organisations to provide greater access to our programs. This effort and engagement has had positive results with the number of customers in our hardship program beginning to decline. However, affordability remains a key issue for both our customers and our business resulting in increasing operating costs, bad debt expenses and funding costs.

Ergon Retail will continue to assist customers in need. We have invested heavily in our people and customer service infrastructure to improve these vital programs and educate customers to better manage their electricity supply.

Ergon Retail also acknowledges the challenges that exist around the Uniform Tariff Policy (UTP) with the removal of regulated prices in South East Queensland on 1 July 2016 and looks forward to the draft recommendations of the Queensland Productivity Commission in late January 2016.

EEQ also believes the requirements of the Delegation assist in ensuring that it remains on the pathway to achieve a competitive electricity market in regional Queensland at a future point. EEQ also continues to advocate for a consistent approach to pricing so that it continues to transition along this path. EEQ supports the QCA using a consistent methodology for pricing for 2016-17 as used in 2015-16, with some exceptions where it believes the current methodology has had unintended consequences. EEQ also supports tariff options that enable customers to respond to price signals and empower them to take control of their energy costs either by load shifting or reducing total consumption. EEQ supports enabling its customers to have, where possible, choice in selecting a regulated tariff that best suits their business or home lifestyle and allows them to best manage their energy costs.

In the remainder of this submission, EEQ has provided direct responses to questions posed by the QCA in its Interim Consultation Paper.

EEQ welcomes the opportunity to discuss any aspects of this submission or to provide further information directly to the QCA.

Section 2 - Legislative Requirements and Pricing Framework

Consultation Questions – Pricing Framework

- For residential and small business customers, should we maintain the 2015–16 approach, which is to keep notified prices at south east Queensland levels, but use Ergon Distribution's tariff structures for time-of-use and demand tariffs? Why?

- For large business customers, should we maintain the 2015–16 approach, which is to base notified prices on regional Queensland costs? Why?

Response

EEQ supports notified prices for residential and small business customers in regional Queensland continuing to be based on a reasonable expectation of south east Queensland price levels while using Ergon Distribution's tariff structures for time-of-use and demand tariffs.

EEQ agrees that such an approach is consistent with the UTP and the delegation.

For large customers, EEQ supports the continued use of regional Queensland costs as the basis of notified prices for these customers. This ensures consistency in the approach that has been in place since 2012 and provides certainty to customers and market participants. EEQ addresses the specific cost components of tariffs further in the sections below.

Section 3 – Network Costs

Consultation Questions – Network Costs

- Should we use Energex's tariff structures as the basis for retail tariffs for residential and small business customers?

Strategic framework/ risk framework.

- Alternatively, should we use Ergon Distribution's tariff structures for some or all retail tariffs for residential and small business customers? If so, how should Ergon Distribution tariffs be adjusted to reflect the uniform tariff policy?

- Should we use Ergon Distribution's tariff structures as the basis for retail tariffs for large business, and street lighting, customers?

- Are there any other issues we should consider?

Response

EEQ supports the use of Energex's network tariff costs and structures for the residential and small business tariffs, with the exception of Tariffs 12A, 14, 22A and 24, as per the delegation.

EEQ continues to support the use of Ergon Distribution's network tariff structures for the Time of Use Energy (Tariffs 12A & 22A) and Demand (Tariffs 14 & 24) retail tariffs.
EEQ also agrees that it is appropriate for Ergon Distribution's tariff structures to remain as the basis of retail tariffs for large business and street lighting customers, and that the rates are based on Ergon Distribution's East Transmission Zone 1 prices.

EEQ also supports the on-going alignment of the network tariff terms and conditions with the retail tariff terms and conditions. Specifically, EEQ supports the QCA's decision that customers can only change retail tariffs once every twelve months for the reasons outlined in the 2015-16 Final Determination.

Section 4 – Energy Costs

Consultation Questions – Energy Costs

- Is there any new information available to suggest alternative approaches to those used in the 2015-16 determination might be more appropriate?
- What improvements could be made to the current approaches?
- Should prudential costs be removed from retail operating costs and accounted for as part of energy costs?
- Are there any other issues we should consider when estimating energy costs?

Response

EEQ continues to support the QCA's approach to determining wholesale energy costs, in particular, continuation of the hedging-based approach applied in a consistent methodology.

EEQ supports a market based approach for determining LRET Costs. However, the ACIL Allen methodology does not adequately consider the policy uncertainty that has clearly been present since the RET Review commenced in 2014 and the subsequent impact on prices.

For an electricity retailer the risk that the scheme might be abolished altogether meant that there were real risks in buying certificates for more than the 2014 surrender requirements.

Many retailers would have delayed buying certificates for 2015 and 2016 requirements until there was more certainty over the future of the scheme. In particular, the period of very low LRET prices from February 2014 to February 2015 during the RET review period should be considered a period of market disruption and not given equal weight to other more stable market periods.

EEQ suggests that LRET prices during this period of market disruption not be used for determining the LRET costs for an electricity retailer for 2016-17.

Current market prices are now well above the LRET costs suggested in the draft determination and are more representative of the LRET costs of an electricity retailer for these years.

Section 5 - Retail Costs

Consultation Questions - How to define a 'representative' retailer

- Is the QCA's current definition of a representative retailer appropriate?
- Are there any alternative definitions the QCA should consider?

Response

EEQ's view is that that the QCA's definition of a representative retailer adequately represents the characteristics of an entity in the context of the historical market and regulatory environment. However, EEQ's view is that the definition should be expanded to include emerging trends in these areas.

The continued penetration of solar and the commercial potential of other distributed technologies (namely small storage systems) are giving rise to new business costs and risks. This is demonstrated by the development of discrete business units by major incumbent retailers that focus solely on the development and sale of these products.

EEQ suggests that it is appropriate to incorporate some specific recognition of emerging technologies within the representative retailer definition as they have the potential to significantly impact a retailer's risk profile and expenditure characteristics and hence efficient returns and customer margins.

Continuing market reform within Queensland is likely to change the practical application of notified tariff prices. The Government's intention to deregulate prices for small customers in south east Queensland from 1 July 2016 means that only regional Queensland customers will be eligible for notified prices.

It is appropriate for the representative retailer definition to recognise some of the unique characteristics of the regional Queensland operating environment. These characteristics include:

- the imperative to service remote and isolated customers
- affordability issues faced by regional and remote customers
- policy mechanisms such as the delivery of drought relief programs and the CSO

Additionally, there are a number of National Electricity Market (NEM) wide reforms that require increased consideration by all retailers.

Consultation Questions - Estimating retail operating costs

- Are ACIL Allen's proposed methods appropriate for estimating efficient ROC allowances?
- Are there any alternative estimation methods the QCA and ACIL Allen should consider?
- What costs should be considered as part of the ROC allowance? What costs should be excluded and why?

Response

EEQ agrees with the AEMC's best practice methodology for estimating efficient ROC costs.

It is noted that in the past, the AEMC has recommended to use both benchmarking and a bottom-up assessment to estimate an efficient ROC.[1] Relying solely on a bottom-up approach may not facilitate the estimation of efficient representative retailer ROC. Additionally, the transition to the recently implemented NECF may distort the outcomes of a bottom-up approach.

EEQ supports the continuation of the benchmarking approach employed in 2015/16. As ACIL Allen has clearly stated the intention to use both a benchmarking and bottom-up approach, EEQ requests the QCA give consideration to the continuing evolution of the regulatory and market environment. This should include recognition of the characteristics of the retail electricity supply to regional Queensland when setting prices for 2016-17 and subsequent periods.

EEQ does not consider any alternative methods to estimating ROC need to be considered.

Ergon Retail notes the QCA's 2015-16 determination defined ROC as costs associated with,

- Customer administration
- Call centres
- Corporate overheads
- Billing and revenue collection
- IT systems
- Regulatory compliance
- Customer acquisition and retention costs (CARC)

EEQ recommends these costs as a minimum should continue to be included in the ROC allowance.

Regional Queensland customers have high rates of hardship and bad debts driven by affordability issues.

Managing customer hardship and bad debt has a direct impact on Ergon Retail's operating costs. As an example of this the average handling time for a customer call related to hardship is significantly longer than a standard customer call. Extending and improving our customer hardship program has required greater human resources and community engagement expenditure to ensure greater access to the program and higher rates of graduation.

[1] ACIL Allen, *Regulated Retail Prices for 2016-17: Estimating efficient retail operating costs and margin,* December 2015, p 3

Customers are also taking longer to pay their bills resulting in increased working capital funding costs to cover the higher debtor balances.

EEQ requests the QCA take into consideration the high levels of customer hardship in regional Queensland, and the importance of providing support to vulnerable customers when setting the ROC allowance based on a representative retailer.

EEQ acknowledges that the QCA's comments that competition in regional Queensland areas is limited[2]. However, the emergence of non-grid alternatives is changing the nature of ROC (including CARC) by compelling prudent retailers to respond to the changing market dynamics through the development of improved capabilities, and investigation of expanded service offerings.

EEQ strongly supports the maintenance of an allowance for CARC in ROC.

Consultation Questions - Estimating ROC allowances for large businesses customers

- Are large and very large customers more costly to serve than small customers? If so, why?
- Should the QCA continue to apply a different ROC allowance for large and very large customers?
- Is ACIL Allen's approach to estimating large customer ROC allowances appropriate? Are there any other estimation methods that should be considered?

Response

The requirements of large and very large customers often results in more tailored product offerings and bespoke servicing. This impacts operational activities across multiple functions within a business including,

- Customer administration (call centre specialists and dedicated customer service representatives)
- Trading
- Billing and revenue collection
- CARC

EEQ supports the approach the QCA employed in its 2015-16 determination of applying discrete ROC allowances for large and very large customers.

EEQ's view is that the benchmarking method used to estimate ROC allowances for large and very large customers as an appropriate approach for the 2015-16 determination.

As stated above EEQ is concerned that relying too heavily on a bottom-up methodology for estimating ROC may distort the estimation of efficient costs. This is true for ROC allowances for both small and large customers.

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[2] QCA, *Interim consultation paper: Regulated retail electricity prices for 2016-17,* December 2015, p 13

Consultation Questions - Applying the ROC to retail tariffs

- Is the QCA's approach to applying ROC to retail tariffs appropriate? Are there any other approaches we should consider?
- Should the ROC allowance apply to the fixed or variable component of retail tariffs or some combination of the two?

Response

EEQ supports the principle of cost reflectivity, in the application of ROC, to fixed and variable charges. In EEQ's view, a majority of the costs included in the QCA's definition of ROC represent fixed charges. Applying the ROC to the fixed component of notified prices is likely to be the most appropriate approach. However, consideration should be given to the impact of fixed charges on customers with low usage, in particular, those who are vulnerable or experiencing financial hardship.

Consultation Questions - Updating the ROC from year to year

- How should the QCA update the efficient ROC allowance from year to year?
- How often should the QCA conduct a comprehensive review/re-estimation of the ROC allowance?

Response

EEQ agrees with the QCA's observation that conducting annual bottom-up reviews of ROC are unlikely to result in a net benefit. A thorough bottom-up approach will provide a solid basis for estimating ROC however, as stated above, EEQ has some reservations about the ability of retailers to provide the data requested by ACIL Allen in conducting its review.

EEQ suggests the results of the bottom-up analysis for the 2016-17 determination should be used to corroborate the benchmarked ROC estimate, rather than providing a basis for benchmarking ROC in future determinations. This will enable the QCA to determine the usefulness of the bottom-up approach for conducting comprehensive ROC reviews in future years.

The QCA reference an argument that retailers should become more efficient over time and the potential for an 'X'-factor to be incorporated into an annual escalation factor[3]. EEQ agrees that a prudent operator will become more efficient over time but only to the extent that their operating environment remains reasonably stable.

Emerging trends in non-traditional products combined with a developing regulatory environment is resulting in fundamental changes to retail operating models.

EEQ's view is that these influences will persist at least in the medium term. This will make it extremely difficult to realise productivity gains that may otherwise be achievable in stable market environments.

EEQ suggests the QCA conduct a comprehensive review of the ROC allowance at intervals of three years or where there are material and definitive changes to retailer costs, regulatory

[3] QCA, *Interim consultation paper: Regulated retail electricity prices for 2016-17,* December 2015, p 17

frameworks or market characteristics.

It is noted IPART undertook a comprehensive review every three years as part of price setting for regulated retail tariffs in NSW[4].

In the absence of these changes, or during times of some transition and uncertainty, supporting a benchmarking approach with some reported retailer data is likely to provide a robust result.

Consultation Questions - How to estimate the retail margin

- Is ACIL Allen's proposed approach to estimating retail margins appropriate?
- Are there any other methods to consider for estimating retail margins?
- What risks should be compensated for through the margin, and what risks should not?

Response

ACIL Allen proposes to use a combination of bottom-up and benchmarking methods in estimating margins[5].

EEQ generally supports ACIL Allen's approach to estimating retail margin. EEQ does however acknowledge, and agree with the concerns raised by other market participants, that a bottom-up approach may have some practical barriers to being an effective method of estimating ROC and margin.

EEQ's view is that changes in the regulatory and market environment may inhibit the application of a benchmarking approach.

If ACIL Allen intends to use the margins of retail businesses from other utility sectors - consistent with the approach undertaken to estimate retail margins in NSW[6] - this may not adequately reflect risks associated with disruptive emerging technologies and new regulatory constraints.

EEQ does not believe any alternative methods to estimating retail margin need to be considered.

The QCA notes that "the retail margin represents the reward to investors for committing capital to a business and for accepting risks associated with providing retail electricity services"[7].

As recognised above, emerging technologies are having a significant structural impact on the operating models of electricity retailers and existing regulatory mechanisms. This is changing the risk profile of retailers.

EEQ supports an approach to estimating retail margin that reflects the systematic risks faced by an entity.

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[4] IPART, *Review of regulated retail prices and charges for electricity 2013 to 2016,* 2012, p 60
[5] ACIL Allen, *Regulated Retail Prices for 2016-17: Estimating efficient retail operating costs and margin,* December 2015, p 5
[6] SFG Consulting, *Method for estimating retail electricity margins: Draft,* 31 October 2012
[7] QCA, *Interim consultation paper: Regulated retail electricity prices for 2016-17,* December 2015, p 18

EEQ understands that the retail margin to date has been determined on an EBITDA (Earnings before Interest, Tax, Depreciation and Amortisation) basis rather than an EBIT Earnings before Interest and Tax) basis.

While there is no impact on the final retail tariff price, EEQ's view is that an EBIT basis is a more appropriate method for setting the retail margin moving forward, with the Depreciation and Amortisation costs instead being captured in the ROC definition, for the following reasons:

- Many retailers are reducing the number of acquired assets and instead using service arrangement for their systems and required assets (e.g. IT systems, buildings, etc). The reclassification of depreciation and amortisation expenses from retail margin to ROC will assist with future benchmarking process

- Retail margin is not a concept well-understood by consumers and can be easily misinterpreted as simply a profit margin. Changing to an EBIT basis removes the depreciation and amortisation business expenses from the retail margin and lowers the required percentage increase of total costs (which would now include depreciation and amortisation costs)

- The IPART consultant for retail margin, SFG Consulting, has historically reported and calculated EBITDA and EBIT margins in all their prior reports. As such, the change should be relative simple for the QCA and ACIL Allen to accommodate

Consultation Questions - Applying retail margin to retail tariffs

- Is the way we have previously applied the margin to retail tariffs still appropriate?
- Are there any other approaches the QCA should consider?

Response

The QCA has previously applied the retail margin as a percentage of total costs - applying the margin equally to the fixed, variable and demand components of tariffs.

EEQ's view is that the way the retail margin has been applied previously is appropriate. Alternative approaches to apply retail margin do not need to be considered at this time.

Section 6 Other Issues

Consultation Questions - Competition and Headroom

- Should headroom continue to be included in notified prices for residential and small business customers? Why?
- Should headroom continue to be included in notified prices for large business customers? If so, at what level? If not, why not?
- What other issues should we consider in relation to competition and headroom?

Response

EEQ acknowledges that in making its determination, the QCA is required under the *Queensland Electricity Act 1994* to consider competition and National Competition Policy requirements.

EEQ notes that the cover letter to the delegation states:

> *"The removal of price regulation for small customers in SEQ removes a reference point for the determination of prices in regional Queensland. In order to maintain consistency with the regulation of prices in previous years, the Government considers that regulated prices in regional Queensland for small customers should broadly reflect the expected prices for customers on standing offers in SEQ."*

Should the QCA seek to adjust the overall notified tariff prices determined using the N+R methodology as a result of the standing offer comparisons in SEQ, EEQ's view is that any adjustments should be solely made to the headroom component rather than recalibrating each component used in the N+R methodology.

Consultation Questions - Pass-through arrangements for 2016-17

- Should we allow for any pass-through of SRES under- or over-recoveries incurred during 2015–16 into 2016–17 notified prices?

Response

EEQ continues to support maintaining the current arrangement for pass through of SRES.

Consultation Questions - Possible removal of Tariff 41

- Should tariff 41 be removed from the tariff schedule?

Response

EEQ recognises the challenges in maintaining Tariff 41 in the tariff schedule in 2016-17 and would support the QCA in engaging Ergon Distribution and ENERGEX in exploring potential solutions to the underlying issues. Notwithstanding these challenges, the QCA should give consideration to the potential customer impacts from the removal of this tariff, particularly in the absence of a transition period. EEQ is happy to assist the QCA in understanding these impacts.

At a minimum EEQ would suggest that:

- A transitional period of 1 year be established for Tariff 41 with it being phased out no later than 30 June 2017
- No new customers be allowed to access this tariff

The above arrangements align with the current conditions around Tariff 22, which was retained this year and remains in place until 30 June 2017, because of the customer impact and the potential metering work required to transition these customers to other tariffs. This would also allow EEQ to engage current Tariff 41 customers as part of a wider customer engagement program around Tariff 22 in 2016-17.

Consultation Questions – Transitional arrangements

- Is there any new information that suggests the overall approach we propose to take for transitional and obsolete tariffs is no longer appropriate?
- What other issues should we should consider (please provide supporting evidence where possible)?

Response

EEQ supports the current arrangements in place for transitional and obsolescent tariffs. We believe that maintaining the previously established timeframe for removal of these tariffs (as well as the price escalation approach) provides customers, retailers and the market certainty in making investment decisions and considering their options against the tariffs they may move to no later than 2020.