



Submission to the  
Queensland Competition Authority  
on the  
Interim Consultation Notice  
Benchmark Retail Cost Index for  
Electricity: 2009-10

July 2008

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# 1. Introduction

Origin Energy (Origin) notes that the Queensland Competition Authority (QCA) has commenced its review of the Benchmark Retail Cost Index (BRCI) for 2009-10.

Origin understands that this process must be completed by 1 December 2008 as directed by the Queensland Government in its latest delegation of powers<sup>1</sup> (Delegation) to the QCA and is therefore cognisant of the limited time available for this process. Accordingly, Origin notes the compressed timeframe proposed in the QCA's *Interim Consultation Notice: Benchmark Retail Cost Index for Electricity: 2009-10* (Interim Notice).

However, Origin fundamentally contests the QCA's assertion that they:

*'...adopted an extensive consultation process during its assessment of the BRCI for 2008-09'; and that, apparently as a result*

*'...they are inclined to calculate the 2009-10 BRCI using the same method it used to calculate the BRCI for 2008-09'.<sup>2</sup>*

Origin is still reviewing the unanticipated methodology changes and outcomes arising from the QCA's *Final Decision: Benchmark Retail Cost Index for Electricity: 2008-09* (Final Decision). While our review is not complete, Origin strenuously urges the QCA to conduct a comprehensive and transparent consultation process and to fully address the issues and concerns raised by Origin and other retailers with the QCA's approach to the 2008-09 BRCI.

If the QCA approaches the 2009-10 BRCI in the same way as the 2008-09 BRCI, in Origin's view, it risks undermining the integrity of the BRCI process, the intent of the legislation and the ongoing development of the competitive retail market.

The Queensland Government's expressed policy and the intent of the BRCI is to ensure that regulated retail tariffs are adjusted annually to reflect any change in the cost of supplying electricity to customers in Queensland. Origin has summarised the legislative instruments in Section 2 of this submission.

These specific statutory and regulatory provisions set out the functions, processes and powers of the QCA under its delegated authority (ss. 90 to 94, and s. 96 of the Act; and ss. 95 to 111 of the Regulation).

The QCA has recognised that there are ambiguities in the BRCI formulation but Origin would highlight that when interpreting legislation or exercising discretion, decision makers are expected to achieve the outcome that will best achieve the statutory objects. As the QCA is aware, s.14A of the *Acts Interpretation Act, 1954* requires that "in the interpretation of a provision of an Act, the interpretation that will best achieve the purpose of the Act is to be preferred to any other interpretation".

Origin believes that the QCA has not sufficiently considered this matter in the 2008-09 Final Decision. As a result, Origin contests the appropriateness of the QCA's proposal in Section 6 of the Interim Notice to calculate the 2009-10 BRCI using the same methodology as was applied 2008-09, and believes that the QCA should observe a full consultation process and be willing to openly test and reconsider its previous assumptions.

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<sup>1</sup> Certificate of Delegation: dated 11 March 2008, issued under section 90(3) of the Electricity Act 1994 (as amended)

<sup>2</sup> QCA 2008, *Interim Consultation Notice: Benchmark Retail Cost Index for Electricity: 2009-10*

Specifically, the QCA has made decisions in a number of key areas that have not been subject to consultation processes befitting their impact, both individually and cumulatively, on the BRCI outcomes, and which in Origin's view are decisions which are inconsistent with the regulatory framework.

These include the following three matters:

- updating the previous year's estimates of many of the BRCI components using actual data and information, and then using a recalculated BRCI for the previous year as the base for measuring change. Apparently this approach has been predominantly based on the reasoning that there has been a methodological change and that this in turn provides the scope for also upgrading inputs beyond those that were known at the time (and which formed the basis of the decision);
- using the total Queensland load, rather than the *NEM Load of the State* as defined in the Queensland *Electricity Act 1994* for the purposes of calculating the two energy cost components, the Long Run Marginal Cost (LRMC) and the energy purchase cost; and
- the use of trend estimates for calculating the LRMC where these trends fail to capture the very real step-changes in LRMC input costs that have been presented to the QCA.

In Origin's view, the QCA's previous decisions on each of these matters are at odds with the objectives of the regulatory framework, including the specific objectives of the BRCI. Each one, and the total impact of the three decisions, should be subject to robust investigation as part of the 2009-10 BRCI process.

Furthermore, Origin has always supported, and highlighted in its submissions to the 2008-09 process, the objectives of the BRCI as stated in the Delegation, which are:

- that the annual indexation should ensure that the existing retail headroom in the tariffs at the date of the Delegation remains relatively stable; and
- that the policy of enabling customer reversion to regulated tariffs should not result in the retail entity incurring a financial loss to supply these non-market customers.

Origin has examined the results of the BRCI process over the last two years and an analysis of residential customers clearly demonstrates that retail headroom has deteriorated during both processes.

The QCA has defended the lack of any analysis to date of the overall impact of their decisions by claiming that it does not have information on actual retail margins. Origin contends, however, that given this will be the third year of operation of the BRCI, it is essential that the QCA commits to investigating various methodological options such as cost and revenue indexing that would allow the QCA to address this essential element of the BRCI.

The remaining sections of this submission address the specific questions raised by the QCA in its Interim Notice and include Origin's proposals on how the QCA can address these issues in a manner that complies with the regulatory framework and good regulatory practice.

Origin would also express its concern with the additional risks being introduced in the 2009-10 process. These additional risks arise because of the requirement in the Minister's March 2008 Delegation to publish the 2009-10 retail tariffs by 1 December 2008, seven months before they become effective and well before there is any clarity on key input costs.

The greatly increased risks of forecast error serve to magnify the existing risks arising from the BRCI index approach. While the QCA can do little about these matters, it should carefully consider the cumulative impact of its decisions on individual costs and adopt a more conservative and balanced approach. Dealing with uncertainty by selecting the lowest point in any cost range introduces a bias and undermines the objectives of the BRCI.

Moreover, the industry has no guidelines regarding the pricing methodology that might be put in place by the Queensland Government beyond 2009-10. The potential that forecast errors will not be corrected with a change in methodology is a major risk for any retailer seeking to invest in the competitive retail market. In this context, a final challenge facing the QCA is incorporating into the theoretical framework a methodology that can address the impact of the Emissions Trading Scheme and the expanded MRETS programme.

The requirement to finalise 2009-10 tariffs by December means that the QCA may not have the benefit of knowing the carbon price set for 2010 or the trajectory of that price, both of which will impact on the Energy Cost calculations. However, if these costs are ignored, then Queensland customers will face a bigger price shock in the following year, an outcome that Origin strongly urges the QCA (and the Government) to avoid.

## 2. Legislative Background

Given the many decisions that the QCA must make in determining the methodology and assessing the relevant inputs to the methodology, Origin believes the starting point must be a clear statement of the Regulatory Framework. This will then provide a reference point for resolving ambiguities.

### 2.1 Objects of the Act and Regulation

The statutory objects are set out in section 3 of the *Electricity Act 1994* while the purposes are set out in section 4 of the *Electricity Regulation 2006*.

#### Section 3, Electricity Act 1994

The objects of this Act are to—

- (a) set a framework for all electricity industry participants that promotes efficient, economical and environmentally sound electricity supply and use; and
- (b) regulate the electricity industry and electricity use; and
- (c) establish a competitive electricity market in line with the national electricity industry reform process; and
- (d) ensure that the interests of customers are protected; and
- (e) take into account national competition policy requirements.

#### Section 4 Electricity Regulation 2006

The main purposes of this regulation are to—

- (a) ensure a secure, efficient and economic supply of electricity to customers on fair and reasonable terms; and
- (b) ensure customers' interests are adequately protected; and
- (c) provide for the proper measurement of the energy efficiency and performance of electrical equipment; and
- (d) inform the public about the energy efficiency and performance of electrical equipment; and
- (e) prescribe particular conditions of employment for employees in the GOE industry.

### 2.2 Minister's statements on purpose of the BRCI

In 2006, the Minister stated in Parliament that the BRCI enabling legislation<sup>3</sup> would '*encourage further investment*', and that the QCA's approach to tariffs would '*provide both customers and new entrant retailers with confidence in the long-term investment environment*'.

The purpose of the legislation is highlighted in the following relevant extracts from the Second Reading Speech.

*'This legislation is now a win-win. It is a win for Queensland consumers through more competitive electricity prices and innovation in product offering and robust protection provisions for small customers. It is a win for the industry given the legislation provides a clear and fair regulatory arrangement.'*

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<sup>3</sup> See Queensland *Electricity and Other Legislation Amendment Bill*, Second Reading, Hon. GJ Wilson, 31 October 2006 (Old Hansard, 31 Oct 2006 at p281)

*Queensland's energy sector is a major driving force behind our economy and a key economic advantage of doing business in Queensland. This legislation will further build on our robust energy sector and will encourage further investment.*

....

*Efficient pricing and improved investment signals – Under the Bill, the Queensland Competition Authority will assess the uniform tariff arrangements for electricity to ensure that the safety net arrangements remain efficient. This approach will provide both customers and new entrant retailers with confidence in the long-term investment environment.*

...

*The uniform tariff will be varied in accordance with an 'electricity cost index'. That is, each year, regulated tariffs will be adjusted based on changes in electricity supply costs.*

*This change will ensure that changes in uniform tariffs reflect cost rises and falls in the electricity sector and allow the benefits of any productivity improvements in the sector to be shared with electricity customers.'*

## 2.3 Minister's delegation and conditions

### Pricing provisions in the Act

Under s. 90(1) of the Electricity Act, the Minister must for each tariff year, decide the prices or the methodology for fixing the prices, that a retail entity may charge its non-market customers for customer retail services, charges or fees relating to customer retail services, etc.

The Act and Regulation set out relevant formulae and processes for developing the indexation that applies to prices for customer retail services decided or fixed under s. 90(1).

The Act allows the Minister to delegate to QCA all or any of his functions under s. 90(1).

### Delegation

By Certificate of Delegation dated 11 March 2008, the Minister delegated his powers under s. 90(1) to the QCA.

The Delegation purports to be subject to seven conditions, including a general condition 7 for '*any other conditions formally notified by the Minister from time to time*'.

Origin would note that clause 2 of the Conditions of Delegation requires the QCA to consider, when exercising its delegated powers, that there should be retail headroom stability and that there should be no retailing to non-market customers at a loss. Those headroom and profit objectives are linked to the Electricity Act s3 objects to:

- (a) set a framework for all electricity industry participants that promotes efficient, economical and environmentally sound electricity supply and use; and
- (c) establish a competitive electricity market in line with the national electricity industry reform process.

The QCA, as the Minister's delegate, must ensure that any actions are undertaken strictly in accordance with the terms of the Delegation, and do not exceed the delegated statutory power.

Origin recognises that the delegation cannot fundamentally change the statutory power or function that is being delegated, or the processes that the Act and Regulation require the decision maker to follow. Therefore, the Minister's powers under s. 90(1) should be exercised consistently with the objects of the Act and the QCA as the Minister's delegate is similarly bound.

### 3. QCA Final Decision 2008-09

Origin has substantive concerns about the QCA's Final Decision on the BRCI for 2008-09 and believes the QCA must take these matters into account in the 2009-10 process, notwithstanding the limited time frames allowed under the Delegation.

Origin contends that the QCA's decision in 2008-09 was not appropriate or reasonable given the information available to it. In particular:

1. consultation during the process was poor, and communicated with very little transparency;
2. the methodology and supporting information used was inconsistently and did not take account of relevant matters and brought into account matters that were not relevant; and most importantly
3. the decision did not comply with the regulatory framework including the Delegation.

**It is for these reasons, that Origin strongly opposes the rolling forward of the 2008-09 approach into 2009-10, as suggested by the QCA in section 6 of the Interim Notice.**

Origin's particular concerns are outlined below.

1) In terms of good regulatory practice, Origin believes that the QCA's decision making process was not sufficiently transparent with key information available only late in the process or not at all, thus restricting the opportunities for reasonable consultation. For instance:

- at no point in the process did industry participants have sufficient information to enable them to replicate the methodology being used by the QCA's consultants;
- significant errors were made in the analysis with little information provided to stakeholders on the impact of this prior to the Final Decision; and
- many elements of the final methodology adopted by the QCA were never raised with stakeholders nor published prior to the Final Decision. This is in contradiction with the requirements for procedural fairness.

**It is essential that despite the shortened time frames, these problems are not replicated in the 2009-10 process.**

Origin notes the additional steps, including the review of consultant's reports, in the QCA's timetable for 2009-10 and hopes that this may improve the transparency and rigor of the consultation process for 2009-10.

2) Many issues were raised by stakeholders during the process which Origin believes were not adequately addressed in the lead up to, and even in the Final Decision. These include (but not limited to):

- the required increase in input costs in the LRMC calculation;
- the impact of the changing cost of capital on retailers' costs; and
- whether the objective in relation to maintaining headroom would be met.

Origin has again raised these issues in direct response to the Interim Consultation questions and would expect QCA to further investigate and respond to these issues.

3) Origin has further fundamental difficulties with the QCA's decisions in the 2008-09 BRCI. These decisions do not necessarily involve the choice between different methodologies.

The methodologies used in the BRCI can generate a number of outcomes depending on the inputs. In most cases, the output for each cost component is a cost range.

The QCA's decisions around the selection of a point within this range that is of concern to Origin, and which we believe warrant robust investigation in the 2009-10 process.

Origin argues that the decisions about which option or point to apply in calculating the BRCI should be made by reference to the regulatory framework, to the internal consistency and the overall impact.

These issues and a summary of why we believe the QCA has erred in their decision on these matters are explained in detail in the following sections.

**Origin believes that at a minimum, the consultation process for 2009-10 must address the following areas which were of great concern to Origin in the 2008-09 Decision:**

- the use of the latest available information to update the values forecast for 2008-09 in the 2008-09 Decision, whenever there is a methodological change;
- the use of an inconsistent approach to the relevant load and, in particular, using the total Queensland load rather than the *NEM Load of the State* as defined in the *Electricity Act 1994* for the purposes of calculating the energy cost; and
- the use of the trend model for LRMC calculation given that it is recognised that the trend model does not capture the real and significant step-changes in input costs to the LRMC calculation.

### **3.1 Revision of prior BRCI estimates using actual data**

In the QCA's calculation of the 2008-09 BRCI, the QCA has used updated information or actual data to change several elements of the 2007-08 BRCI, namely the:

- Energy purchase cost;
- MRET and ancillary service costs
- NEMMCO fees;
- Customer acquisition cost including churn rates; and
- Transmission network cost.

The QCA has provided three reasons for these adjustments namely:

- that if there has been a methodological change in the BRCI then s. 111(2) of the Regulations requires the QCA to recalculate the cost elements using actual data;
- that it may be the only practical source of information to pursue; and
- that as a general principle, using the latest information will provide more robust estimates.

The latter two reasons have no legislative basis and have the effect of ensuring that the BRCI will not correct itself for forecast error.

An approach that enables correction of forecast error is essential if the BRCI, which is calculating rates of change not absolute values, is to achieve its objective of relatively stable headroom. Without these self-correction mechanisms, errors simply accumulate from one BRCI Decision to the next.

With regard to their first and primary reason, the QCA appears to have mistakenly based its rationale on interpretation of s. 111. However, s. 111 merely requires it to recalculate the base year using the new methodology, it does not require the recalculation to be done using "perfect foresight" of the inputs. This is an instance when reference to the intent of the regulatory framework will provide interpretive guidance to the QCA.

This situation is best explained by referring to the QCA's examination of customer acquisition costs for 2007-08 and 2008-09. An examination of this example will illustrate clearly why Origin opposes continuation of this approach in 2009-10.

In the 2007-08 BRCI calculation, the QCA used a specific method to forecast retailers' customer acquisitions costs. The QCA used this method and an estimated 5 per cent churn rate to estimate the costs to retailers at \$3.6 million for that year.

Customer acquisitions costs were obviously zero in 2006-07 as that period preceded the introduction of FRC, so in effect, the QCA provided a total increase in revenue recovery for 2006-07 of \$3.6 million to cover its estimate of retailers' additional costs.

In 2008-09, the QCA has again examined customer acquisition costs but decided to use a different methodology for estimating this cost<sup>4</sup>. For 2008-09, the QCA estimates the annual cost to energy retailers of customer acquisition will actually be around \$51 million.

Given that only \$3.6 million was estimated in 2007-08, and this fed directly into the allowed retailer revenue for 2007-08, it would be expected that the 2008-09 BRCI calculation would contain a significant increase to meet the estimated significant increase in retailers' operating cost.

It is recognised that there has been a methodological change by the QCA and under s. 111 of the Regulations, they must recalculate what "*it would have been*" based on the changed framework.

To provide an apple with apples comparison, the QCA would need to recalculate the 2007-08 customer acquisition costs using the new methodology but using the same inputs as were used in the previous year into the new method. This calculation would have resulted in a cost estimate of approximately \$25 million for 2007-08 and would point to an increase in customer acquisitions costs of \$26 million in the 2008-09 BRCI. As this approach is effectively self-correcting it would be consistent with the legislation and meet the intent of the BRCI.

This was not the approach adopted by the QCA. Rather, the QCA recalculated the customer acquisition costs for 2007-08 using the new method but also changing the churn rate from the estimated 5 per cent to its actual value of 11 per cent - basically assuming perfect foresight. The result was that the QCA estimated the acquisition costs in 2007-08 to be \$53 million. The consequence of this was that their BRCI calculation for 2008-09 assumed that retailers' costs had reduced from \$53 million to \$51 million and that the BRCI should be lower to remove \$2 million from retailer revenue.

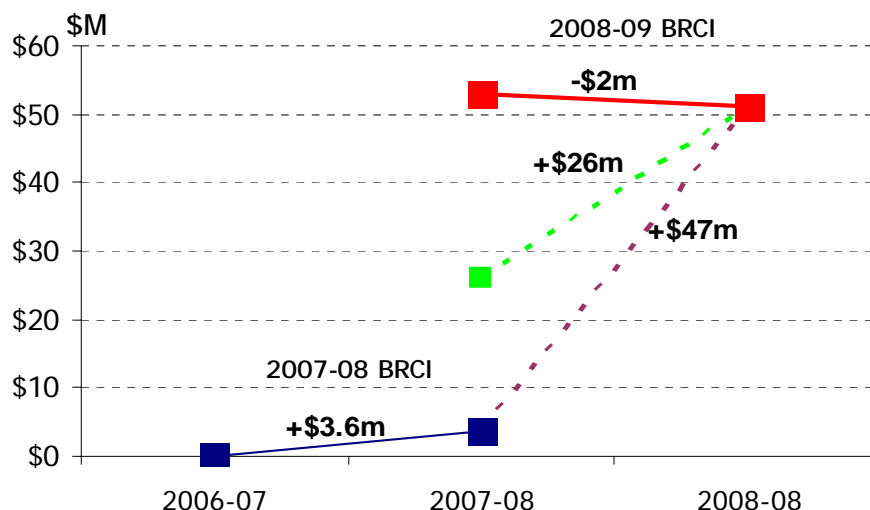
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<sup>4</sup> which Origin supports as a reasonable methodology.

Putting it in context, the QCA has estimated that customer acquisition costs are substantial and have increased from \$0 in 2006-07 to \$51 million in 2008-09. However, because of the way the QCA has chosen to apply its methodology, it has only provided retailers with cost recovery of \$3.6 million in 2007-08 regulated tariffs and then reduced this token recovery by \$2 million through the 2008-09 regulated tariffs.

The stated intent of the BRCI is to ensure that changes in regulated tariffs are reflective of changes in cost. This result clearly demonstrates the limitations of the QCA's approach and the reasons why Origin strongly resists its continuance in 2009-10. .

Figure 1: QCA Treatment of Customer Acquisition Costs in 2008-09 BRCI



This same situation is replicated in the QCA's calculation of many of the BRCI elements including the energy purchase cost, other energy costs and transmission network cost.

The QCA even asserts that:

*'there is no reason to expect that the net impact of using updated data would systematically tend towards either increasing or decreasing the size of the BRCI'.*

In direct contradiction of this statement, the QCA's method of updating inputs using actual data has reduced the recognition in the 2008-09 BRCI of the increase in these costs in all instances. Where there is a bias towards lower outcomes in cases of uncertainty, there will be systematic trends in the outcome. In any case, the question of systemic bias simply does not arise if the original inputs are used when a new methodology is introduced.

Consequently, Origin requests that the QCA fully consider the impact of its current approach and the intent of the regulatory framework and estimate the 2009-10 BRCI without replacing the cost components estimated during the 2008-09 BRCI.

## 3.2 NEM Load

In the QCA's Final Decision for 2008-09, the calculation of the LRMC and energy purchase costs has been determined based on the total Queensland system load including direct connection (DC) customers.

In the Interim Notice, the QCA has not sought specific responses from industry stakeholders on the selection of the total Queensland load as input into the Energy Cost calculation. However, Origin believes the load used for input into the Energy Cost modelling is a key matter for consultation in the 2009-10 BRCI process.

Origin would highlight that retailers, including Origin, only became aware at the industry Workshop in late March 2008 that the 2008-09 BRCI Energy Cost calculations used as input to the models, the total Queensland load, not the NEM load.

As a result there was very limited opportunity to discuss the assumptions behind the use of the total Queensland load as part of the 2008-9 BRCI process. This is a critical matter and must be addressed fully in the 2009-10 BRCI.

**It is Origin's view that the QCA should use the NEM Load definition consistently in every component of the 2009-10 BRCI calculation.**

This is because:

- Purpose of the BRCI - The rationale and object of the BRCI is to reflect the changes in costs associated with the regulated customer base. Therefore, both the numerator and denominator in this calculation need to be consistent with each other and with the relevant customer base;
- Legislative Framework - The legislation and regulation define the NEM Load for the BRCI calculation, including the calculation of the cost of energy;
- Material impact - The impact of using alternative loads and load shapes is significant and has a material impact on the outcome (as evidenced by CRA's analysis in the Addendum report on the 2008/09 BRCI); and
- Regulatory best practice - To do otherwise is contrary to the principles of regulatory best practice.

### Purpose of the BRCI

The BRCI is intended to be an index of the cost associated with supplying the relevant customer base. As stated in s. 105 of the Regulations, the principle behind the theoretical framework for the Energy Cost calculation is to capture the costs of "efficiently supplying the NEM load of the State".

The *Electricity Act* 1994 defines NEM Load for the purposes of the BRCI process in Division 3 of the Act ("Annual Indexation"), and specifically in Division 3 sections 91C and 91F.

The definition of NEM Load in these sections specifically excludes DC customers. In excluding DC customers in the NEM load, it was recognised at the time of drafting the legislation that the inclusion of this load would potentially distort the BRCI.

This is because of the size of each DC customer and the difference between the DC load shape and that of the regulated customer base. These two factors could result in significant and unintended variability in the BRCI calculations. Changes in the DC load and load shape, such as the addition of a new refinery plant, would in effect swamp any changes to the load that was relevant to the BRCI.

In the context of the BRCI, the Act and subordinate regulations are quite clear that the NEM load used in the denominator "L" is based on the residual Queensland load after DC customers, and other loads (such as Mt Isa and Country Energy's load for its South Queensland, Northern NSW regions) are excluded.

The QCA's decision on costs needs to be internally consistent and to date, in assessing both the distribution and the transmission costs for the purposes of the total cost calculations for the BRCI, the QCA has used a calculation that matches the NEM load as defined in the Act. The QCA has excluded all transmission costs that are not related to servicing customers in the two distribution areas of Ergon and Energex.

**In adopting this approach to transmission costs, the QCA explicitly recognises that the relevant "customer base" for the numerator of the BRCI index (ie. the cost calculation) is the same as the customer based for the denominator "L".**

However, in its 2008-09 Decision, the QCA has not used this same NEM load of the State as input into the modelling of the LRMC and the Energy Purchase Cost. Both components have been modelled using the total Queensland load, not the NEM load (or NEM load shape).

In support of its approach, the QCA stated in its Final Decision that:

*In considering the LRMC, CRA has calculated the LRMC of energy to meet the entire Queensland load... CRA took this approach because the generation system that the LRMC estimate is seeking to capture would be built to service the entire Queensland load, not just loads supplied through the distribution networks.*

The QCA has confirmed its intention to continue this approach in the Interim Consultation Notice for 2009-10:

*...while the defined NEM load of the State will be a subset of the total load of the State, the cost for meeting that subset will be determined in the wider context of the actual market and not in isolation.*

Origin's response to this proposal for 2009-10 is two-fold.

First, Origin believes that the regulatory framework quite clearly envisages that the Energy Costs will be calculated on the basis of efficient costs associated with purchasing energy to supply all of the NEM load of the State for the tariff year.

Second, Origin considers that the QCA's view that the costs to supply the NEM load of the State are best estimated by assessing the costs to supply the total Queensland load, does not reflect the reality of a retailers' portfolio and is not therefore correct in principle.

#### Legislative Framework

The starting point for considering the alternatives of deciding between using the total Queensland load or the NEM load of the State must be an analysis of the regulatory requirements of the BRCI.

Section 91C provides the definitions applicable for the purposes of Division 3, including the NEM load.

*NEM load of the State means the State's NEM load as worked out under section 91F*

Section 91F (2) states that:

*The NEM load is the pricing entity's view of the total of the loads for the State supplied at each transmission connection point to a supply network, as adjusted for any matter prescribed under a regulation.*

Section 92 of the Act is the section that specifically refers to the calculation of the Energy Costs. Relevantly: Section 92 (1) states that:

*The cost of energy must reflect the pricing entity's view of the likely total of the costs to be incurred ... to purchase energy to supply all of the NEM load of the State for the relevant tariff year.*

Section 92 (3) states the estimate must take into account the most efficient combination of generating plant to supply all of the NEM load of the State.

The Regulations in section 105, in describing the principles which the Energy Cost calculation framework must comply with, similarly refer to calculating energy costs to efficiently supply the NEM load of the State, and of meeting the demand profile (called the NEM load shape) of the State. Section 106 states that the pricing entity must consider the cost of ancillary services needed to meet the NEM load of the State.

Origin would contend that there is no reference to the use of an alternative load for any part of the energy cost calculation. There is only one explicit definition with respect to the relevant load for calculating Energy Costs, and that is set out in Division 3 and the Regulations as the NEM Load of the State.

**It is therefore a misconstruction of the regulatory requirements of the BRCI to determine a retailer's energy costs in the "wider context of the actual market", (ie the total Queensland load).**

For example, the regulatory framework is based on the cost to a retailer to "purchase the energy" for a given load/load shape (as per s. 92 (1) for instance). The costs related to the purchase of energy by a retailer for the relevant load "L" are clearly not the same as the averaged costs for generators to supply the state as a whole, particularly when there are a number of very large DC customers as in Queensland.

To make the point another way, a retailer seeking to purchase energy contracts for a customer base of L, would be unable to contract on the basis of the average costs for generators as this would involve generators cross-subsidising between their customers in a way that is not viable in a competitive wholesale market such as the NEM. Retailers purchasing for a NEM load profile customer base would get a different price from the same generator and in addition, would require a different mix of generator contracts with more peak delivery capability.

In this context, CRA has noted that DC customers would have a much flatter load than non-DC customers, and that:

*Including the directly connected customers effectively spreads the increased year-on-year peakiness of the load across a wider load base, and thus affects year-on-year changes in energy purchase costs in the calculation of the BRCI.*

In addition, it is important that the QCA takes into account that the majority of DC customers will have purchase arrangements that are very different to other customers. For instance, many DC customers have contracts directly with generators, others buy from wholesalers, while others have various complex pool price pass-through mechanisms in their supply contract.

For this reason, Origin contests the implicit assumption by the QCA in its 2008-09 analysis that retailers sell to the DC market and that the costs of meeting this load is in any way similar to the cost of purchasing electricity for other customers.

#### Material impact on BRCI outcome

The impact of using alternative loads and load shapes is significant and has a material impact on the outcome. The tables in CRA's Addendum to the Final Decision illustrate the impact of the selection of the relevant load input has on the Energy Cost calculation - without any change in underlying methodology for the Energy Cost calculation (3% to 4% minimum impact on the total BRCI).

#### Regulatory best practice and current Australian practice

Regulatory best practice requires regulators to make decisions in context, and on a consistent and transparent basis. In addition, regulatory decisions should be proportionate with the matters in issue and have regard to materiality.

Origin submits that these principles need to be adhered to in relation to the 2009-10 BRCI decision. It notes that:

- regulators in all other jurisdictions who rely on a LRMC approach and/or a calculation of energy purchase costs to determine efficient retailer energy costs, have done so on the basis of using the load that is relevant to their determination as input into their various methodologies; and
- no other jurisdictional regulator in Australia has argued that a retailer's energy purchase costs for a retailer's customers should be calculated on the basis of supplying the total regional load, even when the regulatory framework includes consideration of the LRMC of supply to these customers.

In the NSW pricing determination for 2007-08 to 2010-11, the input into both the LRMC calculation and the Purchase Cost calculations was the regional network load relevant to the tariff customer base. ESCOSA has used a similar reference point for determining retailer's efficient costs as has the Victorian Government.

Origin has considered the arguments put forward by the QCA and its consultants for using a different "Load" for the calculation of the two elements of energy costs in 2008-09 in the Final Decision. In Origin's view, the decision by the QCA to use the total Queensland load as input into these calculations has not been and cannot be justified either on the basis of the regulatory requirements or on the basis of actual market costs for a retailer.

It is therefore essential that the issue of the relevant load that is to be used as input into the 2009-10 decision be fully considered in the 2009-10 consultation process.

Origin contends that the QCA should use the NEM Load as defined in the Act as input into the calculation of all of the cost components in the 2009-10 BRCI calculation, including energy costs.

### **3.3 Trend Estimates in the LRMC Calculation**

Origin considers that the QCA erred in using LRMC based on the trend approach. This matter is examined in more detail in Section 5.

## 4. Change in Retail Headroom

The objectives of the BRCI, as stated in the Delegation, are:

- that the annual indexation should ensure that the existing retail headroom in the tariffs at the date of the Delegation remain relatively stable; and
- the policy of enabling customer reversion to regulated tariffs should not result in the retail entity incurring a financial loss to supply these non-market customers.

Origin and many other stakeholders have continued to highlight within submissions to the BRCI consultation processes that the QCA needs to consider these objectives in reaching their conclusion on the annual BRCI calculation.

The 2008-09 Final Decision states that:

*'the QCA is unable to undertake an actual comparison between years; and as all sources of change have...been specifically addressed in this Final Decision, it considers that the headroom available as at the date of the Delegation will have been maintained'.<sup>5</sup>*

Origin believes that this conclusion is not correct and that our view can be demonstrated by a simple examination of the margin trends that have arisen over the first two years of the BRCI's operation.

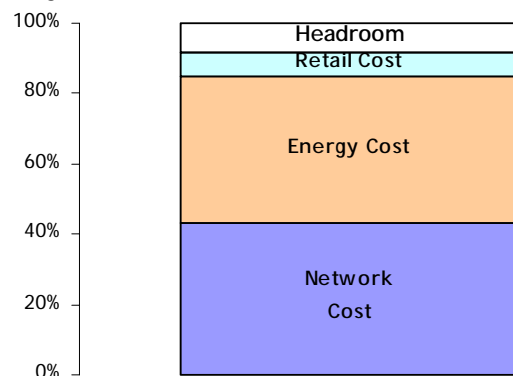
Origin contends that by 2009-10, the BRCI will have been subject to three QCA Decisions. It is essential that the intent of the Delegation is observed. The QCA and its consultants should forward alternatives for assessing this as part of the 2009-10 consultation process

In the following calculations, Origin examines the impact of the BRCI process for both 2007-08 and 2008-09 on the typical residential customers' headroom in the ENERGEX distribution area. This is performed using only information provided within the QCA's Final Decisions and the published regulated retail and network tariffs. It can be readily established without any reference to "actual" retail margins (which is the QCA's explanation for not investigating this matter), but by the application of simple logic.

Although the analysis is limited to residential customers on regulated tariffs (11, 31 and 33) on the ENERGEX network, it will apply to over 50 per cent of the total number of electricity customers in Queensland. This is also almost the entire competitive market that is practically addressed by the introduction of full retail contestability (FRC).

The constituents of the retail cost as provided in the BRCI process are shown in Figure 2. Headroom refers to what would be a retail margin in a situation with cost-reflective pricing. In the case of Queensland regulated tariffs, headroom can be positive or negative. In order to determine the deterioration of headroom for a residential customer, it is first a matter of considering what the change in retail revenue is for the customer from one year to the next based on the regulated tariffs.

Figure 2: Elements of Total Retail Cost

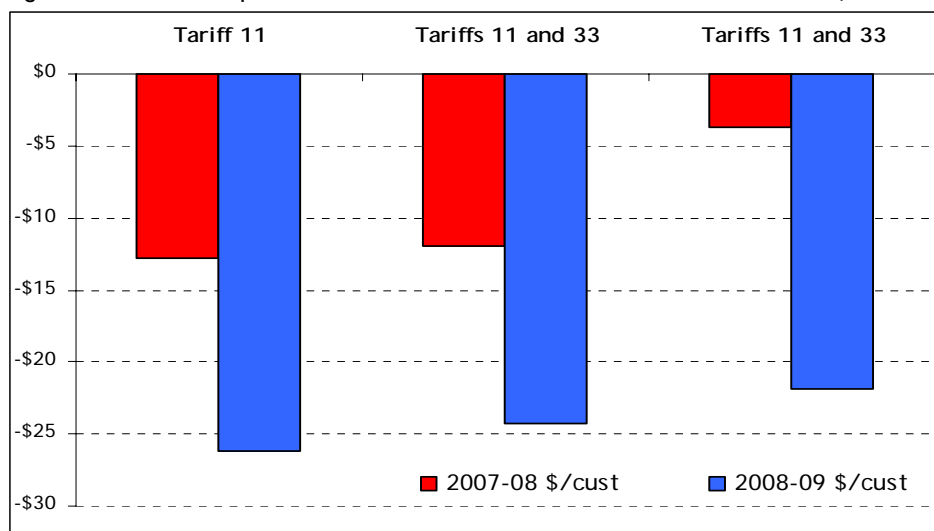


<sup>5</sup> QCA 2008, *Final Decision: Benchmark Retail Cost Index for Electricity: 2008-09*

Origin has then calculated the change in that customer's network charge between years using the QCA approved network charges. As the change in headroom is relative, the calculated change in retail cost and energy cost can be taken directly from the BRCI Final Decisions and applied to the analysis without any consideration of whether the total quantum of these elements is accurate. Similar to the BRCI process, it is only the change in costs that is important.

Origin has performed these calculations for a range of residential customers using various tariff combinations and the impact on headroom in both 2007-08 and 2008-09 is shown in figure 3.

**Figure 3: Annual Impact of BRCI on residential customers' headroom (\$/customer)**



Notes: These representative residential customers have average consumption of 8 MW.h per annum of T11 and 2 MW.h per annum of T31 or T33.

As shown above, the BRCI decision resulted in a deterioration in headroom in both 2007-08 and 2008-09, based only on the treatment of the network costs. In other words, the estimated cost of supplying electricity for each residential customer in the ENERGEX area was well above the BRCI escalation and subsequent retail tariff change. As a result, energy retailers are seeing a \$25-\$40 reduction in headroom over a two year period.

It is vital to note that:

- this analysis makes no representation regarding the state of the headroom prior to the BRCI process and whether it was positive for customers; and
- these calculations have used the change in elements as derived from the QCA's Final Decisions without alteration. This means that they include the perverse reductions in cost that result from the QCA's methodology as highlighted in section 3 of this submission. For example, figure 3 shows that headroom has reduced significantly in 2008-09 despite the BRCI process estimating a reduction in customer acquisition cost.

Furthermore, there are at least three major areas in the 2008-09 BRCI where the QCA's consultants put forward options for the QCA<sup>6</sup> and in each case the QCA decided on the lowest outcome. This approach of taking the lowest of all options builds up a cumulative deficit that compounds the affect of the individual decisions.

<sup>6</sup> These are discussed in detail in later sections of this Submission.

Origin firmly believes that where there is uncertainty in any component of the BRCI, not only should the QCA apply a rigorous test of each component against the objectives of the BRCI but assess the total outcome against the primary objectives of retail headroom. This is particularly important in the lead up to the third decision by the QCA.

To put this in context, Origin has tested the impact of using updated data in the BRCI calculations (see section 3 above). Figure 4 below uses the retail and energy costs for 2008-09 as estimated by the QCA but compared these with 2007-08 costs that would have been calculated if the QCA had not revised the input data.

Origin considers these a more accurate reflection of the change in retail and energy costs for 2008-09 and has also used these to calculate the headroom for 2008-09 (see figure 4).

**Figure 4: 2008-09 Reduction in headroom, QCA updates vs actual allowed.**

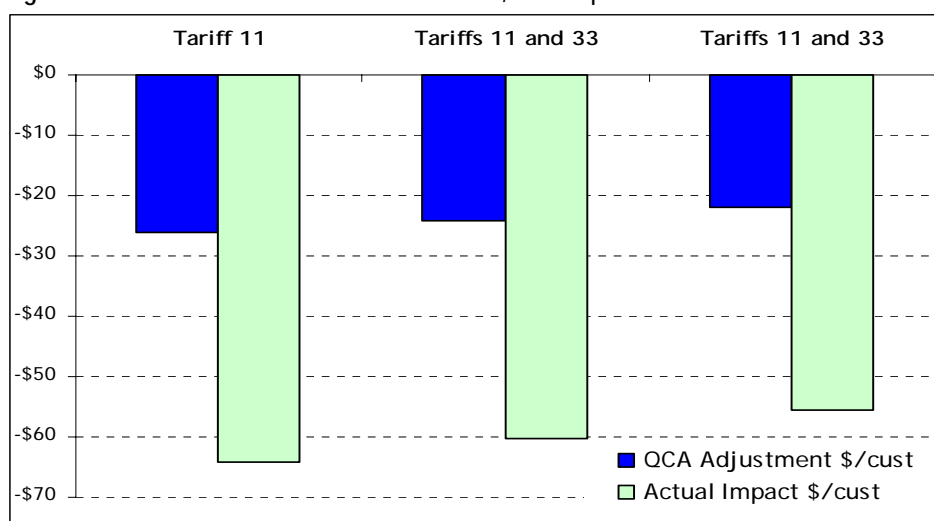


Figure 4 highlights the impact of just one of the decisions of the QCA made in 2008-09, ie the decision to use updated information for the base year. Instead of a \$26 negative impact on headroom as derived from the QCA's Final Decision, there has actually been a \$64 reduction in headroom relative to the "revenue allowed" as a result of the 2008-09 BRCI approach.

The actual deterioration in headroom faced by retailers in South East Queensland in 2008-09 is even greater as a result of the approach adopted (wrongly in Origin's view) by the QCA in relation to a number of other components of the decisions. For example, if the analysis is repeated but the impact of the NEM Load error (using data taken directly from the CRA report) is used then the result is a headroom reduction in 2008-09 in the order of \$90.

The examples above illustrate how the impact of a decision can be assessed in the context of the impact on overall retail margin.

Origin urges the QCA to consult with the industry to develop a methodology for 2009-10 to objectively assess whether the BRCI objective of relatively stable headroom is being met.

## 5. Cost of Energy

Origin believes the QCA's approach to estimating the costs of energy for 2008-09 did not adequately reflect the fundamental change in energy costs to a retailer and should be the subject of robust consultation for 2009-10.

Specifically, Origin's concerns were not with the methodology used by CRA, but with the options that were selected by the QCA in terms of the outputs and inputs to this methodology. In Origin's view, the QCA erred by:

- using a cost trend for estimating LRMC when a trend approach is only suitable if there is no fundamental step change (regardless of whether a step change represents an increase or decrease) over the period. Clearly, there has been a significant step change in capital costs for power plant over the past two years;
- using a flatter load profile, the total Queensland load, rather the NEM Load as defined in the legislation in determining energy purchase costs and LRMC;
- not utilising the latest cost information in deriving the 2008-09 estimates, for example, not updating the LRMC inputs for 2008 or assuming that there is no change to the renewable power percentage (RPP) for 2009; and
- reviewing the calculations from 2007-08, using the latest available data to seemingly minimise the change in the BRCI.

As discussed in section 3 above, Origin believes that for 2009-10, the QCA should use the NEM Load for all aspects of the cost of energy calculation and to cease updating any prior BRCI estimates for the base year for the next decision (2008-09) using the "latest information". Both of these factors have an impact on the Cost of Energy calculation without fundamentally changing the 2008-09 methodology.

Origin also strongly recommends that the QCA consider:

- a point to point approach for LRMC;
- the latest cost input estimates for LRMC which highlight the step change that has occurred in the last two years;
- making allowances for known information in forecasting the other energy costs for 2009-10 including forecasted changes to the MRET and GEC schemes; and even
- including a nominal forecast of the cost of the expected emissions trading scheme in the energy costs for 2009-10. Making an allowance for next financial year will smooth the future impact of the scheme and is a practice that the QCA has utilised many times with regard Energex's FRC cost pass-through application.

### 5.1 Long Run Marginal Cost (LRMC) of Energy

The QCA seeks stakeholder's 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.

CRA proposed a number of alternatives that could be used when calculating the LRMC component of the BRCI. There were four initial options for the conceptual framework. These are listed below, together with Origin's view on each of these items:

- whether the LRMC is calculated from a “Greenfield” perspective or on an incremental basis: Origin agrees with CRA’s conclusion that a Greenfield calculation is the most appropriate method given the purpose of the BRCI;
- whether to allow for load growth and possible load factor change. Origin agrees with CRA’s conclusion that an approach that allows for load and load factor change is more realistic and in keeping with the BRCI intent to measure changes in costs;
- whether the analysis will be undertaken on a deterministic or probabilistic basis. While the BRCI format is most consistent with a deterministic approach, Origin believes that this creates the potential for additive risks that should be recognised when reviewing other aspects of the BRCI such as retail margin; and
- multi-regional rather than isolated: Origin agrees with the selection of the multi-regional model. However, greater clarity on how, under the CEMOS model, this impacts on the purchase costs of the Queensland retailer (versus the costs to produce energy for the generators) as it implies that generators have opportunities to arbitrage their contract prices between states. It also raises questions on the appropriate input costs to be used in the model as discussed below.

Origin therefore generally supports the continuation in 2009-10 of the modelling options selected above for 2008-09 (subject to the issues raised above).

However, Origin cannot support the continuation of the model specifications used in 2008-09 for the 2009-10 BRCI.

A detailed explanation of our view is set out below. It relates to both the practical issues with using the QCA’s approach in a time of rapid change in input costs, and the requirements of the BRCI to identify cost changes in each tariff year.

CRA states in their Paper that once the modelling options are determined (as above), additional decisions have to be made regarding the specifications of the data to be used. CRA modelled two approaches and outlined a number of advantages and disadvantages with each one. The two approaches were the:

1. “Year-to-year” changes in electricity generation costs, in which the actual costs that would be incurred in building and operating an electricity system are optimised to meet a given load shape and its growth over the same period; and
2. “Trended” changes in electricity generation costs that is the measurement of trends over time in the capital, fuel and fixed and variable non-fuel cost rather than exact costs of any given year.

CRA’s modelling of “trended change” utilised a trend estimate of the capital costs in the future based on extrapolation of a 15 year historical trend in capital costs that was derived from a regression analysis and presented in the ACIL 2007 report to NEMMCO.

During a period of cost stability, the year-on-year approach and the trended approach are likely to produce broadly similar results. However, as recognised by CRA, the trend approach cannot reflect a step change in underlying capital, operating and fuel costs.

CRA provided LRMC estimates for both approaches, with markedly different results for the 2008-09 BRCI. The first approach resulted in LRMC cost changes of 13.68%, the second method resulted in LRMC changes of 1.5%.

The extreme differences between these two calculations should have been a strong indication to the QCA that their assumption that LRMC be based on long term trends was not appropriate for the 2008-09 calculation. Moreover, to conclude that LRMC were increasing by less than half the inflation rate must raise fundamental questions about the trend approach.

Indeed, Origin and other stakeholders provided sufficient evidence, including evidence from experts in the field, during the 2008-09 BRCI process to demonstrate with a high level of confidence that there has been a recent and significant capital cost increase in power plants.

The QCA, however, did not appear to take these matters into account. Nor did it address the limitations with the trend model raised by CRA itself or consider how this might impact on the objective of assessing changes in retail purchase costs. CRA sensibly states that the trend approach will lag and dampen any "consistent" changes in the costs and "*in the near term essentially miss the impact that rising iron and steel prices are having globally at present on power plant costs*".

The QCA's principal rationale for selecting the trend analysis approach in the face of all the evidence of a step-change in input costs is summarised in the following statement<sup>7</sup>:

*'... the Authority also considers that, where possible, short-term energy-cost influences should be restricted to the purchase cost calculation and that long-run aspects should drive the LRMC calculations.'*

The underlying assumption behind this justification is that the recent jump in generation input costs are "short-term" factors and as such are largely irrelevant to the LRMC. The basis for this assumption, which is contrary to the views of most experts in the area, is not explained and Origin would argue that a fundamental change has occurred in capital costs over the past two years which has broken the long term trend - hence a simple trend analysis is no longer valid.

The intent of the estimation of the short-term energy costs is to account for wholesale price volatility due to stochastic events, such as drought, very hot summers and plant outages etc. This is quite distinct from the shift changes in underlying costs identified in the LRMC outlook.

Origin therefore questions the usefulness of the trend approach for estimating capital costs in the current economic situation. In addition, the regulatory framework would suggest that the most appropriate approach is to build up costs applicable to each tariff year. This is closer conceptually to the year-on-year analysis of the LRMC.

Furthermore, Origin notes that the trend analysis presented by CRA and used by the QCA was not even updated with available 2007 and 2008 cost observations which means it will further under-estimate the actual capital costs.

The use of the Reserve Bank mid-point target rate of 2.5% inflation across the whole period forecast under the CEMOS modelling similarly failed to capture current inflation data. Origin contrasts CRA's eight year forecast based on 2.5% inflation throughout the period with other recent regulatory decisions covering 5 year forecast periods. In these latter decisions, the early years of the projection included realistic figures based on shorter term forecasts (such as the RBA's *Statement of on Monetary Policy*.<sup>8</sup>)

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<sup>7</sup> Final Decision, page 23.

<sup>8</sup> CRA used this forecast in the year-on-year analysis. There is no reason why it should not apply to the first years of the "Trend" analysis given it is a deterministic model.

### Other Inputs Costs to the LRMC Calculation

In addition to our concerns with the trend approach adopted by the QCA to assessment of the capital costs in the LRMC calculation, **Origin seeks a detailed review for the 2009-10 Decision of a number of the input assumptions used in the calculation. Origin urges the QCA to utilise independent consultants with the specialised knowledge to address these matters.**

One general area of concern is that while CRA used a multi-state model, it appears to have relied solely on existing Queensland contracts for determining the fuel costs, such as the cost of coal, for input into the model.

A number of specific issues with the 2008-09 approach that Origin would like to see addressed in 2009-10 are identified below:

#### *The cost of coal*

The CRA trend model assumes minimal change in the cost of coal for generation. This assumption is made despite the clear evidence of significant increases in the market cost of coal (including from ACIL Tasman) that go beyond the immediate impact of drought and floods on Queensland coal mines. The Queensland budget, for instance from June 2008 contains quite buoyant assumptions about the future cost of coal, as reflected in the Government's explanation for the change in royalties on coal.

Origin does not accept the justifications provided in the Final Decision which appear to rely solely on assumptions that the cost of coal for generation is disconnected from the export market costs; and that fuel procurement personnel in Queensland government owned companies stated that new coal contracts showed virtually no price increases.

**This is not the appropriate and comprehensive data source that is required for a multi-year, multi-regional model and a proper examination of this matter is requested for the 2009-10 process.**

Furthermore, the LRMC is a theoretical concept and in this instance, the methodology is based on "Greenfield" sites. The relevance of existing contracts for this type of calculation is questionable.<sup>9</sup>

#### *The cost of gas*

In the trend analysis, CRA used the trends in the Victorian gas spot market for the period 2002-03 to 2006-07, then used the ACIL report to pro-rate this trend for the other NEM states.

Origin again challenges the relevance of this calculation for the LRMC, given the changes to the gas market over the last year and the likely changes in the future.

CRA also appear to have selectively used other data that ACIL Tasman has updated between the 2007 and 2008 reports. For instance, while they have rejected ACIL Tasman's revised uplift factor for OCGT plant (from 125% to 148%, they accepted ACIL Tasman's change in the availability of OCGT plant (from 75% to 97%).

**In summary, Origin believes the use of a simplified trend-analysis approach for the LRMC calculation in the BRCI is not adequate in a period of step change in capital costs.**

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<sup>9</sup>Inclusion of this type of data may be relevant for a LRMC based on incremental costs, but this is not the case in the model chosen for the BRCI.

However, even if QCA were to adopt a year-on-year approach for the 2009-10 BRCI, it is likely to miss the large changes that occurred between 2006 and 2008. Potentially, the previous under-estimation of costs will not be corrected.

Any new LRMC methodology will need to allow for correction of the previous LRMC which calculated a rate of change between 2007-08 and 2008-09 of 1.5%, a figure well below the actual step changes that have occurred.

In addition, Origin sees many problems with the analysis of the various input costs, such as fuel prices, inflation and WACC. These must be revisited whatever model of LRMC is used.

## 5.2 Energy Purchase Costs

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

Origin supports the QCA taking short term contract market realities into account as these drive actual purchase costs over time. As Origin has noted previously, the purchase cost methodology is designed to capture stochastic events that influence the cost of hedging/risk management contracts that the theoretical retailer will have to acquire.

The energy purchase cost component brings a touch of reality to the theoretical analysis that underpins the LRMC calculation as it notionally represents the type of costs that retailers will actually face (although it does not claim to replicate a retailer's actual hedging strategy).

Naturally, as the energy purchase cost represents the more short-term market element for calculating the cost of energy, there should be a change in the purchase cost between 2008-09 and 2009-10.

Origin generally supports the approach adopted by CRA to calculating the energy purchase cost, although details of the model are not clear and we would seek further explanation of this.

Subject to this, Origin is comfortable with this type of approach continuing into 2009-10.

It is important to reiterate at this point that the purchase costs are NOT the actual contract or spot costs at any one time, as seems to be the perception in some of the commentary on the previous BRCI.

They represent the costs of the theoretical retailer purchasing contracts to cover their load in the future by buying 1/24 of the contracts each month over a 24 month period prior to the relevant tariff year. Thus, even the purchase cost will not represent the most current market price, but a smoothed price reflecting the forward market perceptions for the tariff year over the previous 24 months.

However, there are a number of aspects of the 2008-09 calculation of Energy Purchase Costs that in Origin's view need to be re-considered in 2009-10.

These matters have been raised in previous sections of this submission. They include QCA's decision in 2008-09 to:

- use the total Queensland load rather than NEM Load; and

- re-calculate the prior year's BRCI estimates (using actual data to replace previously available estimates).

With respect to the first of these points, Origin reiterates that the theoretical retailer that makes up the BRCI will not have direct connection customers in its portfolio, or if it does, would supply the customers on quite a different contractual basis; there is little if any synergy between the two portfolios.

#### The Impact of the Early Determination Requirements for 2009-10

The requirement to have tariffs for 2009-10 gazetted by 1 December 2008 means that there is increased forecast uncertainty. This factor alone could undermine the integrity of the BRCI in 2009-10.

Even under the timing schedules of the 2008-09 BRCI process, the forecast of forward contract prices for 2008-09 for the last few months of the 2007-08 year was controversial. The QCA is now being asked to forecast forward contract prices for 2009-10 for a period of 8-9 months.

**Origin urges the QCA to carefully consider the approach to forecasting forward contract prices that will be most applicable to the 2009-10 determination.**

Origin believes that the previous approach was a source of error in both 2007-08 and 2008-09 BRCI. Using the same methodology to derive forward contract prices for each month through to June 2009 is not acceptable as the last known forward contract price for 2009-10 will be September or October 2008.

These difficulties will be compounded by the unknown impact on forward contract prices in the lead up to an Australian Emissions Trading Scheme (AETS).

### 5.3 Other Energy Costs

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

#### Mandatory Renewable Energy Target scheme (RECS)

In the previous BRCI calculation, Origin understands that CRA calculated the price of RECS based on the "average of AFMA prices for RECS for 2008 and 2009".

This methodology is only reasonable if there is no step-change occurring in the REC market prices. However, this is not the case. Origin identified in its response to the 2008-09 Draft Decision that there had been a step change in the REC market price following Prime Minister Rudd's announcement in October 2007 of the expanded MRET scheme to 2020.

These higher prices have continued. However, Origin's recommendations were not accepted by the QCA resulting in a lower average price for 2008-09. It is important that the new calculations of RECS for 2009-10 are compared to the average prices set in the Final Decision and not re-calculated

A more significant difficulty arises because of the requirement for a Final Decision by 1 December 2008. As discussed with regard to energy purchase costs, this creates considerable difficulties for any process that relies on forward prices.

Origin urges the QCA to ensure that there is opportunity for industry discussion and careful review of the methodology used to forecast the 2009-10 RECS prices.

A similar difficulty will arise in estimating the Renewable Power Percentage (RPP). It is unlikely that the RPP trajectory will be available for the QCA by the time it needs to make its Final Decision for 2009-10. As CRA notes, the RPP for 2009 is unlikely to be published before March 2009 and the 2010 RPP will be contingent on the MRET trajectory.

Origin considers that the expected change in the RPP must be factored into the 2009-10 BRCI in some form, as while the quantum is uncertain, the implementation of an expanded Scheme is not.

Again we highlight that under the BRCI year- on- year approach, if CRA ignores what will be very real costs for retailers in 2009, these are not likely to be recovered in subsequent years.

#### Gas Electricity Certificates:

Origin was pleased the QCA adopted the position of using the penalty prices as the penalty price for the Queensland Gas Electricity Certificates (GEC) in the 2008-09 BRCI but notes their recommendation to move to market prices for GECs in future years.

The approach to calculation of GEC's prices for 2009-10 is problematic given the potential impact of the AETS on GEC prices prior to its implementation, and of the Queensland Government's response to the AETS. Origin believes this issue may become clearer over the next few months and so reserves its judgement until later this year. We encourage the QCA to adopt similar caution.

**The QCA seeks stakeholder's views on whether there are any other issues the QCA should consider in estimating the cost of energy.**

The QCA is cognisant of the future impact of the AETS on regulated energy prices. Origin is similarly aware of the projected impact and expects there to be some impact even prior to the implementation of the AETS.

**Origin therefore proposes that the QCA include a nominal forecast of the cost of the scheme within the energy costs estimates for the 2009-10 BRCI.**

Making an allowance within the next financial year will obviously smooth the future impact of the scheme and if the QCA follows the BRCI process correctly, will be self-correcting and not the detriment of any participant.

Origin notes that this is a practice that the QCA has utilised many times with regard their decision on Energex's FRC cost pass-through allowance.

If the QCA does not choose to include an estimate for AETS then it increases the risk of actually preventing competition in 2009-10 and then requiring a very large increase in regulated tariffs in the following year.

## 6. Networks Cost

Origin recognises that with the process timeframe brought forward to December 2008, the estimation of the transmission cost component to be included in the network cost calculation for the 2009-10 BRCI is difficult.

However, Origin believes that there are other issues that are unresolved from the 2008-09 approach that the QCA also needs to reconcile as part of the 2009-10 process. They are:

- the method used to include Energex's additional capital expenditure in the BRCI process; and
- updating elements of the previous year's network costs calculation (eg. transmission cost for 2007-08) with the effect of reducing the self-correction mechanisms of the BRCI and therefore, the full pass through of changes in costs over time.

These matters are discussed below.

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

Origin recommends that the QCA produce a transparent forecast methodology for transmission costs in 2009-10 for consultation with stakeholders.

This may be simply pro-rata of Powerlink's 2009-10 revenue cap based on the percentage share accounted for by Energex and Ergon in 2008-09.

The central criteria for selecting a methodology are that:

- it is robust and transparent so all stakeholders are aware of the methodology;
- the calculation is not re-valued in the future; and
- the change in network cost for 2009-10 is compared against the QCA's network costs in 2008-09 without revaluation.

Following this procedure reduces the significance of any forecast error as the BRCI methodology will effectively readdress any forecast errors in the following year.

Origin has clearly demonstrated the limitations of updating the previous years' BRCI estimates with actual data in section 3.1 and established that the results of such an approach are contrary to the legislative framework and violate the policy intent of the BRCI.

The QCA seeks stakeholder's views on whether there are any other issues the QCA should consider in estimating network costs.

As highlighted above, there are issues with regard to network costs that the QCA has not sufficiently addressed.

### Update of previous network costs in BRCI calculation

Origin highlighted in its submissions to the 2008-09 BRCI process that the QCA had mistakenly recalculated the transmission network costs for 2007-08. This issue is of

particular importance to address in 2009-10 because of the need to forecast so far in advance of the relevant information.

The QCA responded to Origin's concerns as follows:

*'as the Authority has changed the method of calculating the BRCI for 2008-09, it is required to recalculate the BRCI for 2007-08 using the same method.'*

Origin believes this reasoning is flawed as the requirement to recalculate requires a change in the framework, which is not the case with respect to network costs. The 2009-10 process should not repeat this approach.

The method used by the QCA in this instance, is simply to forecast the Powerlink cost for the future financial year. That process should result in QCA retaining the TUOS network cost estimate of \$412.2 million rather than updating this value to the actual incurred cost of \$417.1 million.

Moreover, even if the network costs were to be recalculated for the previous year due to a change in methodology, that **does not mean** that the recalculation for the new base year should be done on the basis of perfect foresight. The new methodology should still apply the data as it was known at the time the previous forecast was made. If the forecast is updated to actual for the base year, the BRCI will never self-correct.

The QCA acknowledged that its unnecessary adjustment will cause the BRCI to be lower than it otherwise would have been as it reduces the change in the network costs between the two years (but not because of the new methodology). Under the BRCI, this negative impact will be carried forward into future years as the BRCI only looks at changes in costs year-on-year.

As stated previously in section 4, the QCA is therefore choosing to reduce the appropriate BRCI and consequently, retail headroom. Origin reiterates this issue because the 2009-10 BRCI process will be based on additional forecasting and if the QCA repeats the approach it took to revisiting the costs in the 2008-09 Decision, then the BRCI cannot work as intended.

#### Energex's additional capital expenditure

Origin has previously questioned the method used by the QCA to incorporate the additional network costs arising from the pass through of Energex's additional capital expenditure<sup>10</sup>.

Origin's query has revolved around the fact that the revenue smoothing adjustment used by the QCA was calculated incorporating adjustments for prior DUOS over-recoveries. This problem was compounded by then removing the whole of the over-recovery amount in the one year 2007-08, which then distorted the change in the BRCI between 2007-08 and 2008-09.

The QCA responded in their Final Decision that they had reviewed the matter and did not believe this was the case.

Origin requests that the QCA provide a reconciliation of the inclusion of the Energex additional capital expenditure within the 2009-10 BRCI process. Origin is not able to easily determine the methodology used by the QCA including the estimate that will be used for 2009-10.

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<sup>10</sup> QCA (2007) *ENERGEX Application for Capital Expenditure Cost Pass-through: Final Decision*

It would aid transparency if the QCA could demonstrate that the method used for smoothing the additional network revenue over the years of 2007-08, 2008-09 and for 2009-10 provides the required impact on the BRCI to account for the additional network costs.

**It is essential that the network costs allowed to retailers over the three years to 2009-10 fairly and demonstrably compensate the retailers for the total additional revenue allowed to Energex.**

To date, only \$36.3M additional Energex revenue has been accounted for in the BRCI process (compared to a total of \$108.8M allowed to Energex up to 2009-10).

## 7. Retail Cost and Margin

Origin has previously supported the QCA's use of retail cost benchmarks and their subsequent approach of escalating annual retail cost using well known indices as an appropriate method for setting the operating cost component of the BRCI.

However, Origin believes the QCA cannot simply replicate its methodology in 2009-10 for retail costs and margins from the 2008-09 BRCI process. This is because the QCA:

- has not addressed stakeholders submissions regarding the impact of the increasing costs of capital on the retail cost of supplying electricity. This significant issue must be addressed through either:
  - a change in operating cost; or
  - a commensurate increase in the retail margin;
- did not consult stakeholders on the final method used to estimate customer acquisition costs prior to the Final Decision; and
- re-calculated the customer acquisition costs for 2007-08 during the 2008-09 process. As shown in this submission, this is contrary to the intent of the process and Origin requires assurance on the QCA's future treatment of this issue before any methodology can be supported.

The QCA seeks stakeholder's 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 Act (s. 94) and supporting Regulations (ss. 109-110) require the QCA to consider retail cost based on an efficient entity with a significant market share and providing retail services to a cross-section of customers while earning a "reasonable" margin. Section 110 of the Regulations set out cost categories that must be considered by the QCA.

The QCA adopted a new approach to the calculation of retail costs in the 2008-09 decision, based on two factors:

- an underlying retail operating cost; and
- a cost associated with customer acquisition, sufficient to replace losses and therefore retain existing economies of scale.

**Origin believes this approach is reasonable but disagrees with the specific way in which it was applied by the QCA in the 2008-09 Decision.**

There must also be a clear understanding of the relationship between retail costs and retail margin in the chosen methodology. Costs that are not allowed for in retail margin, for instance, may need to be captured in retail costs and vice versa. This clear understanding is particularly important when costs are determined by benchmarking against decisions made in other jurisdictions. These matters are further considered in the discussion below.

Origin has previously argued that the allowed retail operating cost is too low. We continue to hold that view, particularly as there are costs that are relevant in the Queensland BRCI that are not relevant to pricing determinations in other jurisdictions. For instance, the relevant customer base identified in s. 109 of the

Regulations includes large customers who have substantially higher costs to serve and to acquire than mass market customers in general.

However, Origin also acknowledges that the total cost is not as important in the BRCI context as the change in costs.

Considering changes in retail operating costs, CRA recommended using the Labour Cost Index to adjust the labour component of retail operating costs and the most recent CPI calculations to adjust the non-labour components. Origin believes this is a reasonable approach to the initial consideration of changes in retail operating costs for 2009-10.

**There are, however, a number of additional items that should be considered by the QCA in assessing changes in retail operating costs between 2008-09 and 2009-10.**

They include:

- changes to the regulatory obligations on retailers. For instance, over the last year, retailers in Queensland have been required to implement a number of new government initiatives such as the solar Feed-in Tariff Scheme and the Home Energy Assistance Scheme. Establishing and operating these schemes has been a significant new cost burden;
- costs associated with increased manual processing and changes to systems arising from the need to accommodate changes in service standards in other parts of the industry; and
- changes to working capital costs associated with recent economic developments.

Origin first raised this matter in its response to the Draft Decision for 2008-09. However, it was not considered by the QCA in its Final Decision.

**Origin now requests the QCA now include an assessment of this the change in the cost of funds in the 2009-10 BRCI.**

Origin considers this increased costs can be included as part of the assessment of retail operating costs and/or, separately, as part of the assessment of retail margin as follows:

- retail operating costs should include the cost of working capital reflecting the fact that retailers must pay their various counterparties on a weekly (NEMMCo) or monthly (distributors) basis. Retailers, however, receive payments from customers largely on a quarterly cycle. Increases in the cost of working capital must be recognised as an additional expense to retailers (in retail costs or retail margin); and
- it is assumed that the relevant retailer for the purposes of the BRCI calculation is a non-Government entity and therefore requiring a market based rate of return to its owners for its investment, and to refund the costs of borrowing to acquire its customer base. Changes in the cost of funds must be recognised as part of a retailer's changing cost base.

With respect to both these matters, the QCA should note that the jurisdictions that they have benchmarked against each made their determinations in a much more stable economic environment. More recent regulatory decisions (by the AER for instance), have moved up significantly in recognition of the increase in the cost of funds.

The evidence of the increase in cost of funds is readily available to the QCA from the increase in interest rates in Australia reflecting a general increase in inflation

in the Australian economy to the 'sub-prime' crisis in America which has significantly reduced liquidity and increased the 'margin' at which lenders will lend funds to borrowers.

Growth in the real inflation rate and subsequently, in interest rates is well known and the recent liquidity issues are more than apparent in the economy in general. The theoretical retailer will have to compete for funds in this difficult market.

If these changes are not recognised appropriately, the BRCI will not enable an appropriate return for the capital that is invested in the retail business including working capital and provision for bad debts.

Origin proposes that the QCA conduct a proper investigation of the change in the cost of funds and the impact of this on the change in retailer costs under the BRCI for 2009-10<sup>11</sup>.

The QCA could incorporate this cost increase in retail operating cost by exploring the inclusion of the cost of capital in their indices used for escalating the retail operating cost, particularly with respect to working capital costs.

The retail margin is also affected by the changes to the cost of funds because both equity and debt providers require a greater return in such an environment (as highlighted previously). In addition, the retail margin needs to be reviewed in 2009-10 to accurately reflect the change in risk profiles of the retail businesses.

The BRCI requires an appropriate retail margin to cover the retailer for its risk-weighted investment. However, the benchmark net margin of five per cent of sales was assumed given the increased risks surrounding energy purchasing and customer acquisition were fully taken into account in other elements of the BRCI.

This assumption ignores the very real differences between the approaches taken by the QCA in calculating the BRCI components and the approaches taken by other jurisdictions who have allowed a similar margin on sales. For instance:

- the NEM load "L" is not representative of the customers actually covered by the regulated retail price as it includes many larger customers over 100 MWh who are on market contracts;
- no other jurisdiction includes customers above the mass market consumption level in their regulated pricing, nor makes regulated pricing available to new customers over the mass market consumption limit - these customers pose different risks from an energy purchase perspective;
- the energy cost calculations are based on single-point estimates, where other jurisdictions rely on simulations - single point estimates typically result in underestimation of the retailer's risks; and
- other jurisdictions treat the network costs as a pass through cost. That is, the unit rates for network are simply added to the retail price components, thereby eliminating the risks of incorrect forecasts of network costs.

The 2009-10 Decision will add a new and significant risk to the Decision process. Because the Decision is being made early, there will be significant increases in forecast risk on all cost components. This has a major impact on rate of return requirements.

Origin believes the assumption of a constant margin no longer applies and there needs to be a change in the retail margin of a retailer investing in the Queensland market to reflect the regulatory, price and investment risks that

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<sup>11</sup> This is not a change in methodology and therefore there is no need to recalculate the 2008-09 base even if it was not part of the calculation for that year. To

have become apparent. The risks around the early Decision for 2009-10 should also be explicitly recognised in the allowed margin.

With regard the QCA's final method for customer acquisition cost as presented in the Final Decision, Origin would like further information on how the cost of a transfer to a market contract was calculated and what reasoning was used to determine that this was an appropriate method.

Irrespective of this insight, Origin and other stakeholders' opinions on both the customer acquisition cost methodology and expectations regarding the level of customer churn in 2009-10 are essentially redundant. That is because of the QCA's current process of re-estimating the previous years cost component using new information as demonstrated in section 3.

Origin encourages the QCA to examine ways in which the actual cost of customer acquisitions could be taken into account and passed through to energy retailers during the 2009-10 BRCI.

One option may be that in calculating this year's BRCI, the QCA compare their 2009-10 customer acquisition cost estimate with the customer acquisition costs that was actually provided for retailers through the 2008-09 process. That is, rather than the estimate from their Final Decision which has no relevance to participants, the QCA could derive the actual acquisition cost that was passed through in last year's BRCI. Put simply, the QCA estimated a customer acquisition cost of \$51 million to retailers but actually only provided for less than \$2 millions within the calculation of the BRCI.

## 8. Queensland Load

The QCA seeks stakeholder's views on how the NEM Load for 2008 might best be estimated.

All cost components that will require additional forecasting in this 2009-10 BRCI process because of the earlier timetable (December 2008) will face additional scope for forecast error. Origin recommends that the QCA follow good regulatory practice and:

- produce a robust forecast methodology for estimating the NEM Load;
- conduct a transparent consultation so all stakeholders are aware of the methodology;
- ensure that the final NEM Load calculation is not changed in the future; and
- the NEM Load for 2008-09 in the BRCI calculation is as per the QCA's previous decision without revaluation.

The significance of any forecast error is then removed as the BRCI methodology will effectively address any forecast errors in the following year.

The QCA also seeks stakeholder's views on whether there are any other issues the QAC should consider in estimating Queensland load.

Origin has explained in detail in section 3.2 why the QCA must utilise the NEM Load for calculation of all energy costs if it is to comply with the legislation governing the BRCI.

## 9. Total BRCI

The QCA seeks stakeholder's views on whether there is any need to change the method for calculating the BRCI for 2009-10 from that used in 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 QCA seeks stakeholder's views on which of these should be given the highest priority.

This submission explains why the QCA must make changes to the way they have been calculating the BRCI. Origin understand that the QCA is reluctant to make changes to its method for 2009-10 given the time constraints, however, Origin believes that the QCA cannot contravene the legislation governing the BRCI process and therefore must not:

- update the 2008-09 BRCI estimates using actual data or updated information when estimating the 2009-10 BRCI; or
- ignore the definition of the NEM Load when calculating the LRMC and the energy purchase cost for next year.

Origin believes that the QCA should also reconsider the use of the trend approach for LRMC. As discussed in section 5, the QCA approach for calculating LRMC has ignored all evidence of a step change in capital costs. As a minimum measure, the QCA must update their trend analysis to incorporate the significant increase in input costs over the last two years. The QCA has already been provided much of the necessary data by ACIL Tasman<sup>12</sup>.

Furthermore, the QCA view of the total BRCI must take into account the objectives of the Delegation and consider the impact the BRCI is having on retail headroom. As shown in section 4, the BRCI has resulted in a significant reduction in retail headroom for both 2007-08 and 2008-09.

When calculating the individual cost components of the BRCI, there are always several possible outcomes that meet the requirements of the legislation that governs the process but in all cases in 2008-09, the QCA consistently opted for the lowest outcome. The approach of taking the lowest of all options has the cumulative effect of driving headroom lower. Origin advises the QCA to consider the impact of the total BRCI calculation on headroom when selecting from the various cost estimates that are produced.

Declining headroom can be expected over time to have a significant negative impact on competition.

To date, retailers have invested significant up-front costs in establishing capability to compete in the Queensland energy market and seek recovery of these sunk costs by competing for customers even as margins decline. However, there are indications from retailers that they are reviewing their position in Queensland and the next decision is critical to these outcomes if the trend to margin erosion continues.

An early signal of the decline in headroom is the number of new large customers not entering market contracts but opting for a regulated tariff.

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<sup>12</sup> ACIL Tasman 2008, Submission to BRCI 2008-09