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Queensland Competition Authority  
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### **Draft Decision - Benchmark Retail Cost Index 2008/09**

Thank you for the opportunity to comment upon the Authority's *Draft Decision - Benchmark Retail Cost Index 2008/09*.

TRUenergy considers there are components of the Benchmark Retail Cost Index (BRCI), in particular the long-run marginal cost of energy (LRMC) and customer acquisition costs, which require further consideration by the Authority regarding the appropriate method on which they are calculated. The changes we believe are necessary to address the current shortcomings are detailed in our submission below. If the Authority believes that it is constrained by legislation from undertaking the necessary amendments to the BRCI calculation, there is opportunity for the Authority to recommend to the State Government that legislative amendments are required.

#### *Energy costs*

The estimated LRMC decline of -2.4% is not credible. CRA claim the result is due to the "less variable" load shape of 2007 relative to 2006. We query the potential for load shape variation between the two years to have such an impact, whilst noting that insufficient information has been provided to assess the claim.

If CRA stand by these findings, the result represents a failure of their modeling to generate a smooth LRMC estimate consistent with the policy objective of stabilising short-term wholesale market volatility. To rectify this shortcoming, variations in LRMC should be calculated on an identical load shape for the base and subsequent year. Thus for the 2008/09 calculation the 2007 load shape should also be used to recalculate the 2007/08 estimate, with the 2007/08 BRCI adjusted accordingly. This would be consistent with the Regulations which only specify that the previous years load shape be used in the LRMC calculation, whilst not specifying the load shape to be used in the base year.

In the short-term, if the LRMC cannot be estimated on a constant load shape, the equivalent weighting of the LRMC and energy purchase cost allowances should be reconsidered. Specifically, if the LRMC estimate cannot operate in the index as a source of pricing stability, consistent with the policy intent, it would be reasonable for the Authority to reduce its weighting.

In addition, we remain concerned at the underlying level of the LRMC estimate. Capital costs have again been underestimated, on the basis of TRUenergy's own experience in constructing new plant, consistent with above CPI increases in ABS input cost indexes, and other data quoted but discounted by CRA. In terms of overall costs, analysis conducted in the recent NSW and South Australian retail price determinations also found LRMC to be relatively constant in real terms across the determination periods.

In our view, a CPI increase is the minimum rate of change in LRMC that can be considered as credible. However, the difficulty with proprietary modeling of LRMC is that the estimates they generate cannot be subjected to detailed interrogation, other than to state that they are inconsistent with pricing outcomes which promote retail market competition and private sector investment. If the proposed adjustments to the load calculations or weightings cannot be accommodated, then the Authority should consider simply setting the LRMC growth rate at CPI, confident that the estimate is at least consistent with findings in other jurisdictions.

As a longer term approach, we would support adopting a simpler method of calculating LRMC, similar to the analysis conducted in the 2004 IES study for IPART, which would at least provide greater transparency and opportunity for correction. Whilst CRA has raised concerns regarding the validity of simpler LRMC methods, the evidence of all jurisdictional pricing reviews is that there is no correlation between the resources devoted to estimating a cost, and the credibility of that estimate.

#### *Retail Costs*

TRUenergy supports the "scale retention" model adopted by CRA to estimate customer acquisition costs. However, we do not support how these costs have been estimated for the 2008/09 BRCI.

Firstly, we dispute the estimate of 10% customer churn for 2008/09, justified by CRA only on the grounds that it is a "reasonable projection." As we have argued previously, if regulated tariffs are set at market based levels, evidence from Victoria and South Australia has demonstrated that, customer transfer rates will consistently exceed 20%. Even in New South Wales, where regulated tariffs generally remain below market based levels, transfer rates have exceeded 10% for the past 2 years. If the Commission has confidence in its price setting arrangements, and believes that the decision will deliver the policy objective of stable margins, then the necessary conclusion is that the customer churn rate will also remain stable.

Secondly, with regard to the back calculation of acquisition costs for 2007/08, it is unreasonable for the Commission to apply the actual churn rate, rather than the 6.7% rate assumed in the 2007/08 Final Decision. If an adjustment is not made to the base year to reflect higher than predicted churn rates, the BRCI will not reflect the actual costs incurred by retailers, causing a decline retail margins. A correction will only occur over the long-term if over and under estimates cancel each other out, and there is no reason why this should be expected.

Assuming that the 2008/09 churn rate is equal to that estimated by CRA for 2007/08, and applying the 6.7% churn rate specified in the 2007/08 final decision leads to the following calculations:

- 2007/08:  $\$171.43 * 126,544 / 1,885,727 = \$11.49$
- 2008/09:  $\$177.69 * 193,373 / 1,909,176 = \$30.21$

TRUenergy supports CRA's calculation of the rate of change in retail operating costs. Whilst the overall level of costs are grossly under-estimated, which is also the view of regulators in other jurisdictions, this has a negligible impact on the BRCI calculation.

Please contact me on (03) 8628 1122 if you require additional information.

Yours sincerely,

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**Regulatory Manager**