

**Further AGL response to
Queensland Competition Authority
on
Draft Calculation of the 2008-09
Benchmark Retail Cost Index**

4 April 2008



Summary

The purpose of this further submission is to:

- seek clarification in respect of a number of very important matters as soon as possible; and
- confirm a number of points made by AGL at the workshop on 27 March 2008 (**Workshop**).

AGL is writing to the QCA separately to raise issues relating to the inadequate provision of information during the consultation process.

Information Request

AGL is requesting from the QCA as a matter of urgency the following information:

- a clear indication of which load data CRA used in which components of the calculation of the wholesale energy cost, and an explanation as to why. CRA indicated in the Workshop that they would provide this information, and AGL is formally requesting it be provided, together with CRA's view of the impact its use of the full Queensland load (ie including direct connect customers) has had on the overall BRCI. AGL's view in respect of the appropriate load under the Electricity Act (**Legislation**) and Electricity Regulations (**Regulations**) is set out below.
- Table 3.1, amended to demonstrate the QCA's view the impact of:
 - the Ergon smoothing removed in accordance with the 'amended' delegation the Minister purported to impose on DATE.
 - a resmoothing of Energex's AARR once the over-recovery has been removed (see below for further detail)
- Figure 8 at page 92 of the CRA report magnified to focus clearly on the Top 100 hours of demand, together with a more detailed explanation as to how this validates assumptions made about the year 2008/09 – ie does it assume that all relevant matters (contract positions of generators, load factors etc) remain constant.
- A 'correlation scatter graph' of price vs demand for 2007/08 (to present date), and a scatter graph depicting the projected price vs demand for 2008/09 as developed by CRA's modelling. These graphs will not be complex or time-consuming to develop, and are essential for AGL's understanding as to the results of CRA's pool price modelling and their impact on the energy purchase costs determined.
- Confirmation as to how CRA intend to determine the GEC price.

Confirmation of submissions made during workshop

Wholesale Cost of Energy

Input Assumptions for LRMC Calculation

AGL has provided the QCA and CRA with ACIL's Report titled 'Energy Costs for Queensland electricity tariffs in 2007/08 and 2008/09 - Input assumptions for estimating the long run marginal cost of generation in Queensland in the context of QCA regulated electricity tariffs updated input assumptions' (**ACIL 2008/09 Input Assumptions Report**). These updated assumptions must be used by the QCA and CRA in determining the appropriate LRMC. AGL draws the QCA's attention to the following statement in ACIL's 2008/09 Input Assumptions Report at page 2:

It is worth noting that the methodology used to update our estimates of the input components of the short run and long run marginal costs is the same as the one used in our 2007 report to NEMMCO, titled 'Fuel resource, new entry and generation costs in the NEM Report 2 – Data and documentation (the NEMMCO report or the 2007 estimates)'.

As indicated to the QCA previously, AGL is happy to make ACIL available for discussions with the QCA, CRA or indeed any stakeholder. AGL remains of the firm view that it is appropriate for the QCA and CRA to use these updated assumptions in determining the LRMC for 2008/09.

AGL understands that the QCA has concerns as to the timing of release of these input assumptions to other stakeholders. AGL recognises that these inputs were only made publicly available at the Workshop. However, AGL notes that the unequivocal view provided to stakeholders in the first workshop conducted by the QCA on 31 October 2007 was that CRA would seek to use the most updated information available as input assumptions to the LRMC calculation, and in making those comments, recognised there had been significant movement in these input assumptions. AGL has responded in commissioning ACIL to undertake this analysis in as timely manner as possible once it became apparent that CRA did not update these input assumptions in its modelling of LRMC. AGL notes in this context that it was not clearly articulated in CRA's draft report as to how, if at all, the input assumptions had been updated in order to determine the 2008/09 LRMC.

NEM Load

As noted above, AGL is requesting clarification as to what load CRA have used in each component of their calculation of wholesale energy costs.

The 'NEM Load' is defined in section 91F(2) of the Electricity Act 1994 (the Act) as:

The pricing entity's view of the total of the loads for the State supplied at each transmission connection point to a supply network, as adjusted for any matter prescribed under legislation.

In their draft report, CRA note (at page 11) that:

The term transmission network connection point in the Act refers to a Queensland transmission network connection point as defined under the National Electricity Rules. The NEM load therefore should include only the energy delivered from the transmission connection network that flows through the distribution system to

customers, and should exclude any end-user load that is directly connected to the transmission system.

As you would be aware, AGL was extremely surprised to discover at the Workshop that CRA have in fact used the entire Queensland system load in determining the LRMC and the energy purchase costs. This fact was not disclosed in the CRA Report, and the QCA at no time disclosed this when AGL was requesting the load data from the QCA in the context of considering the original LRMC finding from CRA.

AGL does not believe there is any basis to use the total Queensland system load in determining the LRMC or the energy purchase costs – neither the Legislation nor the Regulation support such an interpretation:

- Section 92 of the Act clearly states that the relevant cost of energy is that to supply the NEM load, with particular reference in section 92(3) to the LRMC of the 'NEM load';
- Section 105(c) of the Regulations states that the LRMC should be calculated to meet the demand profile, referred to as the NEM load shape, formed over each half hour trading period;
- Section 106 stipulates that ancillary services necessary to meet the NEM load for the State must also be taken into account.

Further, even if there were some doubt as to the requirement to use the NEM load, AGL submits that it is appropriate to consider the purpose of the analysis when considering the methodology and input data. The purpose of the exercise as a whole is to determine the necessary year on year change to regulated tariffs. Accordingly, there should be a nexus between the methodology and the load supplied under regulated tariffs. Retailers do not supply direct connect transmission customers, and the MUT has no relevance to these customers. If the NEM Load is not used, then the relevant load data must be the Net System Load Profile, as this provides the most accurate load data in respect of regulated customers.

Risk premium in actual purchase costs

While stakeholders have not been provided with adequate details of the methodology, CRA effectively accepted at the Workshop that the use of d-Cypha as the data source for electricity contract price inputs does not adequately reflect the prices at which the theoretical retailer (as contemplated by the Legislation), needing to acquire significant contract volumes, would be able to achieve. Whilst AGL recognises the need for a transparent data source, AGL argues that a premium needs to be added to these contract prices to reflect the liquidity required by a retailer with scale.

Accounting for Reserve in LRMC

As AGL noted previously, and as was recognised by CRA at the Workshop, the LRMC calculations need to be redone to take account of reserve requirements for the Queensland region as determined by NEMMCO.

Climate change initiatives not accounted for in current modelling

CRA confirmed that their analysis of LRMC and energy purchase costs do not seek to take any account of the impact of the commencement of the Emissions Trading Scheme (**ETS**) or the expanded Mandatory Renewable Energy Target (**MRET**). AGL reiterates its request that this be specifically acknowledged in CRA's Final Report.

Weighting

AGL notes that the methodology used by CRA in determining the energy purchase costs Weighting – again reiterate that the energy purchase costs already have a significant 'smoothing' incorporated as are based on the 2 year average contract price. Introduces a further 'long term' element into a one year price path.

Other energy costs

AGL continues to assert that allowances for renewable energy certificates be based on long run marginal cost of renewable projects. In the absence of this information (AGL appreciates that there is a lack of transparent data sources for this information), the costs for RECs should be based on a contracting strategy that occurs over a shorter term horizon than electricity contracting. AGL has suggested this contracting strategy be a 1 year horizon immediately prior to the commencement of the price path. The formula for this for 2008/09 would be:

$$(RPP\ 2008 \times REC\ Price\ 2008 + RPP\ 2009 \times REC\ Price\ 2009) / 2$$

where:

RPP is the renewable power percentage set by the MRET legislation

REC Price is the average of the renewable energy certificate price over the period from 1/7/07 to 30/6/08 (or the latest date available before the final BRCI calculation is made).

Network costs

AGL is very firmly of the view that the QCA must re-smooth the Energex AARR in order to account for the fact that the initial smoothing was done without removing the over-recovered revenue. AGL does not see any rationale for the QCA maintaining the current AARR path, as it has already accepted that the over-recoveries should be removed for the purposes of the BRCI.

A failure to conduct this re-smoothing would have a significant impact on the BRCI, and on retailer 'headroom'. AGL is of the view that the QCA must re-smooth this Energex AARR in order for the QCA to comply with the conditions of the conditions of the Original Delegation and the (purported) Amended Delegation.

Retail costs

AGL confirms its position in respect of the following points:

- The acquisition costs must be determined on the basis of the change between the 5% churn assumed by CRA in calculating the BRCI for 2007/08 and the assumed churn for 2008/09 (see below for further detail);

- CRA's assumption that churn will be 10% appears highly conservative. AGL again notes in this respect that CRA ignored retailer assurances that the churn in 2007/08 would be significantly higher than the projected 5%, and churn was in fact 17% over that period;
- The retailer operating costs need to be adjusted to account for higher capital costs, as discussed at the Workshop.

QCA's use of actuals vs estimates from previous BRCI

AGL noted in its initial submission:

The 2007/08 BRCI was calculated with reference to assumptions as to network, TUOS costs, and churn rates, due to the actual figures being unavailable at the time the 2007/08 BRCI Final Decision was made. In order to ensure consistency and an equitable outcome, the QCA must use those same assumed costs in the 2007/08 base year for accurate comparison in determining the 2008/09 BRCI.

AGL understands from comments made by the QCA at the Workshop that the QCA believes that the Regulations operate so as to require the QCA to use the actual data in determining the 2007/08 base year for the calculation of the 2008/09 BRCI. AGL is very firmly of the view that this interpretation is not correct:

- in relation to the retail costs, s 111(2) of the Regulation requires the pricing entity to work out what the BRCI "would have been" based on the changed framework. The use of the past tense clearly suggests that the revised BRCI should use the same inputs as used at the time it was originally calculated. A different methodology applied at the same time would have utilised the same inputs, not the actual inputs that have only become available subsequent to that time;
- in relation to network costs, the Regulation does not require a recalculation of the BRCI, whether or not the methodology has changed. Section 107 and 111 of the Regulation pertain to energy costs and retail costs, rather than network costs. This clearly suggests that even if the QCA is required to recalculate the 2007-08 BRCI because the methodology for changing the other cost components has changed, the network cost component should remain unchanged.

AGL does not believe the QCA has any rational or defensible basis on which to use the 'actual' costs rather than the costs that were estimated and used at the time of determining the 2007/08 BRCI.

QCA and CRA approach to determining BRCI

Irrespective of whether the Minister has effectively revoked the Delegation of 16 March 2007 (***Original Delegation***) and replaced it with the Delegation of 13 March 2008 (***Amended Delegation***), it remains a condition of the effective Delegation that the QCA must have regard to the following policy objectives in determining the BRCI:

- “(a) the annual indexation of electricity tariffs by the index should ensure that existing retail headroom in the tariffs at the date of this delegation (as modified by condition 2 below) remains relatively stable, although not necessarily the same from year to year;*
- (b) 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”.*

Accordingly, it is incumbent on the QCA to approach its determination of the BRCI with a view to ensuring that the difference between retailer’s costs and retailer revenue is not significantly eroded. AGL understands that the QCA must assume (at this stage) in determining the Final Decision that the Amended Delegation is effective. This means that the QCA must consider the impact of the revocation of the Ergon Distribution AARR smoothing on the BRCI and on retailer headroom in determining all other matters in relation to the BRCI.

As AGL noted at the Workshop, the removal of Ergon AARR smoothing from the BRCI calculation will have a very significant impact on retailer headroom. AGL anticipates that the impact on AGL of the removal of Ergon AARR smoothing in combination with an Energex tariff increase of 7.5%¹ will be a loss on the network component on MUT customers of approximately \$4 million.

AGL is very concerned by the approach and attitude demonstrated by the QCA and CRA at the Workshop. The QCA and CRA currently appear to be adopting positions on each of those matters requiring determination such that the cumulative effect will be that of substantially understating the necessary change in the BRCI. Examples of this approach are detailed in AGL’s first submission and in this submission and were discussed at the Workshop.

As AGL submitted at the Workshop, the QCA and CRA must look carefully at the cumulative impact of the decisions made in determining the BRCI, and considering whether each is appropriate in circumstances where:

- the QCA is subject to the conditions as outlined above; and
- retailers are clearly and unambiguously losing considerable ‘headroom’ by reason of the removal of the smoothed Ergon AARR.

AGL is not suggesting that the QCA or CRA need to ignore or ‘misinterpret’ the Legislation or Regulation. AGL is, however, suggesting that the QCA and CRA appear to have taken a very limited approach to a number of matters which has the cumulative result of decreasing the BRCI. AGL does not believe this approach is appropriate in the circumstances outlined above.

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¹ AGL notes that there appears to be potential for Energex to impose an even greater increase in tariffs in respect of small customers.

