



7 November 2008

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By email

Dear Mr Henry

Calculation of the Benchmark Retail Cost Index 2009-10: Draft Second Report

Origin Energy (Origin) is pleased to see that the Queensland Competition Authority (QCA) has released a *Draft Second Report: Calculation of the Benchmark Retail Cost Index 2009-10* (Draft Report) on 28 October 2008 as prepared by its consultants CRA International (CRA).

However, following initial examination of the Draft Report, Origin identified several significant errors in the demand and pool price datasets used to calculate the energy purchase cost element of the benchmark retail cost index (BRCI) within the Draft Report. Origin expressed its concern in writing to the QCA on 31 October 2008. Origin was extremely disappointed that the errors in the demand modelling identified from the previous consultant's draft report had not been rectified.

Origin acknowledges that the QCA held a Workshop with stakeholders on 3 November 2008 to discuss the Draft Report. At the Workshop, it was determined that CRA will rectify the data errors within the energy purchase cost calculation and that the amended data be circulated to stakeholders for review. This process has commenced and it is hoped that this will ensure that the QCA will be able to release a Draft Decision that is not founded on erroneous modelling.

Given these events, this submission focuses on the elements of the Draft Report that are not affected by the data issues and cannot make any final comment on the energy purchase cost element of the BRCI. This will be done when the revised pool modelling and purchase cost outcomes are completed. Moreover, given the limited time between the publication of the CRA report, and the date for response, Origin highlights that our list below represents our initial response, and is not a comprehensive analysis of all the issues. Origin understands that additional issues may be raised in response to the Draft Decision, as advised in the QCA's recent letter to Origin, and our response to the Draft Report does not preclude us from doing so.

However, Origin provides, on a best endeavours basis, the comments it can at this time and Table 1 lists the critical assumptions and findings of the CRA Draft Report and summarises Origin's position on each matter.

Origin would like to highlight two specific issues.

First, it commends the QCA on being able to fulfil its commitment in obtaining a consultant's report to update the fuel and capital costs for the long run marginal cost (LRMC) modelling. The use of the ACIL Tasman report, *Fuel and Capital cost in the NEM: Greenfield cost data for the calculation of the 2009/10 BRCI* is a significant step forward towards meeting their deterministic approach to the LRMC calculation.

Secondly, Origin would like to highlight the issue on whether or not to include the Carbon Pollution Reduction Scheme (CPRS) in the LRMC calculation, as discussed in both the Draft Report and Workshop.

The QCA and CRA have previously opted to use a greenfields, multi-region, multi year methodology for calculating the LRMC. Therefore, Origin must agree with CRA's findings in the Draft Report that, based on this methodology, the CPRS must be included in the LRMC determination for 2009-10.

Origin believes it is important for the integrity of the BRCI, as required by legislation, that the methodology is consistent and is not changed without compelling reason to do so.

There is a clear commitment that a CPRS regime will commence, expected from 2010-11, and as CRA's LRMC methodology has a modelling horizon to 2017-18, it would be theoretically remiss of CRA to not include the impact of CPRS. Only in this manner can CRA achieve their deterministic approach of utilising the best available estimates of values.

The issue is therefore, not whether to include impact of CPRS, but which carbon reduction scenario to utilise and Origin believes this will become more apparent once the Federal Government's White Paper is released in December 2008. Origin consequently proposes that the QCA include an interim scenario for their Draft Decision in December 2008 which can then be revisited with up-to-date information prior to the Final Decision in February 2009.

Origin notes that the QCA's preferred position, as stated at the Workshop, is to not include the impacts of the CPRS in the 2009-10 calculations of the LRMC. This is largely predicated on the fact that the intent of the BRCI is to replicate changes to the cost of supply of electricity for the year. However, as noted, while the objective is to replicate changes in costs, the methodology used to identify this change applies a multi-year modelling approach to the LRMC calculation (as set out in the 2008/09 determination¹).

Furthermore, Origin's position on the CPRS is publicly stated² that the costs of the CPRS must be passed through to consumers to ensure they receive appropriate price signals regarding their energy consumption. Origin has proposed that a national framework be developed that would include a standardised methodology for assessing CPRS and associated costs and for addressing legacy contractual commitments between generators and retailers exposed to price regulation. Origin also notes the AEMC's scoping paper, *Review of Energy Market Frameworks in light of Climate Change Policies* and that Origin is advocating for a consistent approach across jurisdictions. Whether the QCA's approach will satisfy these tenants is doubtful.

Irrespective of these practicalities, Origin cannot support a 'No CPRS' scenario within the current BRCI framework as applied to 2009-10 as such an approach is theoretically unsound given the consistent "multi-year" methodology being employed by CRA. Origin recognises,

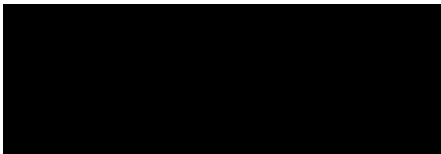
¹ Had the QCA used the alternative methodology for LRMC in 2008-09 of a single year (year-to-year) LRMC cost analysis, the cost increases in that year would have been substantial, and would have changed the actual tariff increase from 5.38% to 9.22% (all other factors being held constant) - see CRA May 2008 Report, Table 26, page 58.

² Origin Energy 2008 : *Submission to Carbon Pollution Reduction Scheme - Green Paper*, 10 September

however, that the relevant assumptions to be included in the 2009-10 BRCI will need to be reviewed again, particularly following the publication of the White Paper.

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

Yours sincerely



Bev Hughson
National Regulatory Manager Retail

Table 1: CRA's Second Draft Report Findings and Origin Position

Issue	CRA Second Draft Report	Origin Position
LONG RUN MARGINAL COST		
Greenfield or Incremental LRMC	CRA utilise a Greenfield approach to LRMC	Origin accepts the greenfields approach as it is consistent with the 2008-09 BRCI decision.
Multi-Year or Single Year LRMC	CRA utilises a multi-year LRMC approach.	Origin accepts the multi-year approach which is consistent with the 2008-09 BRCI decision.
NEM Load	The Load used for the LRMC modelling is the total Queensland load.	Origin reaffirms its previous position that the NEM Load, as defined in the legislation, should be used for the LRMC calculation and should excludes all customers that are directly connected to the transmission network.
Update of Fuel and Capital Costs	<p>The QCA commissioned ACIL Tasman to produce a consultant's report, <i>Fuel and Capital Costs in the NEM</i>, October 2008.</p> <p>The report updates the input costs and greenfield capital costs for use in the LRMC modelling.</p> <p>ACIL also reproduced their capital cost regression analysis using the recent data.</p>	<p>Origin commends the QCA for commissioning ACIL Tasman to update fuel and capital costs for use in the LRMC calculation.</p> <p>Origin notes that fuel and capital costs have increased significantly from those used in CRA's first consultant's report but are generally still below the current costs that Origin has experienced. However, they can be accepted as reasonable, independent inputs for the LRMC calculation.</p> <p>As an example, for 2009-10, CRA has used \$985 per kW for OCGT capital cost in the Draft Report compared to \$749 per kW in their first draft report. Origin provided evidence in its previous submission that OCGT capital costs are currently in the range \$1,100 to \$1,200 per kW but accept that the \$985 per kW used in the Draft Report represents a reasonable forward view.</p> <p>ACIL Tasman acknowledged at the 3 November workshop that there is limited information available on Geothermal generation capital costs and that their modelling calculated relatively low gas prices for scenarios where there is low gas generation. However, ACIL Tasman explained that they focussed on costs and scenarios that had most impact on the LRMC calculation.</p>
Year to Year or Trended data for LRMC	<p>CRA has produced LRMC scenarios using:</p> <ol style="list-style-type: none"> 1. the updated cost data changing from year to year; and 2. a trended analysis using ACIL Tasman's updated regression analysis. 	<p>Origin has previously submitted that the year to year approach is the appropriate method for the LRMC analysis given it has perceived a step change in generation costs.</p> <p>Origin note that using the updated input data results in there being little difference between the year to year and trended approach when calculating LRMC although the difference increases in the CPRS scenarios. .</p>

Issue	CRA Second Draft Report	Origin Position
CPRS	CRA has included 3 scenarios in its LRMC modelling: <ul style="list-style-type: none"> • No CPRS; • CPRS with 10% emission reduction; • CPRS with 20% emissions reduction. 	As highlighted above, Origin believes that the methodology used by CRA theoretically requires the inclusion of CPRS in the LRMC. The details of the CPRS assumptions, however, can be further developed following the publication of the Federal Government White Paper, and prior to the Final Determination.
ENERGY PURCHASE COST		
Scenario Modelling	CRA has modelled three different energy demand scenarios: <ul style="list-style-type: none"> • 10POE; • 50POE; • 90POE; and weighted the results. 	Origin supports the proposal to model various demand forecast scenarios. However, Origin cannot make final comment until it has an opportunity to review that this analysis adequately captures a retailer's costs of hedging load volatility and uncertainty.
Price Duration Curve	CRA has produced a price duration curve from prices from the past 10 years rather than modelling based on a single year.	Origin supports CRA's approach as it should reduce the impacts of transient events such as drought. However Origin advises that caution is applied in the averaging to make sure that the outcome is reasonable. Consideration should be given to structural changes to the market such as VoLL increasing from \$5,000 per MWh to \$10,000 per MWh in April 2002 and removal of events not representative of normal prices such as the high prices that occurred for the Queensland Interim Market in January 1998.
Forecasting Contract Prices	CRA has indicated that contract prices will be forecast for the period February 2009 to June 2009 based on the average of the contract prices paid for the previous two months. CRA uses futures prices published by d-cypha.	Origin acknowledges that complicated modelling of future contract prices is likely to raise more issues rather than settle the debate. Origin would prefer CRA to use actual historical data over a 24 month period prior to the final report in February 2009 but can accept limited forecasting using the most recent two month period for future contract prices. Origin notes that d-cypha prices are generally reliable but are not always representative of forward prices for thinly traded contracts such as caps and peak swaps. Origin is assessing the materiality of this issue and CRA should consider the use of an alternate data source such as ICAP broker prices.
Hedging Strategy	CRA has applied a hedging strategy to all scenarios of: <ol style="list-style-type: none"> 1. Flat swaps 80th percentile of off-peak load; 2. Peak swaps 90th percentile of peak load; 3. \$300 caps up to 105% of maximum peak load. 	In previous submissions, Origin has criticised the CRA methodology for not taking into account the unpredictable and variable characteristics of customer load and the resultant hedge strategy and costs. Origin support the building up of a conservative hedge strategy based on a 50% PoE demand profile and then application of this hedge strategy to 90% PoE and 10% PoE demand profiles to replicate the cost of being long and short to forecast. However the counter intuitive increasing cap payout as demand increases suppresses the cost variation. Origin awaits the revised demand and price data to determine whether this anomaly is addressed.

Issue	CRA Second Draft Report	Origin Position
Loss Factors	CRA have moved from average loss factors to a lower marginal loss factor.	<p>Origin would submit that loss factors less than one are possible but not plausible for the total Queensland load or NEM Load.</p> <p>The way CRA construct the hedges makes the retailer position longer and exacerbates the high cap returns which are driving the reduction in energy purchase costs.</p> <p>Origin note that CRA are to provide with more information on the loss factor issue. Most importantly, the hedge strategies should be applied after the application of loss factors so they should not be impacted by the change.</p>
OTHER ENERGY COSTS		
MRET Scheme Costs	<p>CRA has used an average of weekly forward prices for RECs published by AFMA to determine the REC allowance in the BRCI.</p> <p>CRA has used an average price of \$52 per REC and a national target of 8,100 GWh in 2009 and 8,747 GWh for 2010.</p>	<p>Origin would submit that REC forward prices are strongly influenced by solar hot water RECs which are generally sold to generate cash flow. The true cost to large retailer reflects projects such as wind farms that create significant REC volumes. Having said this, Origin submits that the average price used by CRA is a reasonable representation of forward REC prices faced by large retailers.</p> <p>CRA notes in the Draft Report that the MRET scheme is to be increased from 9,500 GWh to 45,000 GWh but ignore this significant increase and use 8,747 GWh for the national target in 2010. The MRET consultation paper released in July 2008 had two scenarios for implementation of the expanded MRET. Both scenarios had a target of 12,500 GWh in 2010.</p> <p>The Federal Government's Treasury modelling of the CPRS published on 30 October 2008 used 12,500 GWh as the MRET Target for 2010. Origin strongly recommends that the expanded MRET target be used in calculating the REC allowance and in all LRMC modelling scenarios as representing the "best estimate" of the MRET requirements for 2010. Origin understands that additional data on MRET targets will be available to the QCA prior to the release of the Final Decision and, in that event, the published targets should be used.</p>
GECS	CRA has used the penalty price to determine the GEC allowance.	Origin agrees that the GEC market is largely illiquid and supply constrained and supports the continued use of the penalty price for determining the GEC allowance.
NETWORK COSTS		
TUOS	The QCA has indicated that TUOS charges will be forecast by pro-rating of Powerlink's 2009-10 revenue cap based on the share of TUOS passed-through the DNSPs in 2008-09.	<p>Origin believes the QCA's approach as reasonable.</p> <p>However, the percentage of TUOS passed through to DNSPs does vary and care needs to be taken that significant capital expenditures by Powerlink on direct connected customers or assets is not changing the percentage.</p>
DUOS	QCA provided an indicative table of 2009-10 network costs at the Workshop.	Origin believes the network costs are reasonable.

Issue	CRA Second Draft Report	Origin Position
RETAIL OPERATING COSTS AND MARGIN		
Retail Costs	<p>As with previous BRCI calculations, CRA has escalated retail costs based on CPI and wage increases.</p> <p>CRA indicated that the administrative burden on retailers to administer Queensland government schemes is reimbursed or no greater than in other jurisdictions.</p>	<p>Origin accepts the CRA's basic method for escalating retail costs for 2009-10.</p> <p>However, Origin would note that the CRA Draft Report would have been prepared prior to the Queensland Government's introduction of the Guaranteed Service Level (GSL) scheme for retail billing. This unique scheme requires a retailer to make payments of \$15 or \$40 to consumers whenever they receive an overcharge in their retail bill of greater than \$0.40 or \$10.00 respectively. The costs of establishing the capability to implement, audit and report on this Scheme has not been funded by the Government (these costs are incurred irrespective of actual performance).</p> <p>Origin believe that CRA need to consider the additional administrative costs this places on retailers to both comply with the legislation and manage the additional commercial risks this places on all retailers. Origin notes that the interstate benchmarks relied on by CRA were largely developed before the various unfunded schemes have been implemented and CRA's fails to acknowledge this fact.</p>
Customer Acquisition Costs	<p>CRA has escalated the allowances for customer transfers and applied to the same numbers of transfers that were estimated in 2008-09.</p>	<p>Origin believes that at face value, the method of escalation and the use of the 2008-09 forecasts are reasonable until further information is available.</p> <p>However, Origin notes that CRA has not addressed Origin concerns from its previous submissions that because of the treatment of customer acquisition costs in the 2008-09 BRCI process, retailers are only actually receiving around \$1.00 per customer for customer acquisition costs through the BRCI. This is well below the \$27.00 theoretically provided in the Draft Report.</p> <p>This underlying figure is as a result of the QCA's decision in 2008-09 to re-estimate the 2007-08 customer acquisition cost component using revised churn numbers.</p> <p>Origin again encourages CRA or the QCA to examine how their estimated cost of customer acquisition could actually be reflected in the BRCI and passed through to energy retailers rather than continuing their current misleading process.</p>
Retail Margin	<p>CRA believed a retail margin of 5 per cent addresses a retailers risk and has not materially changed.</p>	<p>Origin believes that CRA's supposition that a retailer's margin in 2009-10 would not be materially different from that of 2008-09 is correct. However, Origin would highlight that in the 2008-09 BRCI process, it submitted that retailers were facing significantly higher costs of working capital and that the overall rate of return required on the business by debt and equity providers has increased.</p> <p>The QCA did not investigate these issues during the 2008-09 determination, in a period when the cost of funds had clearly increased. As a consequence, this change in cost was not recognised in that year, and is not currently captured by the BRCI calculation.</p> <p>Origin would also suggest that the ability to obtain debt/equity funding remains constrained because of the perception of risk and tightness of money generally. CRA has not considered this component and all businesses are required to provide a return on investment commensurate with the market's perception of risk which has greatly increased.</p>

Issue	CRA Second Draft Report	Origin Position
Headroom Analysis	<p>CRA has reviewed stakeholders comments on maintenance of retail headroom and suggested two approaches for resolution of this issue;</p> <ol style="list-style-type: none"> 1. legislative change to enable headroom to be considered without the conflict with the BRCI process; and 2. using headroom analysis for elements of the BRCI where a choice must be made. 	<p>Origin would make the following comments on the CRA discussion on retail headroom and its interpretation of Origin's position.</p> <ol style="list-style-type: none"> 1. Origin submitted that to satisfy the policy objective of maintaining headroom, it is not required to know a retailer's actual margin as it is irrelevant. The first policy objective requires the QCA to maintain "existing retail headroom" which refers to headroom across the board, not the headroom of individual retailers. Aggregate retail headroom was impacted by the fact that the QCA underestimated certain parameters in 2007-08 and 2008-09 and these parameters were recalculated in 2008-09 so there was no correction of the underestimation. 2. The measurement of these impacts is relatively simple and highlighted in Origin's submission to the QCA's Interim Paper. 3. CRA analysed these impacts and recognises that the recalculation of costs from the previous year effectively reduces retail headroom by around 2.4 per cent points. 4. However, CRA appears to rely on the premise that this "tells us nothing about the headroom on actual retailers". Origin would submit that this is not required under the objective of the BRCI which is clearly concerned with generic retail headroom. <p>Origin does agree with CRA that the legislation should be amended in order for the objectives of the BRCI to be fully captured without the conflicts that occur with the current prescribed legislative instruments.</p> <p>However, for the 2009-10 BRCI, Origin would encourage the QCA to utilise simple headroom analysis, such as that conducted by CRA, in their Draft Report. This will enable the QCA to avoid situations such as the recalculation of inputs in 2008-09 which reduced headroom by 2.4 per cent in conflict with the objective of the BRCI.</p> <p>Origin understands that the second policy objective regarding reversion of customers to standing contract is more relevant to individual standard retailers. Given the BRCI is theoretically based and focussed on the aggregate retail market, this requirement to assess specific retailer tariffs does represent an anomaly.</p> <p>Origin considers it important for the industry that profitability of individual tariffs is assessed and consequential reform of tariff structures is undertaken. However, Origin accepts the constraints on CRA in following through on this second policy objective.</p>