



Submission to the Queensland Competition Authority

Response to the Interim Consultation Notice on the
Benchmark Retail Cost Index for Electricity: 2011-12

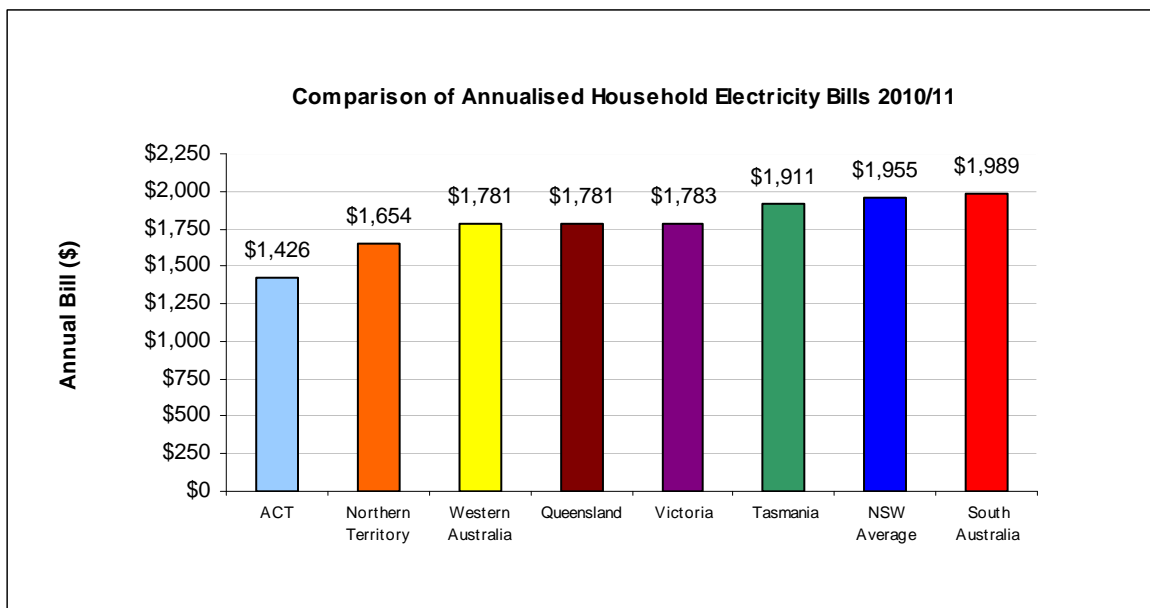
Prepared by the Department of Employment,
Economic Development and Innovation
October 2010

INTRODUCTION

The Queensland Government welcomes the opportunity to provide feedback to the Queensland Competition Authority (QCA) on its Interim Consultation Notice on the proposed approach to the Benchmark Retail Cost Index (BRCI) to determine regulated electricity prices for 2011-12.

The Queensland Government is firmly of the view that **only** genuine increases in the cost of supply must be passed onto consumers. In the Government's submission to the QCA on the 2010-11 Draft Decision, the Government outlined the impact of price rises on both residential and business customers. Again, the Government wishes to stress that the QCA must consider the impact of price rises on consumers when determining regulated prices, from both a household and industry perspective.

Even with the magnitude of the QCA's 2010-11 BRCI Final Decision, Queensland's electricity prices remain competitive when compared to other States, and it is important to maintain this position. The graph below¹ represents Queensland's current standing (as at 1 October 2010) based on an annual consumption of 7,882 kilowatt hours per year. For ongoing economic growth, it is also important that Queensland industry is able to continue accessing competitive prices.



¹ Results are based on consumption of 7,882 kWh of electricity for a representative domestic tariff for each state. The consumption figure of 7,882 kWh has been independently verified as representative of Queensland annual residential consumption and was used for the Government's Q2 statement. The NSW figure represents an average of the three standard retailers whilst for the deregulated Victorian market, a domestic tariff for a large retailer in Citipower's distribution region was used (metropolitan Melbourne).

In line with previous submissions to the QCA, the Government reiterates that notified prices are an important feature of Queensland's electricity market. This 'safety net' policy is especially important for customers in regional and remote locations where the cost of supply is higher than the notified prices and as a result the Queensland Government subsidises the supply to these customers.

The Queensland Government remains committed to the Uniform Tariff Policy which ensures that everyone in Queensland, no matter where they live, pays no more than regulated prices available to consumers in South-east Queensland (SEQ). In 2009-10, the Queensland Government commitment to this policy totalled \$250million.

One of the most significant factors driving price rises is the continued increase in peak demand. It is important however that regulated prices reflect the ongoing investment in Queensland's network infrastructure necessary to ensure safety and reliability of supply.

Residential demand remains a key component of the strong growth in demand. Growth in peak demand in SEQ, which has a high residential component, remains unchanged from the 2009 forecast at 3.9 per cent, and contributes 1,700 MW or around 45 per cent of the 3,900 MW overall increase in peak demand across Queensland forecast by 2020². Also, in contrast to the rest of the State, peak demand growth in SEQ is significantly higher than consumption growth, reflecting the increasingly 'peaky' nature of demand in the region.

While the Government accepts the approach that the QCA intends to use to determine the network costs, parts of the proposed framework to determine energy and retail costs are not supported.

Retailers are currently experiencing low pool prices for energy, Renewable Energy Certificates (RECs) and Gas Electricity Certificates (GECs). The QCA's current approach to determine the cost to retailers to comply with the requirements under the Mandatory Renewable Energy Target (MRET) and the Queensland Gas Scheme (QGAS) is outdated and no longer reflects the true cost of supply and therefore justifies a change to the methodology.

Similarly, the QCA must ensure that the recent significant decreases in wholesale energy prices are reflected in the final price that customers pay.

The Queensland Government **strongly** urges the QCA to consider market based approaches when dealing with these cost components to ensure that consumers also benefit from these low prices.

The Government also believes that the current approach to determining aspects of the cost of retail component is not economically efficient.

Detailed discussions on each of the aspects of concern to the Queensland Government are set out below.

Under s 107 (1) of the *Electricity Regulation 2006*, the QCA is given the ability to change the theoretical framework if necessary. s107(1) states:

² Powerlink Annual Planning Report 2010

The theoretical framework must be the same, or substantially the same, from tariff year to tariff year unless-

- (a) the pricing entity considers that there is a clear reason to change it; and
- (b) the pricing entity has, under section 99, published draft decision material about the reason for the change.

ENERGY COSTS

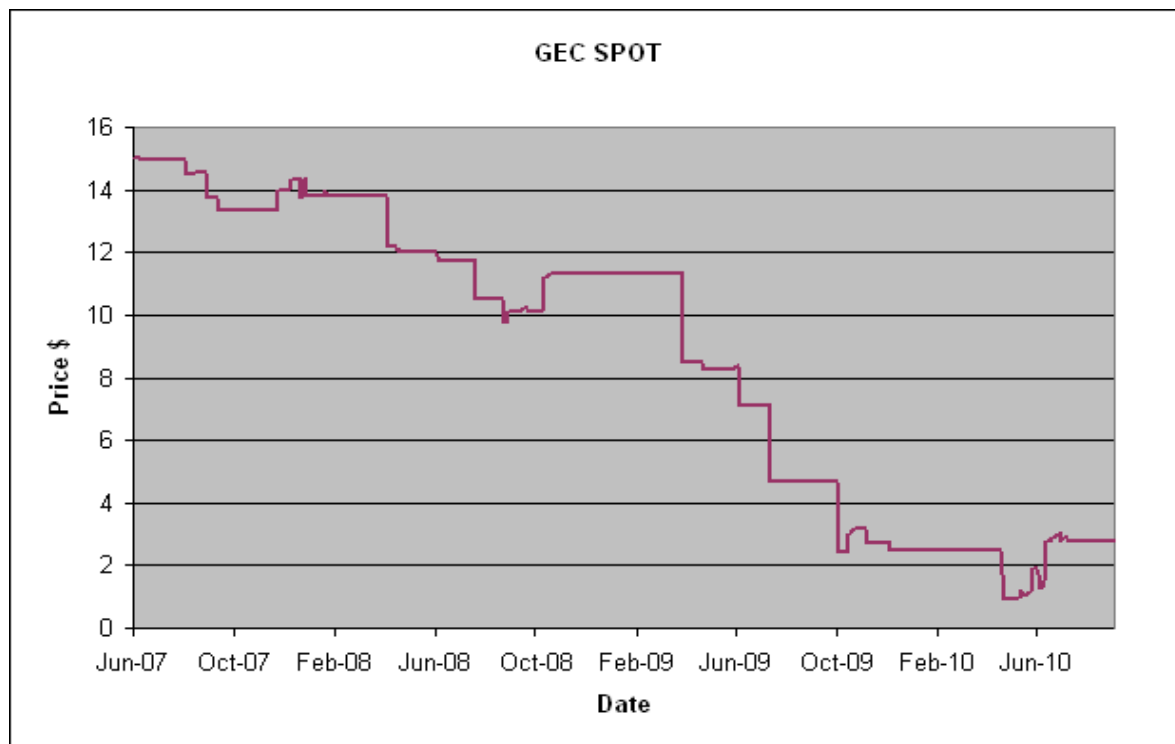
The Queensland Government has a number of concerns with the calculation of energy costs in the calculation of the BRCI, particularly in relation to GECs, RECs and energy purchase costs.

The Queensland Gas Scheme

The Queensland Government notes that the QCA intends to again use a penalty price approach to determine the cost of complying with the QGAS. However, the Government strongly disagrees with this approach as it does not represent what is currently going on within the GEC market on the contribution of GEC costs to the cost of supply.

In 2009, only five out of the 37 liable entities were penalised for not surrendering GECs. The number of certificates not surrendered represented only 0.3% of the total liability. Therefore while all retail customers are currently experiencing prices based on the inclusion in the BRCI of the equivalent of the penalty price, 99.7% of certificates surrendered are being purchased at market prices. As this evidences, a market based approach is more representative of what is occurring in the market and the actual cost of supply.

The Graph below³ demonstrates the GEC spot prices from June 2007 to September 2010. Over the last 12 months, the average spot price was \$2.60 and in May 2010, spot prices dropped to below \$1.00.



³ Graph based on actual movements in the GEC spot market since June 2007.

In the 2010-11 Final Decision, the QCA justified the use of the penalty price approach based on the lack of data for a market based approach. However, even a market based approach based on the spot market is clearly more accurate than using the penalty price.

Conclusion:

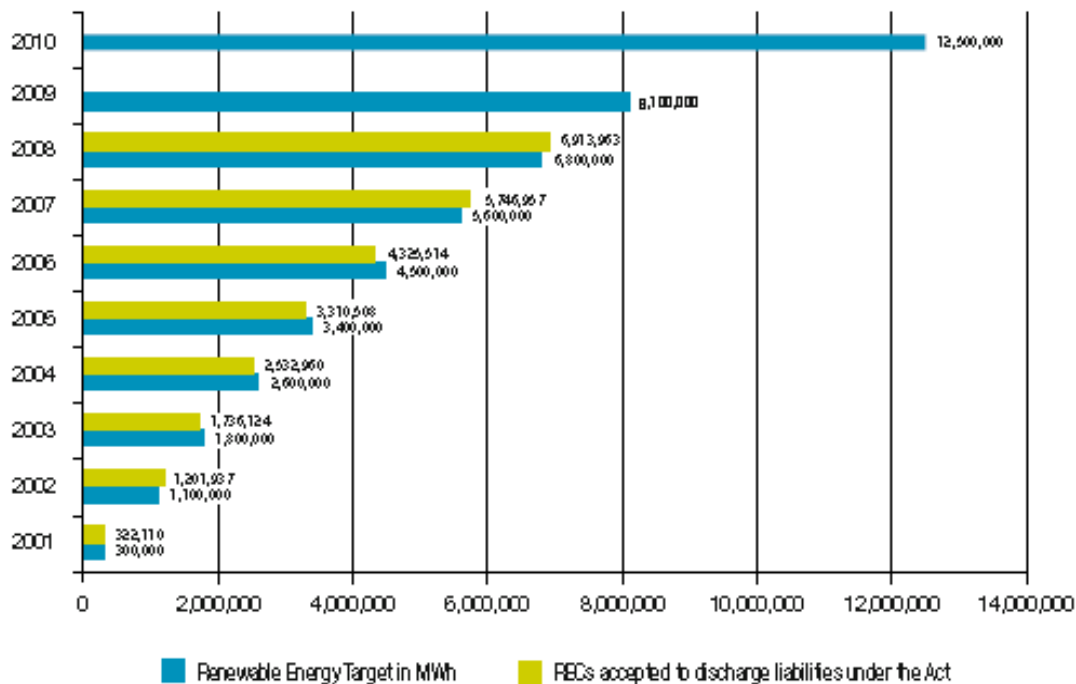
The Queensland Government believes it is unjustifiable to use the penalty price as representative of the cost of complying with the QGAS and a change to this part of the framework is justifiable and allowable under s107 of the *Electricity Regulation 2006*.

Mandatory Renewable Energy Target

The Queensland Government understands that the QCA will need to incorporate the expanded RET scheme into the energy cost component of the BRCI. While we note the QCA's comments on the availability of public information on the costs of RECs for the small-scale renewable energy scheme (SRES) and large-scale renewable energy target (LRET), it is imperative that the QCA adopt a market based approach to ensure that consumers are passed on the benefit of historically low REC prices.

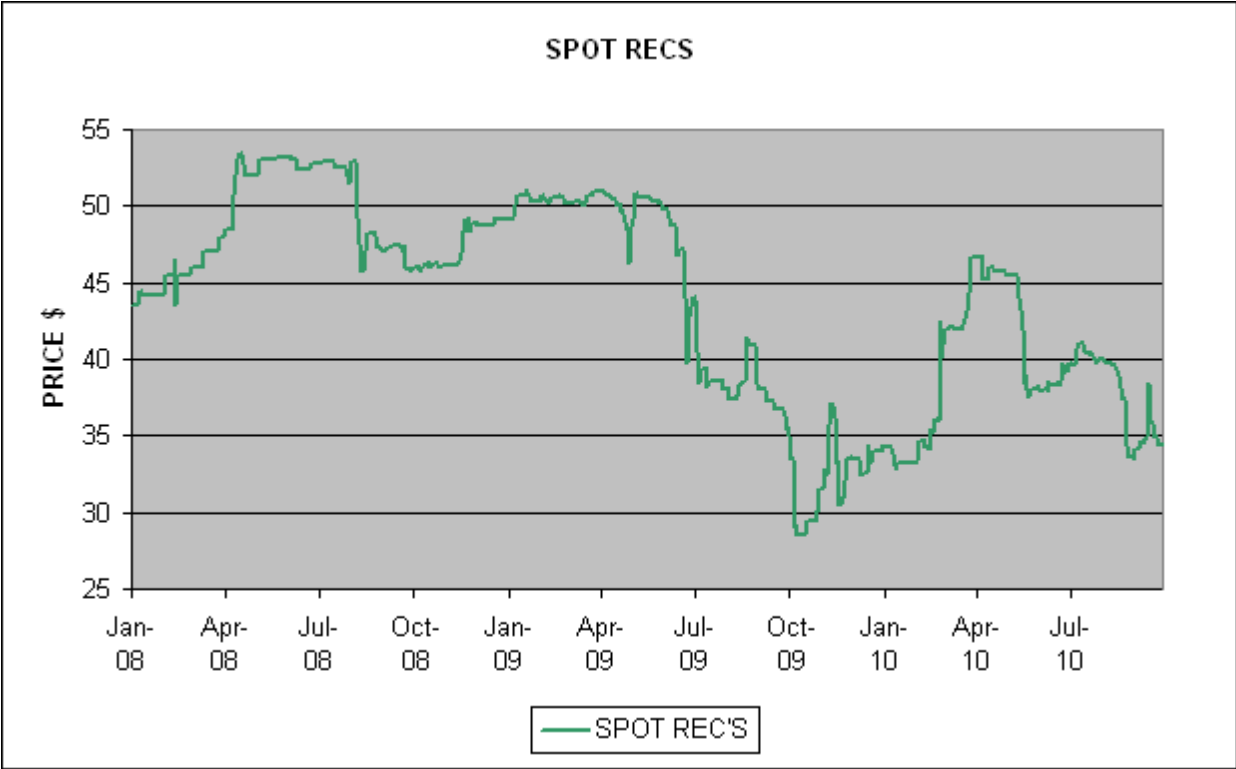
The Government believes that using a penalty price approach should not be considered. As the graph⁴ below demonstrates, there has been a history of high compliance with the MRET scheme and in 2008, compliance was 99.8 per cent (the graph below accounts for future liabilities discharged in some years). This would be expected to continue under the new schemes.

Summary of compliance against the Renewable Energy Target as at 31 December 2009



⁴ Source: Office of the Renewable Energy Regulator Annual Report 2009

Similar to the GEC market, there has been a downward trend in spot prices. The graph below⁵ demonstrates this trend. It is important that the QCA capture what is currently occurring in the market to ensure that these low REC prices are passed onto consumers through the BRCI.



Further, it is expected that there will be an over supply of RECs in 2011-12 including those created from small scale sources up until 1 January 2011, which could result in an overhang in the REC market estimated at \$27million. Therefore it is highly unlikely that retailers will be acquiring a large proportion of their RECs by incurring the LRMC of new project costs. As a result, Government believes that the LRMC should not be used in this context.

Conclusion:

The Queensland Government believes that a market based approach focussed on spot prices must be used to estimate the cost of meeting both SRES and LRET obligations in 2011-12.

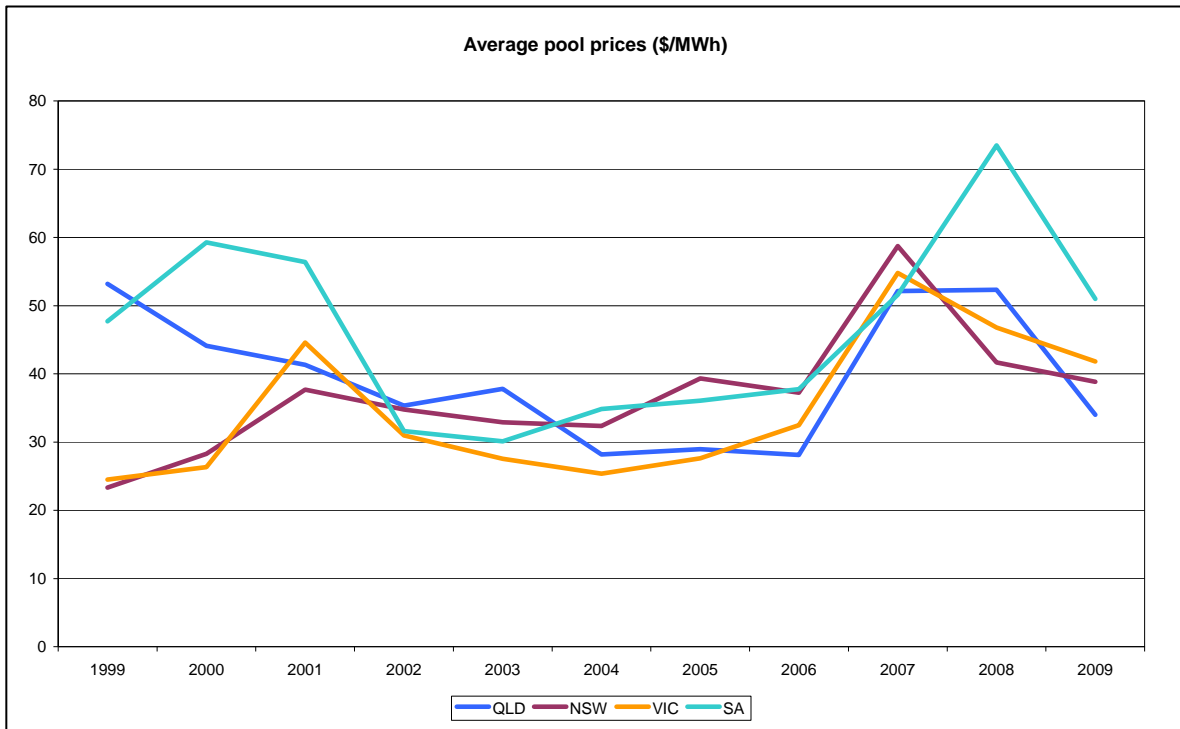
Cost of Energy Component

The Queensland Government notes the significant decline in wholesale energy costs across the National Electricity Market from 2008. This is a result of excess supply capacity following the removal of water restrictions at a number of power stations, and the addition

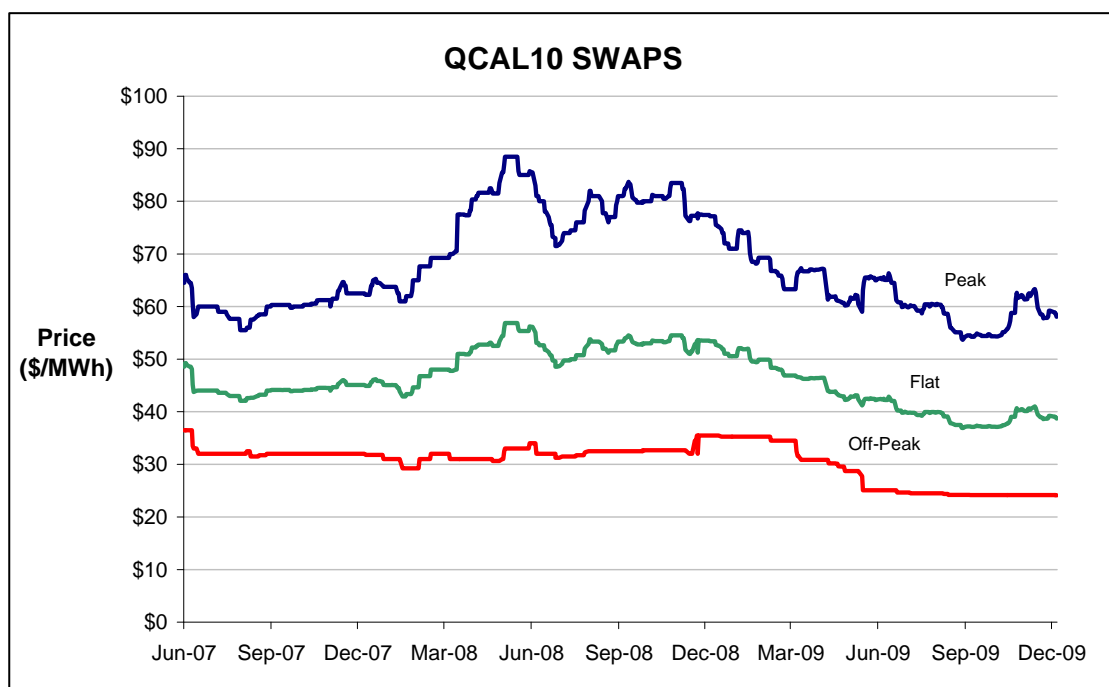
⁵ Graph based on actual movements in the REC spot market since January 2008.

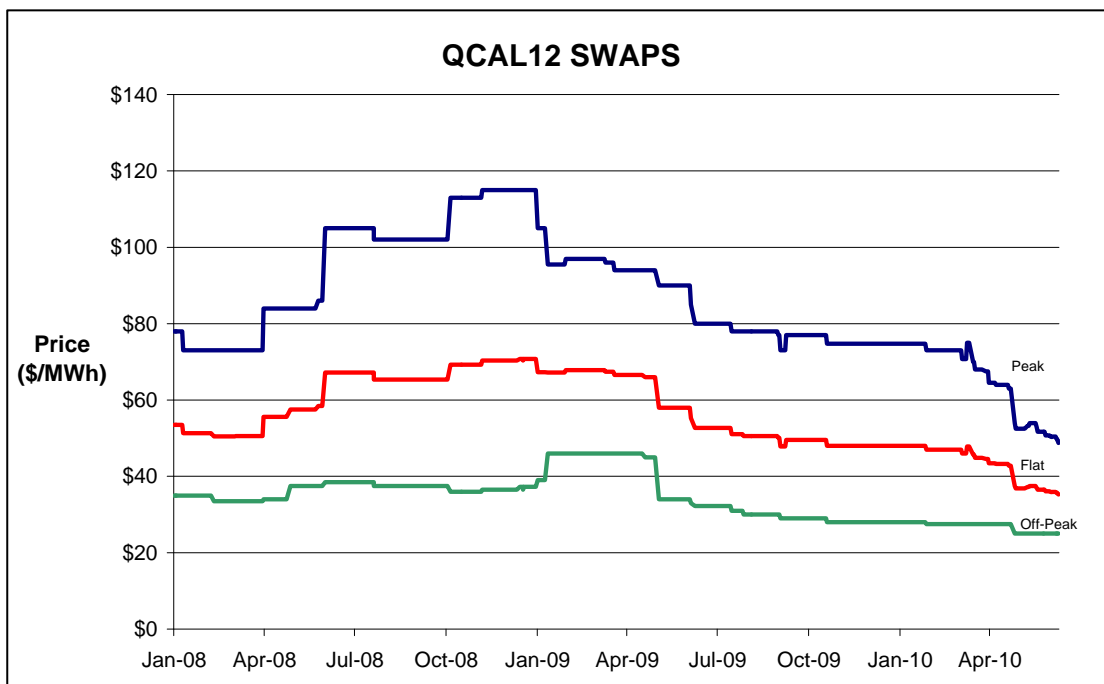
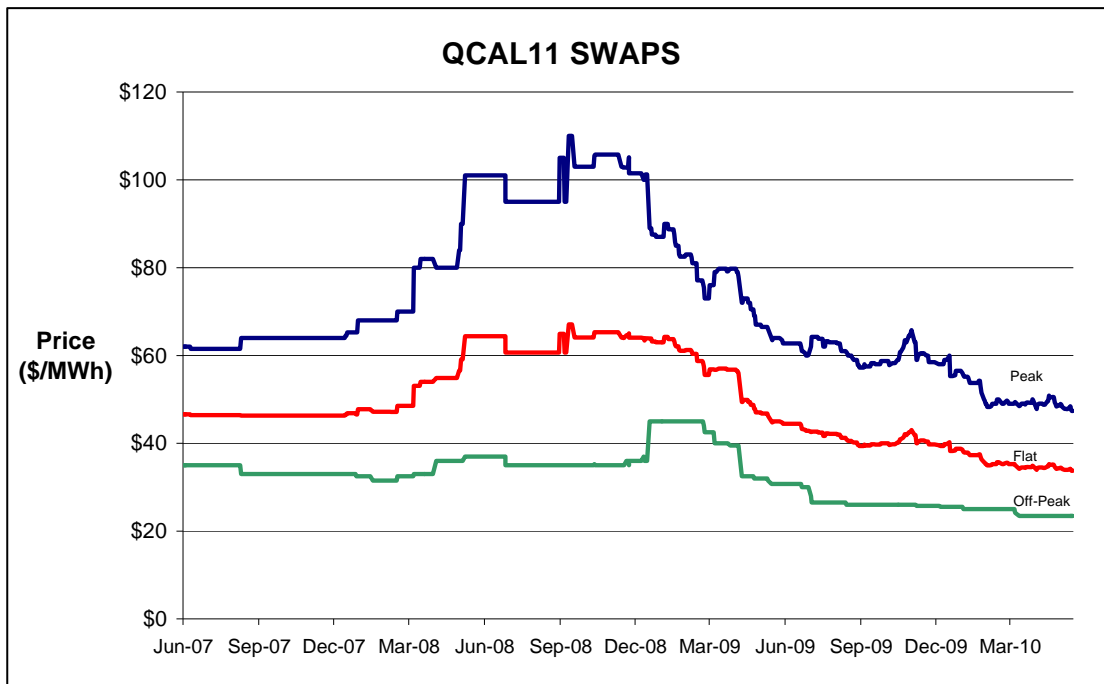
of a number of new gas-fired generators. In Queensland, average pool prices have fallen by nearly 30% from 2007-08 to 2009-10.

Increased supply capacity is expected to continue to place downward pressure on wholesale energy prices into the future, despite strong demand growth forecasts. Indicative prices are shown in the graphs below.



The market contracts represented in the graphs below demonstrate generally lower prices for 2011-12 than 2010-11 and also a progressive decline in prices since mid-2008 for CAL10, 11 and 12 swaps.





The Government recognises the methodology used to calculate the energy purchase cost component of the BRCI results in a significant lag between movements in wholesale energy costs and retail prices.

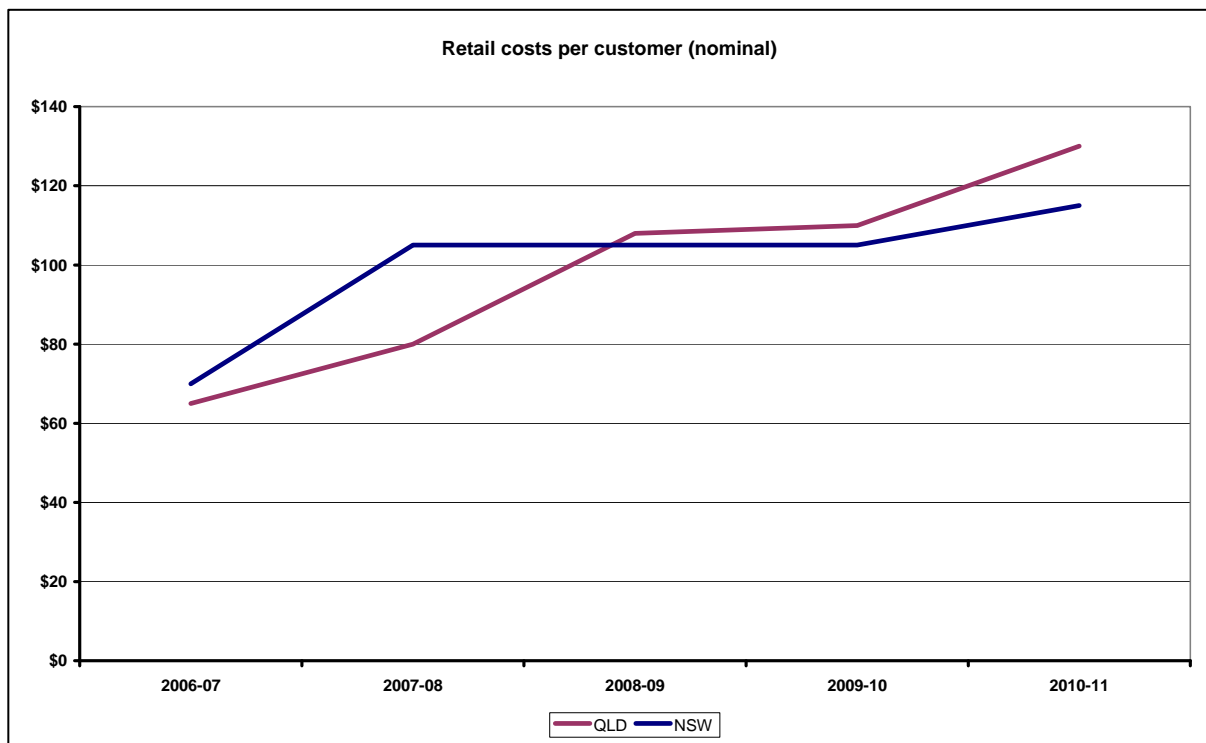
However, the Government expects the 2011-12 BRCI should more accurately capture the fall in wholesale energy costs that has occurred over recent years, and consumers should be starting to benefit from this trend through lower prices.

RETAIL COSTS

The Queensland Government has a number of concerns in relation to the calculation of retail costs within the BRCI, including the level of retail cost allowances over recent years and the determination of customer acquisition costs.

Retail Operating Costs

A review of the retail cost benchmarking study undertaken by the New South Wales (NSW) Independent Pricing and Regulatory Tribunal (IPART) in December 2009⁶, shows the QCA's allowances for retail costs have continued to be above allowances included in IPART's pricing determinations over recent years. The Government also questions the increasing differential between retail cost allowances in Queensland and NSW, as evident from the Chart below.



The retail cost benchmarking study undertaken by IPART also revealed the QCA's retail cost allowances were at the higher end of the range of retail costs reviewed across other States and Territories.

Customer Acquisition Costs

The Queensland Government is concerned about the way in which customer acquisition costs within the retail cost component of the BRCI are determined.

⁶ Review of Regulated Retail Tariffs and Charges for Electricity – Draft Report, IPART, December 2009.

Consistent with comments expressed in previous submissions, the Government is strongly of the view that customers should not bear undue costs associated with a normal level of market activity and typical retailer operations, such as activities aimed at gaining and retaining customers. The current approach to estimating these costs appears to be driving perverse market outcomes, in the sense that indicators of competitive market activity, such as customer switching and transfers, can cause significant changes in the retail cost component of the BRCI from year to year, and therefore contribute to price increases for customers. It is the Government's strong view that customers should instead derive the benefits of a competitive retail electricity market, including lower prices.

As such, the Government considers the QCA should give careful consideration to the approach used to calculate the retail cost component of the BRCI in 2011-12. Calculation of the retail cost allowance, and underlying components such as customer switching and transfers, should occur in a way that delivers relatively stable estimates from year to year, and resulting pricing outcomes. It is the Government's view that this is an accurate reflection of the relatively mature stage of the retail electricity market in Queensland, and also the way in which an established retailer would allocate costs to this category of normal operating activities.

In its Final Report on the 2010-11 BRCI, the QCA indicated it previously considered alternative retail cost approaches, such as adopting fixed customer acquisition costs per customer, but concluded the current benchmark approach was more appropriate.

However, the QCA's current approach to determining customer acquisition costs was developed during the early years of FRC and, four years on, it is questionable whether the reasons the QCA adopted this approach are still relevant in the context of a more mature Queensland retail market.

Government encourages the QCA to revisit this issue in its Draft Report on the 2011-12 BRCI.