

**AGL response to
Queensland Competition Authority
on
Draft Calculation of the 2007-08
Benchmark Retail Cost Index**

May 2007



EXECUTIVE SUMMARY

AGL is actively participating in the consultation undertaken by the Queensland Competition Authority (**QCA**) in determining a Benchmark Retail Cost Index for Electricity (**BRCI**) to be applied to the current maximum uniform tariffs (**MUT's**) to establish the tariffs applicable from 1 July 2007.

AGL welcomes the opportunity to comment on the QCA's Draft Decision and considers that within the agreed shortened consultation period the methodology adopted by the QCA is reasonable and acceptable. AGL acknowledges that the QCA during 2007-08 will undertake a more extensive review of the methodology and approach to the calculation of the BRCI for future years. Accordingly AGL has limited its comments on the draft decision to the key inputs and assumptions used by the QCA to establish the BRCI for 2007-8. Specifically, AGL:

- notes that the QCA proposes a 9.98% increase in tariffs reflecting a 5.3% increase in network charges (covering investment in network infrastructure by government owned network businesses), a 3.5 % increase in the wholesale cost of energy and a 1.1% increase in the costs and margin directly attributable to retailers (covering increases in labour and operational costs and additional costs from the introduction of full retail contestability (**FRC**). Retailer margins as a percentage of sales remain the same year on year.
- supports the approach adopted by the QCA to determine the wholesale costs of electricity whereby the total cost of purchasing electricity to supply customers is based on the long run marginal cost (**LRMC**) and the additional costs of purchasing hedge contracts to manage wholesale price volatility.
- considers the 1.6% change in the LRMC is reasonable, however, there are a number of aspects of this calculation that warrant further attention during the full review of the methodology during 2007-08, for example, why certain costs remain unchanged in nominal terms when it would be expected that costs would increase in line with inflation.
- Considers that the approach of benchmarking the 2007-08 additional costs associated with purchasing hedge cover provides a reasonable basis within the timeframes of this review and notes that a prudent retailer approach of layering in hedge cover over time has been adopted by regulators in other states and generally reflects the behaviour of incumbent retailers.
- Notes that the QCA has determined an increase in this purchase factor of \$3 per MWh utilising flat forward contract prices for the period 1 July 2005 to 30 June 2007. In calculating this purchase factor an assumption has been made that the contract prices for May and June would decline from \$60/MWh in April to \$47.50/MWh. Market prices for these contracts in May have averaged \$90/MWh and expectations are that prices for the remainder of May and June are likely to remain at this level or increase further.
- Requests the QCA to recalculate the purchase factor based on these higher costs for May and June. It is expected these higher costs would increase the purchase factor by \$5.65/MWh (to \$14.65/MWh) and result in the wholesale costs component of the BRCI increasing from 3.5% to 5.9%.
- Notes that the retail costs comprise a small proportion of the increase in the MUT's. Accordingly, while AGL considers a number of the assumptions regarding the extent of FRC costs, the impact of customer churn on costs to serve and the

level of margin appropriate for a electricity retail business warrant further consideration the likely impact on the tariff increase from changes to these items is expected to be minimal and can be deferred to the full review of the methodology during 2007-08.

- Notes that by the very nature of the index the extent to which changes in costs are not fully reflected in the index for this year will result in an increase in the index in subsequent years. Accordingly, should there be changes to the methodology arising from the full review to be undertaken by the QCA due consideration will need to be given to ensuring all changes in costs are captured (from 2006-7 onwards) and that no changes have been double counted.

Methodology and Approach

AGL understands that the methodology adopted in the Draft Decision by the QCA and its consultants, Charles River Associates (**CRA**), is not intended to be a thorough examination of all issues relation to the calculation of the Benchmark Retail Cost Index (**BRCI**). It has been developed as a means of establishing a BRCI for the year commencing 1 July 2007 within the permitted time, with a full review of the methodology to commence in October 2007. On this basis, AGL does not intend to comment on the methodologies used in the Draft Decision, but will focus on the assumptions and inputs used in applying the methodologies. AGL is proceeding on the understanding that any change to the methodology will require the recalculation of the BRCI for 2006/7, 2007/8 and the new calculation for 2008/9, in order to ensure all relevant changes to the BRCI are calculated consistently and captured accurately and fairly.

Cost of Energy

AGL supports the QCA's approach toward establishing a retailer's cost of energy by applying a 'cost of energy factor' in addition to consideration of the LRMC. This approach meets the QCA's legislative requirements of determining the total cost of purchasing energy to supply the NEM load of Queensland for the relevant year. As previously noted by AGL, the Long Run Marginal Cost (**LRMC**) energy is an economic analysis of energy costs based on meeting energy demand with the most efficient plant that can be constructed. The LRMC does not capture the volatility and market risks that are built into hedge contract prices. Retailers need to pay these market contract prices to obtain hedge cover for their retail load. AGL appreciates the QCA's recognition of this in applying the 'cost of energy factor'.

LRMC CALCULATION

AGL notes the CRA approach and report on the calculation of the year on year change in the LRMC. AGL accepts that within the time available the QCA has developed an adequate model to calculate the LRMC. AGL, however, considers that a number of aspects of the input assumptions and the model warrant further consideration including clarity to the load profile used by CRA to arrive at the calculated change in the LRMC. AGL accepts that this analysis will be the subject to major review during 2007/08 and as some items are likely to have offsetting impacts considers that deferral of any further adjustments to the LRMC until the calculation of the 2008/09 index would be acceptable.

CALCULATION OF 'COST OF ENERGY' FACTOR

AGL understands that CRA's methodology for calculating the 'cost of energy' factor has been based on the following:

- The factor represents the market costs paid by a retailer over and above the LRMC in obtaining hedging cover for its retail load;
- The factor relevant to Queensland retailers in the year 2006/7 has been based on the factor calculated by IPART as applicable in the same year – ie between \$9 and \$12/MWh;

- A prudent retailer layers in hedge contracts progressively over time and has assumed that retailers will acquire 1/24th of its hedging requirements each month, so that its hedging requirements for the year commencing 1 July 2007 will be acquired over the 2 years prior - ie commencing July 2005;
- The cost of flat hedges across that 2 year period is an accurate reflection of the cost of all other hedges used by retailers.

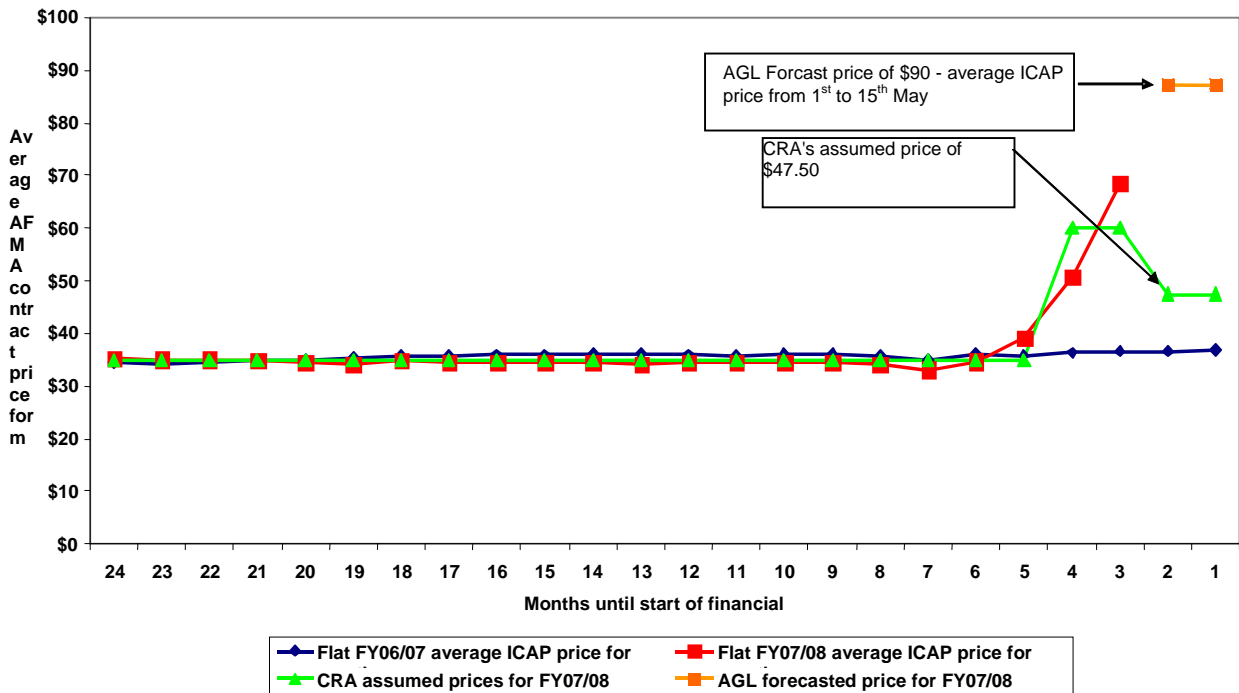
On this basis, the change to the factor from one year to the next can be found by comparing the premium paid in 2006/7 to that which has been paid to hedge the retail load for 2007/8.

CRA has then reviewed and made assumptions as to the prices that flat hedges were traded over the 22 month period from July 2005 through to April 2007, being that:

- In the period July 2005 to February 2007 prices averaged approximately \$35/MWh;
- In the two months from March 2007 to April 2007 prices increased from \$35/MWh to \$60/MWh;
- An estimated cost of \$47.50 for the months of May and June 2007 representing a significant drop of 20% from March / April prices.

Contrary to the CRA estimate flat hedge prices for the month of May have increased to \$90/MWh and are expected to remain at this level or increase further. This difference is reflected in the graph below.

Queensland Financial Years 06/07 and 07/08 contract prices over 24 months



The impact of the difference between CRA estimates and the actual prices in the market for May and expectations for June are:

- the average cost of purchasing hedges for the 2007/08 year increases to \$41.37/MWh from \$38/MWh;
- the wholesale purchase factor for 2007/08 increases from \$12/MWh to \$14.65/MWh;
- the wholesale component of the BRC index will increase from 3.5% to 5.9%;

AGL requests the QCA to recalculate the wholesale component of the BRCI to reflect these actual costs of energy purchasing during May and June 2007.

AGL also notes that should the QCA determine not to change its current estimates of the purchase factor, then as the BRCI reflects a year on year change in electricity costs the approximate \$3/MWh increase outlined above would be reflected in higher index change in 2008/09.

RETAIL COSTS

Retail costs comprise approximately 8% of total costs and as such small changes in retail costs have a minimal impact on the BRCI index.

AGL notes that the QCA has sought to reflect changes in retail costs arising from the introduction of full retail competition (FRC), escalation of labour and other costs and the impact of customer choice. AGL makes the following comments:

- AGL accepts that the 3.9% escalation in labour and other costs is reasonable
- The QCA has benchmarked Queensland FRC costs against FRC costs allowed in other jurisdictions. AGL supports the use of a benchmarking process, but notes that the FRC costs cited for Victoria, NSW and South Australia were prior to the introduction of national B2B systems and processes.
- market expectations as to a reasonable margin are higher than the 5% used by the QCA. AGL acknowledges the comment in the draft decision that as margin is a percentage of sales as it is maintained year on year in bears no impact on the BRCI.
- AGL supports the view that the notional retailer, of the size prescribed in the legislation, will experience an increase in operating costs in the event its customer base is reduced due to customer churn. As outlined by the QCA this matter can be approached in either of two ways:
 - if the notional retailer did not engage in any customer retention/acquisition activity then it would lose market share. The fixed costs would be spread across a smaller customer base thereby increasing operating costs per customer. For example CRA have estimated fixed costs at \$56.25 and a loss of 10% of customers would increase this cost per customer to \$62.50;
 - alternatively, the notional retailer could incur costs to retain/acquire customers, so that its total customer numbers remained static to avoid an increase in fixed cost per customer. These acquisition costs would be spread over all customers.



There exists a range of differing views amongst regulators and market participants as to the most appropriate approach in addressing this issue. A full consideration of this requires a level of analysis not achievable in the time available to the QCA.

AGL considers that, whichever approach is adopted, the \$2 allowance allocated in respect of this fixed cost issue understates the true cost faced by the notional retailer. The approach adopted, and the calculation of the real cost, will require significant further consideration during the QCA's full review commencing later this year.