origin

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Mr Gary Henry
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By email

Dear Mr Henry

Benchmark Retail Cost Index 2009-10

Origin Energy (Origin) welcomes the extension of the deadline for completing the 2009-10 Benchmark Retail Cost Index (BRCI) process as recently provided to the Queensland Competition Authority (QCA) by the Minister for Mines and Energy. It is a logical approach to accommodate the issues noted in the new Certificate of Delegation (Delegation) provided by the Minister.

Given this development, the QCA has provided further opportunity for consultation and Origin subsequently makes this submission in response. Please note that rather than restate Origin's previous positions, this submission is confined to the two specific issues noted in the new Delegation as the QCA has specified that all issues raised in prior submissions are to be considered.

First, with regard to the proceedings in the Supreme Court of Queensland, Origin believes that it is essential that any findings of the Court regarding the BRCI methodology are effectively taken into account in the 2009-10 process.

To make a Final Decision without taken guidance from the prospective declarations of the Court would be imprudent and this extension of time will provide the QCA the opportunity to have regard to any relevant findings made by the Court.

Secondly, the Minister's new Delegation has provided the opportunity for the most up-to-date data to be used in the calculation of the 2009-10 BRCI with the timetable for the Final Decision now mirroring that of 2008-09.

Origin had issue with the reliability of data early in the 2009-10 BRCI process but the QCA has subsequently:

- provided participants with the necessary load data as well as pool and contract price forecasts to enable stakeholders to verify the veracity of the data; and
- obtained additional expert advice on input and capital costs that have been used in CRA's modelling of long run marginal cost (LRMC).

This has provided comfort to Origin on the current state of the BRCI modelling, after much iteration, and although Origin encourages the incorporation of significant changes in data, it cautions the QCA on extensive recalculation. Origin has highlighted the elements of the BRCI that may need to be updated below.

Origin accepts that these comments may be superseded by the findings of the Court which could require further extensive reworking of the QCA's methodology.

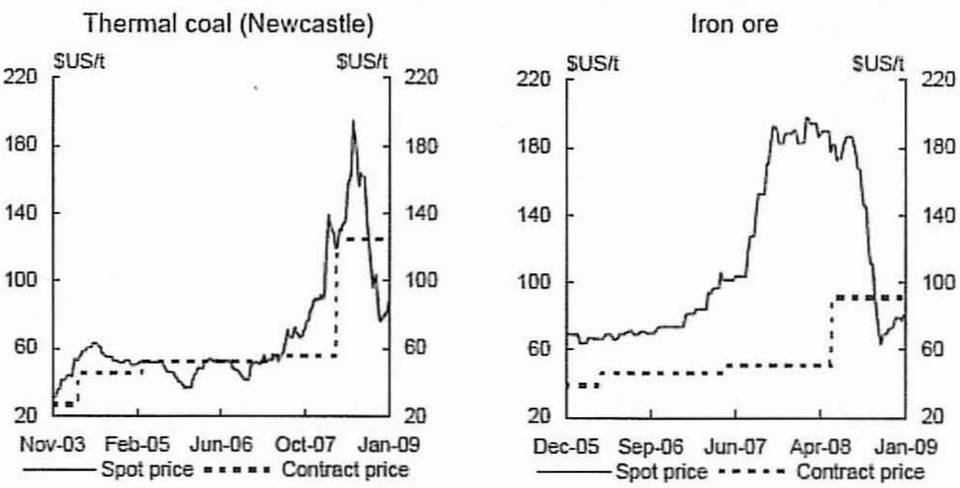
Long Run Marginal Cost (LRMC)

The LRMC calculation is predominantly based on forecasts of load, capital and input costs for generation and the expectations on Government policies. Origin's views on the relevance of any data updates to these variables is such:

1. The load data is based on the calendar year 2008 so no additional data is required (subject to the declaration of the Court);

2. Similarly, the data on input and generation costs provided to the QCA by ACIL Tasman in their August 2008 report, *Fuel and Capital Costs in the NEM*, remains current and appropriate.

   Origin would note that while there have been significant reductions reported in spot prices for various input costs, the relevant factors are the contract prices including longer term contracts that were written in higher cost periods. The chart below demonstrates this effect.



Source: The February 2009 *Updated Economic and Fiscal Outlook, p30*

The QCA proposed in the 2008-09 BRCI process that a longer term view of cost trends should be used, and for this reason, the significant acceleration in input costs in the period from 2006 to 2008 was not a major factor in the BRCI cost of energy calculations. The corollary of this argument is that where market prices decline in response to relatively short term perturbations, they too should be seen in the context of the trend (including any underlying step changes in the trend as identified in previous submissions).

Further to this, Origin notes that ACIL Tasman (ACIL) released a draft report on 13 February 2009, *Fuel resource, new entry and Generation costs in the NEM*, as prepared for the Inter-Regional Planning Committee which would provide the latest estimates if the QCA intends to, or is required to, recalculate the LRMC.

Origin has reviewed the draft report and would highlight that some of the major capital costs such as the cost of CCGT have changed to some degree. For example, in the draft decision CRA International (CRA) used a CCGT cost of $1214 per KW. The latest ACIL report has specified an increase in the 2009-10 CCGT cost to $1314 a KW.

Many other costs may also need to be considered such as the weighted average cost of capital (WACC) which remains at around 6.8 per cent in ACIL's latest report. In fact ACIL 2009 highlights that:

> *"While this WACC may be considered to be low in the context of the current global financial crisis - particularly the debt basis point premium - ACIL Tasman consider these settings to be appropriate in the longer-term which is the focus of this study and most market modelling exercises."*

In terms of modelling longer term investment decisions using a 6.8 per cent WACC is therefore a minimum requirement as it is certainly not reasonable to reduce this WACC by reference to the recent reductions in the Reserve Bank interest rates. As all commercial entities understand, the current lower Reserve Bank rates are below longer Reserve Bank rates, are temporary and not related to the interest rates facing investment projects.

3. Amendments to Government schemes such the Mandatory Renewable Energy Target (MRET) and the Carbon Pollution Reduction Scheme (CPRS) have been confirmed and need to be taken into account as submitted by Origin previously.

On a final note, Origin previously questioned why the QCA would continue with the use of a regression trend to incorporate changes in capital and fuel costs in the LRMC modelling rather than including the actual costs as year on year changes. The QCA raised concerns regarding the existence of a step-change but does raise the option of shortening the time series in the trend analysis.

Origin's position remains that there has been a partial step-change in underlying costs and this component should be included directly rather than smoothed as a trended regression. However, as the QCA continues to utilise the trend analysis then it should be based on a shorter period.

Origin does require that whatever methodology is used by the QCA in its final decision for the 2009-10 BRCI remains the methodology to be retained in future BRCI processes.

Energy Purchase Cost

For 2009-10, Origin has generally supported the approach adopted by CRA in calculating the energy purchase cost, subject to the issue of the relevant load shape to be used in the calculation.

With regard to the energy purchase cost, Origin expects the QCA to use any additional pool price data since that provided in February but does not expected significant changes. The additional pool price data will reduce the requirement to forecast prices out to June 2009. It is important that this forecast be undertaken on a transparent basis and Origin requests the QCA make this forecast, and principles behind it, clear in the release of the price and demand data set in April 2009.

As highlighted earlier, Origin is more comfortable with the energy purchase costs modelling after being provided with the necessary load and pool and contract price input data to replicate CRA's methodology during the 2009-10 process. Origin will review the latest set of price and demand data upon its release during April 2009.

Other Energy Costs

As stated previously, the Federal Government has confirmed that 12,500 GWh will be the MRET Target for 2010. Origin requests that the expanded MRET target be used in the Final Decision.

Retail Costs

Retail costs, customer acquisition costs and retail margin have been calculated based on benchmarks, the consumer price index (CPI), labour rates and forecasting of customer churn.

Origin would expect the QCA to review CPI and labour rates but expects little change from the draft decision.

The extension of time does provide the QCA with the opportunity to use NEMMCO's customer transfer data up to the end of Match 2009 in making their forecast for 2009-10. This is a welcome development as it provides actual data for 9 months of the financial year as used in the 2008-09 process.

With regard to retail margin, Origin has noted above that bank interest rates have declined but would point to:

- the recognition of the increased spread between interest rates and the cost of capital facing businesses due to the debt premium; and
- the higher rates of return and cost of capital required by retail businesses compared to monopoly assets given their credit rating at B or B+;

in requiring the benchmarked retail margin being increased in any review of current data.

Origin notes that Australian Energy Regulator (AER) in its recent draft determination on the WACC for network businesses has proposed a nominal value of 8.60 per cent. This number has been the subject of considerable controversy in terms of whether it is commercially realistic in the face of the current credit crisis and the prevailing debt basis point premiums.

If you wish to discuss these matters further, please contact Patrick Whish-Wilson on (07) 3867 0620.

Yours sincerely

[redacted]

Duncan Permezel
Retail Executive Directions and Growth