7 January 2013

Dr David Watson
Chairperson
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Brisbane QLD 4001
Email: electricity@qca.org.au

Dear Dr Watson,

Regulated Retail Electricity Prices 2013-14 - Transitional Issues and Cost Components

Stanwell Corporation Limited (Stanwell) welcomes the opportunity to provide comment on two elements of the Regulated Retail Electricity Prices 2013-14 consultation process being undertaken by the Queensland Competition Authority (the Authority) – The Cost Components and Other Issues Consultation Paper (the Cost Components Paper) and the Transitional Issues Consultation Paper (the Transitional Paper).

We note that ACIL Tasman has been engaged by the Authority to provide advice on the calculation of energy costs and has produced a Draft Preliminary Report, Estimated Energy Costs for Use in 2013-14 Electricity Retail Tariffs (Preliminary Report). With regards to the consultation process, Stanwell has two areas of key interest – the determination of the headroom and development of the energy costs.

1. RETAIL COMPETITION AND DETERMINATION OF THE HEADROOM

We note in its 2012-13 Determination, the Authority decided to include an allowance for headroom above efficient costs of supply in order to sustain an actively competitive market. This was estimated at around 6 percent for Tariff 11 and the Authority decided to include an explicit allowance for headroom of 5 percent of cost reflective prices.

Stanwell is seriously concerned that the level of competition expected to be driven by this headroom has not materialised. We agree with the comments outlined by some retailers, in the Cost Components Paper, that competition in Queensland has stalled or is in decline since the release of the 2012-13 Determination. The Queensland market is dominated by the two incumbent retailers. While some new retailers have entered the market recently, there is no evidence to suggest that competition will be sustained longer-term (based on past history). We fully expect that any allowance for retailer headroom will result in a wealth transfer to existing retailers, without delivering significant long-term benefits to customers. Overall, Stanwell considers the headroom should be reduced downwards and greater focus provided to improving the level of customer engagement in the market.

We also have concerns regarding the level of the retail margin provided and the extent to which it reflects underlying cost structures and capital investments. We note the Authority, in the 2012-13 Determination, used a benchmarking approach to determine year on year changes, which was largely based on the Independent Pricing and Regulatory Tribunal (IPART) 2010 decision. While this is helpful, it is still important to understand the underlying link to changes in investment costs and the overall level of risk in the market. From the level of information provided it is difficult to form a view on whether the margin is set appropriately or potentially too high. For comparison, we suggest the Authority carries out some form of complementary "bottom-up" analysis, which is made available in the next phase of the consultation process.

2. ENERGY COST COMPONENTS

Stanwell notes the Authority has a clear preference for using a market-based approach. The Authority adopted this approach in the 2012-13 Determination and there are no notable reasons to depart from this approach for the coming year. Stanwell strongly supports the continued use of the market-based approach, recognising it has clear advantages over the main alternative - Long Run Marginal Cost (LRMC) methodology.

Options that draw on historical generation costs and or prices linked to Power Purchase Agreements (PPA) or tolling arrangements are not necessarily reflective of the costs that would be expected to be incurred in supplying customer electricity services in any particular year. Further, we agree with the Authority that another drawback of the LRMC methodology is that it does not draw on publically accessible market data, which is inconsistent with transparent price setting. Stanwell considers that the market-based option ensures tariffs are reflective of market determined wholesale energy prices that relate specifically to the 2013-14 period.

Notwithstanding our strong support for the Authority's preference to adopt a market-based approach, we have a number of specific comments regarding the calculation of energy costs. Each of these issues is addressed below.

Pool price modelling – bid analysis

The ACIL Tasman Preliminary Report outlines the steps associated with the market-based approach methodology including detail on estimating hourly pool prices. With respect to plant operation, bid strategies appear to be based on fuel price and other plant costs. We consider that pool price modelling should reflect actual bidding behaviour rather than based on underlying costs. This is particularly relevant to the plant controlled by vertically integrated (VI) entities. This plant is typically bid in such a manner to manage overall portfolio positions including load requirements, which does not necessarily relate to the fuel cost of the station.

Stanwell readily observes that gas and distillate peaking plant, controlled by VI retailers, is dispatched below its short-run marginal cost to manage price volatility. This bidding behaviour is likely to lower pool price outcomes, which should flow through to overall energy costs. We strongly recommend that ACIL Tasman review

its bid development process ensure the modelling outcomes for VI plant reflects actual market behaviour.

Use of 95th percentile for determining hedged prices

The ACIL Tasman Preliminary Report acknowledges that there is a degree of uncertainty in the market-based approach and there may be some small risk that the actual market costs are higher than its estimate, which could result in additional retailer price and volume risk. ACIL Tasman suggests this is due to "other uncertainties" not accounted for in the process. On this basis, ACIL Tasman proposes to use the 95th percentile of hedged prices for the energy cost estimate rather than the median used in the 2012-13 analysis. The Authority is considering whether it should adopt this recommendation, which would represent a significant departure from the approach adopted in previous pricing decisions.

Stanwell has significant concerns with using a higher percentile of hedge prices in the energy cost estimation process. ACIL Tasman (and the Authority) has not outlined sound reasons why this change is necessary and level of uncertainty it is designed to target. Stanwell considers that there is an equal risk that the modelling fails to appropriately capture drivers that would result in lower market costs (e.g. lower actual load relative to forecast, which aligns with actual observations). We consider a robust modelling process (and determination of inputs) should appropriately account for market risk otherwise the process becomes extremely arbitrary. We are not aware that any similar modelling processes would depart from using the median value.

Load traces- load traces 2009-10 to 2011-12

We note that ACIL Tasman, in developing its load forecasts, is intending to draw on the actual load forecasts for the three previous years (2009-10 to 2011-12). While Stanwell does not have any significant concerns with the overall approach to deriving the load forecasts, we do question whether drawing on the previous three years will provide an appropriate load shape for the forward period. Specifically, we are uncertain whether the 2009-10 load trace would capture the more recent impact of solar PV installations and the associated load shape changes experienced. Stanwell's own analysis suggests that there is a difference in the load profile from 2009 to 2012. We also note that the Australian Energy Market Operator (AEMO) Report - "Rooftop PV Information Paper", which indicates that the National Electricity Market (NEM) has experienced a rapid uptake of rooftop PV over the last four years with the total estimated installed capacity rising from 23MW in 2008 to 1450MW by February 2012. Stanwell recommends that following AEMO's release of the revised economic forecasts (in early 2013), the Authority/ACIL Tasman consult further on the development of load forecasts.

Other Energy Costs - Renewable Energy Scheme and Queensland Gas Scheme

With regard to the price of Gas Electricity Certificates (GEC), Stanwell notes that ACIL Tasman is again recommending the cost be based on 15 percent cover and an average of the GEC price over the past four years. In response to the 2012-13

Draft Determination, Stanwell argued that the two year average should be adopted otherwise customers are likely to be paying above a market price for GECs. This view was formed on the basis that:

- New entrant retailers in Queensland have been successful in sourcing GECs efficiently from the market rather than from long-term GEC contracts;
- Given the Scheme is under review and its future is unknown the willingness for retailers to enter into long-term contracts has diminished. Any forward contracts written are also likely to be priced on a cost of carry basis from the current spot price, and;
- Both of the largest integrated and incumbent retailers (Origin and AGL) also have the capability to create substantial GECs from Queensland gas-fired generation (Darling Downs Power Station and Townsville Power Station respectively). Both retailers would have little or no requirement to enter into additional GEC contracts of any nature other than perhaps to reduce their inventory.

We have observed over the past twelve months the value of GECs has fallen dramatically. Further, customers are now paying a price on carbon under the national scheme. The GEC scheme represents an additional State-based cost. On this basis, we consider there is an even stronger case to average prices over a shorter-time frame (i.e. two years at the maximum) to ensure the pass-through level is reflective of market value and the benefit of lower GEC prices is passed onto customers.

As was the case for the 2012-13 determination, ACIL Tasman is recommending a price of $40 for Small-scale Technology Certificates (STCs). We consider this is inconsistent with promoting cost-reflective retail tariffs. Over the past twelve months the market has remained over supplied with prices around $30. Pricing STC's at $40 will result in windfall gains to retailers and increase retail pricing for customers. We acknowledge the issues identified by ACIL Tasman in forecasting STC requirements, however, we consider there is now sufficient market data to estimate the market cost of meeting Small-scale Renewable Energy Scheme obligations.

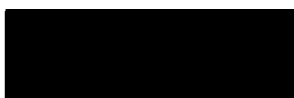
Treatment of Carbon

There is likely to be a more in-depth discussion on the treatment of carbon costs in the next phase of the consultation process (when the modelling is available). Stanwell, however, would like to stress the importance of using the NEM average intensity and ensuring the forecast for 2013-14 is tested against recent market outcomes. Further, this should be based on Australian Financial Market Association (AFMA) data, which is already used by the market. Stanwell looks forward to providing more detailed comments once the ACIL Tasman modelling is released.

3. TRANSITIONAL ISSUES

While Stanwell does not hold a firm view regarding the most appropriate approach to transitioning customers to cost reflective tariffs, we do support the principle of cost reflective tariffs and the need for a smooth transition to allow customers to adjust their consumption decisions to the changing prices. On this basis, we see merit in transitioning the tariff changes in three equal steps. We do, however, consider that the chosen methodology should not result in retailers being "better off " during the transition period.

We would welcome the opportunity to discuss a number of specific issues with you directly. Our contact on this specific matter is Ms Erin Bledsoe and she can be contacted on 07 3228 4529 or be e-mail at erin.bledsoe@stanwell.com.



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