



Benchmark Retail Cost Index 2009/10 Response to QCA Draft Determination

AGL submission to the Queensland Competition Authority

Date: 24 December 2008





1. Executive Summary

AGL welcomes the opportunity to provide comments on the QCA's Draft Determination in respect of the 2009/10 BRCI. AGL views the consultation process adopted by the QCA in respect of the 2009/10 BRCI to be a significant improvement to that adopted in respect of the 2008/09 BRCI. AGL is also pleased to note that not only have the QCA provided stakeholders with detailed data underpinning the calculations performed by CRA, but have also ensured CRA consulted stakeholders in correcting the flaws in the data that characterised CRA's first and second draft report. AGL notes that this process has provided significantly more transparency and credibility to the CRA calculations.

AGL believes the wholesale costs calculated by CRA for the purposes of this Draft Determination reflect a much more realistic analysis of the likely costs faced by a retailer operating in Queensland. As noted by CRA in its Final Second Draft Report, there are still clear issues associated with the manner in which the wholesale costs are calculated which prevent the BRCI from fully reflecting the costs incurred by retailers operating in the south-east sector of Queensland. These include, but are not limited to the requirement to use the LRMC as the basis for wholesale costs, and the inability to reference the Net System Load Profile (NSLP) as the relevant load in determining the costs, coupled with an assessment of network costs on the basis of the average of Energex and Ergon's AARR, rather than a pass through allowance of network costs by retailers.

AGL notes that the network costs reflected in the BRCI are in no way representative of the network costs retailers are likely to incur from Energex in respect of its small regulated customers. AGL notes that while the BRCI captures an increase of approximately 12% in network charges, AGL anticipates that Energex will increase its distribution tariffs to small customers by up to 21%. As such, the Draft 2009/10 BRCI still does not adequately capture the change in costs faced by retailers in Queensland, and the headroom of the retail businesses sold by the Government continues to be significantly less than the headroom at which these businesses were acquired. This deterioration in headroom is contrary to the Delegation under which the QCA exercises its pricing determination function. AGL notes in this respect that the increase in network tariffs accounted for in the BRCI last year was 5.67%, while small customers in south-east Queensland experienced increases of 11-12%.

Preparation of 'alternate' BRCI

Two matters of interpretation are currently before the Supreme Court in Queensland. As the QCA is aware, there will be a relatively short period of time available to the QCA to adjust the tariffs for 2009/10 to take account of the Supreme Court's finding in the event this application is successful.

AGL is firmly of the view that the QCA should immediately instruct CRA to calculate the 2009/10 BRCI on the basis of the 'alternate' view, in the same way CRA calculated the 'alternate' view in respect of the 2008/09 BRCI. A failure to take this preparatory step at this stage risks delaying the finalisation of the 2009/10 tariffs.

Consideration of the CPRS

AGL has consistently supported the exclusion of the CPRS from the calculation of the LRMC for the purposes of the 2009/10 BRCI. As clearly expressed at the Second Workshop on 28 August 2008, and in AGL's comments on the second draft CRA report, AGL does not



believe it is appropriate for customers to 'incur' costs associated with the CPRS before those costs are actually incurred by retailers. However, upon commencement of the CPRS, all costs incurred by retailers should be benchmarked and included in tariffs from this time.

AGL resolutely rejects the methodology suggested by CRA in seeking to determine the impact of the CPRS on LRMC. The methodology suggested by CRA to account for the costs of a CPRS is without merit, and should not be considered further. This approach will not properly account for the costs incurred by a retailer, and cannot be supported. Any mechanism which does not fully account for the costs incurred by retailers will not only threaten the viability of retailers, but will not accord with the stated aims of the CPRS. In the recently released White Paper, the Federal Government has clearly articulated that the full cost of carbon is to be passed through to consumers, with any impact of such a pass through being ameliorated through increased direct and transparent financial assistance. In fact, the Federal Government specifically notes (at page 15-12 of the White Paper) the potential for significant detriment to the market as a whole if the full costs incurred by retailers are not passed through:

If regulated retail prices do not allow for the pass-through of carbon costs, this could threaten the viability of energy retailers and, in turn, weaken their ability to contract with existing and new electricity generators... The Australian Government recognises the importance of carbon cost pass-through in energy markets to ensure that Scheme objectives are not undermined.

AGL notes that CRA itself stated in both workshops that this methodology did not accurately reflect the costs retailers would incur. This position was defended by CRA with the suggestion that in their view it was not the policy intent of the Federal Government that end users would bear the full cost of the CPRS. Given that the policy position of the Federal Government is no longer the subject of speculation, the QCA must reject any suggestion that the methodology proposed by CRA can be adopted in any future consideration of the impact of carbon on regulated retail prices. The manner in which the carbon pass through is ultimately determined for the purposes of the 2010 retail tariffs should be the subject of consultation between the Queensland Government, the QCA, retailers and other stakeholders over the coming months.

LRMC

AGL welcomes the work done by ACIL Tasman in respect of the LRMC input assumptions. AGL maintains that the QCA should accept the step change approach as recommended by both ACIL Tasman and CRA.

However, in the event the QCA remains of the view that a regression analysis is appropriate, AGL agrees that the 15 year period is not relevant, and should be shortened. AGL suggest that a more appropriate period is one of 3-5 years, which relevantly reflects the 'life cycle' of a generation build project.

Network Costs

As noted by all stakeholders throughout the consultation in respect of the 2008/09 BRCI and the 2009/10 BRCI, the network costs reflected in the BRCI do not accurately capture the increase in network tariffs that retailers operating in South East Queensland have and will incur.

While AGL accepts that this is largely attributable to the legislative and regulatory provisions and the ability to Energex to rebalance its tariffs, AGL does not believe that the QCA has adequately considered the impact of this issue on retailers in assessing the 'costs' of a retailer and the direction to substantially maintain headroom.



2. Headroom

The QCA and CRA have each discussed in some detail in the meaning and impact of the condition in the Minister's Delegation which states that:

The annual indexation of electricity tariffs by the index should ensure that existing retail headroom in the tariffs at the date of the original delegation made prior to the commencement of full retail competition remains relatively stable (although not necessarily the same from year to year);

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.

Proper construction of condition in delegation

In order to properly consider the effect of the condition in the delegation, the QCA and CRA must acknowledge the context in which the condition was articulated and imposed.

As the QCA and CRA have both noted, the policy was first articulated in the letter to bidders (copy attached at **Annexure 1**) and placed in the data room prior to the sale of both the Sun Retail business (ultimately acquired by Origin Energy) and Powerdirect business (ultimately acquired by AGL). The purpose the letter was to communicate to prospective bidders that the intended effect of the regulated pricing legislation and regulation was to maintain the current levels of profitability on those businesses. Once this context is recognised, AGL submits that the proper construction of the condition as it appears in the delegation is clear – namely that the pricing regulation should be interpreted in such a way so that any business that acquired the Sun Retail and Powerdirect businesses would be in a position to retain the headroom as it existed at the time of the sale. While AGL accepts that the eventual drafting of the legislation and regulation do not specifically acknowledge this intent, AGL believes this is the clear and natural meaning of this condition in the delegation. While the QCA and CRA may rightly suggest that it is not a simple matter to give effect to this, to suggest that the meaning of the condition is otherwise is to ignore the clear and intended policy underlying the letter to the bidders and the inclusion of that policy undertaking in the Delegation.

From this, it follows that the QCA must consider what the headroom position of any retailer operating the Sun Retail and Powerdirect business would be, and ensure that the BRCI is established with reference to that headroom. This does not call for an examination of the 'actual' headroom of OE and AGL, but rather consideration of what the appropriate benchmark market costs would be for any retailer operating those businesses. This interpretation must be considered the appropriate one, for the following reasons:

- If the policy were in fact to maintain headroom on the basis of the specific retailer's actual costs, rather than the market benchmark costs, the policy would effectively be allowing retailers to engage in inefficient and imprudent cost management, on the basis that they would be 'made whole' in the application of regulated retail prices. The policy underpinning this condition would thus have the effect of guaranteeing to retailers an existing margin irrespective of how efficiently they managed their costs. If



indeed it were to be referable to the actual headroom, neither AGL nor OE would have any incentive to manage their cost position, but would in fact be able to be inefficient and imprudent, and pass excess costs through to customers on the regulated tariffs. This cannot be the intent of the policy;

- As CRA in particular are aware, national retailers hedge across jurisdictional boundaries and use a variety of arrangements to manage their wholesale risk, including investments in upstream assets. It is therefore extremely difficult to isolate the cost attributable to the Queensland franchise load. Further, there are many ways in which such an exercise could be approached, and the choice of approach would be one which would prove very difficult to agree upon. This has been the experience in other jurisdictions, with the result that those jurisdictions have moved to a 'benchmark' wholesale approach.

AGL notes in this respect that:

- AGL is of the view that considering headroom to be the gross margin is an acceptable way of considering the impact of the delegation. AGL does not believe that, as suggested by CRA at page 17, its submission in the Issues Paper on the issue of headroom was in fact materially different to that of Origin Energy's. OE and AGL were both making the same point, namely that whichever way the QCA chooses to consider headroom, be it on a gross or net analysis, or on a \$/customer or percentage of sales basis, the headroom has indeed been eroded.
- AGL welcomes CRA's acceptance (at page 23 of its Draft Report) that the decision to 'update' data in the 2008/09 Determination eroded headroom. An appropriate approach by the QCA and CRA in seeking to maintain headroom (at least in part) would be to make judgements in favour of maintaining headroom rather than establishing principles that have the effect of eroding headroom.
- In order to properly consider the effect of the condition in the delegation, the QCA and CRA must acknowledge the context in which the condition was imposed. As the QCA and CRA have both noted, the policy was first articulated in the letter to bidders, placed in the data room prior to the sale of both the Sun Retail (OE) and Powerdirect (AGL) businesses. The QCA should consider the 'theoretical retailer' in question to be one operating in south-east Queensland patch that formed the footprint of the businesses that were sold and the subject of the statement of policy in the letter in the data room.

Giving effect to the conditions in the Delegation

In respect of how the QCA should take account of the headroom, AGL suggests one approach that should be considered is as follows:

- The relevant headroom is the percentage of gross margin to total revenue of the former Sun Retail and Powerdirect businesses – ie the difference between the revenue obtained from the customer base (as at the time of the sale of the businesses) and the network and wholesale costs (calculated as per an appropriate benchmark) incurred by the businesses in servicing that customer base.
- The headroom of the Sun Retail and Powerdirect businesses at the time of the sale should be considered with reference to:
 - The hedge position these businesses acquired at the time of the sale. This information was provided in the data room at the time of sale, and is



confidential to both businesses. The hedges that were acquired should be valued with reference to a hedging strategy of layering in hedges over 24 months. The price of the hedges should be assumed to have been the flat hedge contract price scaled to account for the shape of the franchise load acquired (referred to as the 'scaling factor'). AGL notes this methodology accords with that suggested by AGL to ESCOSA, and accepted by ESCOSA as providing a robust means of assessing wholesale costs;

- The network costs they were incurring at the time of the sale;
- The tariffs, customer numbers and average consumption at the time of the sale.
- The headroom of the retailers for the purposes of the 2009/10 BRCI is then ascertained with reference to:
 - the percentage of margin on the total revenue obtained with the same customer base as that which was acquired and using the 2008/09 regulated tariffs. This ensures a 'like for like' comparison;
 - the actual network costs that will be imposed on the Sun Retail (OE) and Powerdirect (AGL) customer base. This should take into account the full impact of the ability of Energex to rebalance between tariffs, and the historical willingness of Energex to rebalance fully into its small customer base; and
 - the wholesale costs that would have been incurred in adopting a prudent level of hedging. The cost of those hedges should continue to be referenced to the flat contract hedge price over the preceding 12 months with an appropriate scaling factor applied to ensure a like for like comparison.
- The difference in the headroom between that which existed at the time of the Original Delegation and the difference in headroom under the Draft 2009/10 BRCI should then be assessed, and accounted for in the Final Determination as an additional 'cost' to be taken into account under section 91G(d), which provides that the QCA should include in its assessment of costs 'any other relevant costs the pricing entity considers relevant'.

AGL does not believe there is any 'change in methodology' implicit in taking account of headroom. AGL notes in this respect that Regulation 107(2) and 111(2) determine the circumstances in which a change to the theoretical framework becomes relevant to the calculation of the 'base year' for the BRCI.

The calculations that result from such an approach being applied to the business acquired by AGL are provided in **Confidential Annexure 1**. AGL would welcome the opportunity to discuss these in further detail with the QCA.



3. Cost of Energy

3.1. Load Data

AGL again notes its view that the regulations and legislation require the QCA to use the NEM load, being the volume and shape of the NEM Load, in determining the energy purchase costs and the LRMC, rather than the entire Queensland load as is presently being used. AGL's position in respect of the use of the entire Queensland load rather than the NEM load as required by the Legislation and Regulation is the subject of a judicial review proceeding. AGL makes clear that it is in no way accepting this as the correct approach.

Further, as the QCA is aware, it will be afforded a very limited period of time between the decision of the Supreme Court being made and the data on which the gazettal of the tariffs for 2009/10 are required. It is therefore imperative that the QCA immediately instruct CRA to prepare the load data on the basis of the alternate interpretation (ie the NEM Load). AGL notes that CRA conducted this same exercise in respect of the 2008/09 BRCI, and published the results in the Final 2008/09 Report. AGL does not see that there can be any objection to undertaking this work immediately so as ensure that, in the event the application for judicial review is successful, the QCA are in a position to make the appropriate final determination.

AGL would be very pleased to consult with CRA in the preparation of the appropriate 'NEM Load' in the same manner the entire Queensland load was determined by consultation between CRA and stakeholders.

3.2. Long Run Marginal Cost

3.2.1. Inclusion of CPRS in LRMC

AGL has consistently stated that:

- It is highly probable that the CRPS will be introduced and take effect from 1 July 2010. This has again been confirmed with the release of the White Paper on 15 December 2009, which clearly articulates the commencement date;
- One of the primary purposes of the CPRS is to provide a price signal to customers to drive a change in behaviour, and the full cost of carbon must be passed through to consumers. This is clearly articulated throughout the White Paper, and the need to pass through the full costs of carbon is specifically supported (see below for further detail);
- customers should not incur the costs associated with carbon until those costs are incurred by retailers;
- the methodology suggested by CRA is completely inappropriate, as it in no way capable of reflecting the actual costs a retailer will incur with the introduction of the CPRS; and



- this methodology must be rejected as any guideline to how the impact of carbon will be assessed in future years.

Objective of the CPRS

AGL does not understand the QCA's statement at page 8 of its Draft Determination:

Discussions on emissions trading in the first stakeholder workshop centred on the method by which the additional cost of carbon permits should be calculated. Whilst CRA had included costs at the wholesale level (as per the intent of the Commonwealth Government proposal), AGL had proposed that the per-tonne cost be passed on in full to customers.

Firstly, AGL requests that the QCA specifically acknowledge that AGL's submissions on this point were in no way suggesting that the cost of carbon be included in the 2009/10 BRCI, but were focussed on the inappropriateness of the suggested methodology as a means of calculating the impact of carbon costs on retailers and sought to dispel any notion that the CRA methodology would be appropriate in future BRCI calculations.

Second, AGL is deeply concerned by the implicit suggestion in this statement that the CRA methodology is in any way consistent with the 'intent' of the Commonwealth Government proposal. On the contrary, the Federal Government makes specific note of the need for retailers to fully recover the costs of carbon from consumers. The Federal Government states (at page 15-13 and 15-14):

Failure to adequately provide for recovery of those costs would reduce the potential for competition to develop and could threaten the long-term security of supply if retailers do not have viable business models. Nonetheless, these matters should be addressed through the MCE's energy market reform agenda, rather than in the implementation of the Scheme.

The Australian Government recognises the importance of carbon cost pass-through in energy markets to ensure that Scheme objectives are not undermined.

The White Paper also explicitly recognises the threat to the market presented by a failure to permit retailers to pass through the full costs of carbon:

The Government notes the results of California's partial deregulation of its electricity market...If regulated retail prices do not allow for the pass-through of carbon costs, this could threaten the viability of energy retailers and, in turn, weaken their ability to contract with existing and new electricity generators.

This clear policy intent has further been recognised by the Ministerial Council on Energy which stated in its communiqué dated December 2008:

Noting the importance to the function of the CPRS of allowing carbon-cost pass-through in retail energy markets, Ministers agreed to propose to Council of Australian Governments (COAG) that it amend the Australian Energy Market Agreement (AEMA) to specify that, where retail prices were regulated, energy cost increases associated with the CPRS shall be passed through to end use consumers



CRA Methodology for CPRS

The methodology proposed by CRA cannot be considered an appropriate means of assessing the impact of carbon on the LRMC of energy in Queensland. AGL makes the following comments in relation to the CRA methodology:

- In reality, the carbon price will be a function of the costs of abatement, which in the electricity sector will be driven by the cost of switching between existing high emission technology and low emission technology.
- In the CRA methodology, this relationship is completely reversed - the carbon price is taken as a static value, and is used to drive the theoretical generation build. This means an LRMC is derived which has no connection with reality – it is based on a generation build which delivers 100% of its energy from CCGT plant, a generation build which has no relationship with reality, and in no way reflects the LRMC of the generation plant which will supply customers in Queensland, even under a CPRS. This is expressly recognised by the QCA at page 17 of its Draft Determination, where it states:

Such an outcome, which is driven by the greenfields methodology, would be substantially at odds with the current and likely future generation mix, at least in the medium term.

- CRA is in no way able to warrant that the methodology it has used in determining the LRMC inclusive of a cost associated with carbon will even reflect the most efficient mix of generation under the policy conditions imposed by the CPRS, and thus does not comply with the requirements of the legislation in any case. The CPRS will cover the entire economy, not just the electricity sector. As such, the marginal costs of abatement in other sectors and CER prices will influence the domestic carbon price and therefore the level of abatement required in the electricity sector. Utilising a carbon price based upon a single sector's abatement opportunities cannot be used to accurately determine the most efficient generation mix.
- Under the CRA approach, this LRMC is then weighted at a 50:50 ratio with energy purchase costs. This means that even if the energy purchase costs were calculated in such a way as to capture the full cost of carbon, the methodology suggested by CRA would deny retailers full cost recovery.

The methodology that should ultimately be used to determine the impact of the CPRS on regulated tariffs in Queensland is one that should be considered carefully by the QCA, the Queensland Government, retailers and all stakeholders over the course of the next 6 months. In the interim, AGL requests that the QCA explicitly recognise that:

- Retailers will be incurring significant costs with the introduction of the CPRS on 1 July 2010;
- The clear and unambiguous intent of the Federal Government and MCE is for the full cost of carbon incurred by retailers be passed through to end-use consumers, so as to provide a price signal to customers. The CPRS (and indeed all of the supporting modelling performed by Treasury) is predicated on the assumption that the full cost of the CPRS is passed on to consumers in the form of higher electricity prices; and



- The CRA methodology is not appropriate and will not form the basis of any further consideration.

CRA Methodology for MRET/NRET

CRA have acknowledged that the MRET/NRET used in the calculation of the LRMC for the purpose of the Final Draft Report are incorrect, and will result in an underestimate of the LRMC.

AGL notes the recent release of draft legislation which will effect an expansion of the MRET/NRET. This draft legislation, which will become effective as of 1 July 2009, confirms that the MRET/NRET in 2010 will be 12.5TWh, as suggested in Table 7 of the CRA Report.

3.2.2. Input Assumptions

AGL is very pleased to note the QCA's publication of the report it commissioned from ACIL Tasman in respect of input assumptions for LRMC, and the use of the updated input assumptions by CRA in its LRMC calculation.

AGL has some concerns with the updated input assumptions produced by ACIL Tasman, although acknowledges that these are a vast improvement on those used by CRA and the QCA in 2008/09.

Weighted Average Cost of Capital

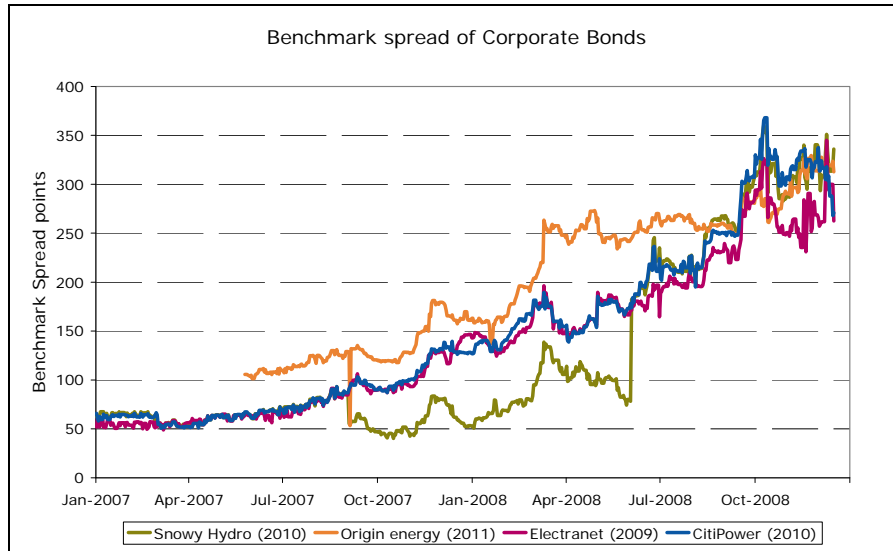
AGL suggests that the WACC assumed by ACIL Tasman appears much too low given the current state of the financial markets. The QCA and CRA assumed a WACC in 2008/09 of 9.20%, and CRA is proposing a (pre-tax) WACC of 9.50% for the purpose of the 2009/10 BRCI. This is clearly at odds with the substantial change in the cost of capital that has been observed in the world and Australian markets in the past year.

More specifically, AGL makes the following comments in respect of the parameters currently used in the WACC calculation:

Debt Basis Point Premium

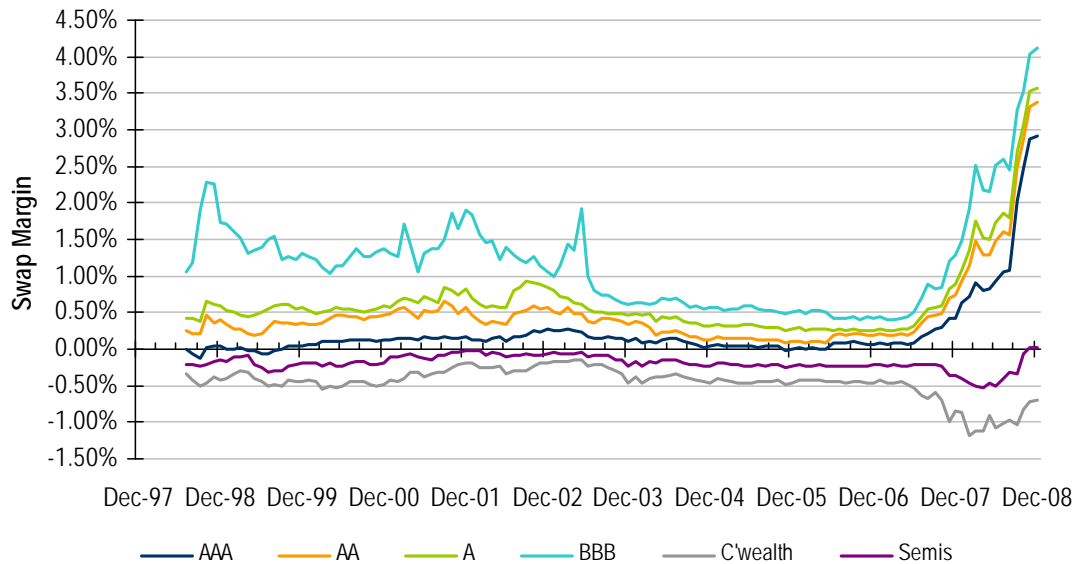
AGL is of the view that a debt basis point of 200 as suggested by ACIL Tasman and the QCA is lower than is justifiable, and suggests a debt basis point of 350 would be more appropriate. To illustrate this point, the chart below shows the benchmark spread of corporate bonds for a few companies in the NEM (those that were available). AGL notes that:

- The transmission companies of Electranet and CitiPower, with regulated returns, have a benchmark spread of 260 points;
- Snowy Hydro, a government owned corporation, has a basis spread of 340 points; and
- Origin Energy has a benchmark spread of 320 points.



Source: Reuters quote "O#AUCORP="

Govt / Corporate Credit Average EoM Margin to Swap Curve (Source: CBA Spectrum)



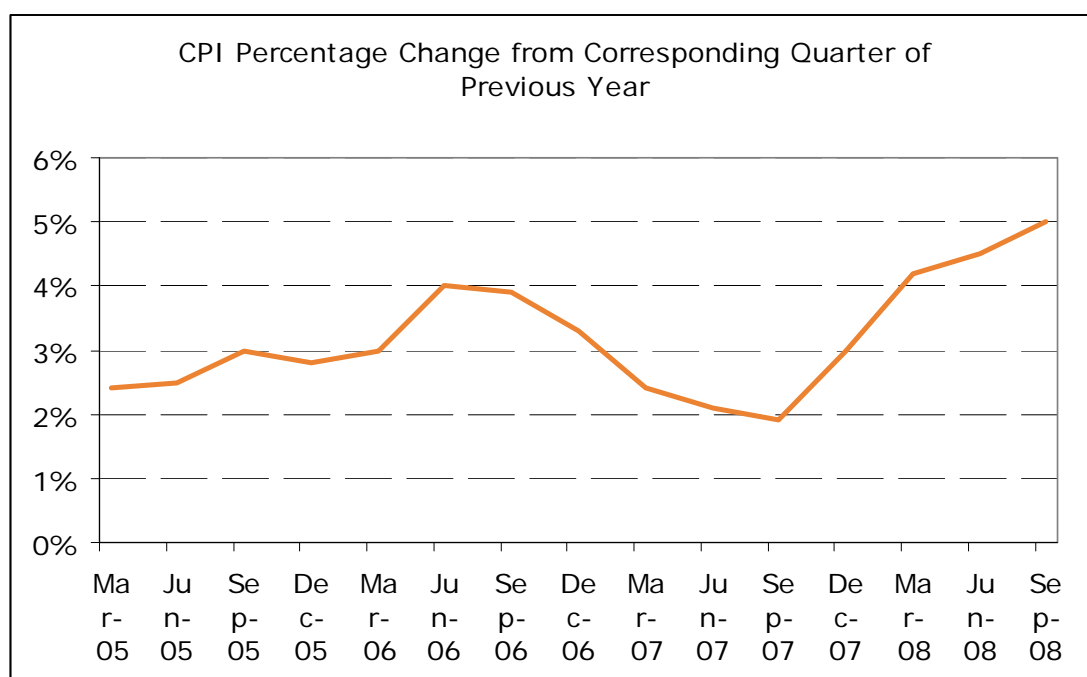


AGL further notes that the spreads indicated in the graph above are for large corporations with significant access to capital. In addition, Simshauser¹ notes that a recent survey of Project Finance and Syndication Bankers confirmed a mean of 250 – 300bps as a margin on senior debt for project financing in 2008, with a mean term of 5 years.

Inflation Rate

AGL does not believe that the inflation rate of 2.50% used by CRA in the WACC calculation on page 83 is appropriate. AGL notes that the annualised CPI has been above this level for most quarters since 2005. The use of this lower inflation number in the WACC calculation leads to an underestimate of LRMC costs- especially in the early years of the LRMC model.

Further, AGL notes that the 2.5% inflation assumption in the WACC is not consistent with section 2.1 (page 26) of CRA's report which states that inflation is forecast to be 3% for the 12 months to June 2010. The inflation level used in the WACC should be consistent with the assumptions in section 2.12, namely a forecast of 3%.



Risk Premium

The risk premium of 6% seems low given the current volatility in equity and debt markets. In the past 12 months, volatility in stock exchanges has approached levels previously unseen since 1987. To illustrate this fact, the figure below shows the Chicago Board of Exchange Volatility Index (VIX). The VIX is a measure of implied volatility of options on US

¹ "On Emissions Trading, toxic debt and the Australian power market", Paul Simshauser, page 16.



equities in the S&P500. From 2000 to 2007 the index averaged 19.5% p.a. but for the past six months this has jumped to an average of 40%. Given this sudden step change in volatility, a risk premium of 6% seems extremely low given the amount of risk investors' face for their equity. (Note: AGL would be happy to construct a similar index for the Australia share market if QCA requires evidence that volatility in the Australian market has increased, although we expect this is unlikely to be considered necessary given recent media attention).

Risk Free Rate

AGL believes that the Risk Free Rate has decreased recently due to an easing in Monetary Policy by the Reserve Bank and hence would like to see a decrease in this parameter so long as the above measures are appropriately adjusted- especially the debt basis point premium and the risk premium. In addition, AGL would like CRA to state which government bond rate yield they are using to calculate the Risk Free Rate.

3.2.3. Step change vs Regression analysis

AGL is disappointed that the QCA has again opted to use LRMC capital costs derived from a 15 year regression analysis instead of from the step change scenario. The QCA are adopting this approach notwithstanding the opinion of both ACIL Tasman and CRA that the step change approach is more appropriate in the circumstances.

In the event that the QCA remain of the view that a regression analysis is appropriate, AGL agrees with the suggestion made by the QCA (at page 15) that the period over which the regression analysis is analysed is reconsidered. AGL notes that use of a 15 year period was at no time justified on the basis of relevance, but rather on the basis of availability of data. AGL accepts that, for as long as the relevant costs increased at a stable rate, the period of time over which a regression analysis was conducted was largely irrelevant. However, in light of the significant changes in the input costs, the period of time needs to be considered more carefully. At present, the use of a 15 year period has the effect over 'over smoothing' the recent increases in cost, a fact the QCA appears to accept in suggesting that it may be appropriate to allocate 'more weight to the recent build up in prices'.

In determining the appropriate period, AGL suggests that the context of the analysis must be considered. The purpose of the analysis is to determine the likely LRMC of a particular generation build on a greenfields basis – ie what would be the LRMC of a completely new build of generation plant. If a step change analysis cannot be accepted, then the relevant regression analysis should be conducted in respect of the period in which the generation plant would be planned, committed, built and commissioned. AGL suggests the relevant period is therefore one of 3 years, extending to 5 years at the outer limit.

3.3. Energy Purchase Costs

While AGL, and indeed other stakeholders, had significant concerns with the data compiled by CRA, and its analysis of that data, in both its First and Second Draft Reports, AGL is pleased to note that CRA has corrected most of the errors identified by stakeholders. AGL congratulates the QCA on embracing a significantly more transparent and robust process in its consideration of the energy purchase cost element of the 2009/10 BRCI.

AGL believes that the energy purchase cost identified by CRA and the QCA is a much more realistic assessment of the actual costs faced by retailers in supplying the Queensland retail load. While AGL maintains that the legislation and regulation actually requires this



cost to be determined on the basis of the NEM Load (and that in actual fact the costs faced by retailers should be referenced to the Net System Load Profile), the result derived on this basis appears to be significantly more robust than that contained within the first and second draft CRA reports.

AGL still has some concerns with the approach adopted by CRA, particularly in respect of CRA's use of the MLF. CRA appear to still be applying the MLF after they have determined the hedged load. As clearly stated by AGL at the Second Workshop, and in AGL's written comments on CRA's second draft report, the appropriate manner in which to determine hedging for the hypothetical retailer is to apply the MLF to the forecast load prior to the 'acquisition' of hedges. This aligns with the approach taken by retailers operating in the market, and ensures the hedge position provided to the hypothetical retailer aligns with the hedging strategy proposed by CRA. CRA agreed at the Workshop that this was the appropriate approach, and that any result whereby the hypothetical retailer is hedged over 10POE levels is not a sensible outcome. AGL notes that CRA do not appear to have amended their approach, notwithstanding their agreement to do so in the Second Workshop. AGL looks forward to receiving the amended hedge data from CRA for its review and consultation.

3.3.1. Settlement of contracts against forecast price and load outcomes

AGL is pleased to note that CRA have adopted a 'weighted' approach to the likely outcomes, rather than assuming a 'perfect foresight' approach whereby the outcome is based only on the 50POE.

As noted in the Second Workshop, AGL is prepared to accept the weighting suggested by CRA of likely outcomes if the demand and price trace are adjusted to more accurately reflect the observed outcomes in the NEM.

3.4. Other costs

MRET/NRET compliance costs

AGL maintains its view that MRET compliance costs should be determined with reference to the long run marginal cost of generation for assets eligible to create RECs as any retailer with a significant REC liability will need to enter into long term power purchase agreements (PPAs) in order to fulfil their liability. Given that CRA is now including renewable generation in its LRMC calculation, it should be able to determine the LRMC of RECs.

AGL considers the use of so-called market price data for RECs as wholly unreliable given the extremely illiquid nature of the market for RECs. A 'prudent' retailer would not rely upon this market to satisfy its REC liability due to this lack of market liquidity.

However, if CRA proceed with the approach of using market price data to determine the cost of RECs, AGL recommends using more recent price data than CRA have currently assumed. Given the lack of market liquidity, the further back one relies on historical data, the more unreliable this data is to reflect costs as trading activity is unlikely to actually have occurred. AGL suggests that price data for 12 months prior to the commencement of the compliance period be used. For 2009, this would mean using price data on 2009 RECs commencing 1/1/08 through to 31/12/08. For 2010, given there will be no data available for 2010 RECs traded during 2009, AGL recommends using the last 2 months price data available for 2010 RECs (presently this would be data for 1/9/08 to 31/10/08). As stated



by CRA in estimating contract price data for electricity the most recent data ought to be the best guide for future prices.

4. Networks

AGL again reiterates its concerns in respect of the manner in which the network component is treated in the calculation of the BRCI, namely that:

- In using the average Energex and Ergon AARR, the BRCI understates the increase that has been incurred in Energex's patch significant in 2009/10; and
- The BRCI makes no allowance for the ability of Energex to re-balance significantly outside the side-constraint in the 2009/10 year.

The combined impact of this is that while the BRCI reflects a network increase of 10.5%, Energex is in fact able to increase its tariffs to small customers by 18-21%.

While AGL understands that the legislative and regulatory framework requires the network component is to be calculated in such a way, AGL requests the QCA specifically note the impact of this on retailers operating in the south-east of Queensland, with specific reference to the following points:

- AGL again notes that any suggestion by the QCA or CRA to the effect that the mechanism of the BRCI will work perfectly, and the headroom of the theoretical retailer is indeed maintained. As noted elsewhere in this submission, this ignores the context of the delegation as being specific to retailers operating in the south-east of Queensland.
- irrespective of how the 'theoretical' retailer is considered, the ability of the distributors to rebalance outside of the AARR means that the BRCI will not operate so as to ensure headroom is maintained.

4.1. Estimating TUOS costs

AGL is very concerned by the prospect that under the timeframe imposed by the government, the QCA will be required to forecast the TUOS costs for 2009/10.

AGL considers the method suggested by the QCA, whereby the percentage share of Powerlink's 2008/09 revenue cap accounted for by Energex's and Ergon Energy's 2008/09 transmission charges to Powerlink's 2009/10 revenue cap could form the basis of the estimate. However, AGL is also of the view that the estimation must take account of the fact that retailer margins will be significantly eroded in 2009/10 due to the impact of the Amended Delegation and the ability of Energex to significantly rebalance into its small customer base. In these circumstances it is imperative that the QCA accommodate the need to ensure the TUOS costs for retailers in 2009/10 are not underestimated.

Further, AGL seeks a clear undertaking from the QCA that whatever estimates are used in determining the 2009/10 BRCI will be used in any subsequent BRCI determination – ie it will not be 'updated' to reflect actual TUOS costs.



4.2. Re-smoothing of Energex DUOS costs

AGL remains of the view that the QCA should re-smooth the Energex AARR in order to account for the fact that the initial smoothing was done without removing the over-recovered revenue.

5. Retail Operation Costs

5.1. Benchmark costs

AGL reiterates its support for the 'benchmark' approach adopted by the QCA in assessing the operating costs of retailers. However, AGL again notes that while it is happy to accept the level of operating costs determined by the QCA for the purposes of establishing a 'rate of change' between years, it does not accept that the operating costs determined by the QCA reflect the actual cost incurred by retailers.

5.2. Acquisition costs

AGL supports the submissions of other retailers in respect of the appropriate level of churn – ie it should be the level expected in a competitive market.



Annexure 1

**Letter to Bidders – placed in dataroom at time of sale of Sun
Retail and Powerdirect businesses**



Letter to Bidders.pdf



Confidential Annexure 1

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