



22 August 2008

Queensland Competition Authority
Level 19, 12 Creek Street
Brisbane QLD 4000

**Submission on 2008 Review of Calculation of the Benchmark Retail Cost Index 2009-10:
First Report Determination**

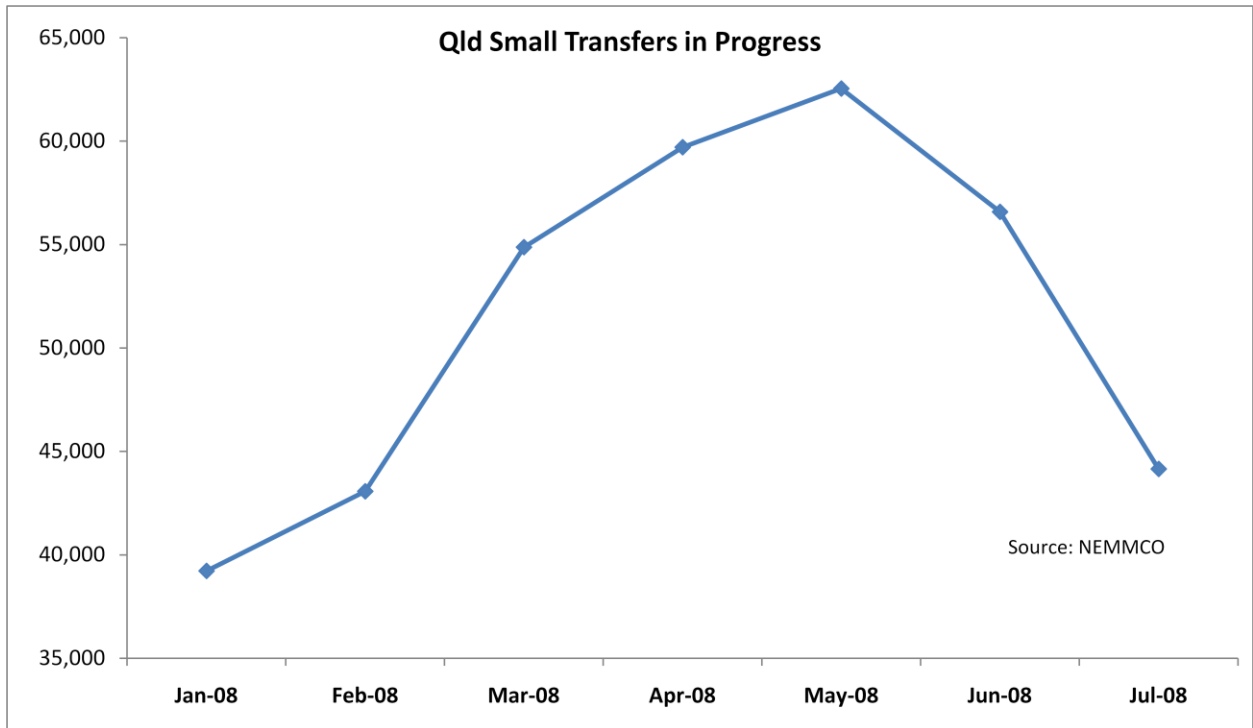
Queensland Electricity (QE) welcomes the opportunity to comment on the Benchmark Retail Cost Index 2009-10: First Report Determination (Draft Determination). We regard this consultation process is extremely important in guiding the future direction of competition in the retail electricity industry.

In fact, it is our view that retail energy competition in Queensland is at a turning point, having already been seriously undermined by an insufficient retail benchmark price increase of 5.38% in May 2008 (reduced from 7%, which was already insufficient). We would be very concerned if the approach adopted in the May 2008 decision were not remedied or compounded in the next price reset. The May 2008 decision was flawed for two main reasons:

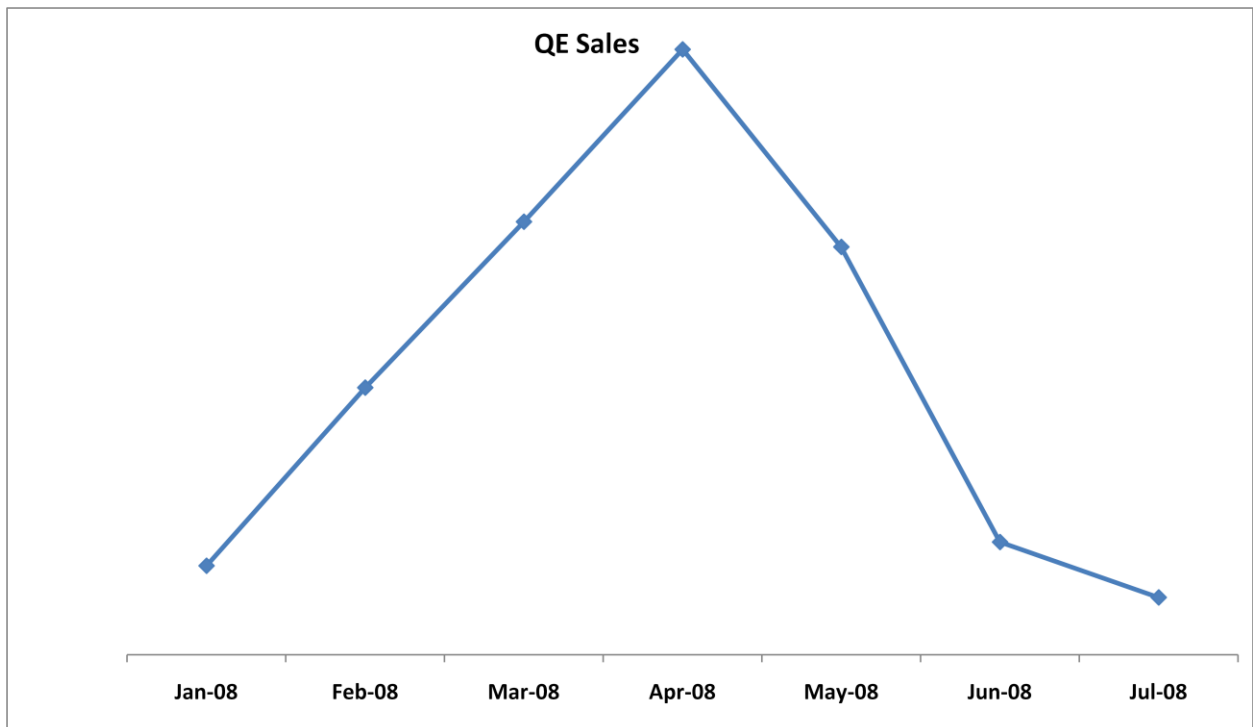
- Notified retail prices failed to keep pace with actual cost of wholesale energy in the contract market faced by prudent retailers serving the contestable market in SE Qld.
- Notified retail prices did not reflect the increases in network costs in South East Queensland – the decision allowed for a 5.7% increase in network prices at the same time as (Government owned) distributor, Energex, announced an increase that amounted to a 12% weighted increase for residential customers in the contestable areas of SE Queensland.

Queensland customers initially benefited from the entry of non-incumbent retailers who had established themselves in other markets. Retailers, including QE, entered the market on the expectation that retail benchmark price would be set in a manner that allowed an actual (rather than theoretical) margin for efficient retailers, ready to offer discounts to customers. However, the May 2008 decision undermined not only margins, but confidence in the market. It appears that non-incumbent retailers have significantly reduced their activity and discounts in Queensland since May 2008, to the detriment of consumers.

NEMMCO's own statistics on small transfers show a clear reduction for June and July, albeit that it takes some time for transfers initiated prior to the QCA and Energex decisions at end May to work their way through the system (see the graph below).



Having entered the market in January 2008, QE has also been forced to severely curtail sales and discounting to Queensland consumers in response to the price setting practices in Queensland in 2008:



While it is obvious that margin results for individual retailers will vary on hedging strategies, pricing offers and efficiency of operations, the switching statistics support the view that there is no basis on which a prudent, efficient retailer can expand its customer base in Queensland and remain profitable. This is not a case of large incumbent retailers “talking their book”. Smaller retailers, including Queensland Electricity, are unfortunately voting with their feet.

Retailers have been provided with very little time to respond to QCA on this important issue, in order that QCA meets a truncated timetable. In those circumstances, there is no scope for detailed analysis or response to the CRA calculation of the retail cost benchmark. However, QE notes that some other parties have provided more detailed comment on the proposed methodology.

At this stage, QE seeks only to add the following points to those already made by other retailers.

1. The Index Itself

- The BRCI provides a basis for moving tariffs from year to year. It is an implicit assumption of the BRCI that the starting tariff is (or was) profitable and provided a 5% retail margin. QE believes this is incorrect.

2. Wholesale Energy Cost (WEC)

- Timing of purchasing hedge contracts – The draft calculation assumes that purchases are averaged over two years. It is true that in practice most retailers purchase hedges incrementally with increasing proportion of load hedged as the period in question gets closer. However, that is a different question to how a retailer evaluates a new customer and hedges for the load of a newly acquired customer. A retailer faced with evaluating whether or not to acquire a customer must do so on the basis that contract prices prevailing *at that time* for all periods will be those faced at the time when hedges are bought. Further, most retailers will acquire hedges for upcoming quarters immediately upon acquiring a customer and, given that the average duration of a customer in competitive markets is only around two years, that represents the bulk of the customer’s consumption over the period of their contract.
- Costs of load and volume risk – In the time provided, Queensland Electricity has not been able to determine how the purchase cost of energy incorporates the price of risk associated with variability of load and volume. Sometimes the costs of those risks are incorporated into transfer prices or prices paid in load following contracts. In other circumstances, the price of volume risk is not explicitly recognized, other than in an elevated cost of equity. The draft calculation appears to be based on an assumption that there is a completely accurate understanding of load. Nonetheless, those risks are a standard element of wholesale energy and comprise:

- The cost of mismatching hedge portfolios (generally set up using quarterly contracts). That is, to hedge peaks, portfolios by their nature exceed average customer load.
- The volume variability risk – the risk of being long or short due to weather variation and general forecasting risk.
- Cost of capital – It is not clear to QE how the purchase cost of electricity incorporates the cost of capital required to cover credit requirements (bank guarantees, trading margins) and liquidity requirements of any prudent retailer (cash on call, reallocation premiums etc). The same is true of cost of trading including brokerage and clearance fees.
- The approach in the draft report does not take account of bid/offer spreads (transactions do not necessarily occur at the mid-point).

3. Network Costs

- The BRCI fails to accurately reflect movements in network costs (NUOS) in the Energex area.
- QE has no view on the reasonableness or otherwise of the capital plans or revenue cap of Energex. However, the BRCI needs to accurately reflect cost movements on a locational basis (at least within distribution areas). Those costs need to be treated as a pass through, or otherwise the index needs to be location specific.
- The alternative is the quite extraordinary situation where one Government agency allows for a 5.7% increase in NUOS while other Government owned companies are increasing the actual NUOS by 12%. It is worth noting that retailers have no way of hedging such unaccounted for movements in NUOS.

4. Retail Costs

- Costs of customer switching – In the past, the BRCI has been self fulfilling in assuming lower switching levels. By artificially deflating cost assumptions, and thereby retail tariffs, the BRCI causes falls in competition. If there is any intent to have a vibrant, competitive retail market in Queensland, the rate of assumed switching should be the rate benchmarked against successfully competitive markets (such as Victoria). That rate is approximately 25% switching per annum.

Please do not hesitate to contact me on 03 9835 0974 if you have any questions.

Yours sincerely

Simon Draper
Managing Director