



Submission to the  
Queensland Competition Authority  
on  
Interim Consultation Notice  
Benchmark Retail Cost Index for  
Electricity: 2008-09

October 2007

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# 1. Introduction

Origin Energy (Origin) welcomes the Queensland Competition Authority's (QCA) public consultation on the Benchmark Retail Cost Index (BRCI) for 2008-09.

Origin continues to support the Queensland Government's policy of ensuring that regulated retail tariffs are adjusted annually to reflect any change in the cost of supplying electricity to customers in Queensland.

Given the time constraints last year, Origin believed that the QCA's truncated process for 2007-08 was satisfactory however, the 2008-09 process provides the opportunity for a more rigorous examination of various components of the BRCI. This submission, in response to the QCA's *Interim Consultation Notice: Benchmark Retail Cost Index 2008-09*, highlights the elements that Origin believes need to be considered in more depth.

Origin submits that the QCA use the 2008-09 BRCI process to further explore:

- the long run marginal cost (LRMC) for electricity in Queensland;
- a transparent and consistent approach going forward that will incorporate the impact of the volatile energy market on retailer's actual purchasing cost in the BRCI calculation; and
- the quantum of retail costs and retail margin for the Queensland regulatory framework that is suitable for inclusion in the BRCI.

Previous submissions by Origin to the 2007-08 BRCI process noted that any methodological or quantum changes accepted during the 2008-09 BRCI process would have consequences for the 2007-08 escalation and this year's calculation must incorporate any necessary adjustments to account for this discrepancy. Origin continues to hold this view.

Origin also supports the QCA investigating the use of fixed principles where possible and practical because the transparency of fixed principles will provide additional confidence on future tariff movements to retailers seeking to contract Queensland customers. There are some elements of the BRCI that Origin believes cannot be adequately translated into fixed principles and must be estimated annually.

Origin is cognisant that the BRCI process does not attempt to estimate the total cost of supplying electricity to Queensland customers and is only used to quantify the change in cost of supply. Consequently, Origin recognises that there is little benefit in debating the exact quantum of each BRCI element in the context of the QCA review.

Origin's acceptance of specific cost estimates during this process therefore does not imply that it supports these estimates as being fully representative of the total retail costs, unless that is clearly stated. Indeed, while we understand it is not within the jurisdiction of the QCA to address such matters under the relevant legislation and delegations<sup>1</sup>, Origin will continue to monitor the actual outcomes of the BRCI process against the major policy objectives of the BRCI process, being to ensure:

1. existing retail headroom remains relatively stable; and
2. retailers should not incur a loss in servicing non-market customers<sup>2</sup>.

To this effect, Origin will be particularly monitoring:

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<sup>1</sup> Such matters being more the direct responsibility of the relevant Minister.

<sup>2</sup> See for instance, the Certificate of Delegation under section 90(3) of the *Electricity Act 1994*.

- any significant changes in the relativities between Ergon and ENERGEX network pricing;
- the impact of any network tariff rebalancing by ENERGEX particularly between large and small customers; and
- existing and potential cross-subsidies in retail tariffs between customer segments.

All of these factors will have an impact on the stability of retail margins generally and the sustainability of servicing small customers.

Moreover, commercially acceptable, stable retail margins are a key element in the continuing development of competition in the market as has been identified in the recent AEMC Review of Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria. Similarly, the progressive removal of cross-subsidies allows for more efficient pricing in the competitive market, in turn a key ingredient in the move towards full deregulation in line with the commitments of all state governments in the Australian Energy Market Agreement.

Origin looks forward to participating in the QCA's consultation process. As this is only the initial step within the QCA's consultation process, Origin has not attempted to quantify individual elements of the BRCI within this submission. Instead, it highlights what Origin believes the QCA and their consultants need to consider in order to produce a satisfactory and more rigorous methodology this year.

## 2. Networks Cost

Origin supports the QCA's methodology used to incorporate network costs within the calculation of the 2007-08 BRCI.

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

- reflect the ENERGEX Average Annual Revenue Requirements (AARRs) as determined in the respective regulatory determinations and ignore the annual variations in actual revenue requirements because of past over and under recovery of revenue;
- continue to utilise the NPV smoothing of Ergon's AARR over the period of the regulatory determination;
- incorporate the impact of all distributors' cost pass-through applications within the AARR figures. That includes ENERGEX's application for additional capital expenditure recovery, Ergon's application for Tropical Cyclone Larry relief funding and any network revenue allowances for distributors' FRC costs in the period. There can be no mid-year changes to network charges during 2008-09 as any mid-year adjustment would not be recognised in the BRCI; and
- utilise the latest transmission network costs estimates, as they are passed through in the distribution NUOS charges for 2008/09, in the BRCI. These should reflect all annual transmission costs that are passed through to Queensland customers utilising the distribution networks while excluding direct transmission customer charges (see below).

### 2.1 Powerlink Network Costs

Origin notes that the QCA's *Interim Consultation Notice* makes representation that the 2007-08 transmission costs were based on the Australian Energy Regulator's (AER) Draft Decision on Powerlink's revenue cap for 2007-08 to 2011-12. Origin understands that the transmission costs used in the 2007-08 BRCI were those passed-through to distribution network consumers and there is little transparency on whether these costs actually were impacted by the AER decision.

Unfortunately, because a significant proportion of Powerlink revenue is derived from customers not connected to the Queensland distribution networks, it is readily apparent that the QCA cannot simply use the Powerlink AARRs derived in the AER Final Decision. This is unfortunate as it does not provide market participants any transparency going forward.

Because of this lack of transparency, Origin supports the QCA's method of utilising the actual transmission charges provided to the distribution networks within the BRCI. This is the only practical method of ensuring that any treatment of the revenue cap by the AER is reflected in the appropriate year.

The result is that the BRCI cannot be finalised until the Powerlink network charges for 2008-09 are derived and communicated to the QCA.

### 2.2 Mt Isa Network Costs

Given that the NEM load used in the BRCI calculation does not include Mt Isa energy consumption then it is consistent that the QCA remove the distribution network costs for Mt Isa from the calculation of the index.

Origin supports this process and recognises that an adjustment must be made to the 2008-09 BRCI to account for the impact of the removal of Mt Isa costs from the 2007-08 BRCI estimation.

### 3. Energy Cost

Origin believes the change to LRMC of energy in the 2007-08 BRCI calculation did not adequately reflect the fundamental change in energy costs to a retailer. Hence, Origin was supportive of the QCA's subsequent consideration of another component, such as the energy purchase cost, to introduce a linkage to actual market costs. In this way, the QCA was able to satisfactorily meet the intent of the government's retail tariff policy.

However, given the additional time available for the 2008-09 consultation process, Origin submits that the QCA is now in a position to investigate more fully:

- the LRMC for energy to supply the Queensland NEM load; and
- a market-based component that reaches an equitable compromise between the LRMC and the volatile short-term energy market.

In order to determine the best approach going forward, the QCA's consideration of these elements needs to be measured against the following criteria:

- transparent - it is important that the basis of the decisions be clear to all parties and that they are able to replicate the methodology and hence, estimate future impacts;
- economically sound - the methodology needs to be aimed at replicating market outcomes; and
- targeted - the approach must result in outcomes that satisfy the Government's policy intent:
  - i. to ensure retail headroom remains relatively stable; and
  - ii. right of reversion for small customers should not result in a retailer servicing non-market customers at a loss<sup>3</sup>.

#### 3.1 Long Run Marginal Cost (LRMC)

The principal element of the total cost of energy set out in the QCA's Interim Consultation Notice is the LRMC of energy.

Origin has expressed its concerns with the lack of a comprehensive study of LRMC options in the 2007-08 BRCI process which only examined the stand-alone concept for LRMC, limited to a single year and treating Queensland as an isolated region. Origin's concern is further heightened given that the Minister has indicated that "the theoretical model should continue to be used indefinitely, unless there is clear reason to change"<sup>4</sup>, at least for calculation of the LRMC beyond 2007/08.

Origin notes that there are multiple acceptable theoretical frameworks for examining the LRMC of energy that deliver a range of feasible cost outcomes. Moreover, the new LRMC approach must adopt a multi-year view and, in Origin's view, be consistent with the reality of a national market with interstate flows, transmission constraints, carbon trading<sup>5</sup> and operational limitations (such as water availability).

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<sup>3</sup> Op cit., Certificate of Delegation

<sup>4</sup> Letter from Geoff Wilson MP (Minister for Mines and Energy) to Chairman of the QCA, dated 16 March 2007 (Appendix B)

<sup>5</sup> While a formal carbon trading scheme may not come into effect until 2011-2012 or earlier, it will have an important effect on generation investment decisions in the current period, which in turn will impact on the LRMC.

The stand-alone concept for LRM used by CRA only calculates a LRM where the existing stock of generation is replaced by the optimal mix of new plant, and in this case limited to a single year and isolated region. For this reason, Origin believes that alternative methodologies of calculating LRM should be considered as part of this exercise.

Indeed an important decision making criteria with respect to the selection of an appropriate methodology is the capability of the methodology to reflect the potential changes in generation investment in the light of such factors as relative cost changes, material and other supply constraints, including drought impacts and the recent commitments to a national carbon trading scheme. It is these factors that will influence investment decisions and thus underpin the short-medium term wholesale market contracts.

In particular, with regard to expected annual change in LRM, it is important to realise that LRM is determined by the input assumptions used in its calculation, including assumptions on plant or capital costs and fuel costs. LRM is therefore expected to increase as:

- all input costs are rising at CPI or above;
- there is no expectation for technological improvements in the next 10 years that will deliver a downwards movement in the unit cost of energy;
- capital costs are increasing as identified by the ACIL Tasman data<sup>6</sup>;
- there are carbon and drought impacts;
- there are significant changes to the Queensland energy load and its shape; and
- the rate of growth in energy demand puts further upward pressure on costs due to labour and general material supply constraints.

Origin does suggest there is an opportunity for the QCA to use its fixed principles process for this BRCI element providing the LRM methodology itself captures the dynamic nature of generation investment decisions as noted above. In this case, future movements of the LRM (while they may vary from year to year can be modelled as a smoothed line increase that reflects the general expectations about cost increases. This would give greater clarity to retailers of the expected price path for the basic element of the energy purchase costs.

### 3.2 Accounting for Actual Energy Purchasing Costs

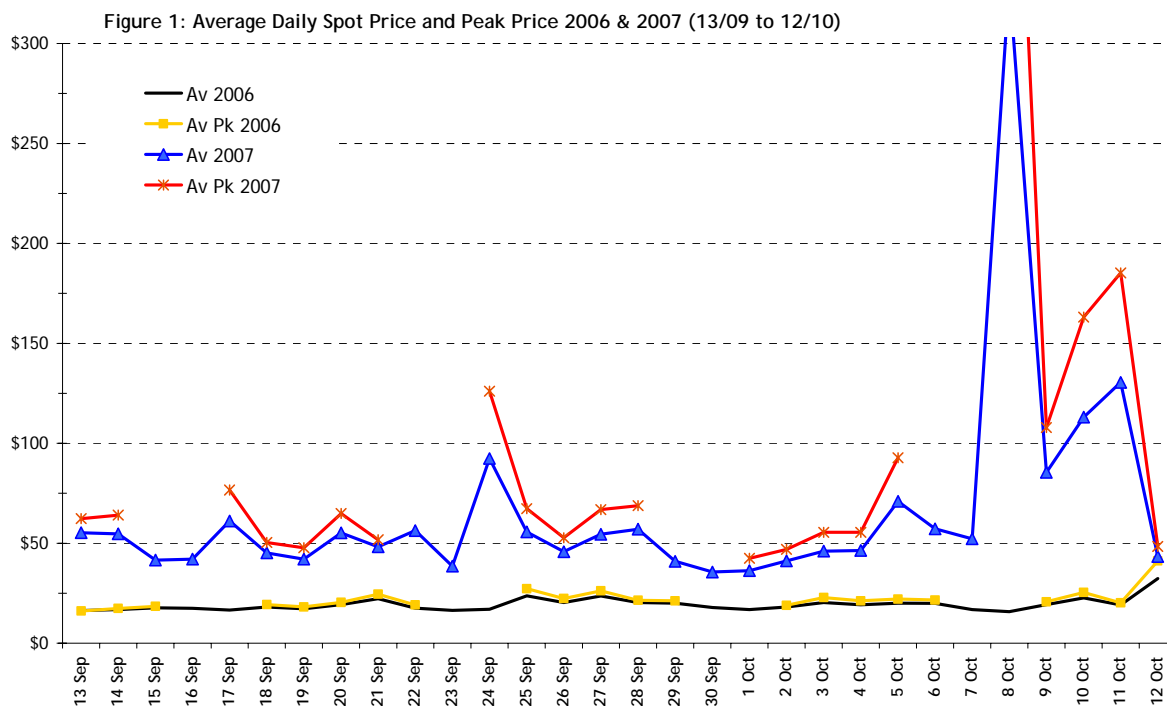
The QCA's 2007-08 BRCI calculation energy purchase cost component was to mitigate the mismatch between actual purchase costs incurred by retailers and the LRM of energy during the given year.

Origin strongly supports the QCA's intent of ensuring the short term contract market realities are taken into account as these drive actual purchase costs over time. Theoretically, energy wholesale prices will converge on the LRM in the longer term, however in practice, consideration must be given to the current energy market dynamics as they directly impact on the retailer's energy purchase costs. Origin cannot buy hedge contracts at LRM and is currently faced with hedging electricity in Queensland for periods of 2008-09 at costs in excess of 200% of the LRM value derived by CRA.

Spot and contract prices continue to be considerably more volatile in 2007/08 (see figure below) and this needs to be incorporated into the relevant methodology in a manner that reflects the real costs facing retailers for 2008/09.

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<sup>6</sup> ACIL Tasman, *Fuel Resource, New Entry and Generation Costs in the NEM Report 2 - Data and Documentation*, March 2007



The difficulty that all the jurisdictional regulators have faced in recent retail price determinations is one of identifying a fair value for this component of retail costs, particularly in the face of unprecedented volatility in wholesale energy prices.

As an example, the final recommendation for the NSW energy cost allowance (which also formed the basis of the QCA's allowed 2006/07 purchase cost in Queensland) reflected the purchase costs facing a retailer with a relatively conservative (prudent) approach to risk. Origin considered this approach as one that came closest to representing the reality of energy purchasing decisions for retailers subject to the commercial discipline of a public company.

Origin supports the investigation of a Queensland specific factor which recognises the differences between Queensland and New South Wales and the unique risk proposition:

- Queensland trading contracts are consistently \$15-\$20 per MW.h above New South Wales;
- the sustained drought issues relative to the Hunter Valley has eased the situation in New South Wales somewhat;
- different liquidity prospects and credit risks in Queensland;
- unique and frequent transmission constraints imposing spot volatility; and
- increased load growth and weather sensitive peaking load in Queensland relative to New South Wales.

The QCA faces the additional challenge of satisfying the broader policy intent of sustaining retail margins (given reversion rights of customers) by approximating the impact of changes in purchase costs whilst also meeting the criteria of transparency and economic soundness and the constraints of the BRCI formula itself which considers the cost of meeting the total Queensland electricity demand.

Origin believes that the current QCA energy purchase factor was a reasonable attempt (given the time constraints) to represent the level of, and change in price volatility and uncertainty particularly in the last four months of 2006/07. However,

the approach now needs to be reviewed in the context of providing a sound methodology that reflects the objectives of the BRCI, and in particular:

- appropriately captures the real price movements and risks and uncertainties in the wholesale market (see Figure 1 above); while
- providing a reasonable level of price stability and predictability.

The current wholesale market prices, and associated contract prices, has made the resolution of these two objectives particularly complex. For instance, a simple moving average 24 month AFMA curve would historically have generated a smooth transition of prices from one year to another. However, in the current market this is not necessarily the case.

In addition, the continuation of drought conditions has again raised questions about the future energy prices in Queensland. For example, even if Tarong water constraints are resolved, if the drought in NSW continues with constraints on Snowy and some of the coal plants, then Queensland spot market prices will remain high as electricity is exported to NSW<sup>7</sup>.

Consequently, Origin suggests that the QCA use this consultation process to explore alternative approaches to estimating the energy purchasing costs (including mechanisms such as smoothing) in order to recognise the changes in purchasing cost without creating large annual swings in the estimates.

### 3.3 Other Energy Costs

With regard to the additional issues raised in the QCA's Interim Consultation Notice, Origin submits that:

- it has not identified any significant reason to alter the QCA's methodology for estimating the impact of the 13% gas scheme and MRET scheme; and
- because the BRCI is based on annual changes rather than quantum, it is not necessary to consider energy losses unless there is a significant change to the regulatory framework and subsequent change to the calculation or responsibility for energy losses.

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<sup>7</sup> This is another reason why it is important to consider the national market interactions in determining the costs of energy purchases in Queensland in the absence of any obligatory contracting by state Government generators with Queensland retailers.

## 4. Retail Cost and Margin

Origin supported the QCA's use of retail cost and margin benchmarks as an appropriate method for setting the 2007-08 BRCI given the time constraints that existed then.

Origin notes that the QCA's Interim Consultation Notice questions:

1. whether retail cost should be considered as individual components or in total;
2. how customer acquisition costs should be estimated; and
3. how retail cost growth should be estimated?

Origin agrees that these are the key issues on retail costs to be considered for the 2008-09 BRCI.

On the first issue, Origin is happy for the QCA to pursue a detailed examination of all retail cost elements in order to construct an indicative total retail cost figure. However, it is not clear to Origin that such a process will provide a more suitable retail cost for use in the BRCI.

Separately estimating retail costs elements is data intensive and Origin's experiences in other jurisdictions have shown that it is a contentious issue given the different structures and activities of the various retailers.

It is doubtful that agreement will be reached and given the BRCI is derived from a change in retail cost rather than the actual total cost, it is doubtful whether this rigorous analysis would provide any further benefit to the BRCI process.

With regard to customer acquisition costs, Origin does support further examination of this cost item as the single retail cost element that has been separately identified to date.

Origin submits that the QCA's use of \$2 per customer to represent the impact of loss of scale for retailers in the 2007-08 BRCI is not appropriate because:

- the benchmark itself is simply a figure derived from South Australia with no consideration of its relevance to the actual impact on retail costs;
- using estimated retailer fixed and variable costs, as the QCA's consultants (CRA) demonstrated in their final report for 2007-08, produced a figure in excess of \$2;
- the \$2 estimate does not consider the impact on a retailer's energy cost of diminishing customers numbers and share of market load; and
- Origin actually questions whether the selection of this methodology meets the intent of section 94 of the *Electricity Act 1994* (as amended) which was expressed as the costs to a retailer with significant, not reducing, market share.

Origin proposes that estimating actual customer acquisition cost is a more suitable methodology and examination of a retailer's costs faced to acquire a customer produces a more fair and reasonable estimate.

Finally, with regard to retail cost growth, Origin agrees with CRA's conclusions from the 2007-08 BRCI process that a significant part of total retail costs is labour and believes their resultant method for escalating annual retail cost is appropriate.

Using a similar methodology provides the opportunity for the QCA to use published, well known indices such as wage growth and CPI to escalate standard retail costs annually. Origin would support designating such a methodology as a fixed principle

in order make the future annual movement of this BRCI element transparent for all participants.

Such a fixed principle could still allow for one-off changes to retail costs because of new regulatory or compliance obligations in the Queensland market if they were introduced.

#### **4.1 Retail Margin**

The BRCI requires an appropriate retail margin to cover the retailer for its risk-weighted investment and Origin previously proposed the use of a benchmark net margin of 5% of sales. However, this benchmark margin assumed that the increased risks surrounding energy purchasing and customer acquisition were fully taken into account in other elements of the BRCI. However, recent energy market volatility and a Retailer of Last Resort event have highlighted the risks and credit issues facing energy retailers.

The retail margin for 2008-09 may therefore need substantial review to accurately reflect the change in risk profiles of retail businesses - depending on the QCA's treatment of energy purchasing costs.

### **5. Energy Load**

Origin concurs with the QCA's methodology for deriving the Queensland NEM load from preceding calendar years.

At this point in time, Origin considers that it is not necessary for the QCA to seek out and remove unregistered embedded generator loads from the NEM load calculation but consideration of a process to quantify these loads may be prudent.