



QLD COMPETITION AUTHORITY

12 MAR 2008

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Queensland
Government

Your Ref:
Our Ref: MBN-292

Office of the
Minister for Mines and Energy

Mr Brian Parmenter
Chairman
Queensland Competition Authority
GPO Box 2257
BRISBANE QLD 4001

Dear Mr Parmenter

The Department of Mines and Energy (DME) welcomes the opportunity to provide comment on the Queensland Competition Authority's (QCA) *Draft Decision on the Benchmark Retail Cost Index (BRCI) for Electricity: 2008-09* (the Draft Decision).

The Queensland Government's objective is to foster competition in the energy market so that the economy and customers derive the benefits of a competitive energy sector. Efficient and sustainable energy pricing is essential to meeting these objectives, particularly in the face of the significant growth currently occurring in south-east Queensland.

In line with achieving efficient and sustainable energy pricing, the Government wishes to ensure that only genuine cost increases are passed onto consumers through the application of the BRCI.

As Minister responsible for the energy portfolio, I continue to be concerned about rising energy costs and the pressure this places on increasingly stretched family budgets. Based on a quarterly electricity bill of \$275, Queensland's current electricity prices represent around 3.5 per cent of weekly disposable income (based on a mean weekly gross income of \$1275 and a mean weekly disposable income of \$632). If notified electricity prices are increased by 7.01 per cent, around 3.8 per cent of weekly disposable income will then be allocated to electricity. For low income households where the quarterly electricity bill is above \$275 (e.g. larger families), the proportion of income allocated to cover electricity costs may be higher.

Accordingly, it is necessary that in making its Final Decision, the QCA review the cost components of the Draft Decision to ensure that, where appropriate, assumptions and estimates are updated to reflect actual market conditions (especially in light of the recent easing of the drought and water restrictions for power stations in south-east Queensland). Areas which the Government would like the QCA to re-examine are detailed in its formal response to the Draft Decision (Attachment 2).

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In addition to my Department's response to the Draft Decision, Attachment 1 provides a new Certificate of Delegation including delegation of the responsibility to calculate and publish in the Gazette the new tariffs to apply in each tariff year and including directions to:

- Remove the current requirement to smooth Ergon Energy's Aggregate Annual Revenue Requirement for the 2008-09 and subsequent Benchmark Retail Cost Index calculations;
- Calculate the BRCI for 2009-10, and publish the tariff schedule to apply to the 2009-10 tariff year, no later than 1 December 2008; and
- Make a public announcement of the change to notified prices, on the same day as it gazettes the tariff schedule for the relevant tariff year.

This new Certificate of Delegation revokes any previous delegation I have made in relation to these matters.

I would also like to foreshadow an additional review that I will be writing to you about shortly. In addition to rising electricity prices, you would be aware of the significant price increases experienced by domestic reticulated natural gas consumers. As Minister for Mines and Energy I intend to direct the QCA to examine the degree of cost-reflectivity in the Queensland natural gas market including consideration of the costs and prices of the alternative forms of gas (reticulated and bottled LPG). Officers from my Department will be contacting your office in the near future to discuss suitable timeframes and Terms of Reference for the review.

I thank you for your consideration of these matters. Should you have any enquiries in the first instance, they should be directed to [REDACTED]

Yours sincerely /

[REDACTED]
GEOFF WILSON MP
Minister for Mines and Energy

Dated: 11th March 2008

CERTIFICATE OF DELEGATION

Under section 90(3) of the *Electricity Act 1994* (Qld)

Delegation

In accordance with section 90(3) of the *Electricity Act 1994* (the Act), from the date of this delegation, I, the Honourable Geoff Wilson MP, Minister for Mines and Energy, delegate to the Queensland Competition Authority (QCA) the following functions and powers:

1. Calculation of the Benchmark Retail Cost Index (BRCI) under Chapter 4, Part 2, Division 3 of the Act;
2. Application of the change in the BRCI to the tariffs for the previous tariff year as required by section 90(5) of the Act; and
3. Publication of the amended tariff schedule for the relevant tariff year in accordance with sections 90(2), 90(7) and 96 of the Act.

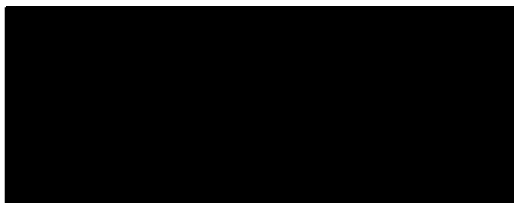
This delegation does not include the power to fix principles under section 95 of the Act.

Conditions of delegation

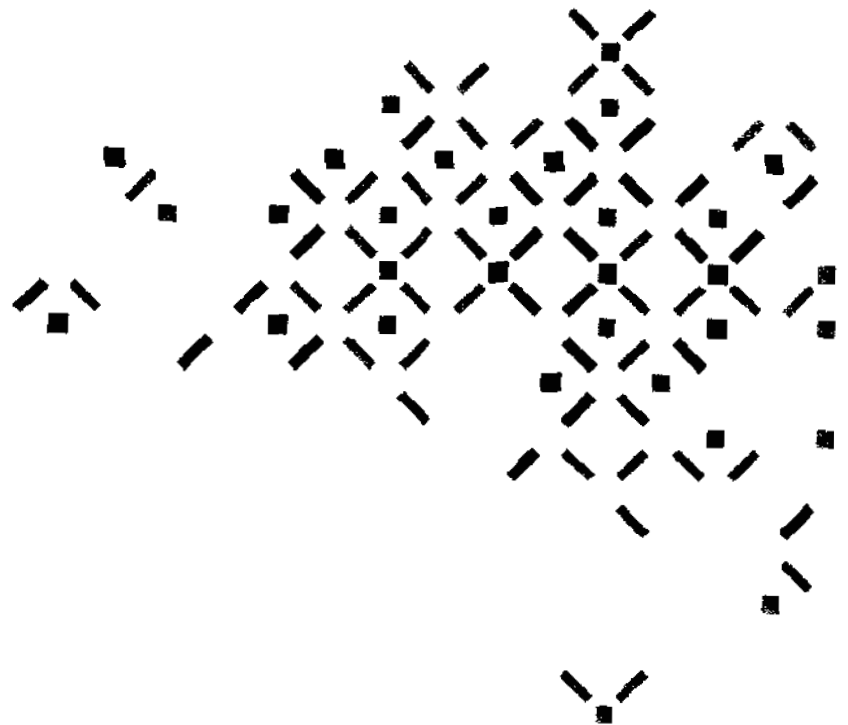
1. The QCA must apply the change in the BRCI to the tariffs for the previous tariff year, taking into account any other changes to notified prices made by the Minister under the provisions of section 90 which are not the subject of this delegation, which will be advised prior to the required date for publication of the tariffs in accordance with the Act and this delegation.
2. The QCA must consider the following policy objective of the Queensland Government when exercising the delegated powers and functions:
 - 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); and
 - 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;
3. In calculating the network cost component of the 2008-09 BRCI, and future tariff years, the QCA must apply the AARR determined for each year of Ergon Energy's current access arrangement (covering the period 2005-06 to 2009-10), and any changes to the AARR for any approved cost pass through subsequent to the finalisation of the current access arrangement, without undertaking any re-smoothing of these AARR amounts;
4. For the purposes of setting 2008-09 notified prices, the QCA must recalculate the network cost component of the index for 2007-08 without undertaking re-smoothing of Ergon Energy's AARR (i.e. consistent with Condition 3) to ensure the change in the index to be used to determine 2008-09 notified prices is based on two index values determined under the same methodology;
5. The QCA must calculate the BRCI for 2009-10, and publish the tariff schedule to apply to the 2009-10 tariff year, no later than 1 December 2008;
6. On the same day that the QCA gazettes the tariff schedule for a tariff year, the QCA must make a public announcement of the change to the notified prices; and

7. Any other conditions formally notified by the Minister from time to time.

This delegation revokes any previous delegation made in relation to this matter and may be revoked or amended by the Queensland Minister for Mines and Energy at any time.



GEOFF WILSON MP
Minister for Mines and Energy



Submission to the Queensland Competition Authority

Response to the Draft Decision on
the Benchmark Retail Cost Index
(BRCI) for Electricity 2008-09

Prepared by the Department of Mines and
Energy

11 March 2008

Executive Summary and Key Recommendations

The Government continues to be concerned about rising energy costs and the pressure this places on increasingly stretched family budgets. Increasing electricity prices for households and small business come in the context of rising interest rates, higher food prices and soaring petrol costs.

Based on a quarterly electricity bill of \$275, Queensland's current electricity prices now represents around 3.5 per cent of weekly disposable income (based on a mean weekly gross income of \$1275 and a mean weekly disposable income of \$632). If notified electricity prices are increased by the 7.01 per cent identified in the Draft Decision, around 3.8 per cent of weekly disposable income will then be allocated to electricity. For low income households where the quarterly electricity bill is above \$275 (e.g. larger families), the proportion of income allocated to cover electricity costs may be higher.

This submission seeks to ensure that only genuine cost increases are passed onto consumers through the application of the Benchmark Retail Cost Index (BRCI).

Accordingly, emphasis is placed on reviewing a number of the cost components used to determine any proposed increase in electricity prices, especially:

- Balancing the short term price increases from recent generation supply constraints arising from water restrictions with energy prices that reflect longer term expectations of energy markets;
- Inclusion of only the approved regulatory costs of the electricity network businesses; and
- Queensland's 13% Gas Scheme compliance costs which represent costs actually paid by retailers, not the higher 'penalty costs'.

Whilst the detail of how these considerations might be achieved has been included in the body of this Submission, the key recommendations from the Department of Mines and Energy are for a re-examination of the following BRCI input components:

- The QCA should review the energy cost component of the BRCI calculation to ensure that only actual and efficient cost increases are passed onto consumers. In particular, given that water restrictions on south-east Queensland power stations have now been lifted, the QCA should review the short-run energy purchase cost estimates used to calculate the BRCI for 2008-09;
- In relation to network costs, the QCA's Final Decision should reflect any changes in transmission or distribution network costs that have been announced after the release of the Draft Decision, and prior to release of its Final Decision;
- The QCA should adjust its estimate of the cost of complying with the 13% Gas Scheme for 2008-09 to reflect a cost based on Gas Energy Certificates (GECs) actually traded, rather than an assumed proxy (the penalty price). The variation between the actual GEC cost and the penalty price is approximately 10 per cent;
- While DME supports the QCA's change in methodology in applying a 50 per cent weighting to each of the LRMC, and short-run energy purchase cost within the cost of energy component, it would like to see an even greater emphasis on LRMC. The *Electricity Act 1994* requires that the QCA base its calculation of the cost of energy on LRMC given that, over a sufficiently long period of time,

average energy purchase costs should broadly equal the long run marginal cost (LRMC) of generation, as periods of surplus and deficit capacity are balanced. As a result, DME proposes that a 75:25 LRMC:short-run purchase cost ratio is more appropriate than the ratio applied by the QCA in the Draft Determination, and more closely in accordance with both legislative requirements and the actual market behaviour of prudent and efficient retailers; and

- The Government will amend the QCA delegation to remove the current requirement that it smooth Ergon Energy's Aggregate Annual Revenue Requirement (AARR) over the current determination period. For the purpose of setting the 2008-09 notified prices, the QCA will be required to calculate the network cost component of the BRCI for 2007-08 without undertaking smoothing of Ergon Energy's AARR.

Introduction

DME welcomes the opportunity to provide comment on the Queensland Competition Authority's (QCA) *Draft Decision on the Benchmark Retail Cost Index (BRCI) for Electricity: 2008-09* (the Draft Decision).

The Queensland Government objective is to foster competition in the energy market so that the economy and customers derive the benefits of a competitive energy sector. Efficient and sustainable energy pricing is essential to meeting these objectives, particularly in the face of the significant growth currently occurring in south-east Queensland (SEQ).

In line with achieving efficient and sustainable energy pricing, DME wishes to ensure that only genuine cost increases are passed onto consumers through the application of the BRCI. Accordingly, it is necessary that in making its Final Decision, the QCA reviews the cost components of the Draft Decision to ensure that, where appropriate, assumptions and estimates are updated to reflect actual market conditions (especially in light of the recent easing of the drought and water restrictions for power stations in SEQ).

Background

Retail competition has been progressively introduced into the Queensland electricity market since 1998. Whilst large electricity users have been able to choose their electricity retailer for some time, it is only recently that competition has been extended to small (domestic) customers. Competition in Queensland has been introduced in a number of stages, or 'tranches', as follows:

- **Tranche 1** (29 March 1998) - Electricity usage of more than 40 gigawatt hours (GWh) per annum, including summation of sites where prior agreement existed;
- **Tranche 2** (1 October 1998) - Electricity usage of more than 4 GWh per annum (large factories, office buildings, shopping centres);
- **Tranche 3** (1 July 1999) - Electricity usage of more than 200 megawatt hours (MWh) per annum (medium retail and commercial outlets);
- **Tranche 4A** (1 July 2004) - Electricity usage of more than 100 MWh per annum (small retail and commercial outlets); and
- **Tranche 4B** (1 July 2007) - Full Retail Competition (FRC) with all customers including households and small business (other than excluded customers or receivers) can choose their electricity retailer. This enabled some 1.8 million household and small business electricity consumers to choose their electricity retailer for the first time.

With the introduction of Full Retail Competition (FRC) in Queensland energy markets on 1 July 2007, electricity retailers were able to offer to supply electricity to all consumers, including those who were on regulated (notified) prices. In addition, customers who have accepted a market contract may revert to a non-market contract at the notified price at the conclusion of their contract.

Notified electricity prices will remain an important feature of the Queensland electricity market, especially for customers in regional locations where the cost of supply outstrips the notified tariff rates charged, and as a safety net reflecting the maximum cost for regulated electricity supply in Queensland.

Under the *Electricity Act 1994* (the Electricity Act), notified electricity prices are adjusted annually according to movements in the BRCI. The Electricity Act allows

the Minister for Mines and Energy (the Minister) to delegate some or all of the process for calculating the BRCI, and determination of new notified prices, to the QCA. On 16 March 2007, the Minister delegated responsibility for calculation of the BRCI to the QCA, subject to certain conditions set out in the Certificate of Delegation.

In broad terms, the BRCI for a particular year is calculated by dividing the cost of electricity for the State (including the cost of energy, network costs, retail operating costs and the retail margin), by the State load for the preceding calendar year.

A consumer protection feature of the legislation is that a small customer's existing retailer must supply electricity at the notified price if the customer chooses to revert from a market contract. Given this feature, the Delegation stated that the policy intent of the BRCI is to ensure existing retailer headroom (the difference between the cost of supply and the current tariff level) remains relatively stable, and that the reversion policy does not result in retailers providing services to customers at a loss.

On 7 February 2008, the QCA released the Draft Decision stating that it expects the BRCI to increase by 7.01 per cent from 2007-08 to 2008-09.

The Government continues to be concerned about rising energy costs and the pressure this places on increasingly stretched family budgets. Based on a quarterly electricity bill of \$275, Queensland's current electricity prices now represents around 3.5 per cent of weekly disposable income (based on a mean weekly gross income of \$1275 and a mean weekly disposable income of \$632). If notified electricity prices are increased by the proposed 7.01 per cent, around 3.8 per cent of weekly disposable income will then be allocated to electricity. For low income households where the quarterly electricity bill is above \$275 (e.g. larger families), the proportion of income allocated to cover electricity costs may be higher.

Increasing electricity prices for households and small business come in the context of rising interest rates, higher food prices and soaring petrol costs. The Queensland Government is concerned that not enough emphasis is placed on issues such as social impact when the BRCI is being calculated.

Energy Costs

In its Draft Decision, the QCA estimated that the energy cost component of the BRCI would increase by 5.9 per cent, contributing 2.6 per cent to the overall increase in the BRCI for 2008-09.

While DME supports the QCA's change in methodology, applying a 50 per cent weighting to each of the LRMC, and short-run energy purchase cost, within the cost of energy component, it would like to see an even greater emphasis on LRMC. This approach should act to reduce undue volatility in the BRCI (compared to the methodology used to calculate the BRCI for 2007-08), and increase pricing certainty for consumers and retailers.

However, DME considers that a larger weighting should be given to LRMC in the cost of energy component, given legislative requirements and the actual behaviour of prudent and efficient retailers.

Specifically, section 92(2) of the *Electricity Act 1994* requires that the QCA base its calculation of the energy cost component of the BRCI on the LRMC of energy. This legislative requirement is based on the theory that, over a sufficiently long period of

time, average energy purchase costs should broadly equal the LRMC of generation, as periods of surplus and deficit capacity are balanced.

However, in any given year, the purchase cost of energy may be higher or lower than the LRMC and, as a result, the legislation also requires the cost of energy in the BRCI reflect the cost of purchasing energy in the year under consideration.

Given these legislative requirements, DME proposes that a 75:25 LRMC:short-run purchase cost ratio is more appropriate than the 50:50 ratio applied by the QCA in the Draft Determination, and more closely in accordance with the actual market behaviour of prudent and efficient retailers. In addition, this re-weighting should further ensure that the BRCI is not unduly influenced by short-term factors (such as variations in supply and demand conditions, and expectations about the future), and will increase certainty for both market participants and consumers.

Impact of Recent Rain on Short-Run Energy Costs

As a result of the drought, a number of restrictions were applied to key SEQ generation assets. Specifically:

- Tarong North – one of the lowest marginal cost generators in the state had its average output reduced by 40 per cent;
- Tarong Power Station, typically a base load station was restricted in 2006 from using Wivenhoe water, and therefore was constrained in order to prolong life of Boondooma dam until recycled water arrived. Average output of Tarong was reduced by 70 per cent. This resulted in up to two units put on standby during low load periods; and
- Swanbank B was limited in its output, with units off-line during low load periods.

The impact of these restrictions saw an increase in electricity market spot prices and a significant increase in forward prices in the electricity contract market, while also reducing the availability of contracts. In forming the Draft Decision estimates, the QCA used forward contract prices for the 2008-09 year that reflected drought impacts on the electricity market.

Given the release of the Draft Decision coincided with substantial inflows into the catchments of SEQ water storages, and a relaxation by the Queensland Water Commission on water restrictions, DME is of the view that, in determining its Final Decision, it is appropriate for the QCA to review the short-run energy purchase cost estimates used to calculate the BRCI for 2008-09. This should ensure that assumptions and estimates are updated to reflect actual market conditions which have seen an easing in forward energy prices and improving contract availability.

Network Charges

In the Draft Decision, network costs account for around two thirds of the increase in the 2008-09 BRCI (4.4 percentage points), due to an increase of around 9.5 per cent in network costs.

DME notes that much of the increase in the network cost component relates to historically high levels of capital expenditure being undertaken by the distributors (particularly ENERGEX). However, DME would anticipate that the QCA's Final Decision will be updated to reflect any changes in transmission or distribution network costs that have been announced after release of the Draft Decision and prior to release of its Final Decision.

The QCA's 2005 distribution determination indicated that it expected low growth in Ergon Energy's Aggregate Annual Revenue Requirement (AARR). Conversely, the QCA indicated that growth in ENERGEX's network area was expected to be considerably higher. Given that the BRCI methodology uses an 'average' for Queensland, it was considered that retailers in SEQ could have been adversely affected by the impact of the low growth in Ergon Energy's area. Consequently, a decision was made (and issued via a Delegation) to smooth Ergon Energy's AARR over the current determination period.

In the 2007-08 BRCI Decision, this process worked largely as anticipated, cushioning the impact of a large increase in distribution revenue in the ENERGEX area. Adjustments to the revenue requirements in the ENERGEX area for the 2008-09 determination means that the increase in distribution revenue is actually lower than the smoothed result for the Ergon Energy area.

It is DME's view that continuing to smooth the Ergon Energy AARR would result in a perverse outcome, providing a windfall for retailers and adversely impacting on residential customers. The Minister intends to issue a new Certificate of Delegation in relation to this issue.

Fixed Principles

In its Interim Consultation Notice, the QCA sought comments on whether it should "fix any of the principles to apply to any or all of the BRCI elements and, if so, what fixed principles should be applied to which elements, and for how long."

DME notes that a number of submissions on the Interim Consultation Notice, including the Queensland Treasury submission, supported the use of fixed principles in order to increase pricing certainty for both consumers and retailers, and reduce undue volatility in the BRCI.

DME notes the view of the QCA in the Draft Decision that, until the market outlook for the various cost components of the BRCI becomes clearer, the benefits of pricing certainty that can be achieved by adopting fixed principles could be offset by "frequent and possibly justified calls for within-period price adjustment mechanisms to be activated."

However, DME is of the view that the utilisation of the fixed principles provision could prove to be an effective means of addressing short-term fluctuations that may unduly influence the BRCI, while still accommodating the needs of retailers. The application of this provision would provide market participants and consumers with a greater degree of certainty around future movements in the BRCI for up to three years.

The attachment details of additional specific issues DME wishes to raise for the consideration of the QCA in its deliberations before it makes its Final Decision on the BRCI for 2008-09.

Detailed Comments Relating to BRCI Input Components

Contract Price Projection

The QCA methodology for calculating (draft) energy purchase costs involved averaging the contract price from 1 December 2007 to 23 January 2008 and projecting this for the period 24 January 2008 to 30 June 2008. DME notes that this was a period of significant change in forward prices.

DME understands that the QCA will revise its energy purchase cost estimates with actual data prior to issuing its final determination.

To provide an approximate indication of the trend of the energy purchase cost that QCA's final assessment may take, DME undertook a simple analysis using the average flat contract price from 1 December 2007 to 23 January 2008 and projecting this for the period 24 January 2008 to 30 June 2008. This resulted in an estimated price of \$55.23 per MWh.

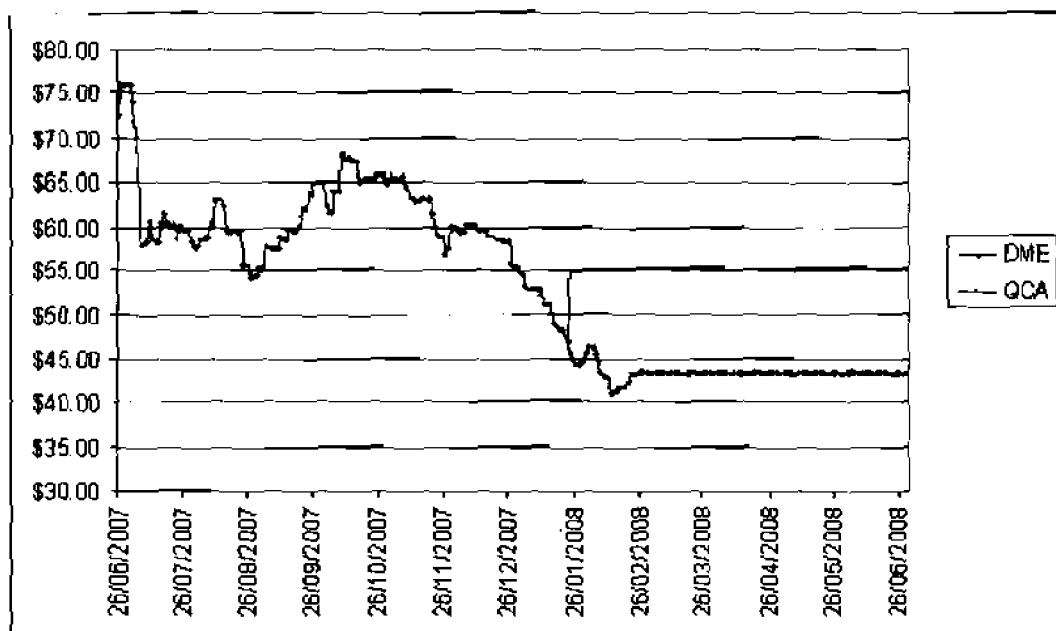
This was compared to a simple analysis using the latest ICAP data up to 23 February 2008 and extrapolating the February 23 value through to 30 June 2008. This was done because the latest market prices reflect the most informed market activity. February prices take into account the most recent changes to the market environment.

DME does not consider that December and January prices are indicative of the future contract prices because these prices do not reflect market information that is currently known (for example, the recent rainfall resulting in much greater water security for generators).

This second methodology resulted in an estimated price for the same period of \$43.37 per MWh.

The forecast period is 159 days long (24 January to 30 June) and assuming that the full contracting period is 2 years (730 days), the average purchased energy cost for the full contracting period is 4.7 per cent lower when using more recent data.

The following chart illustrates these two simple methodologies/ projections.



Weighting of Long Run Marginal Costs and Short Run Marginal Costs

As discussed in the energy cost section above, the *Electricity Act 1994* requires that the QCA base its calculation of the energy cost component of the BRCI on the LRMC of energy given that, over a sufficiently long period of time, average energy purchase costs should broadly equal the LRMC of generation, as periods of surplus and deficit capacity are balanced. As a result, DME proposes that the QCA give a higher weighting to LRMC in determining the energy cost component of the BRCI. It is proposed that a 75:25 LRMC:short-run purchase cost ratio is more appropriate than the 50:50 ratio applied by the QCA in the Draft Determination, and more closely in accordance with legislative requirements and the actual behaviour of prudent and efficient retailers..

Gas Electricity Certificate Pricing

The QCA has estimated that the cost of complying with the 13% Gas Scheme for 2008/09 will rise from \$80 million to \$83 million.

DME understands that the GEC penalty price adjusted for tax offsets has been used in previous years to calculate Retailers' GEC cost obligations and that it has again been used to calculate the GEC cost for 2008-09.

However, DME believes a more accurate GEC compliance cost is one based on GEC prices that have actually been traded, rather than an assumed proxy. Analysis by DME indicates an average traded GEC price for 2008 and 2009 of \$15.59. This is more than 10 per cent below the effective penalty price of \$17.36.

Ergon Energy AARR Smoothing

The Minister's 16 March 2007 delegation of responsibility for the BRCI calculation required that the QCA recalculate Ergon Energy's Aggregate Annual Revenue Requirement (AARR) as a smoothed series over the five-year determination period to 2010, while maintaining the Net Present Value of the AARRs, and use the smoothed AARR series to calculate the BRCI.

The QCA's 2005 distribution revenue determination indicated that it expected low growth in Ergon Energy's AARR. Conversely, the QCA indicated that growth in ENERGET's network area was expected to be considerably higher. Given that the BRCI methodology uses an 'average' for Queensland, it was considered at the time that retailers in SEQ could have been adversely affected by the impact of the low growth in Ergon Energy's area. Consequently, a decision was made (and specified in the Delegation) to smooth Ergon Energy's AARR over the current determination period for the purposes of the BRCI.

In the 2007-08 BRCI Decision, this process worked largely as intended. Adjustments to the revenue requirements in the ENERGET area for the 2008-09 determination meant that the increase in distribution revenue was lower than the smoothed result for the Ergon Energy area. Consequently, it appears clear that continuing to smooth the AARR would result a windfall for retailers and adversely impact residential customers.

The Minister will issue the QCA with an amended Delegation under section 90(3) of the *Electricity Act 1994* (as amended). The new Certificate of Delegation will direct the QCA to undertake the following:

- In calculating the network cost component of the 2008-09 BRCI, and future tariff years, the QCA must apply the AARR determined for each year of Ergon Energy's current access arrangement (covering the period 2005-06 to 2009-10), and any changes to the AARR for any approved cost pass through subsequent to the finalisation of the current access arrangement, without undertaking any smoothing of these AARR amounts; and
- For the purposes of setting 2008-09 notified prices, the QCA must calculate the network cost component of the index for 2007-08 without undertaking smoothing of Ergon Energy's AARR to ensure the change in the index to be used to determine 2008-09 notified prices is based on two index values determined under the same methodology.

This amended Delegation will remove the Condition of Delegation numbered 3 in the Delegation issued to the QCA on 16 March 2007.

Powerlink TUOS Cost Pass Throughs for Ergon Energy and ENERGEX.

Powerlink is required to advise the distribution businesses of the amount it intends to recover from the distribution businesses for the year ahead based on its AER allowed Revenue Cap and its internal allocations between network connected customers and distribution businesses.

DME is aware that Powerlink will advise the distribution businesses on or before 20 March 2008 of its revenue requirements.

The QCA should update its draft determination with the actual Powerlink revenue requirements prior to issuing a final calculation of the BRCI.