16 November 2015

Mr Kim Wood
Principal Commissioner
Queensland Productivity Commission
PO Box 12112
George St QLD 4003

Dear Mr Wood

RE: QUEENSLAND PRODUCTIVITY COMMISSION - ELECTRICITY PRICING ISSUES PAPER

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Queensland Productivity Commission's (QPC's) *Issues Paper: Electricity Pricing in Queensland*. As a Queensland company we take a particular interest in the evolution of the State energy market. We congratulate the QPC on a comprehensive and fair issues paper across some very complex topics.

While we have interests in many of the issues raised by the QPC, as the largest non-vertically integrated electricity retailer to commercial and industrial businesses in Australia, ERM Power has a range of specific concerns related to energy security, affordability and innovation for small and large businesses.

We have focussed our comments on three key areas addressed by the Issues Paper:

- the potential merger of CS Energy and Stanwell;
- retail price deregulation in south east Queensland; and
- the need to shift to a network-based CSO in regional Queensland.

About ERM Power Limited

ERM Power is an Australian energy company that operates electricity generation and electricity sales businesses. Trading as ERM Business Energy and founded in 1980, we have grown to become the second largest electricity retailer to commercial and industrials in Australia, with operations in every state and the Australian Capital Territory. We are also licensed to sell electricity in several markets in the United States. ERM Power is the largest non-integrated retailer of electricity to big businesses in Australia, providing more than 16TWh of load to customers in 2015. We have equity interests in 497 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland, both of which we operate.

Merging CS Energy and Stanwell

ERM Power is concerned that merging CS Energy and Stanwell, as has been proposed, will dampen competition and have the end effect of higher prices for business and residential consumers. We note that the QPC has stated that 'a merger of CS Energy and Stanwell may reduce competition in Queensland's wholesale electricity market, given the proportion of the market represented by the two businesses, and this may have implications for retail electricity prices' (p. 18). Further, and also as noted by the Commission, this has been the view of the Chairman of the ACCC as well as ACIL Allen (in the context of providing advice to the QCA on retail electricity prices for 2015-16).

The QPC has suggested that there may be ways to mitigate the competition impacts of any merger options. We do not believe this is possible or efficient to pursue. In our view the best option is to retain full separation of CS Energy and Stanwell.

The current level of competition in Queensland's electricity generation sector is already somewhat compromised with the existing structure of the market. The two State-owned generators between them provide the bulk of the power for the State: in any given five-minute trading period there is not sufficient electricity from other sources to meet the needs of Queensland consumers, outlined further in Appendix One. If CS Energy and Stanwell were merged this would mean the combined entity would alone be able to set the marginal bid in any five-minute period. This would have deleterious effects on retailers who would likely find it difficult to hedge efficiently, with higher retail prices to consumers as the outcome.

Even as separate entities we have seen high price outcomes when these generators have adopted similar strategies in the wholesale market; it is unclear how any mooted economic efficiencies from a merger would outweigh the likely increased risk to the market and resulting cost to energy consumers.

Separately, these two entities have significant market power and influence over wholesale energy pricing and the wholesale market. This market power is further advantageous to these entities considering the role of CS Energy and Stanwell as retailers, able to leverage the wholesale and retail pricing mix.

Stanwell and CS Energy operating as a merged entity in both generation and retail pose a significant threat to the development of a competitive and innovative energy market in Queensland. It is unlikely that other retailers would be able to compete effectively against an organisation that controls such a significant portion of the available supply and pricing.

As a final point, ERM Power does not support any merger of State-owned corporations, including between generators and retailers. This is because the competition issues identified above would only be amplified with a shift toward vertically integrated government-owned businesses in Queensland.

Retail price deregulation in south east Queensland

Queensland is one of the signatories to the 2006 Australian Energy Market Agreement that states that jurisdictions will phase out the exercise of energy retail price regulation where the Australian Energy Market Commission (AEMC) finds retail competition to be effective. As discussed by the QPC, the AEMC has found that Queensland's retail market is competitive (p. 33) and that price deregulation will improve competitive outcomes. As noted by the AEMC, electricity customers can choose from a range of energy plans from 11 different retail brands, and they are actively shopping around.[1] We also note that the AEMC found that switching for SEQ residential customers is higher for electricity than for a range of other services such as car insurance, home insurance, health insurance, home phone, banking, mobile and internet services.[2]

Previously, the Queensland Inter-Departmental Committee on Electricity Sector Reform (IDC) also recommended price deregulation. ERM Power supports the AEMC's and IDC's findings and strongly recommends that price deregulation occurs as planned on 1 July 2016.

ERM Power, as a retailer to SME and commercial and industrial customers, is particularly supportive of deregulation as a matter of urgency, given the benefits it can provide to SMEs who have been captured along with residential consumers in the current regulated Queensland market. Deregulation will spur

---

[1] Australian Energy Market Commission (2015) *2015 Retail Competition Review*, Final Report, June, Sydney, p. 46.
[2] Ibid., p. 59.

competition, innovation, and the pricing of energy solutions which better meet the energy consumption requirements of SMEs. ERM Power looks forward to bringing this innovation to a deregulated Queensland energy market for the benefit of small businesses for which energy can be a very high input cost. The potential for efficiency and productivity gains through deregulation bodes well for investment and employment. Additionally, ERM Power is supportive of tariff reform and transparency of network costs as a means of promoting awareness of the component energy costs among users and ultimately, driving competition and development of a robust and customer-focussed energy market in Queensland.

Similar to the potential costs to SMEs and residential consumers of reduced competition in the generation sector, retail price regulation stifles competition in the retail sector and so increases costs to businesses and households. Limiting competition also reduces the potential for retail contracts that meet business and residential consumer's non-price needs. To explain, a highly competitive market provides a range of non-price as well as price benefits, in the form of varied payment options, energy efficiency solutions, and offers bundled with other services and products. These options will not exist where prices are regulated below or at cost, meaning that customers' expectations about choice and flexibility (formed particularly from experiences in other markets) will not be met.

From a broader perspective, the costs and risks of price regulation are also felt in other areas: businesses and residential consumers see governments as 'in control' of energy prices and so are blamed when retail prices increase.[3] Regulators do not like regulating retail prices either: they know that they are almost guaranteed to get the prices 'wrong' relative to the effective regulation of price by a market. This has negative effects on competition as above, and it also means that price shocks are inevitable as prices are required to eventually rise to reach the level required for adequate industry investment and system security in an essential service.

A price regulated environment also limits innovation and investment in demand side response service offerings. The supply-side investment to provide these services is significant, and depends on rolling out technology such as smart meters and IT platforms to support half-hourly data and relevant consumer interfaces. Even where regulated prices allow for these developments, unpredictable political intervention in regulated pricing is always a possibility and creates a risk for retailers when investing in new products and technology. In contrast, price deregulation facilitates the adoption of new technologies that can deliver new pricing structures and services to customers.

We note the Commission's consideration of the consumer protection arrangements that should be in place for SEQ consumers in a deregulated market. As discussed by the Commission, the recent adoption of the National Customer Energy Framework (NECF, and particularly the Queensland version) has provided Queensland SMEs and consumers with comprehensive consumer protections, including for those who may require further and more targeted support through hardship programmes. In our view, the consumer protection aspect of deregulation is appropriately managed through NECF's provisions.

The more important policy issue in the context of prices and bill affordability relates to the fitness for purpose of Queensland's concessions policy. ERM Power does not have residential customers and so we will leave this issue to others to elaborate; however, we note that the Energy Retailers' Association of Australia (ERAA) will be providing recommendations to the QPC and the Government about changes to

[3] AGL research has shown that governments keep political risk from regulation that they do not have with deregulation – see Simshauser, P. and Laochumnanvanit, K. (2011) *"The price-suppression domino effect and the political economy of regulating retail electricity prices in a rising cost environment",* AGL Applied Economic and Policy Research Working Paper No.20 – Domino Effect, at http://www.aglblog.com.au/wp-content/uploads/2011/01/No.20-Domino-Effect1.pdf.

Queensland's concessions policy. These views were developed as part of a broader collaborative process about energy bill affordability that has taken place this year between retailers, the consumer sector and Ombudsman schemes.

We also note that the Department of Energy and Water Supply has commenced work on a deregulation communications campaign. ERM Power supports this project: we believe that the right mix of broad messaging relating to the general and targeted support for particular communities will manage community and other stakeholder needs and allow for a seamless transition to retail price deregulation. The experience of other Australian jurisdictions bears out that this is not a highly problematic process for consumers with the right framework in place.

The retail CSO in regional Queensland

As noted by the QPC, the issue of where the Uniform Tariff CSO is best placed to serve consumers and support competition has already been discussed at some length. This is a vexed issue in need of resolution given the significant impact this has on the market. Delaying the reassignment of the CSO to the distribution businesses is a delay in providing end users with choice, access to innovative solutions and efficient pricing that a competitive retail landscape will bring. The two key advisors on this issue to date are the Queensland Competition Authority (QCA) and the 2013 IDC Panel.

The IDC noted in its 2013 report:

> The Uniform Tariff CSO is paid directly to Ergon Energy retail to allow the business to provide retail electricity prices at a level well below the cost of supplying the service for most customers—particularly households. On the whole, other retailers do not compete in this market as without direct government support they would supply to most customers at a loss.
>
> Developing retail competition in regional Queensland would mean that the Uniform Tariff CSO would need to be 'unbundled' and paid to Ergon Energy's network (rather than retail) business. This would mean retailers would have access directly to the government funded CSO through subsidised network prices and could then compete for customers profitably.[4]

In a 2014 report the QCA also agreed that the retail subsidy is a barrier to competition, stating:

> The subsidy arrangements are a significant barrier to the development of retail competition in regional Queensland and effectively entrench Ergon Retail's monopoly position. Less than 1% of small regional customers are supplied on a market contract with another retailer, despite the legislative barriers to competition being removed nearly seven years ago.[5]

While the QCA did suggest a retail-based subsidy (applied to all retailers) would be an option to resolve the issue, this was considered administratively burdensome compared to a network-based subsidy paid to Ergon's network business. The QCA appeared to prefer a network-based subsidy, as did submissions to its consultation process.[6]

---

[4] Interdepartmental Committee on Electricity Sector Reform (2013) *Report to Government*, May, p. 106.

[5] Queensland Competition Authority (2014) *Final Advice: Uniform Tariff Policy & Regional Retail Electricity Price Regulation*, April, p. 10.

[6] In its 2015 competition review the AEMC also found that retailer respondents to a survey advised that they: 'did not expect any changes in the level of competition until the Uniform Tariff Policy is removed or changes are made to the way in which the subsidy is paid, such as paying the subsidy to the distribution network rather than the final retailer'. See Australian Energy Market Commission (2015) *2015 Retail Competition Review*, Final Report, June, Sydney, p. 79.

ERM Power recognises the complexity inherent in the management of the CSO and the various options that need to be considered by the QPC. However, we also believe that once the decision is made to reform the Uniform Tariff CSO the only choice is to shift it to being network-based. This principle must be the starting point.

Regional Queensland reflects a large untapped market for energy retailers, and ERM Power is keen to compete in this market and offer business consumers the high quality service that we are known for. As a Queensland based-business we believe we are in a good position to work with the QPC and Government on fleshing out issues of implementation and timeframes for regional electricity reform in regional Queensland.

If you have any queries about this submission please contact Michelle Barry on (07) 3020 5145.

Yours sincerely

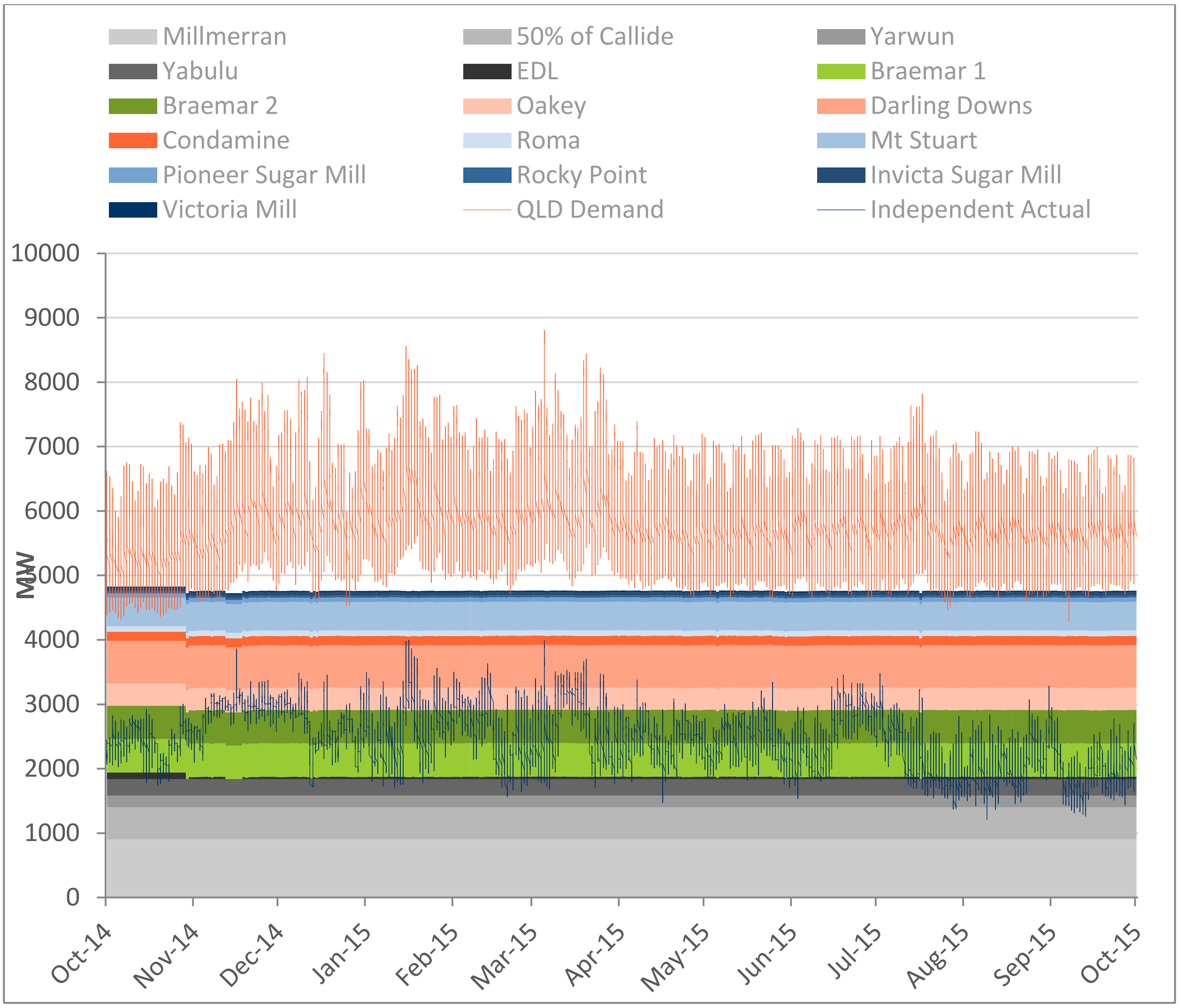
[signed]

Jon Stretch
Managing Director & CEO

Appendix One

Chart 1 below demonstrates that in Queensland the non-government owned generation assets do not have enough combined capacity to meet the State's electricity demand during any period of time. That is, at any given 5-minute interval a combined CS Energy and Stanwell could set the pool price at the market price cap which is currently $13,800/MWh. Such a situation would cause contract prices to rise sharply due to the increased risk of high pool prices. Queensland has experienced this scenario recently to some degree, where wholesale energy prices have increase by approximately 50% following the summer of 2014/15 where both CS Energy and Stanwell concurrently adopted more aggressive pool bidding strategies. Furthermore, intermediaries such as banks and trading houses that provide liquidity to the national wholesale electricity market would be reluctant to do so, given the heightened risk, therefore leading to a likely shortage of efficiently priced contracts, which are required by retailers to manage risk.

Chart 1



The gap between the blue, which depicts the combined non-Government owned generation dispatched between September 2014 and October 2015, and the red line, which depicts Queensland electricity demand for the same period, demonstrates the minimum amount of supply required from Government-owned generation.

Chart 2 below also takes into account the energy flow over the two interconnectors which allow electricity transmission between NSW and Queensland. Historically Queensland has been a net exporter of electricity, therefore the real gap between demand (adjusted by interconnector flow) and non-government owned generation is actually greater, highlighting the market significance of Stanwell and CS Energy.

Chart 2