



INTERNATIONAL

ADDENDUM

Prepared for:

Queensland Competition Authority

GPO Box 2257

Brisbane QLD 4001

Calculation of the Benchmark Retail Cost Index for 2006-07 and 2007-08

Prepared By:

CRA International Pty Ltd

Level 31, Marland House

570 Bourke Street

Melbourne VIC 3000, Australia

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CRA Project No:

Author(s): L Hoch, D Prins, M Gemmola

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1. INTRODUCTION

1.1. BACKGROUND

With the introduction of Full Retail Competition (FRC) in the Queensland energy market on 1 July 2007, licensed electricity retailers will be able to offer market contracts to all electricity customers. For those customers who do not enter into a market contract, **notified prices** will apply. In addition, at the conclusion of a market contract, customers will be able to revert to a notified price for their electricity supply.

Previously the notified prices that applied to non-contestable customers were set by the Queensland Minister for Mines and Energy (the Minister), and in recent years these prices have increased each year in line with CPI. With the introduction of FRC, a new method of adjusting notified prices will apply each year, as set out in recent amendments to the *Electricity Act 1994* (the Act).¹ Commencing in 2007-08, changes will be made to the notified prices with reference to movements in the new Queensland Benchmark Retail Cost Index (BRCI).

Because the notified prices are to be varied at 1 July each year in accordance with movements in the BRCI, in this initial year the BRCI must be calculated for two financial years to enable notified prices to be in place from 1 July 2007:

- For the year 2006-07; and
- For the year 2007-08.

The Queensland Competition Authority (the Authority)² engaged CRA International Pty Ltd (CRA) to provide assistance in calculating the BRCI for these two years.

CRA provided the Authority with a report (the CRA report), which presented the calculation of the BRCI for 2006-07 and 2007-08.³ The report included discussion of the methodology employed for developing the various components of the BRCI, and the data sources that had been used, as well as the actual calculation of the BRCI and its component parts.

¹ These amendments to the Act were incorporated in the *Electricity and Other Legislation Amendment (EOLA) Act 2006*. The EOLA Act can be downloaded from www.legislation.qld.gov.au/LEGISLTN/ACTS/2006/06AC060.pdf.

² Queensland legislation refers to the Authority as the *pricing entity* in regard to the Authority's responsibilities that are relevant to the calculation of the BRCI.

³ *Calculation of the Benchmark Retail Cost Index for 2006-07 and 2007-08*, CRA, 7 May 2007

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The Authority published the CRA report along with its own Draft Decision⁴, inviting submissions from interested parties. The closing date for submissions was 23 May 2007.

The Authority has asked CRA to review and comment on the issues raised in submissions which relate to matters discussed in the CRA report. This addendum to the CRA report documents CRA's comments on those issues raised in submissions, and should be read in conjunction with the original CRA report and the Authority's Draft Decision.

1.2. ORGANISATION OF THIS ADDENDUM

The remainder of this addendum is structured as follows:

- Section 2 summarises the issues raised in submissions which relate to matters discussed in the CRA report, and categorises them by cost component of the BRCI – these being the cost of energy, retail costs and margins, network costs, and other relevant costs.
- Sections 3, 4 and 5 discuss in detail the issues raised by these different cost components.
- Section 6 summarises and quantifies the proposed changes to the calculation of BRCI that are discussed in this addendum.

⁴ *Benchmark Retail Cost Index for Electricity: 2006-07 and 2007-08*, Draft Decision, Queensland Competition Authority, May 2007

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2. ISSUES RAISED IN SUBMISSIONS ON THE DRAFT DECISION

The Authority received six submissions on its Draft Decision – these were from:

- AGL;
- Centre for Credit and Consumer Law, Griffith University;
- Origin Energy;
- St Vincent de Paul Society, Queensland;
- SunWater; and
- TRUenergy.

The issues in these submissions that related to matters discussed in the CRA report have been categorised by cost component of the BRCI – these being the cost of energy, retail costs and margins, network costs, and other relevant costs.

Several of the submissions were generally supportive of the approaches taken by the Authority and by CRA in calculating the BRCI for 2006-07 and 2007-08, particularly given the short time that was available this year to formulate a methodology and to undertake the necessary calculations.

AGL's submission stated:

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 also commented that specific comments on methodology and related matters should be subject to further consideration as part of the Authority's full review of the methodology to be undertaken later during 2007/08.

Origin Energy's submission similarly stated:

Origin supports a rigorous and consultative process for determining the benchmark retail cost index (BRCI), as planned for the indexation calculation for 2008-09. Origin acknowledges the current time constraints on the Government and the QCA and accordingly, accepts the use of a truncated process for 2007-08.

Given this need for expediency, Origin agrees that the QCA has used reasonable endeavours in calculating the BRCI in its Draft Decision.

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TRUenergy also stated:

TRUenergy acknowledges the work of the Authority in determining the benchmark retail cost index, particularly given the external time constraints imposed.

This section of the addendum summarises the issues in the submissions that relate to the calculation of the BRCI for 2006-07 and 2007-08. It does not extend to a discussion of changes to the methodology that might be made in calculating the BRCI for 2008-09 and later years. We understand that a full review of the methodology to be used in future years will be initiated by the Authority later this year.

2.1. ISSUES RAISED ON COST OF ENERGY

Origin Energy questioned CRA's use of the 2007 ACIL report⁵ and not the 2005 ACIL report⁶ in regard to the estimation of capital costs, as compared to CRA's use of both the 2005 and 2007 ACIL reports in regard to variable and fixed maintenance costs, and plant thermal efficiencies. Origin commented that CRA provided no evidence to justify its assertion that the large difference between the plant capital costs in the 2005 and 2007 ACIL reports was due to methodological differences.

TRUenergy commented that the ACIL estimates show a consistent increase of 2.0% to 2.5% per annum from 2007-08 to 2011-12, and on that basis the Long Run Marginal Cost (LRMC) should increase from 2006-07 to 2007-08 by 2.25% rather than 1.62%.

TRUenergy suggested that the two-year period used to calculate hedging costs should be shortened because the decisions to introduce both retail contestability in Queensland and to sell the government-owned retail businesses were taken within the two-year period.

Both AGL and TRUenergy commented that calculation of the allowance for energy purchase costs should be updated based on actual forward contract prices that have become known since the analysis in the CRA report was undertaken. This would mean that actual contract prices for May 2007 would also be taken into account.

⁵ *Fuel Resource, New Entry and Generation Costs in the NEM: Report 2 – Data and Documentation*, ACIL Tasman, draft prepared for NEMMCO, 27 March 2007

⁶ *Report on NEM Generator Costs (Part 2)*, ACIL Tasman, prepared for Inter Regional Planning Committee (IRPC) and NEMMCO, February 2005

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Origin Energy raised some issues with the approach to determining energy purchase costs in the CRA report. In particular, Origin Energy expressed the view that it was inappropriate to quantify energy purchase costs in Queensland with reference to IPART's recent draft determination on energy prices in NSW. In support of this view, Origin Energy stated that there are differences between the two states which may be significant, and also that IPART's data came from various retailers at a single point of time, rather than over a longer period of time. Origin Energy also pointed to changes in contract prices since IPART's draft determination was published.

2.2. ISSUES RAISED ON RETAIL COSTS AND MARGINS

AGL raised various issues on retail costs. These issues related to assumptions regarding the extent of FRC costs, the impact of customer churn on cost to serve, and the level of margin appropriate for an electricity retail business. Recognising that small changes in retail costs have a minimal impact on the calculation of the BRCI, AGL suggested that further consideration of these matters could be deferred rather than being taken into account in the calculation of the BRCI for 2006-07 and 2007-08.

Origin Energy noted that it expects retail costs and margins to be revisited during the 2008-09 BRCI consultation. In regard to the \$2 per customer allowance for loss of scale, Origin Energy suggested that this appeared to be an arbitrary choice. Alternatives would be over \$5 per customer (based on a proportion of fixed costs) or \$3.50 per customer (based on customer acquisition costs of \$35 per customer); both of these estimates assume 10% churn rate.

TRUenergy proposed that the South Australian electricity FRC cost allowance is the only benchmark which should be considered, on the basis that South Australia was the only market that facilitated a highly competitive market in the early stages of FRC, and ESCOSA had the benefit of experiences in Victoria and New South Wales in establishing prudent cost benchmarks. Adjusted for inflation, this would provide an FRC allowance of \$11.30 per customer rather than \$10 per customer.

TRUenergy claimed that CRA had misunderstood the IPART draft decision on customer acquisition costs. TRUenergy asserted that the full customer acquisition cost of \$35 per customer should be allowed for all customers in Queensland, and should not be discounted on the basis of the level of churn.

Regarding an allowance for loss of scale, TRUenergy stated that the ESCOSA analysis cited in the CRA report was based on an explicit assumption that electricity customer losses would be balanced by gas customer gains. TRUenergy proposed that a more appropriate approach for Queensland would be to base the calculation of an allowance on the proportion of total costs that are fixed, adjusted for the rate of churn. TRUenergy stated that there was no indication from CRA as to why this would not be an accurate estimate of loss of scale costs.

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2.3. ISSUES RAISED ON NETWORK COSTS AND OTHER RELEVANT COSTS

Origin Energy made various observations and suggestions in regard to network costs, which are outside the scope of the CRA Report.

No comments were made on any other relevant costs.

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3. COST OF ENERGY

Issues were raised in submissions regarding the calculation of the LRMC and the factor that was introduced in the CRA report to account for the extent to which actual energy purchase costs are expected to diverge from the LRMC. These are addressed in this section of the addendum.

3.1. CALCULATION OF THE LRMC

Origin Energy questioned CRA's use of the 2007 ACIL report and not the 2005 ACIL report in regard to the estimation of capital costs, as compared to CRA's use of both the 2005 and 2007 ACIL reports in regard to variable and fixed maintenance costs, and plant thermal efficiencies. Origin commented that CRA provided no evidence to justify its assertion that the large difference between the plant capital costs in the 2005 and 2007 ACIL reports was due to methodological differences.

The 2007 ACIL report undertook a regression analysis of historical costs to determine a linear trend in capital costs over time. The 2005 ACIL report did not present the capital costs in the same detailed format, instead providing a single point estimate of capital cost for each type of generating plant. We compared the single point estimates for capital cost in 2004 that were presented in the 2005 ACIL report with the costs derived for 2004 based on the trend analysis in the 2007 ACIL report, and found that the estimates from the 2005 ACIL report were noticeably lower. This led to the conclusion that the difference was due to methodological differences.

We contacted ACIL to gain more understanding of the approach taken to determining capital costs. We were informed that the capital costs presented in the 2005 ACIL report were best estimates based on the information that was available at the time. Subsequently, ACIL developed a detailed database of capital cost information and was thus able to undertake the trend analysis that was presented in the 2007 ACIL report. This confirms the initial conclusion that the approaches to calculating capital costs in the two reports were different. ACIL also agreed that using the 2007 ACIL report would provide a consistent basis to derive and compare capital costs for 2006-07 and 2007-08.

Although this was not an issue specifically raised in any of the submissions to the Authority, CRA also evaluated whether the trend analysis presented in the 2007 ACIL report was appropriate to calculate the capital costs for 2006-07. If the capital costs of generating plant in 2006 were significantly higher than in previous years then a trend analysis with costs for this year excluded would yield a lower estimate for 2006-07 than a trend analysis that included the 2006 costs.

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The data points used for ACIL's trend analysis are presented in Figure 10 (CCGT) and Figure 13 (coal) of the 2007 ACIL report. Based on a visual review of these charts, we concluded that the 2006 data points would not discernibly change the trend line, and therefore the capital cost estimate for CCGT and coal plants in 2006-07 excluding the 2006 data would be the same as that calculated from the trend line presented. The most robust approach to confirming this conclusion would be to recalculate the capital cost excluding the 2006 data points. ACIL confirmed to us that as far as they are aware this analysis has not previously been undertaken, and it would be a time consuming process. Given the limited time available, we determined that basing our conclusion on a visual observation of the data was acceptable, and ACIL informed us that they did not see any reason why this would not be an appropriate approach.

TRUenergy commented that the ACIL estimates show a consistent increase of 2.0% to 2.5% per annum from 2007-08 to 2011-12. While it is not clear to which estimates TRUenergy is referring, it is likely that it relates only to capital costs. The capital costs for CCGT and black coal plant presented in Tables 77 and 78 respectively of the 2007 ACIL report increase at a rate of 2.0% per annum between 2007-08 and 2011-12. The costs presented for each technology in Table 94 of the 2007 ACIL report are the annualised project capital costs, the fixed operating costs and the tax costs that are required to be recovered each year. These costs, which do not include fuel costs, increase at an average rate of 2.0% per annum for CCGT, and 2.1% per annum for black coal plant.

The 2007 ACIL report presents the capital and variable operating costs independently but does not compute the LRMC for each technology. Capital costs alone do not determine the LRMC of generation, which is dependent on both capital and operating costs. Based on cost trends presented in the 2007 ACIL report, the CRA report showed that the fuel cost for each technology would either remain flat or decrease over the period 2006-07 to 2007-08.⁷ Therefore, the rate of increase in LRMC is below the 2.0% to 2.1% increase in capital costs, and is in fact 1.62%.

3.2. ENERGY PURCHASE COSTS

In its submission, TRUenergy suggested that the two-year period used to calculate hedging costs should be shortened because the decisions to introduce both retail contestability in Queensland and to sell the government-owned retail businesses were taken within the two-year period.

⁷ See Table 4 on page 29 of the CRA report.

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As noted in the CRA report, Section 92 of the *Electricity Act 1994* (the Act) does not set out a clear, unambiguous methodology for determining the cost of energy. The allowance for energy purchase costs is determined with reference to the LRMC of energy, which is calculated on the basis of the adjusted NEM load, and does not vary between retailers. Retail costs are calculated for a retailer that has a significant market share of the State's electricity retail business in both 2006-07 and 2007-08. Such a retailer would have purchased energy for its retail load in 2007-08 before the FRC announcement and sale process, and the Queensland retail electricity businesses were sold as going concerns with hedge books already in place. Taking all these factors into account, we conclude that the two-year timeframe for purchasing energy is still reasonable.

Both AGL and TRUenergy commented that calculation of the allowance for energy purchase costs should be updated based on actual forward contract prices that have become known since the analysis in the CRA report was undertaken. This would mean that actual contract prices for May 2007 would also be taken into account.

The CRA report commented that the high prices currently seen reflect the impact of the reduction of capacity in the market due to the drought, and that prices in future months were uncertain due to whether the drought ends or not. Therefore, the approach that was used to determine contract prices for May and June 2007 assumed that the expected price was the average of the high prices seen in April and May and the longer term average price. This was based on the information available at the date of the CRA report (7 May 2007).

Section 96 of the Act sets out that notified prices must be gazetted at least one month before the commencement of the tariff year in which they are meant to apply. Thus, the notified prices should be gazetted by the end of May each year. The Certificate of Delegation from the Minister further stated that the Authority must complete its calculation of the BRCI for each tariff year no later than 15 working days (or another date agreed with the Minister) prior to that latest gazettal date. Therefore, under normal circumstances, the Authority would need to complete its work by 10 May, and it would not be possible to take into account any information that came to hand after that date.

However, this year the work on calculation of the BRCI commenced later than would normally be the case and these timeframes are not being followed. Therefore, on this occasion there is an opportunity to base the BRCI on data and information that has become available at a later date.

Since the CRA report was prepared, flat contract prices for 2007-08 have increased in May to even higher levels, reaching almost \$100/MWh. For the period in May over which we have extended the analysis, flat contract prices have averaged \$77/MWh. The methodology that was used previously in the CRA report estimated future prices based on uncertainty over whether or not there is an end to the drought and a return to long-term prices. Adopting the same methodology now leads to a price of \$56/MWh for the remainder of May and June.

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Table 1 below shows a summary of the flat contract prices for 2007-08 that have served as inputs to our calculation of the factor to allow for energy costs in the CRA report and in this addendum. It shows that inclusion of AFMA data since 7 May 2007 changes the average price of flat contracts for 2007-08 from \$38.0/MWh to \$39.5/MWh.⁸

Table 1: Flat Contract Prices 2007-08 (\$/MWh)

	Based on AFMA Data up to 7 May 2007	Based on AFMA Data up to 23 May 2007
1 July 2005 to 28 February 2007	35.0	35.0
1 March 2007 to 30 April 2007	60.0	60.0
1 May 2007 to 23 May 2007	47.5	77.0
24 May 2007 to 30 June 2007	47.5	56.0
Average	38.0	39.5

Source: CRA analysis

In the CRA report, the average price for flat contracts in 2006-07 was reported to be \$35/MWh. As shown in Table 1, based on AFMA data up to 7 May 2007, flat contract prices for 2007-08 are on average \$38/MWh, which is \$3/MWh higher than the average price in 2006-07, but based on more recent AFMA data the difference is \$4.5/MWh.

In the CRA report, the factor to allow for the difference between LRMC and average energy purchase costs was estimated at \$9/MWh, and this remains the best estimate. The factor for 2007-08 is equal to the factor in 2006-07 plus the change in energy purchase costs between the years. Therefore that factor now changes from \$12/MWh to \$13.5/MWh.

Due to a lack of contributors, AFMA was unable to provide quoted prices for 2007-08 on many days during May. This suggests a very thinly traded market, where there is little volume being purchased. Therefore, our assumption that one twelfth of the volume required to hedge 2007-08 load would be purchased in May and June 2007 may actually overstate the true proportion of the volume actually being purchased by the incumbent retailers in these months.

Origin Energy raised some issues with the approach to determining energy purchase costs in the CRA report. In particular, Origin Energy expressed the view that it was inappropriate to quantify energy purchase costs in Queensland with reference to IPART's recent draft determination on energy prices in NSW.

⁸ This update is based on AFMA data for trades reported up to 23 May 2007. Due to lack of contributors, AFMA did not provide prices for the period 24 to 29 May inclusive. Where prices were not available for earlier days in May, we determined prices based on interpolation.

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We agree with Origin Energy that there are differences between the two states. However, our use of base data from NSW did not seek to suggest that the absolute values of energy price were comparable across the two states. Instead, we introduced a factor that would account for the extent to which actual energy purchase costs are expected to diverge from the LRMC, and compared those between NSW and Queensland. Since there was insufficient time to undertake more detailed analysis, the IPART analysis was used solely to determine a benchmark in 2006-07 for that factor. The value of that factor for 2007-08 was then the sum of the value of the factor in the previous year (2006-07) and the change in prices between the two years.

In Queensland, 2006-07 contract prices were relatively stable and therefore a value of the factor for that year could be determined by reference to the IPART work, taking into account the differences between NSW and Queensland. We selected a factor of \$9/MWh for energy purchase costs based on an analysis of historical prices and the correlation between price and demand in NSW and Queensland.

In determining the \$9/MWh factor, we note that it is the change from 2006-07 to 2007-08 in the allowance for energy prices that impacts the BRCI. Thus, for the current determination, the decision to set the factor at \$9/MWh in 2006-07 has a significantly lower impact on the BRCI for 2007-08 than the \$4.50/MWh increase in the factor from 2006-07 to 2007-08 that was derived above.

Origin Energy suggested that we used “a range of energy purchase costs between different retailers at the one point in time to determine a range of energy purchase costs over time”. When reviewing the IPART analysis, consideration was given to the magnitude of the difference between the energy purchase costs and LRMC for each retailer and to the reasons why the difference varied between retailers. This assessment was used as a qualitative input to selecting the \$9/MWh factor for Queensland for 2006-07 only, i.e. one point in time.

Origin Energy also asserted that we used IPART’s determination to inform energy purchase costs for the recent period when there have been significant movements in the forward curve. As mentioned, IPART’s work was used to determine the factor for 2006-07, and the relative price stability for 2006-07 contracts allowed the assessment to be undertaken without being distorted by the price volatility seen in 2007-08 contracts.

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4. RETAIL COSTS AND MARGINS

In relation to the calculation of the BRCI for 2006-07 and 2007-08, issues were raised in submissions regarding FRC operating costs and customer acquisition costs. These are addressed in this section of the addendum.

4.1. FRC OPERATING COSTS

Section 4.1 of the CRA report noted that operating in a competitive environment imposes costs on retailers, and reported that previous regulatory decisions on standard retail pricing in Australia have included allowances for these costs in the range of \$5-10 per customer. Origin Energy also included this range in its submission to the Authority on the Interim Consultation Notice.

The submission from Griffith Law School expressed strong opposition to the consideration of FRC related costs in the calculation of the BRCI. However, these are actual costs incurred by retailers, and therefore they are necessarily a component part of retail costs as defined in the Act.

In its submission, TRUenergy proposed that the South Australian electricity FRC cost allowance is the only benchmark which should be considered, on the basis that South Australia was the only market that had facilitated a highly competitive market in the early stages of FRC, and ESCOSA had the benefit of experiences in Victoria and New South Wales in establishing prudent cost benchmarks.

The ESCOSA allowance of \$10.60 per customer for FRC operating costs in December 2004 can be traced back to an allowance of \$10 per customer proposed by its predecessor, the Office of the South Australian Independent Industry Regulator (SAIIR), in August 2002. At that time, the SAIIR noted that FRC costs were in the range of \$5-10 per customer and adopted the figure of \$10 per customer on the basis that "a cost of \$10 per customer for the retail costs would seem to be a reasonable upper estimate of the FRC costs for a stand alone retailer".⁹

Given that the South Australian allowance was established as an upper estimate of a range, we do not believe that it would be appropriate to use that estimate now as the only estimate, and our proposed allowance of \$10 per customer for FRC operating costs in Queensland remains unchanged.

⁹ *Electricity Retail Price Justification*, Discussion Paper, SAIIR, August 2002

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AGL supported the use of benchmarking to set an allowance for Queensland FRC costs in the calculation of the BRCI based on consideration of FRC costs allowed in other jurisdictions. AGL also noted that the FRC costs cited for Victoria, NSW and South Australia were prior to the introduction of national B2B systems and processes. Given that these national systems and processes were introduced in order to provide net benefits,¹⁰ this could support a view that the allowance for FRC costs in Queensland ought to be lower than the allowance that was made in other jurisdictions.

4.2. CUSTOMER ACQUISITION COSTS

The CRA report noted in section 4.2 that there were three options for handling customer acquisition and retention costs in the BRCI for 2007-08:

1. Allow acquisition and retention costs to retain scale.
2. Allow for loss of scale.
3. No allowance for acquisition or retention costs.

Arguments in favour of and against each of these options were included in Table 12 of the CRA report. We considered option 2 to be the most appropriate, and proposed an allowance for loss of scale of \$2 per customer in the calculation of the BRCI for 2007-08.

The submission from Griffith Law School adamantly opposed the inclusion of customer acquisition costs (as in option 1), stating that including such costs “is completely unnecessary, favours the incumbent retailer and, we believe, is anti-competitive”.

In its submission, AGL noted that “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”. Origin Energy also noted that it expects retail costs and margins to be revisited during the 2008-09 BRCI consultation.

4.2.1. Option 1 – Allow Acquisition Costs to Retain Scale

TRUenergy claimed that CRA had misunderstood the IPART draft decision on customer acquisition costs. TRUenergy asserted that the full customer acquisition cost of \$35 per customer should be allowed for all customers in Queensland, and should not be discounted on the basis of the level of churn.

¹⁰ The B2B Objective is defined in the National Electricity Rules to be that “the benefits from B2B Communications to Local Retailers, Market Customers and Distribution Network Service Providers as a whole should outweigh the detriments to Local Retailers, Market Customers and Distribution Network Service Providers as a whole”.

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We agree with TRUenergy that IPART's draft decision accepted Frontier Economics' recommendation that a mass market new entrant (MMNE) should be thought of as a retailer that had already achieved economies of scale, but we do not agree that this retailer is one which "had already established a customer base in New South Wales", as TRUenergy suggests. Specifically, Frontier Economics stated:

While recognising that the concept of a MMNE is very much a hypothetical construct, Frontier uses the costs that large-scale retailers operating elsewhere in the NEM would face on entering the mass market in NSW as the benchmark for estimating the costs of a MMNE.¹¹

We understand that IPART was considering an established, large-scale retailer entering the NSW market, which would therefore need to acquire any mass market customers to be served in NSW. This explains why the extra acquisition cost was added to all customers, and not discounted on the basis of the level of customer churn. Since the publication of the CRA report, the Authority has also confirmed this understanding with IPART.

If acquisition costs were to be included in the calculation of the BRCI for 2007-08, they would therefore need to be discounted by an assumed churn rate. As discussed in the CRA report, it is difficult to assess the actual costs that might be incurred to retain scale. The only benchmark figure currently available is that of \$35 per customer from IPART's recent draft report and decision. Origin Energy's suggested figure of \$3.50 per customer assumes a churn rate of 10%.

With regard to churn in the first year of opening a market to FRC, IES reported that:¹²

- In Victoria, annualised churn reached 10% after the first 12 months (and averaged much lower than that during the first 12 months).
- In South Australia, churn averaged 2.5% for the first 12 months.
- Churn in NSW averaged less than 2% for the first 12 months.

IES also suggested that there were three principal reasons that help explain the comparatively low churn rates for the initial six to twelve months of FRC in these jurisdictions:

- The requirement to bed in new systems and processes before launching large scale marketing and sales campaigns;
- Initial low margins in existing tariffs; and

¹¹ *Mass Market New Entrant Retail Costs and Retail Margin*, prepared for IPART, March 2007

¹² *Some Perspectives on QLD Post FRC*, IES, 18 December 2006

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- Initial low customer responsiveness as a result of insufficient awareness.

IES believed, however, that the churn rate in Queensland would be greater than the levels achieved historically in NSW. This was based on the view that initial margins would be attractive and that retailers would be better prepared than they were at the start of FRC in other NEM regions.

On the other hand, TRUenergy's submission to the Authority's Draft Decision stated that if the BRCI is set at 9.98% "margins will be substantially eroded, turning negative for some customers. This will diminish the level of competitive activity from the commencement of FRC".

A churn rate of 5% may be a reasonable benchmark for 2007-08. It would equate to acquisition costs of \$1.75 per customer – a smaller allowance than the \$2 per customer in the CRA report. This relies on the IPART benchmark of \$35 per customer, which is only a draft finding at this stage, and may be subject to modification in IPART's final decision.

4.2.2. Option 2 – Allow for Loss of Scale

The CRA report discussed two methods for making an allowance for loss of scale:

1. Estimate the proportion of retail operating costs that are fixed, and estimate a churn rate to determine the fixed costs that, due to loss of customers, would no longer be recovered.
2. Use the precedent from South Australia, as shown in Table 10 in the CRA report, where the year-on-year allowance was around \$1.75 in March 2005.

The first method could be based on IPART's draft decision finding that the retail operating costs of a retailer operating to scale should be treated as 75% fixed and 25% variable. Taking the retail costs per customer of \$77.54 (before allowing for loss of scale) from Table 13 of the CRA report, the 75% fixed costs amount to \$58.16 per customer. If the churn rate is, say, 10%, and churn is evenly spread across the year, then on average during the year the customer numbers are only 95% of what they otherwise would have been, so 5% of the fixed costs are not recovered. Recovering this cost from the average remaining 95% of customers makes the additional cost per customer \$58.16 times 5% divided by 95%, which equates to \$3.06 per customer.

A churn rate of 5% spread evenly across the year would equate to \$1.49 per customer – again a smaller allowance than the \$2 per customer in the CRA report. As with the benchmark for customer acquisition costs, the benchmark of 75% of costs being fixed is also only a draft finding at this stage, and may be subject to modification in IPART's final decision.

The second method used precedent from South Australia – the only regulatory decision of which we are aware in which an explicit allowance of this nature has been made (as against the IPART allowance for acquisition costs).

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In its submission, TRUenergy stated that the ESCOSA analysis in South Australia was based on an explicit assumption that electricity customer losses would be balanced by gas customer gains. The Act specifies that retail costs are to be calculated based on a retail business that is separate from any other business, and therefore it is not appropriate in the calculation of the BRCI to take into account any cost saving that could result from a retailer operating a gas business alongside an electricity business.

Indeed ESCOSA did note that AGL SA could spread some of its fixed costs over its market contract gas and electricity customers. On that basis, we accept that the South Australian benchmark would need further analysis and modification in order to make it more applicable to the calculation of the BRCI in Queensland.

4.2.3. Allowance for Acquisition Costs – Conclusion

We concur with the view of AGL that “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.”

The further analysis in this addendum shows that the allowance of \$2 per customer may not be the correct one to use to allow for loss of scale. However, the analysis also shows that there is no obviously correct alternative number, and a revised number might be lower or higher, depending on the assumptions that are made. On that basis, we do not propose at this stage any change to the \$2 per customer allowance for loss of scale in the calculation of the BRCI for 2007-08.

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5. NETWORK COSTS AND OTHER RELEVANT COSTS

There were no issues raised in submissions in regard to network costs and other relevant costs which need to be addressed in this addendum. The Authority has also confirmed that the figures for network costs for calculation of the BRCI for 2006-07 and 2007-08 remain unchanged from the figures given previously in the CRA report.

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6. RESULTS

The CRA report presented the calculation of the BRCI for 2006-07 and 2007-08.

6.1. CALCULATION OF THE BRCI FOR 2006-07

This addendum does not propose any quantitative changes in the calculation of the BRCI for 2006-07.

6.2. CALCULATION OF THE BRCI FOR 2007-08

As discussed in section 3.2 above, there is one area where this addendum proposes a possible quantitative change in the calculation of the BRCI for 2007-08. The factor to account for energy costs in the calculation of the BRCI for 2007-08 was previously estimated in the CRA report at \$12/MWh – based on the information that was available at 7 May 2007. Under normal circumstances, the Authority would need to complete its work on calculating the BRCI by 10 May each year, and it would not be possible to take into account any information that came to hand after that date.

However, this year the work on calculation of the BRCI commenced later than would normally be the case and these timeframes are not being followed. Therefore, on this occasion there is an opportunity to base the BRCI on data and information that has become available at a later date. We bring to the attention of the Authority that updating for actual prices would result in the factor to account for energy costs in the calculation of the BRCI for 2007-08 being estimated at \$13.50/MWh compared to the figure of \$12/MWh that was presented in the earlier report.¹³

If the Authority takes this opportunity to use the latest available data, the consequential changes to the calculation of the BRCI for 2007-08 that would result can be summarised as follows:

- The factor to account for energy costs in 2007-08 would increase from \$12/MWh to \$13.50/MWh.
- The total cost of energy in 2007-08 would increase from \$59.90/MWh to \$61.40/MWh.
- The BRCI for 2007-08 would increase from \$124.88/MWh to \$126.46/MWh.

¹³ This update is based on AFMA data for trades reported up to 23 May 2007. Due to lack of contributors, AFMA did not provide prices for the period 24 to 29 May inclusive.

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6.3. COMPARISON OF THE BRCI BETWEEN 2006-07 AND 2007-08

Table 2 below shows a summary of the results for the calculation of BRCI for 2006-07 and 2007-08.

Table 2: BRCI Calculation Results

Cost Item	2006-07	2007-08 – based on information available at 7 May 2007	2007-08 – based on AFMA data up to 23 May 2007
Cost of Energy (\$/MWh)	\$55.90	\$59.90	\$61.40
NEM Load (L) (MWh)	35,515,141	36,263,205	36,263,205
Total Cost of Energy (\$)	\$1,985,228,903	\$2,172,227,627	\$2,226,622,434
Retail Costs (\$/customer)	\$65.00	\$79.54	\$79.54
Customer Numbers	1,862,566	1,885,727	1,885,727
Total Retail Costs <i>excluding retail margin</i> (\$)	\$121,066,790	\$149,981,297	\$149,981,297
Total Network Costs	\$1,724,500,000	\$1,979,800,000	\$1,979,800,000
Other Relevant Costs	\$0	\$0	\$0
Total Benchmark Retail Cost <i>excluding retail margin</i> (\$)	\$3,830,795,693	\$4,302,008,924	\$4,356,403,731
Margin on Revenue (%)	5.00%	5.00%	5.00%
Margin on Revenue (\$)	\$201,620,826	\$226,421,522	\$229,284,407
Total Benchmark Retail Cost (R) <i>including retail margin</i> (\$)	\$4,032,416,519	\$4,528,430,446	\$4,585,688,138
BRCI for the Year (equals R / L) (\$/MWh)	\$113.54	\$124.88	\$126.46
BRCI for the Year (equals R / L) (¢/kWh)	11.354	12.488	12.646

As stated in the previous CRA report and in the Authority's Draft Decision, basing the BRCI calculations on information available at 7 May 2007 equated to a year-on-year increase from 2006-07 to 2007-08 of 9.98%.

Basing the BRCI calculations instead on AFMA data up to 23 May 2007 would equate to a year-on-year increase from 2006-07 to 2007-08 of 11.37%.