TRUenergy Australia Pty Ltd
ABN 96 071 611 017
Level 33, 385 Bourke Street
Melbourne Victoria 3000

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Chief Executive Officer
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

electricity@qca.org.au

Energex Application for FRC Cost Recovery

Thank you for the opportunity to comment upon Energex's application for recovery of FRC costs.

TRUenergy is concerned with the quantum of Energex's application on three grounds:

- The discrepancy between the current application for $117 million, and Energex's earlier estimate of $50 million provided in 2005.
- The extent to which costs relate to the separation of the distribution and retail businesses, as distinct from direct FRC costs
- The impact the claim, particularly due to the front-loading of the cost recovery application, would have on the level of retail competition in the Queensland electricity market.

Detailed comments are provided below.

Previous estimate

In 2005 Queensland Treasury commissioned consultants GHD to undertake an independent cost-benefit analysis of introducing full retail contestability (FRC) in Queensland. On the basis of detailed information provided by the existing GOC businesses, including Energex, a total statewide distribution cost of $50 million was identified. The analysis was regarded as sufficiently robust by the Queensland Government for it to proceed with the introduction of FRC.

It is inconceivable that either that the study underestimated costs by 134%, or that costs have increased by that amount in the past 18 months. In the first instance Energex should be required to account for the difference between the current claim and the results of the independent study. If Energex are unable to do so, or if the response is inadequate, an independent audit of the claim should be undertaken to explain the discrepancy.

Figure 2 in the application confirms that Energex's claim is at the high-end of FRC cost benchmarks and we do not consider that the arguments put forward as to why costs could be expected to be higher in Queensland are adequate:

- FRC was a truncated process, for various and differing reasons in all other jurisdictions.
- The final timing for commencement of FRC was, if anything, more certain in Queensland than in the south-eastern states.
- Churn rates should have no impact on FRC costs. The expectation in all jurisdictions is that systems would be fully automated at the time of market start.
- Labour market conditions were known in 2005.

With regard to operating costs generally, it is our understanding that as part of the separation of the distribution and retail businesses, the overwhelming majority of resources were allocated to the distribution business, to provide the scale required to support FRC and the general provision of stand-alone distribution services. This allocation in favor of the distribution business was certainly greater than could have been foreshadowed in 2005, thereby placing further downward pressure on the additional costs required for FRC readiness relative to the 2005 expectation.

In addition, Queensland has enjoyed the benefit of being the last jurisdiction to commence FRC, and as such benefit from the experiences observed in other states. We would expect that this would enable Energex to capture some efficiencies in the development of the FRC solution not available elsewhere.

For these reasons we believe Energex's costs should be at the lower end of the benchmark comparisons, consistent with the 2005 study, rather than the higher end, as per the current claim. To the extent that there is any substance to a higher amount, significantly greater detail is required. In a prudent commercial environment a more substantive business case than a 22 page summary would be required for a claim of funds in excess of $100 million.

Business separation costs

There is an important distinction to be made between costs incurred as the result of FRC, and costs incurred by the separation of the distribution and retail parts of the old Energex business. Critically, the former was not dependant upon the latter whereby, as in Victoria, competition could have commenced in conjunction with the stapled retail-distributor model. As such any costs attributable to the separation of businesses should not be considered in an FRC cost application.

Finally, we have a number of concerns with the items listed under "Key areas of impact":

- Communications with retailers – National B2B arrangements are the result of business separation, not FRC. There may be some additional costs arising from the need to have arrangements with multiple retailers, but these will be at a marginal cost to business separation.
- Communication with customers – There are no communication requirements which relate to FRC (awareness of which is appropriately a government message), only to business separation. The claim for $580,000 should be totally rejected.

- Agreements – Single uniform Co-ordination Agreements and Connection Agreements have been developed at minimal cost, which would be required in any case due to business separation.
- Field Work – The nature of these costs are unclear. If anything, field workers will be having less communication with customers, thereby reducing costs.
- Metrology – These costs appear to relate to improved service standards, which should have been delivered irrespective of FRC.

Similarly in Table 1, "Key areas of Compliance" most of the costs, excluding NMI discovery and transfer management, relate to business separation not FRC:

- Service Orders – These costs relate to implementation of national B2B that a stand-alone retailer in a non FRC environment would reasonably have required.
- Energy Data Management – To the extent that they relate to network billing, would be required from a stand-alone retailer in a non-competitive environment.
- Trouble Call – Presumably Energex currently deals with "network emergencies & trouble calls," and would do so with a stand-alone retailer in a non FRC environment.
- Ring Fencing – By definition a business separation cost.
- Agreements – As above, these costs relate to standard agreements that would have been required regardless of FRC.
- ICT systems – These costs should be apportioned between directly attributable FRC costs and business separation costs.
- Metering – Any costs directly attributable to FRC, as distinct from other regulatory changes, should be separately identified.
- Compliance – As above.

Finally, but most significantly, is the claim of over $22 million for de-energisation and re-energisation costs. The standard approach of retailers to request a de-energisation at the time of customer move out is not related to FRC, but to mitigating exposure to unknown consumption. If anything, the advent of FRC reduces that exposure, as the customer may churn to another retailer whereby the new retailer, rather than the old retailer, is responsible for the wholesale cost at the site. Not only is it reasonable to expect that a stand-alone retailer in a non FRC environment would require a de-energisation on customer move-out, but a prudent integrated business, operating in accordance with industry best-practice, would also be requiring the same.

Impact on competition

Calculation of the benchmark retail cost index required the total network cost in the calculation to be the weighted average of costs in the Energex and Ergon areas. Lower costs in one area will suppress margins in the other. A cost pass through at the level proposed by Energex would approximately halve the retail margins in south-east Queensland. This is contrary to Queensland Government policy for margins in the area to be retained at current levels over-time.

This is exacerbated by the front-loading of the claim whereby 42% is requested for recovery in 2007/08. It is standard practice for FRC claims to be smoothed

over a 5 year period. TRUenergy recommends that the final approved amount, which should represent a substantial reduction on the current claim, should be recovered over this period.

Please contact me on (03) 8628 1122 if you require additional information.

Yours Sincerely,

Graeme Hamilton
Regulatory Manager