



Submission to the
Queensland Competition Authority
on the Draft Decision
Benchmark Retail Cost Indexation
for Electricity: 2006-07 and 2007-08

23 May 2007

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1. Introduction

Origin Energy (Origin) welcomes the opportunity to make a submission to the Queensland Competition Authority (QCA) regarding their Draft Decision for the *Benchmark Retail Cost Index for Electricity: 2006-07 and 2007-08*.

As previously stated, Origin remains fully supportive of the Queensland Government's policy intent of ensuring that regulated retail tariffs are adjusted annually to reflect any change in the cost of supplying electricity to customers in Queensland.

In line with this policy, 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. Origin does believe there are findings in the Draft Decision where the derived cost estimates are unrealistic or the full impact of market changes have not been recognised and this submission highlights several of these areas. Origin encourages the QCA to address these issues in their Final Decision.

In line with the truncated process for 2007-08, Origin provides this submission on the basis that:

- it does not infer that Origin supports any specific cost estimates provided for in the Draft Decision; and
- there is to be a rigorous and transparent consultation process for calculating the 2008-09 BRCI and the findings stemming from this consultation will include a resetting of the 2006-07 and 2007-08 indexation. This recalculation will include necessary adjustments being made to the 2008-09 BRCI to account for any discrepancies between the preliminary and final methodology used for 2007-08.

2. Energy Cost

Although Origin has concerns with lack of a comprehensive study of long run marginal cost (LRMC) options, it agrees that the QCA focus on the changes to the LRMC from 2006-07 to 2007-08 and hence understands the sole use of the stand-alone concept for LRMC. Origin expects the consultation process for 2008-09 to allow more considered analysis.

However, Origin has some concerns with the preliminary modelling performed by CRA, the QCA's consultants, which are detailed below and need to be addressed in the QCA's Final Decision.

2.1 Long Run Marginal Cost (LRMC)

The principal component of the total cost of energy set out in the QCA's Draft Decision is the LRMC of energy. On advice from CRA, the QCA's position in its Draft Decision is that the LRMC of energy will increase from \$43.3/MWh in 2006/07 to \$44.0/MWh in 2007/08, an increase of 3.8 per cent.

One of the key determinants of LRMC is the input assumptions used to estimate LRMC, including assumptions on plant costs. The QCA noted in its Draft Decision

that the data from ACIL Tasman's report on plant costs provides the most reliable data for the purposes of estimating LRMC.

In advising the QCA, CRA in fact used data from two ACIL Tasman reports for NEMMCO; one report from 2005 and a second report from 2007. In regard to capital cost assumptions, CRA note that the capital cost assumptions from the 2005 report are significantly lower than the capital cost assumptions from the 2007. In estimating LRMC, CRA use the capital costs from the 2007 report for both 2006/07 and 2007/08. This approach differs from CRA's approach in regard to variable and fixed maintenance costs, and plant thermal efficiencies. For these inputs, CRA form a view on costs in 2006/07 and 2007/08 on the basis of a comparison of cost estimates from the 2005 report and the 2007 report.

CRA's explanation for only using the ACIL Tasman's 2007 report to inform assumed capital costs is that there is a significant change between the 2005 report and the 2007 report. CRA suggest that this may be due to a methodological difference between the two reports, and that only the latest report should be used in order to avoid a step change in LRMC due to any such methodological difference. However, CRA provide no evidence to support their view that there has in fact been a change in ACIL Tasman's methodology, and do not undertake any analysis of capital costs to inform their view that a methodological change may have occurred. In the absence of any such evidence, there is no support for the conclusion that the change in capital costs is a result of a methodological change, rather than reflecting actual increases in capital costs over that period. Indeed, in the absence of any such evidence, it would seem appropriate for CRA to adopt the same approach to capital cost inputs as they have done for other cost inputs: that is, to develop input assumptions for 2006/07 and 2007/08 on the basis of a comparison of cost estimate from the 2005 report and the 2007 report.

Origin's initial submission included modelling by Frontier Economics which estimated LRMC using data from ACIL Tasman's 2005 and 2007 report with the 2007 data leading to a LRMC estimate that is 13 per cent higher than using the 2005 data.

While more detailed examination of capital cost assumptions may reveal that some blend of 2005 data and 2007 data is more appropriate for 2006/07, this comparison nevertheless highlights the impact of CRA's capital cost assumptions. This also indicates that CRA's conclusion that LRMC increases by 3.8 per cent from 2006/07 to 2007/08 is likely an understatement of the true increase in LRMC.

2.2 Energy Purchase Costs

The cost of energy set out in the QCA's Draft Decision includes several components that "flesh out" the raw LRMC to better reflect energy purchase costs. One of these is an energy purchase cost, which reflects the likely mismatch between actual market based purchase costs incurred by retailers and the LRMC of energy during a given year. On advice from CRA, the QCA's position in its Draft Decision is that the energy purchase cost component will increase from \$9/MWh in 2006/07 to \$12/MWh in 2007/08.

CRA's conclusion that the energy purchase cost would increase from \$9/MWh to \$12/MWh is based on estimates of LRMC and market-based energy costs relied on by IPART in its draft determination.

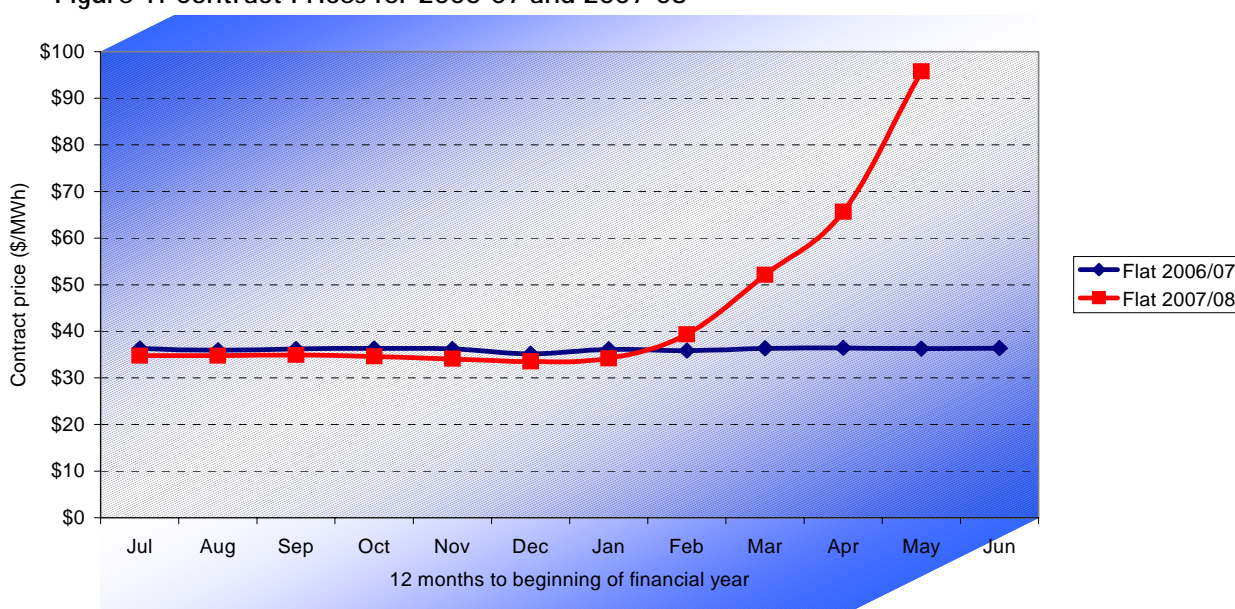
CRA argues that "there are no obvious major structural differences that would make the difference between the LRMC of energy for the retail load and the costs incurred in purchasing energy for this load significantly higher or lower in Queensland than in NSW." On the basis of this argument, CRA judgementally concludes that the energy purchase cost for 2006/07 should be from the lower end

of the range, and the energy purchase cost for 2007/08 should be from the higher end of the range.

The QCA is correct in noting that the LRMC of energy may not reflect the cost to a retailer of purchasing energy and Origin strongly supports the QCA's consideration of energy purchase costs. Nevertheless, there are some issues with CRA's approach to quantifying the energy purchase cost in that it is:

- incorrect to assume that results from NSW will hold for Queensland; given the very different load shapes and differences in the correlation between load and price;
- inappropriate to use a range of energy purchase costs between different retailers at the one point in time (as set out in the IPART Draft Determination) to determine a range of energy purchase costs over time; and
- inappropriate to use the results from IPART's draft determination to inform energy purchase costs because of the significant recent movements in the forward curves that have occurred since IPART released its draft determination (see Figure 1).

Figure 1: Contract Prices for 2006-07 and 2007-08



An appropriate analysis of the change in energy purchase costs between 2006/07 and 2007/08 should consider the impact of the recent substantial movements in forward curves on energy purchase costs. Analysis by Frontier Economics suggests that the magnitude of the increase in energy purchase costs is similar to the magnitude of the increases in spot and contract prices. This is much greater than the 36.1 per cent increase suggested by CRA and needs to be appropriately recognised in the methodology.

While Origin recognises the difficulty in undertaking this task in such a short period, it nevertheless needs to be incorporated into the current BRCI. Perhaps, more importantly, there should be recognition that the CRA approach as it now stands, is (inevitably, given the short time-frames) a very limited approach and will need to be significantly amended for future years. It is important to recognise here that, given the likelihood of a significantly amended approach being used in 2008/09, it is most desirable to avoid underestimating the impact in 2007/08 in the current determination. Underestimating the impact in 2007/08 will result in larger increases in 2008/09 to "recover" the errors in the 2007/08 calculation.

3. Networks Cost

Origin supports the conclusions reached in the QCA's Draft Decision regarding the change in network costs for 2007-08.

Specifically, Origin agrees that the network costs for the BRCI should:

- reflect the Ergon, ENERGEX and Powerlink Average Annual Revenue Requirements (AARRs) as determined in the respective regulatory determinations;
- ignore the annual variations in actual revenue requirements because of past over and under recovery of revenue;
- use NPV smoothing of Ergon's total revenue requirement;
- incorporate the impact of ENERGEX's cost pass-through application for additional capital expenditure;
- include any network revenue allowed for distributors' FRC costs in 2007-08; and
- utilise the latest transmission costs estimates in the BRCI - these should reflect the transmission costs that are passed through to Queensland customers utilising the distribution networks.

Both the approval of any additional allowance for distributor's FRC costs in 2007-08 and the finalisation of Powerlink's transmission costs for 2007-08 will most likely occur after the setting of the BRCI for this financial year. Consequently, Origin requests assurance from the QCA that there will be no mid-year changes to network or transmission charges in 2007-08 to reflect these adjustments. A mid-year adjustment would not be recognised in the BRCI and would contradict the Government's stated policy objectives of implementing the BRCI. That is, it would significantly impact on the existing retail margin in the notified prices at the date of delegation.

Origin also has some queries over the specific numbers used in the calculation, such as the adjustments to the distributors' AARRs, but recognises the QCA has additional information and experience on such matters. However, it does raise the issue of transparency of distribution and transmission revenue going forward. Origin understands that individual network charges are currently publicly released, however, the BRCI process means that market participants in Queensland will be required to make significant commercial decisions based on projected total network revenues. Origin therefore encourages the QCA to ensure that any necessary adjustments to network revenues during a regulated period are transparent to all parties, not simply implied through the approval of network charges.

On a separate but related issue, Origin note that the inclusion of \$15 million in FRC costs for ENERGEX yet no allowance of costs for Ergon clearly demonstrates how the averaging process of the BRCI reduces its effectiveness as an instrument of the Government's policy intent. The additional cost is specifically related to customers in the ENERGEX network, however, the cost is being averaged across all Queensland customers' retail prices. Origin understands that the QCA is limited in accounting for this discrepancy but believes there are avenues to modify the BRCI methodology to better impart the Government's policy objective of sustaining retail margins.

For instance, if all or some of the FRC costs are recovered in excluded services charges, then these particular charges will sit outside the BRCI and be a direct pass-through to customers. This has the added advantage that Ergon customers will not have to "cross-subsidise" FRC costs which are very largely for the benefit of ENERGEX's customers. It also provides more transparency on the costs of FRC and enables the charges to align better with the cost drivers more directly.

4. Retail Costs and Margins

Origin agrees that for the purpose of setting the BRCI for 2007-08, the QCA's use of retail cost and margin benchmarks from within the range of recent studies carried out in other jurisdictions is appropriate.

Origin also proposed the use of a retail cost of \$75 per customer and retail margin of 5% of sales for 2006/07 to expedite the BRCI process as they were the recent findings of the Independent Pricing and Regulatory Tribunal (IPART)¹ for mass market new entrant retailers in New South Wales. Origin expects both retail costs and margin to be revisited during the 2008-09 BRCI consultation and for more realistic estimates to be produced. This includes examining the QCA's allowances within the Draft Decision of:

- \$10 per customer as a proxy for increased FRC costs; and
- wages growth of 4.5 per cent.

Origin does suggest that the QCA reconsider the use of \$2 per customer in the Draft Decision to represent the impact of loss of scale for retailers. Origin proposed costs of \$35 for customer acquisition which translated to the \$3.50 per customer considered by the QCA (using a 10 per cent churn rate). However, even using the alternative method of compensating for loss of scale economies, the \$2 per customer appears arbitrary as one method for estimating loss of scale used by the QCA's consultants provided for over \$5 per customer (using 10 per cent churn rates).

5. Energy Load

Origin concurs with the QCA's methodology for deriving the BRCI Queensland NEM load for 2006-07 and 2007-08, including the use of load data from the respective preceding calendar years.

Origin agree that current embedded generation load is not material at this point in time but suggest that it may become more significant in future years and an adequate process to quantify and remove this load be investigated in the 2008-09 BRCI consultation.

¹ IPART 2007: Promoting Retail Competition and Investment in the NSW Electricity Industry.