

AGL Response

to

**Queensland Competition Authority
Interim Consultation Notice**

on

**Calculation of the 2007-08 Benchmark
Retail Cost Index**

Public Version

April 2007



PREAMBLE

From 1 July 2007, regulated prices will be adjusted using a Benchmark Retail Cost Index (BRCI). The policy intent of the requirement for the annual indexation of prices by the BRCI is to ensure that tariffs are adjusted annually by changes in the cost to supply electricity to customers.

Legislation requires that the BRCI for a particular year be calculated by dividing the total retail cost of electricity in the relevant year by the load in the previous calendar year. The total retail cost of electricity is to include:

- Cost of energy;
- Network costs;
- Retail costs; and
- Any other relevant costs.

The Minister for Mines and Energy has issued a Certificate of Delegation to the Queensland Competition Authority (QCA) which delegates to the QCA the function and power to calculate the BRCI and to fix future principles for benchmark retail cost elements.

When exercising its delegated powers and functions the QCA must consider the objectives of the Queensland Government that:

- The annual indexation of tariffs should ensure that existing retail headroom remains relatively stable; and
- The policy of enabling small market customers to revert to notified prices should not result in a retail entity providing customer retail services to non-market customers at a loss.

The Delegation also requires the QCA to recalculate Ergon Energy's Aggregate Annual Revenue Requirement (AARR) for the period 2005-06 to 2009-10 using Net Present Value (NPV) smoothing of the actual AARR to determine annual revenue requirements which increase by the same percentage each year. The resultant smoothed revenue is then to be used in the calculation of the BRCI.

The QCA has identified a number of key issues that it will need to consider in calculating the BRCI for 2006-07 and 2007-08. AGL Energy Limited (AGL) is pleased to be able to provide comment on these issues.

EXECUTIVE SUMMARY

AGL is committed to providing its customers with electricity at reasonable prices that reflect the costs and risks incurred in supplying electricity.

The Queensland Government has established arrangements through legislation and regulations to provide for an annual change in the Maximum Uniform Tariff (MUT). These arrangements have been designed to ensure the changes to the MUT reflect the costs of purchasing and supplying electricity to non-market customers across Queensland.

AGL supports the proposed arrangements and encourages the QCA to consider all relevant costs in determining the BRCI for 2007-08. AGL has addressed the specific issues raised by the QCA in their Interim Consultation Notice. In summary, AGL:

- Notes that the energy costs are required to reflect the likely total costs to be incurred to purchase energy to supply all of the NEM load for the state (as defined). These costs are to be based on an assessment of the Long Run Marginal Cost (LRMC) of energy but should also incorporate consideration of the costs of hedging to manage price volatility and demand variability, the costs of ancillary services and the impact of renewable energy schemes;
- Notes that LRMC methodologies derive a theoretical energy cost based on a market that is perfectly competitive and reflects an optimum pattern of investment and use in productive capacity. In reality the total cost of energy to a retailer will be higher than a LRMC outcome and have more volatility than a year on year change in the LRMC;
- Proposes that in assessing the year on year change in the LRMC consideration needs to be given to the following:
 - The increasing peakiness of the load profile for the Queensland market driven by the increased penetration of air-conditioners
 - Increased fuel costs for generating plant and appropriate consideration of transportation costs for plant which operates below a 100% capacity factor
 - Increases in labour costs associated with the operation and maintenance of generation assets
 - Increases in the capital costs of generation assets arising from changes in commodity prices
- Advises that a preliminary LRMC analysis undertaken by AGL has indicated a real increase in the LRMC for the Queensland market;
- Notes the Queensland market has seen a significant increase in hedge contracts (swaps and caps) since January 2007. The QCA should utilise the provisions of section 92G2(d) of the Electricity Act to make allowance for these increased costs in order to reflect the total cost of purchasing energy;
- Supports the arrangements for the smoothing of the Ergon Energy network charges;
- Notes that the QCA is currently reviewing a pass-through application from Energex for FRC costs. Any allowable pass-through costs should be included in the AARR for 2007-08. The QCA should also give consideration to any FRC cost recovery to be obtained by Ergon Energy;

- Agrees that the NEM load used for determining the BRCI should exclude both the isolated distribution networks and the customer load directly connected to the transmission network;
- Expects that the retail costs for 2007-08 should make allowance for FRC costs and associated market related costs incurred by retailers.
- Considers that the increases in retail costs between 2006-07 and 2007-08 should take into account increases in the underlying cost drivers. For example, call centre costs that are predominantly labour will increase at the EBA rates for these employees. Typically, labour costs are escalating at around 4%;
- Expects that the retail costs post FRC will also include costs to acquire and retain customers to help defray fixed costs. The inclusion of such costs has been explicitly allowed for in the recent IPART decision in NSW;
- Experience is that regulated margins vary across jurisdictions depending on the nature and risks in those markets. We note that the Minister's delegation to the QCA requires the existing retail headroom to be maintained. Accordingly, it is important that the QCA decisions on energy costs, network charges and operating costs reflect the actual costs incurred by retailers else the current margins may be eroded.

AGL is prepared to meet with the QCA to provide further information on a confidential basis.

BENCHMARK RETAIL COST INDEX

The legislation passed by the Queensland Parliament and related regulations establish the arrangements for the annual indexation of the Maximum Uniform Tariffs (MUTs) applicable to non-market customers across Queensland.

The Minister has delegated to the QCA the responsibility for developing the BRCI to apply to the current MUTs to establish the MUTs for 2007-08. In doing so, the QCA must take into consideration the specific requirements of the Electricity Act and regulations and the guidance provided in the delegation notice.

The QCA must establish benchmark retail costs for both 2006-07 and 2007-08 in order to calculate the BRCI to be applied to existing MUTs. Accordingly, the absolute level of the benchmarks for energy costs, network charges and retail costs is not as critical as it would be if the QCA were calculating the absolute price. However, the year on year change in these cost components is critical in ensuring the index reflects the changes in retailer costs, particularly given the requirement for the QCA to maintain existing margins.

NEM LOAD

AGL supports an adjustment to the NEM load so that where load is directly connected to the transmission system it is excluded from calculations. This ensures that energy, network and retail costs are more reflective of the actual costs of customers who will be on MUTs.

COST OF ENERGY

Energy costs incurred by retailers in a competitive market are a combination of the hedge contract prices paid to generators (swap, cap and other derivative costs) and the pool price for energy purchases not covered by hedge contracts. These prices reflect the costs and returns for existing generating assets, the supply/demand balance, the peakiness of the load in a particular market and the volatility of demand. Hedge contract prices inevitably include a risk premium covering these volatilities.

Long Run Marginal Costs (LRMC) reflect a theoretical assessment of the energy cost based on a perfectly competitive market, with an optimum investment in an efficient mix of generating assets and effective use of that productive capacity. The LRMC is to be used as a basis for assessing the change in the energy costs. However, it is noted that the legislation also requires the energy costs to reflect the total cost of purchasing energy.

Accordingly, any assessment of the year on year change in energy costs must not only consider the changes using LRMC but also must take account of changes in hedging and other related costs. The current NSW electricity price review being conducted by IPART has similarly recognised the need to include these other costs in addition to the LRMC.

The need for this approach is clearly evident in the significant changes that have occurred in the wholesale cost of energy, being the cost of acquiring hedging cover in Queensland in recent months.

The wholesale price of energy in Queensland has increased significantly in the past few months. In AGL's assessment, the primary reason for this increase is the effect the drought is having on the available generation capacity in Queensland – as supply shortens, the price increases.

It should be noted that this increase will not be temporary – contracts are entered into for a period of years and the 'forward curve' (the term used to reference the future prices of electricity contract cover) is showing a consequent increase. In short, this means that retailers such as AGL can expect to pay more, well into the future.

LRMC methodology and expected changes year on year

As discussed above, AGL does not consider the LRMC to be a true measure of Wholesale Electricity Costs (WEC). WEC costs reflect the capital and operating costs of existing generation plant, together with the retailer's costs of risk management and other applicable market charges. A LRMC approach to estimating the cost of wholesale energy does not adequately address the market risks that arise from operating in a complex and volatile market.

LRMC generally does not have any 'stand alone' meaning in a competitive market, as it is incapable of capturing the risk premium built into contract prices. Notwithstanding this, AGL acknowledges that the QCA is required to calculate LRMC for the purpose of determining the BRCI and in doing so requests the QCA to take account of all drivers of generation costs including, but not limited to, the following matters:

- An appropriate load profile of the customers being covered by the MUTs;
- The peakiness of the profiles, including the impacts from changing climate and air conditioner penetration levels;
- The impact of any transmission issues. Should transmission constraints occur then additional generation capacity within the Queensland jurisdiction would become necessary. If this was to occur then the LRMC calculation should take into account the frequency of transmission constraints and include an additional 'capacity payment' component whereby generators are able to hold some level of spare capacity in their generation portfolio to ensure an adequate level of supply at times of transmission constraint;
- Access to water is an essential requirement for generators, and the costs of access to water are likely to increase in the future. These costs would include any associated with water entitlements and any pass-through amounts to generators of costs associated with the development or augmentation of

infrastructure (eg pipes and dams). The LRMC calculation should be capable of capturing any increases in these costs;

- The increasing capital costs and operating costs, as well as the varying assumptions on mix of expected generation capacity;
- The losses that occur between the generation plant and the regional reference node where energy is priced; and
- Market fees and charges.

There is strong evidence to suggest that the LRMC will change between 2006-07 and 2007-08. Specifically:

- The peakiness of individual load profiles is expected to vary quite markedly due to the combined impact of increasing levels of air conditioner penetration and a rapidly growing population;
- The costs of generation fuel are likely to increase:
 - the cost of coal may increase in the event that a 'carbon' tax is imposed
 - the cost of gas may increase as coal becomes less utilised and as conventional gas supplies become constrained
 - Gas costs will increase in line with current contract escalations
 - transport costs of gas need to take account of the capacity factor of the generating assets as firm transport costs for full year are required to be recovered over the period when generating;
- capital costs of generating assets will reflect increases in commodity prices;
- The required WACC for generation plant is likely to increase, particularly for coal-fired plant in response to the uncertainty surrounding carbon pricing and the risks attached to that uncertainty;
- Labour costs are anticipated to rise by more than the CPI.

Generating plant and gas schemes

As noted above, the overall load in Queensland will increase, as will the 'peakiness' of the Queensland profile, due to the increasing level of installation and use of air-conditioning units. In order to efficiently meet this increasing demand and changing profile there will need to be an increase in low-emission gas-fired peaking plant. The LRMC calculation should be constructed so as to allow for and encourage an increase in this type of plant, rather than focusing on an increase in base load generation only.

The revenue obtained by gas-fired generation from the 13% Gas Scheme should be treated as an incremental source of revenue for these gas-fired generators. The LRMC calculation, including its consideration of the 13% Gas Scheme, should encourage and allow for an increase in the level of gas-fired peaking generation.

AGL expects there to be a marked increase in the demand for renewable generation in the coming years. This increase will be driven by an increasing awareness of issues associated with climate change and would be accelerated by the introduction of any form of 'carbon tax'.

NETWORK COSTS

Network charges incorporate both the transmission use of system charges (TUOS) and the distribution use of system charges (DUOS). The Australian Energy Regulator (AER) regulates the TUOS charges. The DUOS charges are established under a determination by the QCA.

In calculating the network charge component of the BRCI the QCA must have regard to the revenues allowed for Powerlink, Ergon Energy and Energex. Specifically:

- AGL notes that a Final Decision on the TUOS charges for Powerlink is yet to be made by the AER. The draft decision reduces Powerlink's proposed revenue by up to 3% over the 5-year period. For 2007-08 this reduction amounts to \$4million. The QCA should utilise the draft decision during the initial period of consultation on the BRCI. The AER final decision may be available prior to finalising the BRCI and accordingly an appropriate adjustment can be made at that time.
- AGL supports the recalculating Ergon Energy's AARR using NPV smoothing.
- AGL notes that the QCA approved the capital expenditure pass-through application from Energex and has determined revised AARR amounts for 2007-08 and subsequent years.
- AGL notes that Energex has also applied for recovery of FRC costs of \$48.9m up to and including the financial year 2007-08. AGL has separately commented on this matter to the QCA. AGL considers that the amount allowed as a pass-through by the QCA should be also be included in the Energex AARR for 2007-08 for the purposes of the BRCI.
- It is not clear whether Ergon Energy also proposes to make a FRC pass-through application. AGL considers that the determination of the BRCI should also make allowance for the recovery of FRC costs by Ergon energy.

RETAIL COSTS

Retail operating costs

Retail operating cost benchmarks should allow for a range of retailers (large or small, incumbent or new entrant) to compete in the marketplace. AGL considers that retail operating costs should be set at a level that includes all costs of attaining, retaining and servicing customers. The allowance for retail operating costs should cover a retailer's costs associated with:

- Billing and revenue collection;
- Operating a telephone call centre;
- Providing advice and assistance to consumers.
- IT system costs and business to business (B2B) costs associated with handling metering data and other transactions with the distributors;
- Regulatory compliance;
- Corporate overheads, including licence fees and ombudsman charges; and
- New service or regulatory requirements not currently being incurred, such as those associated with the roll-out of interval meters.

An efficient new entrant retailer will also incur customer acquisition and establishment costs in addition to the costs mentioned above. A new entrant retailer usually experiences higher operating costs than incumbent retailers stapled to a distributor. For example, experience in other jurisdictions indicates that stapled retailers have lower B2B costs than new entrant retailers, both as a capital cost and a day-to-day cost.

In addition, regulators generally accept that bad debts are included in operating costs and not in the retail margin.

AGL notes that the regulation requires the QCA to consider that an efficient stand-alone retailer has a customer base of about 500,000 customers. In other jurisdictions, the definition of an efficient retailer is one that is of sufficient size to achieve economies of scale.

AGL supports the inclusion of additional retail costs arising from the introduction of FRC including additional costs for system and process changes, B2B transaction processing, additional customer communications and call time, etc.

In determining the retail operating costs for the notional retailer (as described in the legislation) the QCA should take guidance from benchmark operating costs allowed in other jurisdictions. Specifically:

- In Victoria and South Australia the current benchmark is \$95 per customer which includes FRC costs but make no specific allowance for customer acquisition costs;
- In NSW the current IPART draft determination allows for \$110 per customer including FRC costs and customer acquisition costs.

Determining the retail cost for the notional retailer for 2006-07 becomes more problematic. It is suggested that the QCA could derive this by deducting from the 2007-08 benchmark an allowance for:

- FRC costs of retailers – historically in the range \$10-\$20 per customer;
- Customer acquisition costs - \$35 per customer allowed by IPART.

The QCA will also need to give consideration to the basis for escalation of the benchmark to 2007/08 dollars. This should take account of the underlying cost drivers, for example, labour costs are typically escalating at or above 4%.

Retail margin

In general terms retail margins need to be sufficient to cover business risks, interest payments, tax liabilities, etc, as well as ensure a reasonable return to shareholders. Low retail margins are a significant impediment to developing competition and to future investment in generation capacity. The benchmark margin must also be sufficient to attract new entrant retailers and to enable the transition to market based prices thereby reducing the reliance on regulated prices.

Benchmark retail margins exhibit an asymmetric risk. If the benchmark costs and margins are set below realistic levels then competition and investment are likely to be stifled. However, if margins are set above realistic levels then any benefit is likely to be competed away as retailers seek to attract customers.

The Minister's delegation notice requires the QCA to maintain the retail headroom that existed at the time the delegation was provided to the QCA. AGL supports the retaining of current margins in Queensland to maintain consistency with the introduction of FRC.

As discussed above, to give effect to this the QCA will be required to ensure allowable change in each of the cost components (energy, network and operating costs) reflect the extent of change occurring in the market, particularly with respect to energy costs.

Further, to effectively maintain the margin it is appropriate that it is determined as a percentage of sales. This approach is commercially accepted across a range of industries and is generally consistent with that adopted in other jurisdictions.



Tariff reversion

Retail customers would only be expected to revert to the regulated tariff if market contract prices are higher than the regulated rate. Where the retail margin is retained and the BRCI effectively reflects changes to the costs of purchasing and supplying electricity to customers there would be limited expectation of customers reverting to the MUTs. This does, however, place significant emphasis on the QCA to establish an effective BRCI.

The QCA is afforded the opportunity under the legislation to consider any other relevant factors in determining the BRCI and accordingly can provide appropriate consideration to the factors driving the increase in costs in the Queensland market.