



Submission to the
Queensland Competition Authority
in response to the
Consultant's Draft First Report:
Calculation of the Benchmark
Retail Cost Index 2009-10

25 August 2008

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1. Introduction

Origin Energy (Origin) is pleased that the Queensland Competition Authority (QCA) has released the CRA International (CRA) draft *First Report: Calculation of Benchmark Retail Cost Index 2009-10* (Draft Report) for public comment.

With submissions due only a week after the release of the Draft Report, and even less time available after the release of the supporting data, it is not possible to properly review and comment comprehensively on all the analysis in CRA's Draft Report.

This is disappointing to Origin, particularly as the CRA Draft Report raises some very important conceptual and analytical principles that are integral to the 2009-10 benchmark retail cost index (BRCI) process. Origin therefore anticipates having further opportunities to discuss the Draft Report at the proposed Workshop on 27 August 2008 and in the period prior to the QCA's release of its Draft Decision.

Nevertheless, there are a number of significant issues in the Draft Report which Origin would raise in this submission to the QCA, bearing in mind that these represent initial views of the CRA analysis.

In commenting on these issues, however, Origin would highlight an over-riding concern that the QCA's Terms of Reference (ToR) for CRA appear, in this instance, to have constrained CRA's ability:

- to examine many of the issues raised by stakeholders in the Interim Consultation Notice (Interim Notice); and to
- provide a report and recommendations which conform to the obligations imposed by the legislative framework.

As a result, there are a number of sections in this submission where Origin requests the QCA broaden their directions to CRA so that issues can be more fully and robustly considered.

Origin's views on this matter and other issues are summarised below:

- CRA's approach in the Draft Report is based on the QCA's decision criteria in the 2008-09 pricing decision and therefore does not address the major issues raised by Origin and others in submissions in response to the Interim Notice, including the:
 - the QCA's decision to use the total Queensland load shape in its calculations, rather than the *NEM Load of the State* as defined in the *Queensland Electricity Act 1994*;
 - the QCA's use of the trended costs estimates for the LRMC calculation where this approach fails to capture the well documented step change in input costs; and
 - updating of the previous year's estimates of many of the BRCI components using actual data and revised information;
- As a result, although the Draft Report discusses the statutory objectives of the BRCI process, and the legislative framework in which the QCA must operate, it does not adequately address them.
- In large part, these limitations in the CRA Draft Report reflect the constraints of the ToR set by the QCA and Origin believes the constraints placed on CRA by the ToR must be addressed by the QCA before the QCA's draft decision in September 2008 (see below); and
- Given these constraints, there are still matters that require further explanation by CRA, including their approach to forecasting volumes, load shape and prices. These are critical parameters in the BRCI and, as such, warrant proper investigation prior to the QCA's draft decision. Origin's

response in this submission provides only a preliminary consideration of these important matters.

With regard the methodology presented in the Draft Report, Origin is appreciative of the increased information and associated data provided by the CRA in the Draft Report and associated data worksheets. Origin's submission addresses some of the issues arising from our review of this information.

However,

- the limited time provided to stakeholders particularly with respect to the data which was only issued to stakeholders on the 19th August; and
- CRA's ongoing failure to permit stakeholders access to its proprietary model CEMOS;

prevent Origin from completing a substantive examination of the data.

Origin will endeavour to complete its review on the basis of the information available to it and provide the QCA any further feedback at the planned Workshop on 27 August or, at the very least, well in advance of the date announced for the release of the QCA's Draft Decision.

The QCA's Terms of Reference to CRA

It appears to Origin that the QCA's ToR to CRA has effectively precluded CRA from addressing many recommendations put by stakeholders, including Origin, to the Interim Notice. The QCA has stated in the ToR that: "*the framework that the QCA will adopt ... for 2009-10 will be that which the QCA adopted in its May 2008 Final Decision on the BRCI*".

This is a matter of great concern to Origin, and one that Origin intends to pursue separately from this response to the Draft Report.

Origin, in its response to the Interim Notice, urged the QCA to conduct a comprehensive consultation process for 2009-10 and to ensure that the matters raised previously by Origin and many other stakeholders are given the appropriate level of consideration.

It is Origin's view that the shortened time-frame has been imposed by the Minister for the 2009-10 process does not of relieve the QCA of its statutory obligation to conduct a rigorous and open decision making process in accordance with the relevant legislation. It is essential for the integrity and credibility of retail pricing process that a robust and independent process is followed, and is seen to be followed, each year.

The ToR, however, indicate to Origin that the QCA has, at this early stage, embarked on a process which will likely fail to adequately take account of the legislative framework or to have regard to the many issues raised by stakeholders.

Origin therefore seeks to understand how the QCA proposes to address the issues raised by Origin and others given the constraints placed on CRA by the ToR.

Impact of the Requirement for an Early Decision.

In his Delegation of March 2008, the Minister established a requirement that the QCA come to a Final Decision on and publish retail prices for 2009-10 by 1 December 2008.

This requirement for an early decision has introduced a new area of difficulty for the QCA, CRA and all stakeholders in setting prices that meet the legislative

framework objectives of setting annual changes in retail prices that reflect changes in retail costs to supply customers.

Origin believes that the shortened timeframe available to the QCA to make its Final Decision may be behind the QCA's narrow ToR to CRA. However, as noted, Origin believe the shorter time period is not grounds for the QCA to impose limits on the extent of the CRA review in areas of great concern to stakeholders.

Nevertheless, Origin acknowledges that even were the QCA to direct CRA to conduct a robust review, there would be many aspects of the decision that will rely extensively on forecasts where in previous years actual data could have been used. This factor alone could undermine the integrity of the BRCI in 2009-10 and poses a risk for all participants in the retail energy markets including investors in energy assets.

For instance, under the current methodology for determining retail energy purchase costs, CRA is required to forecast forward contract prices for 2009-10 for a period of 8-9 months. This requirement must inevitably further compromise the accuracy of the process as indicated by CRA's own comments on their proposed forecast methodology for forecasting forward contract prices for 2009-10.

Similar problems arise in terms of forecasting the relevant inflation rates, customer churn etc. The ability to provide reasonable forecasts of these factors for 2009-10 depends in large part on the time at which the forecasts are made. In 2008-09 decision, these forecasts were made around April 2008 (3 months in advance of the commencement of the relevant year); in 2009-10 these forecasts will be made in September 2009 (8 -9 months before commencement of the relevant year).

These difficulties will be compounded by expected introduction of the new ETS in 2010 as foreshadowed in the Commonwealth Government's Carbon Pollution Reduction Scheme (CPRS) Green Paper, and the expanded national Renewable Energy Target proposed by the COAG Working Group on Climate Change and Water. Had QCA been required to make its decision in the normal period (1 June 2009) much more would have been known about the two Schemes and their potential impact on 2009-10 prices.

In this submission, Origin has made some comment on the forecast approaches suggested by CRA. However, as these forecasts are central to a number of they key parameters in the BRCI calculation, much further work on the forecast methodologies needs to be undertaken (including scenario testing) by CRA. Origin anticipates that the industry will be actively involved in this process.

Correction of Previous Errors

Origin argues both in previous submissions and in this current submission that there are a number of important errors in the approach that was adopted by the QCA in its Final Decision for the 2008-09 BRCI. These views have been supported by many other stakeholders.

Nevertheless, as noted above, it appears that the QCA has chosen to limit CRA's investigation of many of these matters by the constraints imposed in the ToR to CRA.

Origin encourages the QCA to revisit these constraints in the interests of achieving a robust and open process. However, in doing this, Origin is most conscious of the need to address the question of how any such amendments might flow through to the BRCI. For instance, at various points in this submission, Origin has highlighted that CRA could have updated the input costs in the LRMC calculation even within a trend model approach.

Origin (and many other stakeholders) had urged CRA and the QCA to consider these matters in the 2008-09 decision as many of these costs had demonstrably increased in the period between 2007-08 and 2008-09 (and will continue to increase between 2008-09 and 2009-10).

In the current instance, Origin is seeking a fair and reasonable approach to accounting for factors that were overlooked or misapplied in the 2008-09 decision.

2. Requirements for calculation of the BRCI

2.1 Queensland Government Policy Objectives

Section 2.8 of the Draft Report addresses the objectives of the BRCI, as stated in the Delegation, of ensuring that:

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

This section highlights the evidence raised by Origin and other stakeholders that there has been a clear and demonstrable deterioration in headroom faced by retailers in South East Queensland.

CRA has expressed the view that despite the clear terms of the Minister's delegation, there will be no attempt to meet these policy directives and that the second falls outside the ToR given to it by the QCA¹. CRA has confined its analysis to the variations between the analyses provided by Origin and AGL as to whether retail headroom:

- refers to net or gross margin; or
- should be measured in \$/customer or as percentage of sales.

These differences in analyses are not, however, central to the obligation to have regard to whether the policy objectives set out above are met by the BRCI decision. CRA raising these differences in the report merely serves to distract from the fundamental obligation under the BRCI regulatory framework to examine the impact of the BRCI on retail headroom. Origin notes that:

1. the calculation of the BRCI by the QCA (with the assistance of its consultants must attempt to replicate the change in the annual cost of supplying electricity; but
2. an examination of previous BRCI calculations shows that retail headroom for the majority of Queensland customers has deteriorated (whether taking the approach suggested by Origin or AGL in response to the Interim Notice).

Origin has already demonstrated the impact of the "smoothing" of the Ergon and Energex costs on retail head room² in its response to the Interim Notice. While Origin recognises that the Minister's delegation required the QCA to undertake the smoothing of network costs, this does not mean that the QCA did not have the responsibility to consider the impact of this approach and to adjust parameters under its control in order to ensure that annual indexation keeps retail headroom at the date of the Delegation relatively stable.

Beyond the example previously given with respect to network costs, a simple indexation of costs relative to revenues will demonstrate consistent deterioration of margins arising from the previous decisions by the QCA (which appear to Origin to have been made without any consideration of the BRCI objectives).

For instance, the QCA's decision in the 2008-09 BRCI to update 2007-08 costs when calculating the 2008-09 BRCI is quite clearly detrimental to the maintenance of stable margins, as illustrated in Table 1, using an index approach only (ie. without reference to actual margins).

¹ CRA draft report 15 August 2008, pages 17 and 18

² Noting that the impact on head room of network charges is equally valid whether considered from a gross or net margin point of view.

That is, if (as was the case in the 2008-09 Decision):

- retail prices in 2007-08 were set on the basis of a forecast view of changes in costs; but
- these costs were updated to reflect actual costs in the next 2008-09 review such that the new “base costs” for 2007-08 are higher than those forecast, and allowed in the revenue determination; then
- the increase allowed in the BRCI for 2008-09 must be lower than the required increase in revenue to keep existing retail headroom in the tariffs relatively stable.

Table 1: Theoretical Analysis of Retail Headroom Changes

Indicative Index Table: Relative changes in costs and revenues							
	"Actual" 2006-07	Forecast 2007-08	BRCI Change 06/07 - 07/08	Revised 2007-08 "Base"	Forecast 2008-09	BRCI Change 07/08 - 08/09	Cumulative Change 06/07 - 08/09
Costs (inc margin)	\$ 1000	\$ 1050	5.00%	\$ 1100	\$ 1150	4.55%	15.00%
Revenue Allowed	1000	1050	5.00%	Not applicable	1098	4.55%	9.77%
Difference Costs Vs Rev	0	0	0		52		

Note: The theoretical analysis only considers one factor in the erosion of margin stability, and that is the impact of updating the forecast when recalculating the base year.

It should also be clear from Table 1 that any such errors in the BRCI will simply compound over time, further eroding stability of headroom. In the example above, the revision of the 2007-08 base will continue to impact the absolute value of the difference between revenue and costs in the 2009-10 decision, even if there is no revision to the 2008-09 cost estimates.

It is the obligation of the QCA, given the legislative framework which governs the setting of the BRCI, to direct CRA to fully investigate the stability of retail headroom in 2009-10 – particularly given that 2009-10 will be the third year of the BRCI. As illustrated above, such an exercise does not require detailed knowledge of actual costs. In fact, Origin would argue that the theoretical approach is the most appropriate approach as the BRCI methodology is not designed to capture an individual retailer’s actual costs in any of the BRCI components. Both energy costs and retail costs are theoretical or benchmark costs while network costs in the BRCI clearly do not relate to individual retailer network costs³.

Origin finds it unsatisfactory to conclude, as the QCA appears to have done in previous decisions, that investigating the impact of its decisions on retail headroom stability is too difficult.

It is concerning that CRA’s only response in the Draft Report to this central issue is to focus on a discussion on perceived differences between Origin and AGL on the side-issues (as highlighted above). It is even more concerning that three years into the BRCI process, no direction has been given by the QCA to investigate this matter as part of its BRCI analysis. Origin believes that:

- the statutory framework requires the QCA to address this matter, whether by direction to CRA or to some other expert consultant, and
- while industry discussion on potential approaches may be very useful, such an analysis does not, and should not require examination of “actual” retail headroom for any individual retailer.

³ If the BRCI measured actual network costs, then retailers in South East Queensland would have seen far larger price increases over the last 2 years, as Energex’s network costs for tariff customers have increased more rapidly than those allowed under the BRCI – refer to Origin’s previous analysis on network cost impacts in our submission to the QCA on the Interim Notice for 2009-10.

3. Cost of Energy

Origin believes the QCA's Final Decision with respect to the calculation of the Cost of Energy components for 2008-09 did not adequately reflect the fundamental requirements of the BRCI. Specifically, Origin considers that the QCA erred by selecting a methodology in 2008-09 that:

- used the total Queensland load, rather than the NEM Load as defined in the legislation in determining energy purchase costs and LRMC;
- used a "trend" approach for estimating LRMC, which did not include any recognition of the fundamental step changes in LRMC input costs when clearly there has been such a step change in key costs over the past two years;
- failed to use the latest cost information in deriving the 2008-09 estimates, for example, did not update the LRMC inputs from the 2007 ACIL study, for the 2008-09 BRCI; and
- updated the forecast costs calculations for 2007-08 when calculating the 2008-09 change in costs.

Origin is therefore disappointed that the QCA, through the ToR it set CRA, appears to have limited CRA's current analysis to one that continues the same approach as the QCA selected in its 2008-09 Final Decision from the range of options provided in CRA's May 2008 Report on the 2008-09 Decision.

Origin believes that for 2009-10, QCA must direct CRA to use the NEM Load (as defined) in all aspects of the Cost of Energy calculation. The reasons given for not using the NEM load as defined in the energy cost calculations in the 2008-09 BRCI do not stand up to scrutiny (as identified by many stakeholders including Origin in submissions to the Interim Notice) and put the QCA process at odds with both the legislative framework and regulatory practice in other jurisdictions⁴. Origin also considers that the QCA should direct CRA to cease updating any prior BRCI cost estimates for the base year when recalculating the BRCI percentage change (see Section 2 above for the impact of this).

The factors identified above all have a significant impact on the Cost of Energy calculations, as demonstrated in CRA's May 2008 Report. However, these changes do not necessarily have to change the fundamental 2008-09 methodology but need to be discussed in the workshop.

Origin also strongly recommends that the QCA direct CRA to calculate the Cost of Energy for 2009-10 by:

- using an LRMC methodology that can be calibrated to include recognition of the recent step-changes in input costs; and
- using the latest cost estimates for LRMC as input into this methodology, including the step changes in input costs in the period since 2006-07 rather than the 2007 ACIL study costs.

In addition to the comments above, Origin believes there are a number of other important matters raised by CRA's Cost of Energy forecasts for 2009-10.

They are discussed in the following sections.

⁴ NSW, South Australia and Victoria have all calculated energy costs on the basis of the load profile of the relevant population for the determination. In Queensland, this would imply at least using the NEM load profile as defined for the purposes of the BRCI (ie excluding direct connected customers).

3.1 Long Run Marginal Cost (LRMC)

The discussion in section 3.1 relates to the general calculation of the LRMC. Section 3.3 separately considers CRA's analysis of the impact of an Emissions Trading Scheme (ETS) and an expanded Mandatory Renewable Energy Target (MRET) programme.

The LRMC Model Specifications: Inappropriate use of a Trend Model

A detailed explanation of Origin's view is set out below. It relates to the practical issues with using the QCA's approach in a time of rapid change in input costs, and the overarching requirement contained in s.91 of the Act that the BRC should reflect the estimated total cost of supplying customers in Queensland in each tariff year.

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

CRA modelled two approaches in 2008-09 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" generation costs are optimised to meet a given load shape for the base and forecast year of the BRCI; and
2. "Trended" changes in electricity generation costs that is the forecast of future generation costs based on the extrapolation of historical trends in these costs. The capital cost trends were based on the ACIL 2007 report to NEMMCO while various data sources were used to establish "trends" in input fuel and other costs.

In its May 2008 Final Report, CRA recognised that the trend approach, as modelled by CRA at least⁵, cannot reflect demonstrated step-changes in underlying capital, operating and fuel costs. Nevertheless, the QCA adopted this approach in their Final Decision in the face of all the evidence provided by stakeholders of a step-change in input costs in the recent period.

In making the 2008-09 decision, the QCA apparently considered that all the Energy Cost movements were captured in the short-term purchase cost calculations⁶, and therefore LRMC model should only reflect very long term trends (eg 15 years in the case of the capital costs in the LRMC trend model as used by CRA). Such a conclusion is highly questionable as it ignores the different drivers for changes in the short to medium term energy purchase market compared to changes in the underlying trends in generation costs.

The wholesale spot and contract markets are influenced by short to medium term factors such as the prevailing supply/demand balance, transmission constraints, and more specific stochastic events (e.g. drought, very hot summers and plant outages etc). Capturing changes in a retailer's costs (as required under the Act) requires some weight to be put on the shorter term market dynamics.

LRMC, as outlined by CRA, is more about capturing the underlying trends in the East Coast generation mix. However, this does not mean that the LRMC calculation can

⁵ As noted later in this Submission, Origin sees no reason why a trend analysis that is adjusted for step-changes could not be developed within the existing modelling framework.

⁶ Noting the CRA methodology in fact uses contract prices for the relevant year based on forward contract purchases spread evenly over a 24 month historical period - it is not based, as has been suggested by some, on the immediate price volatility in the spot market. Although this will be captured in some part through the 24 month contract period, short term spot market events are strongly diluted in the calculation.

ignore the effect of step-changes in generation input costs, such as those which have occurred over the last two years.

The impact of the step-changes was signalled by CRA in its Final Report 2008-09 BRCI by comparison of the year on year versus trend approaches to LRMC cost calculations. The first approach resulted in LRMC cost changes of 13.68%, the second method resulted in LRMC changes of 1.5% per annum in the 2008-09 BRCI, an increase that was less than half the prevailing inflation rate.

The extreme differences between these two calculations should have been a strong indication to the QCA that a LRMC calculation which ignored recent events and was calculated on the basis of 15 year trends up to 2006 (using the ACIL 2007 study), was not appropriate for the 2008-09 calculation and did not meet the requirements of s. 92 of the *Electricity Act*, which requires the cost of energy to reflect the QCA's view of the likely total of the costs to be incurred during the tariff year to purchase energy to supply the NEM load (as defined).

Origin considers that the QCA has, through the ToR, placed an unwarranted constraint on CRA reviewing its 2008-09 trend approach and developing an alternative LRMC calculation that allows for the recognition of the very significant step-changes in generation input costs that have occurred over the last 2 years.

Evidence of a step-change in LRMC cost inputs has been ignored in the 2009-10 Draft Report.

Perhaps because of the limitations imposed by the ToR, CRA has continued to rely on the long term trends identified in the 2007 ACIL study for the 2009-10 analysis. That has occurred notwithstanding CRA's recognition in May 2008, that extension of the regression analysis available from the ACIL 2007 report is likely to understate recent trends (ie actual costs), and in Origin's view, those long term trends do not provided a proper basis for the calculation of the cost of energy in the manner required by s. 92 of the *Electricity Act*. Having decided to rely on the 2007 ACIL study for the 2009-10 analysis, there has not even been an attempt to update the regression coefficients or objectively assess the variances between the regression predictions and actual data for 2007-08 and 2008-09.

Origin therefore questions the usefulness of continuing with the current form of the trend approach in 2009-10. However, Origin believes that alternative versions of a trend approach that satisfy the general objective of capturing underlying longer term trends while still incorporating step-change affects could and should be developed as part of the 2009-10 BRCI.

Origin, and several other stakeholders, has already provided sufficient evidence, 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. This information alone should justify consideration of a modified trend model.

However, as noted above, CRA's Draft Report for 2009-10 pays no recognition to this information, relying instead on:

- continuation of the previous approach to use the trends in capital costs identified in the ACIL 2007 study (underlying data is now over 2 years old) to project into the forecast period with no attempt to update for known shifts in costs;
- using the Reserve Bank long-term CPI target (2.5%) to update and forecast these trended costs, again with no reference to recent economic data (see below).

The data available to CRA to update the ACIL 2007 study includes, but is by no means limited to, the ACIL Tasman 2008 report (prepared for AGL in April 2008) that updated the ACIL 2007 study with new generation costs. Moreover, Origin

believes data available since that time has further confirmed the existence of a shift change in LRMC cost inputs over the last two years.

Obligation on CRA to determine the best estimates of LRMC cost inputs.

While a new specification for the trend model is preferable, there is no reason why the ACIL 2007 study could not be updated with more recent actual data to achieve a better model fit with real world events. Origin considers such an approach is within the bounds of QCA's ToR (although as noted previously we also believe that the ToR are unnecessarily constraining on CRA).

Origin highlights CRA's own statement that the BRCI framework is "*more suited to the use of a deterministic approach, using the best estimates for input values...*" (p.32). It is difficult to accept that CRA considers the input values it has used in the Draft Report represent the "best estimates" available to it.

Origin notes that it currently involved in a number of generation projects where the relevant capital costs are on the public record. This data reinforces the observation that forecasts being used by CRA are outdated and significantly understate project capital costs. These projects are:

- the July 2008 purchase by Origin from Babcock and Brown Power of the 640 MW OCGT Uranquinty Power Station in NSW at a cost of approximately \$1,100 per kW; and
- ERM Power announced in July that they had achieved financial close on the 450 MW OCGT Braemar 2 power station at a cost of just over \$1,200 per kW.

The costs for these projects are on average 53% higher than the \$749 per kW in 2009-10 dollars used by CRA for OCGT. There is no evidence that financial markets considered the reported costs excessive in the current economic environment.

Contributing to the error in CRA's LRMC modelling (both for 2008-09 and for 2009-10) is the use of an inflation rate of 2.5% to update the original ACIL 2007 study data. For example, Origin notes and agrees with CRA's use of the ANZ's Economic Outlook as an appropriate reference for CPI forecasts for a number of components of the 2009-10 BRCI analysis. There is no reason why CRA should not also use the best estimates of CPI in the LRMC calculation as follows:

- update the ACIL 2007⁷ costs up to June 2008 with actual CPI;
- use forecast changes in CPI up to June 2010 (as per Table 1 in the CRA Draft Report); and
- for the six years after that, use well established medium term outlook forecasts.

Similarly, CRA continues to use the weighted average cost of capital (WACC) parameters, including a risk free finance rate of 5.70 per cent, directly from the 2007 ACIL Report. These parameters are now well out of date. For instance, the risk free rate is significantly below current government bond rates.

As Origin has noted previously, and again in this submission, the Australian Energy Regulator (AER) has recognised changes to the cost of capital over the past two years and has modified its Draft Determinations in recognition at the speed at which this has occurred (see for instance, the GasNet determination). In doing this, and applying the modified WACC forecasts across the five year determination periods, the AER has also acknowledged that the increase in WACC is more than just a "blip".

⁷ Assuming continued use of the ACIL 2007 study, which in Origin's view is inappropriate given the age of the data, and the availability of more recent data.

Origin therefore urges CRA to provide an update of the WACC using best available sources and taking into account decisions by other regulators that have recognised this factor over their five-year determination periods.

In addition, Origin requests that CRA undertake an analysis of the ACIL 2007 data with the aim of comparing the regression model forecasts of capital costs (adjusted for the 2.5% CPI), inflation and cost of capital with actual market data provided to them for 2006-07, 2007-08 and 2008-09.

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

Other Capital Costs

Because the CRA trend model (appropriately) brings into account the introduction of a CPRS in the form of an Emissions Trading Scheme (ETS) - see Section 3.3 below - CRA have also considered the likely capital costs of various renewable energy generators.

Origin acknowledges some of the difficulties in obtaining current data for these projects in the Australian context and believes that additional data may become available during the course of the current 2009-10 BRCI process. Origin suggests that this matter be closely monitored over the coming months.

Nevertheless, the capital costs used by CRA for wind, small hydro and geothermal appear reasonable although there are large degrees of uncertainty around site specific and developing technologies such as these. The capital cost used for biomass of \$3,336 per kW is high but is feasible when considering the broad range of biomass generation technologies. Origin notes that biomass contributes a small amount of generation in the modelling so having a number at the high range is not likely to significantly impact on the LRMC.

The cost of coal

The CRA trend model assumes minimal change in the cost of coal for generation. This assumption is made despite clear evidence of increases in the market cost of coal that go beyond the immediate impact of drought and floods in Queensland coal mines⁸.

The Queensland June 2008 budget papers, for instance, contain quite buoyant assumptions about the future cost of coal, as reflected in their explanation for the change in royalties on coal. As the Treasurer the Honourable Andrew Fraser is reported to have said in the context of the Queensland budget in June 2008:

- *"Most recently, forward contract prices have indicated that coal - one of our state's most valuable and abundant resources - has increased significantly in value"*⁹ and
- *"coal is fetching record prices"; and "coal companies are achieving prices that have doubled and trebled"*¹⁰.

Similar evidence of increases in coal prices can be found for NSW coal providers

The CRA modelling uses a cost of coal of \$0.9876 per GJ in 2009-10 dollars. This is equivalent to approximately \$43 per tonne of coal. However, spot prices for steaming coal are currently circa \$200 per tonne and forward prices have been consistently over \$100 per tonne for over 12 months. Even after taking into

⁸ Origin has previously provided a number of sources, including the April 2008 ACIL Tasman report, on changes to the cost of coal. We refer CRA and the QCA to these in the first instance.

⁹ Press release 2 June 2008 Resources Boom to Benefit All Queenslanders

¹⁰ Statements to ABC News, 2 June 2008

account cleaning and transport costs and port congestion, the coal costs used by CRA are less than half of conservative market prices.

As Origin noted in its response to the Interim Notice, it is inappropriate in a greenfield multi-regional deterministic trend model to rely on historical contract data from one state as indicative of the current cost of coal for generation across the Eastern seaboard. In Origin's view, the use of historical costs and annual price increases of the type set out in the CRA Draft Report (eg. Table 33 - illustrating negative real increase in coal prices) is no longer valid.

Moreover, under a greenfield model of LRMC, even where coal generation plant is located at sites where coal is not and/or cannot be exported (and therefore not necessarily priced at export parity), the modelling would need to account for any changes in costs of establishing mine fields and extraction of coal compared to historical trends. CRA has not investigated this.

The cost of gas

In the trend analysis for 2009-10, CRA have used the trends in the Victorian average gas spot market price developed over the period 2002-03 to 2006-07. CRA has then used the ACIL 2007 report to determine regional price differentials and extrapolate the Victorian trend to each of the other states in the NEM.

The CRA approach has some fundamental problems. First, the period over which the gas cost trend was identified means that the effect on future prices of the significant increase in Victorian gas prices throughout Calendar 2007 is minimised.

Also overlooked in the CRA analysis was evidence of increases in gas prices from other states. Information available to the QCA and CRA includes recent decisions by regulators in other states for 2007-08, such as ESCOSA in South Australia and IPART in NSW. Origin requests that CRA update all gas costs taking this more recent evidence into account¹¹.

These recent decisions should have demonstrated to CRA that:

- the cost of gas across the NEM region has increased over the last 2 years significantly above the Victorian historical (2002-03 - 2006-07) trend;
- separately, the trended costs should have been adjusted to 2009-10 dollars by actual CPI not the 2.5% -used by CRA (as all of the underlying gas contracts are linked to actual CPI); and
- there are significant pressures on gas costs in the forecast period to 2017-18 that mean CRA should not rely on the historical trends.

These pressures exist separately from, but will be exacerbated by both an ETS and prospective LNG plants in Queensland. CRA has conducted no analysis of any of these factors, but simply applied the trend adjusted for CPI.

CRA includes gas transport at \$0.50 per GJ and a premium for OCGT gas of 25% over CCGT gas. The precise costs vary but in Origin's experience, CRA is understating the actual cost by approximately a factor of two¹².

Moreover, the assumption that transportation costs will increase by only 2.5% per year is unwarranted. First, CRA has applied the CPI for periods where CPI is well above that figure (see ANZ forecasts). Second, the significant gas infrastructure that will be required to meet the growing demand for gas is more likely to lead to average transportation cost increases across the eastern seaboard in excess of 2.5% per year. As an example, GasNet in Victoria has recently been granted a significant

¹¹ Details of these decisions are readily available.

¹² There is insufficient time to provide further detail, however, Origin is happy to discuss these matters further with the QCA and CRA, on a confidential basis, at any time.

increase in average revenue for 2008, a reflection of both its expanded capital investment programme and increased costs of funds.

CRA also continued to selectively use other data that ACIL Tasman has updated between its 2007 report to NEMMC and its 2008 report to AGL (as part of the 2008-08 BRCI process). For instance, while CRA has again rejected ACIL Tasman's revised uplift factor for OCGT plant (from 125% to 148%), it has accepted ACIL Tasman's change in the availability of OCGT plant (from 75% to 97%).

Summary of LRMC Issues for 2009-10

In summary, Origin believes the continued use by CRA of a simplified trend-analysis for calculating the LRMC does not meet the obligations imposed on the QCA as the pricing entity responsible for determining the BRCI under the *Electricity Act*, particularly in a period where there is a clearly established step-change in capital and other input costs.

If the QCA is to base its decision on changes in retail costs, then CRA needs to develop a LRMC cost modelling approach that incorporates the established step changes in input costs. While the year-to-year model clearly captures step-changes, trend models can also be adapted to capture these specific movements without replicating or "double counting" the type of cost changes that are observed in the energy purchase cost analysis.

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. There is no reason why CRA could not have included updated, available data in the current modelling approach which would at least in part address the issues raised by Origin and other stakeholders.

However, even if QCA were to direct CRA to develop such an approach for 2009-10, it would still create difficulties with respect to capturing the full extent of cost changes over the last 2 years given these were not captured in the 2008-09 decision.

As noted elsewhere in this submission, the fact that the BRCI approach cannot adequately redress errors in any previous decision is a serious flaw in the BRCI approach as interpreted by CRA and QCA and, potentially, previous underestimation of costs will not be corrected.

3.2 Energy Purchase Costs

Origin supports the QCA's consideration of short term contract market as these drive actual purchase costs over time. As Origin has noted previously, the purchase cost methodology is designed to capture changes driven by the short to medium supply/demand balance and stochastic events that influence retailer's purchase costs.

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.

Origin acknowledges and appreciates that the QCA has made available the load and price input data that was used to calculate energy purchase costs.

Origin is currently reviewing this data and will provide detailed comments to CRA and the QCA as soon as possible. However, Origin provides the following preliminary comments on the energy purchase cost analysis and data:

- The forward contract price data set provided by the QCA stops at 15 July 2008 and uses recent historical averages to populate the data set to the end of June 2009 - specifically the average price of each contract type in the period 16 May 2008 to 15 July 2008. Such an approach to forecasting contract prices is fraught with difficulty and it is of great concern to Origin that CRA and the QCA appear to have been placed in this position by the terms of the Minister's March 2008 delegation.

That said, Origin does not agree with CRA that it has "*no basis for suggesting there is a better method that will more accurately predict the outturn of prices over the period*" (p.68). Predicting prices based on averaging purchase costs over a very limited period when it is clear that contract prices in the very short term can be affected by many factors, including seasonal factors, will deliver a poor outcome.

Origin would prefer CRA to use actual historical data over a 24 month period prior to the final report in October 2008 than the current methodology where forward prices are arbitrarily estimated. At the very east, limiting the 24 month period to December 2008 would minimise the forecast requirements to that of the previous years BRCI;

- The demand curves use actual data until mid-July 2008 and then extrapolated forecast data. The forecast data is NEMMCO's most recent forecast at the 50% PoE for all states other than Queensland where a 90% PoE forecast is used. It is neither consistent nor accurate to use a lower forecast for Queensland.

It is concerning that CRA did not provide an illustration of the Queensland 50% POE shape so that its argument could be more clearly demonstrated.

Moreover, the fact that the Statement of Opportunities (SOO) recent 50% PoE forecasts have exceeded the "observed peak" in Queensland should not be cause for CRA to put aside the considerable statistical analysis that underpins the SOO forecast for the 50% PoE, and selectively replace it with the 90% PoE.

- Origin would highlight also:
 - The 90% PoE peak demand forecast of just over 8,000 MW in late July has already been superseded; and
 - If a 90% PoE is chosen on the basis of fit to one year (noting that Origin disagrees with this), Origin suggests for consistency in the multi-state LRMC model, the 10% PoE be used in Victoria and South Australia as clearly the 50% PoE forecast underestimated actual peak demand in these states (see Figures 5 and 6).
- More generally, retailers hedge to more conservative or higher demand levels. If the purpose of the calculation is to replicate a retailer's purchase costs and hedging strategy, then the 10% PoE forecast (for all states) has greater relevance. This is particularly true when there is no separate component in the BRCI modelling for extreme demand events (un-hedged risk costs - such as allowed in NSW pricing decisions).
- The spot price distribution used is much greater with respect to average prices and volatility than any recently observable years and therefore lacks any credibility without further explanation.

This use of non-representative data has a significant impact on the calculated energy purchase costs of \$50.96 per MWh. The use of non-representative data also has a significant distorting effect by overstating the return on caps, given the hypothetical hedging strategy outlined i.e. the payoff where the spot price is greater than the cap strike price of \$300 per MWh. As a result, the model presumes that a retailer's insurance premium will pay out and recoup almost the premiums that are paid given the unrealistic spot prices which have been contrived. Under normal conditions, a prudent retail risk

policy may be expected to insure retail positions with caps and receive minimal returns, adding \$10 per MWh to purchase costs in some years.

It is important to state again 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 its 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.

As Origin has raised in this submission, and in previous submissions to the QCA, the QCA has erred in its direction under the ToR to CRA, with the effect that CRA has continued to use the total Queensland load rather than NEM Load for energy purchase cost calculations, contrary to the requirements of the Act.

Even if the Act permitted that to occur, Origin reiterates that the theoretical retailer that is the subject of the BRCI calculation would, in the unlikely instance that it has a portfolio of direct connected customers, supply those customers on a quite different contractual basis, such as there is little if any synergy in the two portfolios.

Finally, as noted above, Origin is still examining the additional data provided by CRA to stakeholders on 19 August.

Origin has, however, formed some preliminary conclusions, regarding a number of the calculations and will be seeking clarification of these issues at the Workshop, and if possible, will provide comments before the Workshop in order to facilitate a constructive dialogue on these matters.

3.3 The inclusion of the forecast cost of the Carbon Pollution Reduction Scheme (CPRS) and expanded MRETs

Origin has previously argued that there is a need to recognise in advance the impact of the CPRS and expanded MRETs (the Schemes) in the 2009-10 pricing as the impact of those schemes will begin to impinge on pricing and investment decisions prior to their expected commencement.

Origin is therefore pleased to see that CRA have proposed that such costs be included, at least in the calculation of the LRMC.

More particularly, CRA have identified that if the LRMC approach used in the 2008-09 decision ("trend" based, "greenfield" approach to LRMC) is continued in 2009-10, this in turn necessitates the inclusion of the forecast impacts of the CPRS and expanded MRETs as part of the 2009-10 prices.

In its analysis of the impacts of the Schemes, CRA used a study by ACIL Tasman that was commissioned by the Energy Supply Association of Australia (ESAA) as part of its response to the Garnaut Climate Change Review. In particular, CRA relied on the ACIL forecast of permit prices under various carbon reduction target scenarios.

Origin accepts this is probably the most reasonable data set to use, at least at this point in time. Importantly, CRA's sensitivity analysis in the Draft Report (Table 16) indicates that for the 2009-10 year, the model is relative stable with respect to different assumptions about the carbon target (i.e. a 10% or 20% carbon reduction target for 2020). This means that uncertainty about the carbon target percentage

should not be a reason to reject the recognition of the cost impacts of the Schemes in the 2009-10 decision.

Nevertheless, there are a number of areas in CRA's analysis that are either not clear to Origin or are inconsistent. For instance, the July ACIL study found that natural gas prices increase under both the 10% and 20% scenarios for carbon reduction targets yet CRA has used the same approach to calculating the gas prices as in the previous BRCI decision, without regard to the interaction between the Schemes and fuel and transport costs. It is important that logical consistency is maintained throughout the LRMC modelling approach and Origin looks forward to further consideration of this matter over the next few weeks.

Given the timings of the study, and of the BRCI decision itself, every effort should also be made by the QCA, CRA and the industry generally, to undertake ongoing review of these estimates up until the date that the Final Decision is made by the QCA. The proposed economic modelling may provide more information on the interaction between the targets, permit prices, fuel mix and input energy costs.

Other Impacts of the Schemes

Origin considers that the Schemes will have impacts not only on LRMC calculations, but also on other cost components of the BRCI calculations during the course of the 2009-10 pricing period. These have not been modelled by CRA in the Draft Report.

Origin acknowledges the potential difficulty of taking these costs into account at this stage in the 2009-10 decision process when the details of the Schemes are not available to the market. Nevertheless, Origin urge the QCA to keep an open mind on this matter, and to work with the industry over the next few months to better understand the general cost implications of the Schemes in addition to the impact on the LRMC calculation identified previously.

3.4 Other Energy Costs

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 reasonable if there is no step-change occurring in the REC market prices. This is not the case. Origin identified in their response to the 2008-09 Draft Decision that there had been a step change in the REC market price in early 2008 and since then prices have further increased.

However, Origin's recommendations were not accepted by the QCA resulting in a lower average price in the calculation of the 2008-09 BRCI. It is important that the new calculations of RECS for 2009-10 are compared to the prices used in the 2008-09 Final Decision and that the 2008-09 prices are not re-calculated before that comparison occurs.

A difficulty will arise in estimating the Renewable Power Percentage (RPP). It is unlikely that the RPP trajectory will be available to 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 forecast change in the RPP must be factored into the 2009-10 BRCI in some form, as while the precise 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.

CRA notes in the Draft Report that the MRET scheme is to be revised to increase from the current maximum target of 9,500 GWh in 2010 to a maximum of 45,000 GWh in 2020. This significant increase is then ignored. From the Federal Government's published options for the expanded MRET, the calendar year 2010 MRET target will increase from the current level of 8,747 GWh to approximately 12,500 GWh. This increase alone will increase the cost of complying with MRET from \$1.88 in 2009-10 to approximately \$2.30 per MWh.

Gas Electricity Certificates (GEC):

Origin was pleased that the QCA has adopted the position of using the penalty prices as the penalty price for the Queensland GECs in the 2008-09 BRCI but notes its 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 ETS on GEC prices prior to its implementation, and of the Queensland Government's response to the ETS.

Origin encourages the QCA to again adopt a conservative approach to the allowance for GECs and continue to use the penalty prices as being the best representation of future GEC prices in this period of uncertainty.

4. Network Costs

The QCA has provided data to CRA to allow an estimation of changes in network costs. While the CRA Draft Report does not investigate these, network costs are of sufficient importance to the final outcome to justify further comment in this submission.

Origin notes, for instance, that the increase in average network costs, amounts to around 11.5%, and explains over half (5.5% out of the 10.27%) of the total BRCI calculation.

It is essential that the network cost calculations are clearly set out to stakeholders, preferably at the August Workshop, or at least before the Draft Determination. A complete reconciliation of the three year period (including 2009-10) since the BRCI commenced would be very useful to stakeholders.

Origin was particularly frustrated at the difficulty stakeholders had in understanding how various components of the network cost calculation were derived in the 2008-09 determination. At the end of the day, Origin was left with a number of concerns with this aspect of the QCA's Final Decision, particularly with respect to:

- the treatment of the additional Energex capex costs, and the method used to allocate these costs across the three years remaining in the Electricity Network Determination period; and
- the inappropriate updating of the transmission costs when recalculating the base year for 2007-08 with "actual" data. This meant that the under-recovery of costs in the 2007-08 determination was never recovered in the 2008-09 determination.

5. Retail Cost and Margin

Origin continues to support CRA's use of retail cost benchmarks¹³ and the approach of escalating annual retail cost using well known indices for setting the operating cost component of the BRCI.

However, Origin notes with concern that CRA has not addressed the impact of the increased costs of capital despite the considerable evidence on this matter.

Retailers need funding from the debt and equity markets to continue in business. Moreover, retailers face significant working capital costs particular for tariff customers because of the lag between payments from customers and payments which must be made to providers such as NEMMCO and networks.

This significant issue needs to be addressed through:

- the change in retail operating cost; and/or
- an increase in the retail margin.

CRA has recognised in their Draft Report that retailers have higher costs of funding working capital but has not proposed any allowance to cover this cost. Instead, CRA has requested further evidence of this additional costs being incurred in 2009-10. Origin has several problems with this request.

In the first instance, the BRCI is calculated on the basis of changes in various costs inputs for a theoretical retailer (characteristics are set out in the Electricity Regulations). Knowledge of a given retailer's actual costs, or changes in costs, is not relevant to this framework whether that be retail costs or costs of energy.

Second, retailers are no different from any other business, including government owned businesses. Changes in the cost of funds generally can be expected to flow through retailers to tariff customers as energy retailers have relatively large working capital requirements (simplistically, energy is settled weekly, networks settled monthly, customers pay quarterly, bad debts accrue to the retailer only).

Finally, the evidence of the increase in cost of funds is readily available to CRA from multiple sources and CRA does not need "actual" data from individual retailers to demonstrate this point any more than it needed "actual data" on retail purchase costs to demonstrate movements in costs under the BRCI format.

Origin would expect CRA to be considering how to incorporate this cost in retail operating costs or retail margin given the clear terms of the Act, and CRA's explicit acknowledgement of higher cost of funds.

5.1 Retail Margin

The BRCI requires an appropriate retail margin to cover the retailer for its risk-weighted investment. As stated by CRA on page 94 of the Draft Report:

'Thus, the net margin is intended to provide an appropriate return for the capital that is invested in the retail business, including working capital and provision for bad debts. Determination of the appropriateness of different levels of expected net margin needs to reflect various business and industry risk factors.'

¹³ Although Origin disagrees with the quantum allowed under the retail cost benchmarks, it accepts that in the BRCI format, the focus for this particular item should be on the relative change in the cost rather than the absolute value of the costs.

This statement provides the conceptual basis for considering the elements of retail margin and why margin requirements might change over time. It clearly includes (simplistically) two components, both of which are well understood by regulators:

- risk free rate of return on capital investment; and
- market risk premium.

The changes in the cost of capital in the last 18 months are relevant to the first component, while changes in the risk profile of the business are relevant to the second component.

Origin has presented substantial data to the QCA on the changes in the cost of capital since the 2007-08. Both CRA and the QCA have failed to take this into account despite their obligation to assess changes in costs for retailers.

Origin has also highlighted instances over the last year where owners of transmission and distribution assets have had higher cost of funds recognised by the regulator. The QCA appears to have assumed in its Final Decision for 2008-09 that retail businesses have no such exposure without any stated justification. Origin notes with concern that the matter is still not discussed appropriately in the CRA Draft Report for 2009-10 and requests the QCA to direct a proper investigation of these matters.

With respect to the second component, changes in the risk profile (and therefore market risk premium), Origin notes that the benchmark net margin of five per cent of sales was assumed in previous BRCI processes based on the claim by CRA that any increased risks surrounding energy purchasing and customer acquisition were fully taken into account in other elements of the BRCI.

Origin does not agree that the methodology used in the 2008-09 decision, and replicated in the CRA Draft Report, fully or adequately captures retailers' risks. For instance, in the LRMC calculation, CRA continues to use a deterministic approach which potentially compounds forecast error in a way that a probabilistic analysis (which captures combined effect of many uncertainties) generally does not.

This is a particularly important source of risk when using the LRMC trend model that requires prediction of multiple inputs over a forecast period of many years (with the chance of error in each point estimate increasing for each forecast year).

The above issue was identified by Origin previously, and is one of the factors that makes benchmarking retail margins against those allowed in other jurisdictions largely irrelevant. In addition, the CRA approach does not appear to adequately provide for volatility and changes in load growth shape over time as discussed in detail in Section 3.2.

The discussion above and CRA's suggestion of providing more information to demonstrate additional working capital costs in 2009-10 illustrate further flaws in the approach, which also compound the risk to the retailer. That is:

- an increased cost was not recognised in the 2008-09 BRCI, when this is the point at which the largest step increase occurs; and
- having failed to recognise the particular cost increase in 2008-09, retailers are now required to demonstrate a change between 2008-09 and 2009-10, if it is to be recognised in 2009-10.

Clearly, this approach (which applies equally to other costs that saw large step changes in 2008-09) ensures that any step changes in one year, if not recognised in that year, are never fully captured in the BRCI. This is a risk that does not exist in other jurisdictions.

Additional Risks in the Current Decision:

The 2009-10 Decision adds a new and very significant risk to the Decision process because it is being made early and there will be significant increases in forecast risk on all cost components.

This has a major impact on rate of return requirements which cannot be simply put aside by the QCA as an irrelevant consideration. The discussion on page 68 of the CRA Report amply demonstrates the uncertainties that have been introduced into this process by the requirement of the Minister's Delegation for a decision by 1 December 2008.

The risks associated with that requirement should not be placed on retailers without due compensation.

More particularly;

- the QCA's reported direction to CRA that CRA should not consider the impact of the BRCI timetable on retail margin incorrectly assumes that commercial businesses do not quantify regulatory risk or uncertainty; and
- the QCA's claim (as reported by CRA) that recognition of this additional risk is not consistent with the legislation, is unsubstantiated and without merit.

The *Electricity Act 1994* requires the pricing entity to form a view of the likely cost of providing customer retail services based on an efficient entity that meet the criteria of (inter alia) earning a "reasonable retail margin" (s 94 (1)(d)).

A reasonable retail margin must take into account the circumstances under which that margin is being earned. In this particular instance, the circumstances involve setting a "fixed price" for the provision of the retail services seven to eight months in advance of delivery and well before key cost parameters are known. A retailer in a competitive market faced with this proposition would seek, and would be reasonable in doing so, an additional premium in the price compared to a price offered when cost inputs were known. The current situation is no different to this.

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

Origin requests that the QCA recognise recent changes and direct CRA to review, and incorporate in their relevant modelling, the impact of the changing cost of funds and the additional risks associated with the BRCI generally and in particular in relation to the requirement to that the BRCI for 2009-10 be fixed by December 2008. In doing this, we expect CRA to model the outcomes in a manner consistent with commercial realities of a private business.

5.2 Customer Acquisition Cost

CRA has replicated the method from the 2008-09 Final Decision to estimate customer acquisition cost in its Draft Report using transfer costs to market contract between retailer and within a retailer and using forecast churn numbers.

CRA has indicated that the estimated transfer costs to a market contract between retailer and within a retailer should be reassessed and Origin will endeavour to provide estimates for such costs.

Similarly, because of the difficulty in forecasting churn at this point in time, the CRA Draft Report has only used the number of customers' switches as forecast in

2008-09. This is understandable at this point in time. However, Origin would like to specifically highlight two issues arising from the estimation of the customer acquisition cost.

First, CRA has stated that:

"It may be that switches will decline, given submissions to the Interim Consultation Notice that informed that some retailers that were previously active in the small customer market in Queensland are no longer active."¹⁴

This may indeed be correct but the QCA and their consultants need to understand that the departure of some retailers from this market is a direct result of the unsatisfactory BRCI processes in 2007-08 and 2008-09.

It is essential that CRA's approach is not caught in circuitous methodology where on the one hand, previous decisions have the potential to reduce future retail competitive activity and on the other hand, this reduction is used as a reason to further undermine the accuracy of the BRCI. Indeed to do so, would take the market on a downward spiral that puts the outcome even further at odds with the stated legislative intent.

Secondly, the QCA and CRA need to understand that because of their treatment of customer acquisition costs in the 2008-09 BRCI process, and particularly the QCA's decision to recalculate the 2007-08 BRCI using actual data, not available at the time that the 2007-08 decision was made, the impact of this component is misleading and actually negligible.

Secondly, the QCA and CRA need to acknowledge that because of their treatment of customer acquisition costs in the 2008-09 BRCI process, the impact of this component is misleading and actually negligible.

To put it in context, CRA has estimated an indicative figure for customer acquisition cost in 2009-10 of \$27.00 per customer. On face value, this would appear to be an increase of 1.3% or \$0.35 per customer compared with the 2008-09 figure of \$26.65 per customer apparently allowed to retailers.

That is not the case. The effect of the 2008-09 BRCI was to allow an underlying cost to retailers for customer acquisition in 2008-09 of only \$1.10 per customer¹⁵. This occurred because the QCA, erroneously in Origin's view, decided to re-estimate the 2007-08 customer acquisition cost component using actual churn numbers.

The methodology adopted for the calculation of the 2008-09 BRCI means that the CRA Draft Report indicative result for 2009-10 is only an increase of \$0.01 per customer, even though CRA has clearly accepted that customer acquisition costs for 2009-10 will be substantially greater than that.

Origin again encourages the QCA to examine how the actual cost of customer acquisitions can be properly passed through to energy retailers during the 2009-10 BRCI.

Origin previously submitted a proposal that the QCA compare its 2009-10 customer acquisition cost estimate with the underlying customer acquisition costs that was provided for retailers in the 2008-09 process. Despite the difficulties this raises, it may be the only way that the QCA can make up for the errors from 2008-09.

¹⁴ CRA International 2008, First Report: Calculation of the Benchmark Retail Cost Index 2009-10, p.91

¹⁵ In 2007-08, \$2.00 per customer (\$3.7M) was allowed for customer acquisition cost. This was then reduced by over \$1.6M in 2008-09 because of the change in methodology and revision of churn rates for 2007-08. This resulted in an allowance of \$1.10 per customer in 2008-09.