18 July 2012

Essential Services Commission of South Australia
Electricity Standing Contract – Wholesale Electricity Cost Investigation Discussion Paper
GPO Box 2605
Adelaide SA 5001

Sent by email: escosa@escosa.sa.gov.au

Dear Sir / Madam

Re: Electricity Standing Contract – Wholesale Electricity Cost Investigation Discussion Paper

Qenergy Limited (QEnergy), a transitioning retailer under the National Energy Consumer Framework intending to enter the South Australian market as soon as possible, welcomes the opportunity to provide comments on the *Electricity Standing Contract – Wholesale Electricity Cost Investigation Discussion Paper* (the Discussion Paper). QEnergy is an established National Electricity Market retailer with 9,000 customers in Queensland specialising in providing retail electricity to small businesses.

QEnergy's key customer base is in Queensland, where the recent Queensland Competition Authority (QCA) regulatory determination followed a path akin to that discussed in the Discussion Paper, shifting away from a consideration of the Long Run Marginal Cost (LRMC) of energy as a component of the regulatory price cap setting process, instead basing the wholesale component only on short-term contracts and a 'black box' pool model.

Because of our experiences in Queensland, QEnergy firmly believes that there should be no change to the use of the LRMC methodology in setting the Wholesale Electricity Cost (WEC) component of the standing contract.

QEnergy knows better than most the impacts on competition and business sustainability – whether intended or otherwise – posed by a significant structural shift in pricing methodology such as this. As a result of the QCA decision, QEnergy has ceased actively marketing in Queensland despite having been originally configured as a Queensland retailer.

Further, although the days are early in demonstrating the impact of this decision, we are certain that competition has been significantly harmed – if not virtually abolished – in Queensland. For example, QEnergy monitors our transfers out on a weekly basis and has seen these fall to below 30% of previous months' transfers, a sign that competition overall will be severely impeded through the outworkings of the review.

This goes to the heart of the issues associated with setting standing contract prices when a market is transitioning to a fully competitive status. As noted in the Discussion Paper:

> *If estimates are too high, standing contract customers will pay too much, although those who have signed market contracts may receive prices more in line with efficient costs, to the extent that retailers compete with each other. If the forecasts are too low, standing contract customers may receive short-term benefits although, in the long-run, retailers may not compete robustly and the benefits of competition (innovation, low-cost offerings) may disappear, again, leaving customers paying more than they should.*

The industry response to the QCA decision suggests that the removal of the LRMC component from any consideration in a regulatory price cap setting process results in the forecasts being too low.

For the purposes of the current Determination, the Essential Services Commission of South Australia (the Commission) adopted an LRMC approach as it considered that the lack of liquidity in the contract market for wholesale energy raised doubts about the reliability of contract prices at the time. It is QEnergy's view that the contract market remains illiquid and does not offer sufficient reliability for benchmarking the WEC component of the standing contract.

Although wholesale electricity contract pricing has declined in recent months, there has also been a very significant price increase since the start of June; and liquidity, which had been slowly increasing for contracts relating to the 2012/13 financial year, has once again dried up. In comparison to the more liquid NSW and Victorian markets, the volume of traded contracts and open interest for South Australia is materially lower than those states.

The futility of using Sydney Futures Exchange contract pricing in determining the WEC is highlighted in Table 3 of the Discussion Paper where the implied Off-Peak price for FY2015 is given as $67.64 / MWh against a Peak price of only $55.83 / MWh. This mispricing is a function of the daily settlement price calculation for futures contracts whereby a lack of liquidity can result in a distortion of the price relativities between the Flat, Peak and Off-Peak contracts. This also proves that liquidity – on the basis of which the Commission is potentially seeking to re-open the Determination – has not improved and in fact is giving false signals.

The volatility of the pool price as seen in the first half of July 2012 also highlights the risks associated with retailing in South Australia which must be factored in when considering price setting. The first few days of July saw the five minute dispatch interval in South Australia reach a maximum price of $12,900 / MWh due to significant disruptions to the demand-supply equation in the NEM.

This increased volatility resulted in a $13.00 / MWh increase in the near contract price on the futures exchange. Note that since the start of July there has been almost no liquidity in the market for either of the near-term flat contracts, with only a paltry 5MW trading on the exchange. Again, the extreme volatility of short-term hedge contracts is a function of insufficient and reduced liquidity.

The published futures Peak and Flat pricing also does not take into account the shaping requirements needed in order to efficiently hedge the customer base on standing contracts. A cursory analysis of the Net System Load Profile shape outcomes for South Australia – the shape against which all NMI class 'SMALL' customers are settled – indicates that the standing contract shape would attract a further premium of up to 30% over the flat contract price.

Many of the retailers that are active in South Australia are vertically integrated, and a large proportion of hedging is also undertaken using Power Purchase Agreements (PPAs) which provide diversity of term and some surety of availability when looked at over the long-run. As well as being a key risk management tool for prudent retailers, this use of PPAs is absolutely crucial to ensuring the ongoing incentivisation of generation as required in any region, since merchant power plants are no longer able to be banked without secure long-term offtake agreements priced at LRMC.

Because of the prevalence of LRMC-based PPA contracts in retailers' portfolios – particularly in South Australia where there is generation concentration and significant vertical integration at play – any analysis of the futures market on its own is ignoring major components of the wholesale cost which are not visible to the ordinary trader.

Also note that the 'shape premium' is inherent in PPA prices and the LRMC of generation because capacity usage is a component in the equation, but is exceedingly difficult to estimate when looking at short-run contract structures.

Although QEnergy does not believe that the WEC should be re-opened for the purposes of the current Determination, if it were re-opened, any review based on prices observed in the wholesale futures market would need to factor in the significant changes to the contract prices brought about by increases in pool volatility, alongside the drying up of liquidity as traders stay away from the market and retailers rely on the PPA and physical generation they already have in place. It would also need to consider a significant shape premium to account for 'SMALL' customers' peakiness of load.

If the Commission's concern is that the current standing contract has been set too high, then according to the *1 August 2011 Electricity Standing Contract Price Adjustment*

> *Less than 30% of all small electricity customers now use the standing contract, as the majority of customers have elected to switch to a market contract.*

Regulatory analysis over the past years suggests that much of the standing contract customer base is made up of those who do not wish – or potentially even need – to move onto market contracts. For this reason, there is no evidence to suggest that those customers still on standing market contract are vulnerable. As such, any downward adjustment to the standing contract rate in the interest of vulnerable customers will have the effect of only rewarding those customers who have not taken advantage of the competitively priced market contracts in South Australia, to the long term detriment of competition and the customer base as a whole.

If the Commission's primary objective is to

> *protect the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services*

then vulnerable customers should be dealt with outside of the pricing mechanism. It would be most concerning should a pure market mechanism start to be altered to cater for non-market social policy objectives.

So QEnergy firmly believes that there should be no change to the use of the LRMC methodology in setting the WEC component of the standing contract. Any changes to the WEC component of the standing contract would have an adverse effect on competition within South Australia and a reduction in the standing contract rate would in effect undermine the incentives in place for customers to make the most of the competition that has flourished to date.

To this end, it is important that ESCOSA are not seen to be making changes to the standing contract for non-market reasons to the detriment of retail competition.

QEnergy stands ready to discuss any element of this submission with you or to answer any questions.

Yours sincerely

Kate Farrar
Managing Director