

Ergon Energy Queensland Pty Ltd

**Interim Consultation Notice
Calculation of the 2008-09 Benchmark Retail
Cost Index**

**Queensland Competition Authority
15 October 2007**

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This submission, which is available for publication, is made by:

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1. INTRODUCTION

Ergon Energy Queensland Pty Ltd ('Ergon Energy') welcomes the opportunity to provide comment to the Queensland Competition Authority ('Authority') on the calculation of the Benchmark Retail Cost Index ('BRCI').

This submission provides Ergon Energy's views on the questions raised in the Consultation Notice. The issues are addressed in the order raised in Consultation Notice

Ergon Energy looks forward to participation in the Authority's workshop on the subject, and would be pleased to discuss this submission or to provide further details about any specific concerns.

2. COST OF ENERGY

The Authority seeks stakeholders' views on whether there is a substantive reason why the Authority should adopt an alternative approach for adjusting the LRMC of energy to account for the short run purchase cost of energy. If so, what changes should be made?

Ergon Energy proposes the adoption of an approach that uses the flexibility provided in the *Electricity Act 1994* ("Act") to take appropriate account of the actual costs of energy purchasing. The approach should capture the change in energy purchasing costs over time, thereby addressing the requirement in the Act for the BRCI to reflect "the likely total of the costs to be incurred ... to purchase energy". The proposal is the establishment of an average market electricity contract price, or benchmark, which reflects the market cost of a retailer purchasing energy in Queensland for a future demand load profile.

The benchmark can be calculated by applying an equal weighting to three current independent market indexes:

- (1) Sydney Futures Exchange (SFE) is a benchmark determined by taking the average of the close of business "settle" prices of each day. This benchmark captures the price that was actually paid by participants in the market.
- (2) Over The Counter (OTC) broker screens is a benchmark determined by taking the average of daily midpoints between the highest "bid" and lowest "offer" on each trading day. This benchmark captures the price that participants value in the market.
- (3) Australian Financial Markets Association (AFMA) electricity forward curve is a benchmark determined by participants submitting to AFMA their expectation of particular contract prices in the future. This benchmark captures the price that participants expect to see in the market.

Each index would be separately calculated, and then averaged (equally) to form a single market benchmark price. The benefits of this methodology of determining the costs to be incurred during the relevant tariff year to purchase energy are as follows:

- (a) The benchmark follows economic demand/supply equilibrium theory to determine a market price in each period;
- (b) The benchmark is based on market prices, which are already in \$/MWh units;
- (c) Each benchmark has within it peak/off-peak/flat components weighted accordingly to match demand load profiles;
- (d) The contract market is separate to the regulatory schemes market, and as such will not account for them; and

- (e) Price movements in the wholesale market due to adverse conditions (i.e. environmental conditions) will be appropriately captured in the BRCI to reflect the cost impact on retailers.

The result would be a cost component in the BRCI which, when combined with additional costs such as renewable energy costs (i.e. purchase of certificates), addresses the concerns previously raised by the Authority with the calculation of LRMC and achieving the legislative requirement of reflecting “the likely total of the costs to be incurred ... to purchase energy”.

It is arguable that the adjustment to LRMC required to take account for the short run purchase cost of energy is in fact the variance between the calculated LRMC and actual market costs of whole electricity calculated in accordance with the methodology described above. Alternatively it may be appropriate to adopt a methodology which applies an appropriate weighting between the LRMC and the short run purchase cost to achieve a balance between the conflicting requirements in the Act for calculation of the BRCI.

3. NETWORK COSTS

Should the costs for the Mt Isa region be included or excluded from the BRCI data for 2008-09?

Ergon Energy Corporation Ltd recovers approximately 1.25% of its total revenue from the Mt Isa regulated network prices. When taking into account both Ergon Energy’s and Energex’s revenue requirements in the calculation of the BRCI, the Mt Isa costs become insignificant. Therefore, the inclusion or exclusion of costs for the Mt Isa region is unlikely to have any material impact on the calculation of the BRCI.

4. RETAIL COSTS

Should the retail cost components set out in the legislation be considered individually or in total?

In the absence of further detail, it is not clear what benefit would be gained from calculating each of the retail cost components separately and then disaggregating further into customer segments to identify costs. It is not clear how such an exercise could be achieved with a level of certainty that justifies its use, given that every retailer will have a different cost breakdown. Attempting such a breakdown for the hypothetical retailer in question appears to be unnecessary when use can be made of appropriate benchmarks.

5. QUEENSLAND LOAD

Should the Authority seek to include the loads of unregistered embedded generators in the NEM load of Queensland?

Two issues should be considered when addressing this question. Firstly, the load of unregistered embedded generators in Queensland is very small compared to total Queensland generation, and is also likely to remain reasonably consistent over the years. As such, it is very unlikely to have a material impact on Queensland load calculations if incorporated into the BRCI.

Secondly, unregistered embedded generators by nature sell their entire load export to their local retailer. As all unregistered embedded load purchases occur off the market, it

is intuitive to exclude unregistered embedded load from the BRCI load calculation in order to remain consistent with the wholesale energy purchase calculations. That is, if the costs of unregistered embedded generation are not captured in the energy costs, then the load should also be excluded.

Ergon Energy therefore recommends the exclusion of unregistered embedded generators in the NEM load of Queensland calculation.

6. Total BRCI

Ergon Energy notes the comment in the Consultation Notice that “customers on non-market contracts may have either been under- or over-charged for electricity depending on whether the previously calculated change in the BRCI from 2006-07 to 2007-08 was found to be too low or too high when recalculated using the new method”. It is important to note however, that the purpose of the BRCI is not to achieve cost reflectivity in setting retail tariffs. It is recognised that the Queensland retail tariffs are not cost reflective. There is headroom in the tariffs for customers in south east Queensland, while in the remainder of the state the tariffs are below cost reflective prices. One of the purposes of the BRCI calculation is to maintain that existing headroom in south east Queensland and in doing so, help ensure retail competition. Therefore, in the absence of an approach which seeks cost reflectivity in pricing, it is clear that prices which have been set according to BRCI calculated in accordance with legislative requirements, are neither too high nor too low.

To achieve that headroom objective, it may have been appropriate for the BRCI to ultimately be calculated by reference to the base year 2006-07, as calculated by the methodology adopted for the year in question. One issue with such an approach is that as new methodologies become available to more accurately calculate the BRCI, the data for 2006-07 may not be available to apply to that new methodology. In any event, it is not apparent that the Act provides flexibility for such a calculation.

As such, no consideration should be required to be given to the impact of a new calculation methodology on the previous year’s pricing. It should be assumed that the purpose of recalculating the index for the previous year using the new method is solely to allow comparison of the index for the following year with a similarly calculated index for the previous year. No consideration should be given to what the tariff adjustment would have been in the previous year if the new method is adopted. Such a result would necessarily result in a requirement to effectively recalculate the BRCI and its relevant impacts on prices back every year to the base year if any change to the methodology is ever adopted. The issues identified in the previous paragraph would then again become relevant.