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Interim Consultation Notice - Benchmark Retail Cost Index 2008/09

Thank you for the opportunity to comment upon the Authority's *Interim Consultation Notice – Benchmark Retail Cost Index for Electricity 2008-09*.

In our submission to the 2007/08 Draft Decision, TRUenergy acknowledged the work of the Authority in determining the benchmark retail cost index (BRCI) for that year, particularly given the external time constraints imposed. However we considered that an Index of 9.98% was insufficient to justify TRUenergy adopting the aggressive customer acquisition campaigns that have characterised our retail strategy in the southern states. Despite an adjustment to 11.5% in the final decision, our initial prognosis was correct and our entry strategy has been adjusted accordingly.

As the third largest non-Government owned retailer in Australia, TRUenergy's approach to new retail markets has been a reliable indicator of overall market competitiveness. In South Australia, regulated prices have facilitated an aggressive approach, whereby we have established significant market share, contributing to a state-wide customer transfer rate of 20-30%. In New South Wales regulated prices have restricted market entry, with TRUenergy establishing a smaller customer base, reflected in a state-wide transfer rate of just 10-15%. At current price settings, the opportunities for retail growth in Queensland are much closer to those in New South Wales than South Australia.

Given that the appropriate price signals were not achieved for 2007/08, it is important that the 2008/09 decision not only considers cost variations between 2007/08 and 2008/09, but also the level of correction required to the 2007/08 decision.

We support the decision of the Authority to set an extended consultation process for the 2008/09 review, creating the opportunity to utilize the fixed principles approach of the legislation. It is our view that there is no correlation between the accuracy of consultant predictions and the level of resources expended by the consultants in the calculation of those estimates. We note the CRA results in a study commissioned by the esaa that found the cost price regulation reviews could easily exceed \$2 million per regulator and \$1 million per regulated retailer per regulatory period. These costs could be substantially reduced through the

use of a fixed principle approach. Importantly, however, these fixed principles must reflect market reality, and the current settings do not.

Actual Energy Purchase Costs

In our response to the Draft Decision we raised our concerns regarding CRA's assumption that wholesale prices would fall in May and June to an average of \$47.50, the mid-point between prices in March (\$35/MWh) and April (\$60/MWh). Data available at the time of the Final Decision vindicated our position, with prices for the period 1 May to 23 May averaging \$77/MWh. However, whilst the Final Decision was updated to include this data, CRA held their view that wholesale prices would fall for the remainder of the year, predicting a price of \$56/MWh. In fact, wholesale prices continued to increase over the final weeks to an average of \$99/MWh. Overall the two-year hedging position would have set a price of \$41.4, almost \$2 higher than the final decision. The 2008/09 BRCI must be adjusted to ensure that shortfall is recaptured.

Both the original predictions for May and June, and the updated predictions for the final 5 weeks of the financial year, demonstrate the predisposition of consultants and regulators to understate costs in the absence of any credible reason for doing so. The very rationale for establishing a competitive market is that the market will establish efficient pricing, whilst recognizing that governments, regulators and consultants are incapable of replicating competitive market outcomes, particularly those with the potential volatility of the wholesale electricity market. Consequently, the priority should be to ensuring that costs are not understated, confident that any excess margins will be eroded through competitive activity.

LRMC of Energy

It would appear that a paradigm shift is required in the calculation of LRMC, given that the CRA decision of 1.68% is clearly inadequate. Construction costs are rising by over 5%, labour costs by over 4% and fuel costs by over 2%, whereby it is difficult to understand how other factors could reduce the overall LRMC figure to below 2%. Whilst still below expectations, it is noted that the Frontier Economics analysis for IPART identified LRMC growing at broadly the rate of inflation over the period of their determination.

Network costs

Calculation of the benchmark retail cost index requires total network costs to be the weighted average of costs in the Energex and Ergon areas. Consequently, if there is a discrepancy in the rate of increase in network costs across the distribution areas, retailers will not be able to fully recover those costs within that distribution area with the higher rate of network cost increase. The Authority should reconsider all options for resolving this inadequacy in the calculation of the BRCI.

Retail Operating Costs

TRUenergy generally supports CRA's method of estimating the increase in retail costs over time, and we do not consider that devoting additional resources to this

work will improve its accuracy. In our view, a fixed principle approach should be adopted whereby the rate of growth in retail costs should be calculated with reference to CPI changes, wages growth, and an assumed ratio of labour/other costs. Additional consideration is required to identifying which ABS statistic should be used to estimate wages growth.

In our submission to the 2007/08 review, we supported adopting the South Australia FRC cost, CPI indexed, reflecting the most recent interstate decision, and the jurisdiction that has most rapidly succeeded in achieving effective competition. Given the inadequacy of the final decision, the 2008/09 BRCI should be adjusted in accordance with our recommendation.

Customer Acquisition Costs

TRUenergy supports the use of the Frontier Economic analysis conducted for IPART, the most recent and robust investigation of its type, as a fixed principle approach to estimating customer acquisition costs. It is important to recognise that the Frontier allowance of \$35 was based upon a total acquisition cost of \$200 recovered over 8 years, the assumed customer retention period. Therefore, applying the Frontier analysis to the BRCI is not as simple as multiplying \$35 by the customer churn rate.

For any year the hypothetical retailer must be able to recover the customer acquisition costs for all customers acquired from the commencement of full retail contestability, across the period it is assumed they will remain a customer of that retailer. Thus the allowance can be expected to increase over-time both as the proportion of the hypothetical retailer's customer base acquired post-FRC increases, and the assumed period of customer retention decreases in response to an accelerating churn rate.

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

Yours Sincerely,

Graeme Hamilton
Regulatory Manager