



**Queensland  
Government**  

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**Treasury**

**QUEENSLAND TREASURY SUBMISSION**

**QUEENSLAND COMPETITION AUTHORITY**

**INTERIM CONSULTATION NOTICE**

**Benchmark Retail Cost Index  
for Electricity: 2008-09**

**October 2007**

## Background

The energy sector is a major driving force behind the Queensland economy. The current structure of the Queensland energy sector has evolved from the disaggregation of the government owned sector in 1997, and the establishment of the NEM in 1998. Energy market reforms have underpinned investment in Queensland's energy industry, and delivered significant price reductions for customers. A considerable proportion of this investment has been from the private sector, with Queensland the only state to attract new private sector investment in base load generation since the inception of the NEM.

Full Retail Contestability (FRC) in Queensland was introduced after a series of electricity and gas reforms since 1998, in which competition has been progressively extended from the largest industrial customers, through medium sized industrial and commercial customers, to all customers from 1 July 2007. FRC was implemented to encourage the energy sector in Queensland to become more competitive, and be more responsive to customer needs. In addition, FRC reforms aim to increase industry investment and ensure efficient energy supply for the longer term.

Before the introduction of FRC, the Government undertook a comprehensive review of the Queensland energy government owned corporation (GOC) sector in 2006 to examine whether GOC structures supported the development of competitive electricity and gas markets, and ways to protect and improve GOC value. As a result, the Government made key decisions to sell the retail businesses of Energex and Ergon Energy, along with the Allgas gas distribution business.

With these industry changes, the challenge for the Queensland Government is to ensure that competition is efficiently fostered, and the economy derives the benefits from the energy sector that it has done over the past. In line with these objectives, the regulatory framework is designed to provide clarity and fairness for industry, while protecting small customers.

The Benchmark Retail Cost Index (BRCI) was introduced to ensure that, each year, the notified price of electricity is adjusted based on changes in the underlying cost of supplying electricity to consumers. In determining the BRCI, all of the following need to be taken into account:

- the *Electricity Act 1994* (the Act);
- the Electricity Regulation 2006; and
- the Certificate of Delegation from the Minister for Mines and Energy (delegating responsibility for the calculation of the BRCI to the Queensland Competition Authority).

The Certificate of Delegation sets a requirement that the Authority must consider the policy objectives of the Queensland Government when exercising the delegated powers and functions to calculate the BRCI. This encompasses the policy intent that:

- a) The competitive headroom in Queensland to remain relatively stable; and
- b) The reversion policy does not result in retailers providing services at a loss to customers.

## Cost of Energy

Section 2.2 of the Interim Consultation Notice seeks stakeholder views on whether there is a substantive reason why the Authority should adopt an alternative approach for adjusting the long-run marginal cost (LRMC) of energy to account for the short-run purchase cost of energy.

Section 92 of the Act describes the framework to which the Authority must adhere when calculating the energy cost component of the BRCI. The Act states that:

- The cost of energy must reflect the pricing entity's view of the likely total of the costs to be incurred during the relevant tariff year to purchase energy to supply all of the NEM load of the State for the relevant tariff year.
- The view must be based on the pricing entity's most recent estimate of the LRMC in the part of the State connected to the national grid, after taking into account:
  - The 13% gas scheme under chapter 5A; and
  - The scheme under the *Renewable Energy (Electricity) Act 2000* (Commonwealth).
- The estimate must take into account the most efficient combination of generating plant to supply all of the NEM load of the State for the relevant tariff year.

Treasury notes that the consultant commissioned by the Authority to calculate the BRCI for 2006-07 and 2007-08 has stated in its report that there is apparent inconsistency within section 92 of the Act. In the *Final Determination on the BRCI for Electricity: 2006-07 and 2007-08* (the Final Determination) the Authority "estimated the LRMC of energy as the basis for determining the energy cost component of the BRCI, and included some additional factors to reflect the difference between LRMC and actual purchase costs of energy."

It is possible that the way in which the BRCI is currently calculated could potentially lead to undue volatility in BRCI changes from year to year. For example, at present, energy market prices are being particularly influenced by short-term factors such as variations in supply and demand conditions, and expectations about the future. Specifically, the current drought and subsequent withdrawal of some generating capacity in response to water shortages is significantly affecting the market prices with immediate flow on to the annual increases in the BRCI. When the drought breaks, market prices should fall, and

the BRCI may reduce significantly (with the possibility that a negative BRCI could conceivably result).

More specifically, the Authority arrived at the following values in its Final Determination on the BRCI for 2007-08:

	\$/MWh
<i>LRMC</i>	44.00
Factor - Contract Premium	
Base	9.00
Movement*	4.50
<i>Sub Total Factor – Contract Premium</i>	13.50
Other	
MRET	1.07
13% Queensland Gas Scheme	2.20
NEMMCO Participant Fees	0.25
FRC Establishment	0.03
FRC Operation	0.04
Ancillary Service Fee	0.31
<i>Sub Total Other</i>	3.90
<b>Total Energy Cost</b>	<b>61.40</b>

\* The contract premium movement is derived by the variance between average of contract forward price (\$/MWh) over 24 months prior to the commencement of the financial year being measured and the deemed long term average contract price average of \$35/MWh.

The Authority's calculations seem to more heavily weight the short-run costs than might be the situation faced by a representative retailer in Queensland. The current contract premium calculation assumes that the retailer will be subject to electricity contract market price shocks at any point in time. However, it could reasonably be assumed that an efficient representative retailer will develop prudent risk management strategies to minimise the effects of such price volatility.

One method for retailers to manage the risk of short-term fluctuations is to build their hedge books through forward market contracts. The most appropriate way of managing hedge books is to use a rolling hedge policy, which means that the cost of managing wholesale risks should be subject to lower levels of year on year fluctuations than under the current methodology adopted by the QCA. In its recent review of regulated retail prices in South Australia, the Allen Consulting Group concluded that "a staggered purchase of contracts over the previous three years is a more appropriate assumption for the timing of the purchase of a portfolio"<sup>1</sup>, and noted that this assumption was supported by AGL's actual market practices.

<sup>1</sup> Allen Consulting Group, *Wholesale Electricity Costs for Standing Contract Customers in South Australia* (August 2007), p. 19.

In the event that the volatility in the BRCI is greater than the volatility in actual retailer costs, due to the hedging strategies employed by retailers, headroom will vary over time. Treasury believes that this is counter to the Government's policy objective to ensure that competitive headroom in Queensland remains relatively stable. Stability in competitive headroom is desirable from both an industry and consumer perspective, as a degree of certainty is provided to market participants. Such certainty allows informed decisions to be made by industry, in terms of the development of risk management strategies, and consumers, in relation to demand management.

## **Fixed Principles**

Section 6 of the Interim Consultation Notices seeks stakeholder views on whether the Authority should fix any of the principles to apply to any (or all) of the benchmark retail cost elements.

The legislative framework provides for a fixed principle to be set where "the benchmark study is not expected to change greatly, or where the price movement can be expected to move in a predicted fashion." The Delegation requires that the Authority "must consult on whether or not it will include 're-openers' to each fixed principle. If including 're-openers', they must be listed with trigger values and what process will be followed."

The utilisation of the fixed principles provision could prove to be an effective means of addressing short-term fluctuations that may be unduly influencing the BRCI, while still accommodating the needs of retailers. For example, the fixed principles provision could be applied to variables such as LRMC, and the retail margin, that the Authority considers are unlikely to change significantly. The application of this provision would provide market participants and consumers with a greater degree of certainty around future movements in the BRCI up to three years.

In addition, Treasury believes that there may be merit in considering an approach to wholesale costs similar to that adopted by IPART in NSW, in which wholesale costs are a fixed input with a "trigger mechanism" for review should actual costs vary materially from the costs assumed in the Review of Regulated Retail Tariffs in NSW - 1 July 2007 to 30 June 2010.