



Final Decision

**Advice to the Minister for
Mines and Energy**

**Benchmark Retail Cost Index
for Electricity:
2006-07 and 2007-08**

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Electricity Benchmark Retail Cost Index: 2006-07 and 2007-08

Introduction

On 16 March 2007, the Minister for Mines and Energy delegated to the Authority responsibility for calculating a Benchmark Retail Cost Index (BRCI) to be used in adjusting notified (regulated) retail electricity prices from the commencement of full retail competition (FRC) in the Queensland electricity market on 1 July 2007. This Final Decision sets out the Authority's advice to the Minister on the BRCI for 2006-07 and 2007-08.

On 8 May 2007, the Authority released its Draft Decision on the BRCI for 2006-07 and 2007-08. The Draft Decision set out the Authority's position on issues affecting the cost of electricity supply and the calculation of the BRCI. At the time of the Draft Decision, the Authority estimated that the BRCI would increase by 9.98 per cent between 2006-07 and 2007-08.

In response to its Draft Decision, the Authority received six submissions from interested parties. In arriving at this Final Decision, the Authority has considered the issues raised in those submissions.

The Authority had previously engaged CRA International (CRA) to assist it in considering issues relevant to the calculation of the BRCI. To maintain continuity and undertake a thorough assessment of the issues raised in submissions, the Authority re-engaged CRA to provide further advice.

This Final Decision provides a response to key issues raised in submissions on the Draft Decision and, as discussed in the following sections, has resulted in the change in the BRCI from 2006-07 to 2007-08 being calculated to be 11.37 per cent.

While the discussion contained in the Draft Decision has not been reproduced here, the issues raised have been addressed in a format consistent with the structure of the Draft Decision. Given the time constraints upon the Authority in preparing its Advice to the Minister, some of the discussion contained herein is necessarily brief. In considering the change in the BRCI for 2008-09, the Authority will elaborate further on issues discussed here and provide interested parties with the opportunity to have further input as part of a more extensive consultation process.

Cost of Energy

Long Run Marginal Cost (LRMC) of Energy

In its Draft Decision, the Authority expected the LRMC of energy in Queensland to increase by 1.62 per cent from \$43.3/MWh in 2006-07 to \$44.0/MWh in 2007-08. This view was consistent with advice from CRA, which estimated the LRMC of energy based on capital costs for electricity generation published by ACIL Tasman in 2007.

Issue – Source of Capital Cost Data

In its submission, Origin Energy suggested that CRA should also taken account of capital cost data published by ACIL Tasman in 2005. Origin Energy suggested that these data indicated a more rapid growth in capital costs and, as a consequence, a higher increase in the LRMC of energy.

CRA had excluded the 2005 ACIL Tasman data on the basis that it believed they were not comparable with later data published in 2007 due to a change in methodology. However, Origin Energy questioned whether this was in fact the case.

In response, CRA had advised that both the 2005 and the 2007 ACIL Tasman reports included estimated capital costs for 2004. As the two reports provided different estimates, CRA concluded that the methods used in the two reports were not the same. ACIL Tasman has confirmed that different methods of calculating capital costs were adopted in the 2005 and 2007 reports and has suggested that the 2007 report would provide a consistent basis to derive capital costs for 2006-07 and 2007-08.

The Authority is satisfied that the 2007 ACIL Tasman report provides a sound basis for deriving capital costs of energy generation.

Issue – LRMC of Energy in 2007-08

In its submission, TRUenergy suggested that the 1.62 per cent increase in the LRMC of energy in 2007-08 proposed by the Authority in its Draft Decision was insufficient. TRUenergy suggested that the LRMC of energy had increased by 2.25 per cent to \$44.38/MWh, based on the medium-term LRMC trend identified in the ACIL Tasman report.

In response, CRA noted that, while the ACIL Tasman results indicated around 2 per cent growth in capital costs and operating costs (excluding fuel costs) between 2007-08 and 2011-12, CRA was of the view that fuel costs were likely to remain flat or decrease between 2006-07 and 2007-08. As the LRMC of energy reflects capital costs and operating costs (including fuel costs), CRA concluded that the LRMC of energy would increase by less than 2 per cent in 2007-08.

The Authority has made no adjustment to the BRCI on the basis of this issue.

Energy Purchase Costs

In its Draft Decision, the Authority included an ‘energy purchase’ factor to recognise the likely mismatch between actual energy purchase costs incurred by retailers and the LRMC of energy during a given year. On advice from CRA, the Authority adopted energy purchase factors of \$9/MWh in 2006-07 and \$12/MWh in 2007-08. CRA’s estimate of \$12/MWh in 2007-08 was based on an assumption that the May and June 2007 price of electricity contracts for supply in 2007-08 would be \$47.50/MWh.

Issue – Recent Electricity Prices Higher than Assumed in Draft Decision

AGL, Origin Energy and TRUenergy all noted that, at the time of their submissions, the May 2007 price of electricity contracts for 2007-08 had been significantly higher than the assumed price and that this was likely to continue through June 2007. All three submissions suggested that these higher contract prices should be reflected in the calculation of the BRCI for 2007-08. If energy costs in 2007-08 were underestimated, a larger increase in the BRCI would be required in 2008-09.

AGL claimed that the May 2007 price of contracts for supply in 2007-08 had averaged \$90/MWh and that it expected prices to remain at that level to the end of June 2007. On this basis, AGL expected that the energy purchase factor in 2007-08 should be, on average, \$14.65/MWh above the LRMC of energy.

The Authority considers that it is appropriate to use the most recent data available in the calculation of the BRCI. On this basis, the Authority has included information on actual contract prices up to 23 May 2007 and lifted the average price for this period (1 May 2007 to

23 May 2007) from the \$47.50/MWh included in the Draft Decision to \$77/MWh and has lifted the average price for the remaining period to 30 June 2007 from the \$47.50/MWh included in the Draft Decision to \$56/MWh. As a result, the energy purchase factor that the Authority has included in calculating the BRCI for 2007-08 has increased from \$12/MWh in its Draft Decision to \$13.50/MWh in this Final Decision.

Issue – Forward Energy Purchase Arrangements

In its submission, TRUenergy queried the assumption that retailers purchased energy contracts for 2007-08 over a two year period, on the basis that the decisions to introduce retail competition in Queensland and to sell the Government-owned retail businesses were taken within two years of the start of 2007-08 and that a more truncated hedging strategy was therefore more appropriate.

However, the legislation requires the Authority to calculate retail costs for a hypothetical retailer that has significant market share. This implies that the retailer has not recently entered the Queensland market but rather one who has been in the market for some time and has well established energy purchase arrangements. The entry of the hypothetical retailer is not tied to the timing of the announcements to introduce competition or to sell the incumbent retail businesses.

In addition, the existing Queensland retail electricity businesses were sold as going concerns with arrangements for the future purchase of energy already in place.

The Authority remains of the view that it is reasonable to assume that energy contracts for 2007-08 were purchased over a two year period. This view was supported by CRA in its response to submissions.

Issue – Use of Data from Other Jurisdictions

In its submission, Origin Energy suggested that it was incorrect to assume that results of similar studies relating to the cost of energy supply in NSW were relevant in Queensland. Origin Energy also suggested that it was inappropriate to use a range of energy purchase costs between different retailers at one point in time to determine a range of energy purchase costs over time. Origin Energy did not suggest an alternative approach.

In response, CRA acknowledged that there would be differences in prices between Queensland and NSW but noted that it had not suggested that absolute energy prices were comparable across the two jurisdictions. Given insufficient time to undertake more detailed analysis, CRA had only drawn on the analysis by IPART in order to establish the energy purchase factor for 2006-07.

Energy Costs Summary

In response to the submissions on its Draft Decision, the Authority has revised its estimated energy costs for inclusion in the BRCI, as set out in Table 1.

Table 1 Changes in the Cost of Energy Components from 2006-07 to 2007-08 (\$m)

	2006-07	2007-08	% change	Previous % change*
LRMC of energy	1,538	1,596	3.8	3.8
Energy purchase costs	320	490	53.2	36.1
MRET	30	39	28.5	28.5
13% gas scheme	76	80	5.0	5.0
NEM fees	11	12	10.2	10.2
Ancillary services	11	11	2.1	2.1
Total	1,985	2,227	12.2	9.4

* From Draft Decision

Network Costs

Other than questions regarding the way in which any impact on transmission prices stemming from the Australian Energy Regulator's (AER) Final Decision on Powerlink's revenue would be handled, no issues were raised in submissions regarding the network costs included in the Authority's Draft Decision.

The Authority has been advised by the AER that Powerlink's 2007-08 transmission prices will not change as a result of the AER's Final Decision on Powerlink's revenue cap for 2007-08 and that any impact on revenue for 2007-08 will be reflected instead in prices for 2008-09.

Network costs therefore remain as in the Draft Decision and are summarised in Table 2

Table 2: Network Costs (\$m)

	2006-07	2007-08	% change
Energex	683.8	806.5	17.9
Ergon Energy	670.6	761.1	13.5
Powerlink	370.1	412.2	11.4
Total network costs	1,724.5	1,979.8	14.8

Retail Costs and Margin

In its Draft Decision, the Authority considered a range of different retail costs that contribute to the overall cost of supplying electricity to consumers. Of the retail costs considered, only those relating to the introduction of FRC and customer acquisition were raised in submissions.

FRC Costs

In its Draft Decision, the Authority accepted that a cost to retailers of \$10 per customer would be incurred due to the introduction of FRC. This estimate was within a range of FRC costs allowed by regulators in South Australia, NSW and Victoria when FRC was introduced in those jurisdictions.

Issue – Which Jurisdictions FRC Experience is Most Relevant for Queensland

In its submission, TRUenergy suggested that the estimate of FRC costs by ESCOSA of \$11.30 per customer (indexed for inflation) should be used by the Authority in calculating the

BRCI. TRUenergy noted that South Australia had experienced strong competition in the early stages of FRC and that this was due, in part, to a realistic estimation of retailer costs.

In response, CRA noted that ESCOSA's 2004 Final Decision on FRC costs followed on from an earlier decision by the Office of the South Australian Independent Industry Regulator (SAIIR) in 2002. In that earlier decision, SAIIR suggested that FRC costs could range from \$5 to \$10 per customer but chose a cost of \$10 per customer as a reasonable upper estimate of the FRC costs for a stand alone retailer. CRA noted that the FRC cost estimates of the various regulators varied considerably and that no one was necessarily more robust than another. However, CRA also noted that \$10 per customer was still towards the higher end of the range.

The Authority accepts that the decisions of other jurisdictional regulators on FRC costs will reflect the particular circumstances in each jurisdiction. However, the Authority finds it difficult to establish that any one jurisdiction's experience with estimating FRC costs necessarily provides the best guidance as to the likely outcome in Queensland. In the absence of compelling arguments for change, the Authority considers that the approach it adopted in its Draft Decision remains reasonable.

Issue – Business-to-business Obligations

In its submission, AGL supported the benchmarking approach to determining FRC costs but suggested that the costs should be higher, as all the decisions made on FRC costs in other jurisdictions preceded the introduction of national 'business-to-business' obligations which add a further element to these costs.

The Authority acknowledges that the introduction of national business-to-business obligations followed the introduction of FRC in other jurisdictions. However, this does not mean that retailers operating in these jurisdictions were without business-to-business obligations prior to the introduction of FRC. Such obligations were often contained in licensing provisions and the costs of these would have been reflected in retailers' operating costs.

In addition, the national business-to-business obligations are intended to increase the efficiency of existing business-to-business arrangements which should lower a retailer's operating costs overall. Jurisdictions are also expected to remove state based business-to-business obligations that duplicate those at the national level.

Accordingly, the Authority does not consider that any further allowance is required to reflect national business-to-business obligations.

Customer Acquisition Costs

In its Draft Decision, the Authority accepted that an efficient retailer would be exposed to potential loss of scale due to customer churn following the introduction of FRC and that some costs would be incurred by the retailer in response to this threat. In calculating the BRCI for 2007-08, the Authority included \$2 per customer to reflect customer acquisition and retention costs.

The Centre for Credit and Consumer Law (CCCL) in its submission considered that no allowance should be made in calculating the BRCI for customer acquisition costs because such an allowance is unnecessary, favours the incumbent retailers and is anti-competitive.

However, the Authority considers that the introduction of FRC will alter the risks an incumbent retailer faces and that this changing risk profile needs to be reflected in costs.

TRUenergy questioned the Authority's interpretation of the IPART estimate of \$35 for customer acquisition costs, suggesting that the Authority should apply this to all Queensland customers not just that proportion of customers assumed to change retailer.

The Authority has discussed this issue with IPART and confirmed that this analysis was based on a retailer having to acquire all of its customers. As a result, IPART's \$35 per customer estimate of acquisition costs for NSW applied to all customers to be acquired.

The Authority is required to estimate costs for a retailer with an established customer base. As a result, the Authority maintains its position that acquisition costs would only be relevant for customers who are expected to be lost due to churn. This view was supported by CRA in its response to submissions. Therefore, the Authority maintains its view that, with 10 per cent of customers potentially changing retailers, \$3.50 per customer would be an appropriate allowance for acquisition costs, were this approach to be adopted.

However, the Authority did not adopt this approach in its Draft Decision. Rather, for reasons outlined in its Draft Decision, it focussed on the reasonable costs of retaining customers based on the potential cost of loss of scale due to churn.

Origin Energy, AGL and TRUenergy suggested that the allowance for customer acquisition costs based on loss of scale should be greater than the \$2 per customer included by the Authority. TRUenergy noted that this estimate was based on retail operating costs calculated by ESCOSA, which explicitly assumed that electricity customer losses would be offset by gas customer gains. TRUenergy suggested that a more appropriate approach for Queensland would be the alternative method for calculating the costs of loss of scale described by CRA, based on the proportion of total costs that are fixed, adjusted for the rate of customer churn. On this basis, TRUenergy suggested an allowance for customer acquisition costs of \$5.63 per customer was appropriate.

Origin Energy suggested that an allowance of \$2 per customer for loss of scale seemed arbitrary given that the alternative method produced an estimate of over \$5 per customer.

The Electricity Act specifies that retail costs are to be calculated based on a stand alone retail business. This requirement precludes an electricity retailer with an associated gas business. The Authority acknowledges that the approach adopted by ESCOSA may not represent the best approach for calculating customer acquisition costs in Queensland. However, as noted by CRA in its response to submissions, there are several different methods for estimating acquisition costs and a number of assumptions that need to be made for each. Depending on the approach taken and the assumptions made, there is potentially a broad range values the Authority could choose to adopt as a measure of customer acquisition costs. The Authority is not convinced that its allowance of \$2 per customer, based on the potential loss of scale from losing customers, is insufficient.

Nevertheless, this is an issue that the Authority will investigate more fully in calculating the BRCI for 2008-09.

Retail Costs Summary

The Authority's estimates of retail costs remain largely unchanged from its Draft Decision and are summarised in Table 3. The retail margin is the only element of retail costs that has changed. This is because the retail margin is calculated as a percentage of retailers' total costs, which have risen in response to submissions on the Draft Decision due to the increase in the cost of energy, as noted above.

Table 3: Retail Costs (\$m)

	<i>2006-07</i>	<i>2007-08</i>	<i>% change</i>	<i>Previous % change*</i>
Operating costs	121	127	5.2	5.2
Retail margin	202	229	13.7	12.3
FRC costs	0	19	-	-
Customer acquisition costs	0	4	-	-
Total	323	379	17.5	16.6

* From Draft Decision

Electricity Load

The Authority's estimates of the electricity load of Queensland remain unchanged from its Draft Decision and are summarised in Table 4.

Table 4: Queensland Load (GWh)

	<i>2005</i>	<i>2006</i>	<i>% change</i>
Gross NEM load of Queensland	45,151	45,862	1.6
Less exclusions	9,636	9,599	-0.4
NEM load of Queensland	35,515	36,263	2.1

Other Issues

Origin Energy expressed concern that any mid-year increase in distribution or transmission network charges would not be recognised in the BRCI but would still impact on retailers' margins. Origin Energy requested an assurance from the Authority that there will be no mid-year changes to network charges in 2007-08, in particular due to any additional allowances for distributors' FRC costs or the finalisation of Powerlink's transmission revenue for 2007-08.

As has already been noted for Powerlink charges, no further adjustments will be made to 2007-08 distribution prices to reflect anticipated or actual FRC costs incurred by the distributors. The outcome of the Authority's detailed assessment of Energex's FRC cost pass-through application will be accounted for in prices from 2008-09 and not impact further on 2007-08 prices.

A number of submissions expressed concern at the short time frame in which the Authority has calculated the BRCI for 2007-08. The Authority explained the reasons for this truncated process in its Draft Decision and outlined a more thorough process for calculating the 2008-09 BRCI.

Three submissions, from CCCL, St Vincent de Paul Society and Sunwater, raised concerns regarding the impact on some consumer groups of applying the increase suggested by the BRCI to electricity prices. These views were also reflected in a number of phone calls to the Authority from individual consumers following the release of the Draft Decision, expressing concern regarding the potential impact of the likely price increases on, particularly, those on fixed incomes such as pensioners. However, consideration of these issues is beyond the clearly defined task assigned to the Authority.

Final Advice

The Authority has considered the submissions received in response to its Draft Decision on the BRCI for 2006-07 and 2007-08. Where possible and appropriate, the Authority has responded to the issues raised in them.

A number of issues raised in submissions could not be addressed in the time available but will be addressed by the Authority in a more fulsome process for determining the BRCI for 2008-09. There were also a number of policy issues raised in submissions that were beyond the Authority's jurisdiction to consider.

The principal change from the Authority's Draft Decision relates to the cost of energy where the Authority has accepted that more recent data suggest that some upward revision is appropriate. The overall affect of updating this estimate is to increase the change in the BRCI from 2006-07 to 2007-08 to 11.37 per cent from the 9.98 per cent estimated at the time of the Draft Decision.

The Authority's final advice on the BRCI in 2006-07 and 2007-08 is summarised in Table 5.

Table 5: Change in the BRCI and its components from 2006-07 to 2007-08 (c/kWh)

	<i>2006-07 (c/kWh)</i>	<i>2007-08 (c/kWh)</i>	<i>Change (%)</i>	<i>Share of total costs 2006-07</i>	<i>Change in BRCI (%)</i>	<i>Previous change in BRCI (%)*</i>
Cost of energy	5.59	6.14	9.85	49.2	5.60	3.53
Network costs	4.86	5.46	12.44	42.8	4.86	5.32
Retail costs	0.91	1.05	15.11	8.0	0.91	1.14
Total	11.35	12.65		100	11.37	9.98

Note: Totals may not add due to rounding

* From Draft Decision

List of Submissions

Centre for Credit and Consumer Law (2007), *Submission to Queensland Competition Authority: Benchmark Retail Cost Index in relation to the regulation of retail electricity prices.*

AGL (2007), *AGL Submission to Queensland Competition Authority Draft Decision on Benchmark Retail Cost Index.*

Origin Energy (2007), *Submission to the Queensland Competition Authority on the Draft Decision Benchmark Retail Cost Indexation for Electricity: 2007-08.*

St Vincent de Paul Society (2007), *Submission to the Queensland Competition Authority on the Draft Decision: Benchmark Retail Cost Index for Electricity 2006-07 and 2007-08.*

SunWater (2007), *Submission to the Queensland Competition Authority on the Draft Decision on the Benchmark Retail Cost Index for Electricity: 2006-07 and 2007-08.*

TRUenergy (2007), *Submission to the Queensland Competition Authority on the Draft Decision, Benchmark Retail Cost Index.*