



Interim Consultation Notice

Benchmark Retail Cost Index

for Electricity: 2009-10

July 2008

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SUBMISSIONS

Public involvement is an important element of the decision-making processes of the Queensland Competition Authority (the Authority). The Authority is releasing this Interim Consultation Notice as the first step in its review to calculate the Benchmark Retail Cost Index (BRCI) for 2009-10. To assist stakeholders in preparing a submission, the Authority has identified a number of key issues that will need to be considered. The issues that have been identified are not exhaustive and are provided as guidance only. Submissions received on issues other than those identified will be fully considered. The Authority will take account of all submissions received.

Submissions in response to this Interim Consultation Notice should be restricted to those issues regarding the application of the FRC legislative framework to the calculation of the Benchmark Retail Cost Index. Any comments submitted in relation to the legislative framework underpinning the calculation of the BRCI, or how the BRCI is to be applied, are not able to be considered by the Authority as these are matters of Government policy. This includes, for example, the ability of customers to pay for their electricity services.

Written submissions should be sent to the address below. While the Authority does not necessarily require submissions in any particular format, it would be appreciated if a printed copy and an electronic version (Microsoft Word format on disk or by e-mail) are provided. Submissions, comments or inquiries regarding this paper should be directed to:

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Submissions must be received by **5pm Monday 21 July 2008**.

For further enquiries contact Moston Neck on (07) 3222 0511.

Confidentiality

In the interests of transparency and to promote informed discussion, the Authority would prefer submissions to be made publicly available wherever this is reasonable. However, if a person making a submission does not want that submission to be public, that person should claim confidentiality in respect of the document (or any part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available. It would be appreciated if two copies of the submission could be provided, the complete version and another version excising all confidential information. Where it is unclear why a submission has been marked as "confidential", the status of the submission will be discussed with the person making the submission.

While the Authority will endeavour to identify and protect material claimed as confidential as well as exempt documents (within the meaning of the *Freedom of Information (FOI) Act 1989*), it cannot guarantee that submissions will not be made publicly available. As stated in s187 of the *Queensland Competition Authority Act 1997*, the Authority must take all reasonable steps to ensure the information is not disclosed without the person's consent, provided the Authority is satisfied that the person's belief is justified and that the disclosure of the information would not be in the public interest. Notwithstanding this, there is a possibility that the Authority may be required to reveal confidential information as a result of an FOI request.

Public Access to Submissions

Subject to any confidentiality constraints, submissions will be available for public inspection at the Brisbane office of the Authority, or on its website at www.qca.org.au. If you experience any difficulty gaining access to documents please contact the office (07) 3222 0555.

Information about the role and current activities of the Authority, including copies of reports, papers and submissions can also be found on the Authority's website.

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1. INTRODUCTION

Full retail competition (FRC) in Queensland energy markets commenced on 1 July 2007. With the introduction of FRC, electricity retailers were able to offer to supply electricity to all consumers, including those who were on regulated (notified) prices. Consumers taking up such an offer transfer from the notified price to the market contract price they have accepted from the retailer.

However, notified electricity prices remain an important feature of the Queensland electricity market. In particular, customers who are not offered a market contract or who choose not to accept an offer remain on a notified price. In addition, customers who have accepted a market contract may revert to a non-market contract at the notified price, subject to any contractual conditions that may apply.

Under the *Electricity Act 1994* (the Electricity Act), the notified price of electricity is to be adjusted annually according to the cost of providing electricity. In particular, the rate of change in a Benchmark Retail Cost Index (BRCI) is to be used to adjust notified electricity prices each year.

The BRCI approach to the determination of the notified price of electricity does not involve a calculation of the efficient retail price of electricity each year. Rather, the existing electricity price is to be escalated by the expected change in the underlying cost of supplying electricity to consumers (that is, by the change in the BRCI).

The method for calculating many components of the BRCI are set out in the Electricity Act and the *Electricity Regulation 2006* (the Electricity Regulation). In broad terms, the BRCI for a particular year is calculated by dividing the total cost of electricity for the State by the State load for the preceding calendar year. The total cost of electricity is to include the following elements:

- the cost of energy;
- retailers' costs (including an appropriate retail margin);
- network costs; and
- any other relevant costs (for example, government fees).

The Electricity Act allows the Minister for Mines and Energy (the Minister) to delegate the calculation of the BRCI to the Queensland Competition Authority (the Authority). On 11 March 2008, the Minister issued the Authority with a delegation which requires the Authority to calculate the BRCI for 2009-10, apply the annual change in the BRCI to notified prices and publish these prices by 1 December 2008. The Certificate of Delegation can be viewed on the Authority's website (www.qca.org.au/electricity-retail/).

The Electricity Regulation sets out the consultation process that the Authority must follow in calculating the expected change in the BRCI for the following financial year. While the Authority adopted an extensive consultation process during its assessment of the BRCI for 2008-09, the limited time available to the Authority to complete the calculation of the 2009-10 BRCI and publish revised prices will limit the extent of consultation beyond the minimum required by the Electricity Regulation and may also limit the extent to which the Authority is able to consider any changes to the method used to calculate the BRCI, as discussed in Section 6.

Nevertheless, the Authority invites comment on all aspects of the calculation of the BRCI for 2009-10. To assist stakeholders in preparing their submissions, this Interim Consultation Notice includes a discussion of each component of the BRCI and some relevant issues.

Stakeholders will also have an opportunity to respond to a Draft Decision to be released by the Authority prior to the Authority making its Final Decision on any change in the BRCI for 2009-10. A

workshop will be held following the release of the Draft Decision (and before submissions on the Draft Decision have to be finalized) to provide an opportunity for interested parties to discuss with the Authority and its consultants any aspects of the calculation of the BRCI for 2009-10.

The proposed timetable for considering the BRCI for 2009-10 is provided below.

Timetable to determine the BRCI for 2009-10

- Interim Consultation Notice issued and call for submissions 2 July 2008
- Submissions on Interim Consultation Notice close 21 July 2008
- Consultant's first report released for comment 15 August 2008
- Comments on consultant's first report close 22 August 2008
- Workshop to be held on consultants report 27 August 2008
- Draft Decision released 26 September 2008
- Submissions on Draft Decision close 10 October 2008
- Consultant's second report released for comment 21 October 2008
- Comments on consultant's second report due 27 October 2008
- Final Decision by the Authority released and adjusted prices for 2009-10 gazetted by 1 December 2008

Due to the short timeframe for conducting this review, any submissions received after the due dates are unlikely to be able to be considered.

Relevant documents

In addition to the 11 March 2008 Ministerial delegation noted previously, the following references provide important information regarding the legislative framework that the Authority is required to consider in calculating the Benchmark Retail Cost Index.

The *Electricity Act 1994* can be obtained from:

- <http://www.legislation.qld.gov.au/legisln/current/e/electricA94.pdf>

The *Electricity Regulation 2006* can be obtained from:

- <http://www.legislation.qld.gov.au/legisln/current/e/electricR06.pdf>

The Authority's Final decision on the BRCI for 2008-09 can be obtained from:

- <http://www.qca.org.au/electricity-retail/nep0809/finaldecision.php>

2. COST OF ENERGY

2.1 Legislative Requirements

The Electricity Act requires that the cost of energy in a particular year must reflect the Authority's view of the cost of purchasing energy to supply the National Electricity Market (NEM) load of Queensland in that year. This view must be based on the Authority's estimate of the long run marginal cost (LRMC) of energy, taking account of the 13% gas scheme under the Electricity Act and the Mandatory Renewable Energy Target (MRET) scheme under the *Renewable Energy (Electricity) Act 2000*.

The Electricity Act also requires that the Authority's estimate of the LRMC of energy take into account the most efficient combination of generating plant to supply the entire NEM load of Queensland. The method used by the Authority to estimate the LRMC of energy must be a theoretical framework that:

- is generally recognised and understood in economic theory;
- calculates the LRMC of energy needed to meet the State NEM load for each half hour trading period during the previous calendar year;
- avoids double counting of costs;
- takes account of ancillary services needed to meet the NEM load of the State; and
- produces a cost of energy in terms of dollars per megawatt hour (\$/MWh).

2.2 QCA Approach for 2008-09

To meet the above requirements for 2008-09, the Authority estimated the LRMC of energy and the purchase cost of energy and then calculated an equally weighted average of the two costs as the basis for determining the energy-cost component of the BRCI.

As required, the Authority calculated the per unit LRMC and purchase costs associated with supplying the total load of the State and applied these unit costs to the smaller NEM load.

In this regard, the requirements in relation to the relevant load to be used in calculating LRMC and purchase cost are two fold. In the case of the LRMC, the Authority is required to consider the combination of generating plant to meet the Queensland NEM load and, in the case of purchase costs, the Authority is required to consider the likely costs to meet the Queensland NEM load.

In its Final Decision on the BRCI for 2008-09, the Authority considered that, while the defined NEM load of the State will be a subset of the total load of the State, the costs for meeting that subset will be determined in the wider context of the actual market and not in isolation. As a result, the Authority calculated the per unit LRMC and purchase costs associated with supplying the total load of the State and applied these unit costs to the smaller NEM load.

2.2.1 LRMC of energy

The LRMC of energy was estimated based on an efficient combination of generating technologies for Queensland. In doing so, the interconnection of Queensland with the rest of the NEM was taken into account as were changes in the LRMC of energy over time as key cost inputs are expected to change.

In selecting inputs to the LRMC calculation, the Authority considered that, where possible, short-term energy-cost influences should be confined to the purchase cost calculation and that long-run aspects should drive the LRMC calculation. The Authority was of the view that this was in keeping with the intent of the legislation and the different focus of these two elements.

Based on this approach, the Authority estimated the LRMC of energy would increase by 1.5% from \$41.98/MWh in 2007-08 to \$42.61/MWh in 2008-09.

The Authority seeks stakeholders' views on the calculation of the LRMC of energy and expectations and supporting reasons regarding any likely change in the LRMC of energy between 2008-09 and 2009-10.

2.2.2 Energy purchase costs

For 2008-09, the purchase cost of energy was calculated based on a combination of energy contracts that a representative retailer could be expected to purchase over a two-year period and spot energy purchases in order to meet the Queensland load. In doing so, it was assumed that the representative retailer would spread its purchases of energy contracts for a single year in the future evenly over the preceding two years.

Based on this approach, the Authority estimated the purchase cost of energy to increase by 8.3% from \$48.86/MWh in 2007-08 to \$52.91/MWh in 2008-09.

The Authority seeks stakeholders' views and reasons on any likely change in the purchase cost of energy between 2008-09 and 2009-10.

2.3 Other energy costs

For 2008-09, the costs to retailers of complying with the 13% gas scheme was estimated using the penalty price to retailers for not surrendering sufficient Gas Electricity Certificates (GECs).

The costs to retailers of complying with the Mandatory Renewable Energy Target scheme were based on weekly market prices for Renewable Electricity Certificates published by the Australian Financial Markets Association and actual and estimated annual Renewable Power Percentages.

In arriving at a final estimate of the cost of energy component of the 2008-09 BRCI, the Authority also recognised the cost of NEM participant fees and ancillary services charges paid by retailers.

The Authority seeks stakeholders' views and supporting reasons on likely changes in other energy costs reflected in the BRCI between 2008-09 and 2009-10.

The Authority also seeks stakeholders' views on whether there are any other issues the Authority should consider in estimating the cost of energy.

3. NETWORK COSTS

3.1 Legislative Requirements

The Electricity Act requires that the network cost component of the BRCI include the Authority's view of the likely total revenue requirements for transmission and distribution networks in Queensland.

3.2 QCA Approach for 2008-09

In calculating distribution network costs, the Authority recognised adjustments to the revenue requirements for Energex and Ergon Energy that have occurred since the release of its 2005 Final Determination. These included several cost pass-through decisions and adjustments made by the Authority to account for the exclusion of non-distribution use of system services from the distributors' revenue caps.

Transmission network costs were based on the latest Powerlink and other transmission-related charges (such as avoided transmission use of system (TUOS) payments to embedded generators) that the distributors were expected to pass through to customers in 2008-09.

On this basis, the Authority has calculated the relevant network costs to be \$1,975 million for 2007-08 and \$2,131 million for 2008-09, an increase of 7.9%.

An implication of the 1 December 2008 deadline for calculating the BRCI for 2009-10 is that the 2009-10 transmission charges to be levied on Energex and Ergon Energy during 2009-10 will not be known with any certainty prior to the decision deadline. As a result, the Authority will have to estimate the transmission cost component of network costs on some other basis, such as by applying the percentage share of Powerlink's 2008-09 revenue cap accounted for by Energex's and Ergon Energy's 2008-09 transmission charges to Powerlink's 2009-10 revenue cap.

The Authority seeks stakeholders' views on the appropriate method for arriving at an estimate of the transmission costs payable by Energex and Ergon Energy in 2009-10.

The Authority also seeks stakeholders' views on whether there are any other issues the Authority should consider in estimating network costs.

4. RETAIL COSTS AND MARGIN

4.1 Legislative Requirements

The Electricity Act and the Electricity Regulation set out how the retail cost component of the BRCI is to be determined. In particular, retail costs are to reflect the likely cost of providing customer retail services to Queensland customers connected to the national grid, based on an efficient retailer carrying on a retail electricity business. In considering what costs would be incurred, the Authority is required to assume that the retailer:

- is operating separate from any other business (that is, the business is a stand-alone Queensland retailer);
- has a significant share of the State's retail electricity market;
- provides customer retail services to a cross-section of customers throughout the State;
- has a mix of customers in the same proportions as the customer mix for Queensland as a whole; and
- earns a reasonable retail margin.

In addition, the Electricity Regulation requires that the Authority consider the following cost categories in determining the cost of providing customer retail services:

- billing;
- customer call centres;
- credit management;
- energy trading activities;
- corporate overheads, including, for example, treasury functions, human relations and facilities management;
- information technology systems; and
- any other cost category the Authority considers reasonable.

The Certificate of Delegation also requires the Authority to be mindful of two policy objectives of the Queensland Government. First, that the existing retail margin in the notified prices at the date of the delegation should remain relatively stable (although not necessarily the same from year to year) and, second, that the policy of allowing small market customers to revert to notified prices should not result in a retailer providing customer retail services to non-market customers at a loss.

4.2 QCA Approach for 2008-09

In calculating retail costs for 2008-09, the Authority took account of retail operating costs and customer acquisition and retention costs.

4.2.1 *Operating Costs*

For 2008-09, the Authority escalated forward its 2007-08 estimate of per customer retail operating costs which had been based on an analysis of retail costs accepted by regulators in other jurisdictions. Costs were escalated to 2008-09 based on a weighted average of expected price inflation and wages growth in 2008-09 of 3.85%.

4.2.2 *Customer Acquisition Costs*

In calculating the change in the BRCI for 2008-09, the Authority estimated the cost to a retailer of responding to the potential loss of customers by including costs likely to be incurred by a retailer to maintain its customer base and its scale of operation. These costs were calculated based on rates of customer switching between retailers and from regulated prices to market contracts with the same retailer. Differing acquisition costs were attributed to each of these rates of change.

4.2.3 *Retail Margin*

The Authority considered that a retail margin of 5% would provide a reasonable return to a retailer for the risks it faces.

Based on forecast total customer numbers, total retail costs, including the retail margin, were expected to be \$409 million in 2007-08 and \$432 million in 2008-09, an increase of 5.7%.

The Authority seeks stakeholders' views and supporting reasons for any likely change in retail costs, retail margin or factors affecting churn rates between 2008-09 and 2009-10.

The Authority also seeks stakeholders' views on whether there are any other issues the Authority should consider in estimating retail costs.

5. QUEENSLAND LOAD

5.1 Legislative Requirements

Section 91E of the Electricity Act requires that the BRCI be determined by dividing the total benchmark retail cost by the Queensland NEM load in order to determine the unit cost of supplying electricity, expressed in c/kWh. The Queensland NEM load is to be calculated from the loads supplied at each transmission connection point to the regulated networks of Ergon Energy and Energex. Isolated distribution networks and customers directly connected to the transmission network are therefore to be excluded from the Queensland load.

5.2 QCA Approach for 2008-09

In calculating the BRCI for 2008-09, the Authority used historical data for the calendar years of 2006 and 2007 as required by the legislation. Data obtained from National Electricity Market Management Company (NEMMCO) on the load attributable to Queensland in the NEM were adjusted to remove the load associated with customers connected directly to the transmission network and to remove the load flowing through Queensland to Country Energy's network in NSW.

This estimate of the NEM load included the output of relatively large generators embedded in the Energex and Ergon Energy networks that participate in the NEM but did not include small embedded generators that do not participate in the NEM or customers connected to isolated distribution systems not participating in the NEM (such as the Mt Isa network load).

On this basis, the Authority determined the relevant NEM load of Queensland to be applied in calculating the final step of the BRCI as 36,263GWh in 2006 and 37,040 GWh in 2007.

An implication of the 1 December 2008 deadline for calculating the BRCI for 2009-10 is that the Authority will not have actual load or half-hourly load data for all of calendar year 2008 in order to calculate the BRCI for 2009-10 and will therefore have to forecast this data for part of 2008.

The Authority seeks stakeholders' views on how the NEM load for 2008 might best be estimated.

The Authority also seeks stakeholders' views on whether there are any other issues the Authority should consider in estimating Queensland load.

6. TOTAL BRCI

The method the Authority adopted to calculate some aspects of the BRCI for 2008-09 differed from that used to calculate the BRCI for 2007-08. Therefore, as required by Sections 107(2) and 111(2) of the Electricity Regulation, the Authority re-calculated the BRCI for 2007-08 based on the new method so that a like-with-like comparison could be made.

For 2009-10, the Delegation requires the Authority to calculate the BRCI and publish the revised tariff schedule to apply in 2009-10 no later than 1 December 2008. This means the Authority has significantly less time available to calculate the 2009-10 BRCI than it had previously.

The Authority is concerned the shortened timeframe for 2009-10 will not allow robust consideration of, and adequate consultation on, any changes to the method of calculating the BRCI (and hence the recalculation of the 2008-09 BRCI) that might be proposed for 2009-10. As a result, the Authority is inclined to calculate the 2009-10 BRCI using the same method it used to calculate the BRCI for 2008-09 and to rule out any consideration of method changes which would initiate a recalculation of the 2008-09 BRCI.

The Authority seeks stakeholders' views on whether there is any need to change the method for calculating the BRCI for 2009-10 from that used for 2008-09 and, in any event, whether it should consider implementing any proposed method changes in calculating the BRCI for 2009-10.

If changes are considered necessary and required to be implemented in the 2009-10 process, the Authority seeks stakeholders' views on which of these should be given the highest priority.