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Interim Consultation Notice on the Benchmark Retail Cost Index

Thank you for the opportunity to comment upon the Authority's *Interim Consultation Notice on the Benchmark Retail Cost*.

TRUenergy supports the Minister for Mines & Energy's delegation to the Authority, and in particular the commitment under condition 1(a) for retail margins to be held stable at current levels. Meeting this commitment in 2007/08 will be challenged by three factors that have the potential to significantly erode retail margins, particularly in the Energex distribution area, due to sharp increases in network and wholesale costs.

Overall an increase in the benchmark retail cost index substantially above CPI will be required for current margins to be retained in the forthcoming financial year, due to:

- A sharp increase in wholesale costs.
- Energex's FRC cost-recovery application for an additional \$48.9 million in 2007/08.
- Energex's successful capital expenditure pass-through application.

If costs, both energy and network, were able to be attributed to the relevant distribution area and reflected in tariff adjustments within that area, dealing with these cost increases would be straightforward process. However, the statewide weighted averaging approach of the benchmark retail cost index ensures that if costs consistently increase at a greater rate in one distribution area, margins in that area will be eroded over-time. This will require ongoing monitoring by the QCA, and, when necessary, adjustment by the Minister. In the longer-term, the adequacy of the index in accounting for the discrepancy in cost movements across distribution areas should be reviewed.

Energy Costs

Historically, TRUenergy has supported the use of long-run marginal cost (LRMC) by regulators in regulated tariff reviews to estimate energy costs. LRMC is the price signal that determines the point at which potential new generators will enter the market. However, it is now apparent, as demonstrated by a number of pricing reviews across various jurisdictions, that regulators are unable to access

reliable data to establish an accurate measure of LRMC. As a current developer of new generation plant in NSW, TRUenergy is well positioned to make such a comment.

A further weakness of the LRMC approach is the short-term variation between LRMC and retailers energy purchase costs. This is a particular concern in the current review, as the current water shortage in south-east Queensland has restricted capacity from local coal powered generators. Consequently higher priced sources have been dispatched at lower than normal demand levels placing severe upward pressure on Queensland's wholesale electricity costs, in addition to the longer-term upward trend. In turn, there has been a sharp increase in the forward price of electricity which will have a significant impact on energy costs for 2007/08. If these increased prices are not taken into account in the calculation of the BCI there will be a substantial erosion of retail margins below current levels.

All other energy cost components, including NEM fees, energy losses, compliance with the 13% gas scheme, and any other extraneous costs, sourced from industry data, should be included in the energy cost estimate.

Network costs

Calculation of the benchmark retail cost index requires total network costs to be the weighted average of costs in the Energex and Ergon areas. Consequently, if there is a discrepancy in the rate of increase in network costs across the distribution areas, retailers will not be able to fully recover those costs within that distribution area with the higher rate of network cost increase. In this context, Energex's cost recovery application, in addition to the approved capital expenditure pass-through application, would have a significant impact on retail margins in the Energex distribution area. Indeed if approved, these cost increases would approximately halve available retail margins.

To ensure that the commitment to stable retail margins is met, as per condition 1(a) of the delegation, an adjustment will be required to allow the full amount of the approved FRC cost pass-through to be passed through by retailers to consumers.

With regard to the AER's current determination on Powerlink's maximum allowed revenues for 2007-12, it is noted that Powerlink has strongly objected to the Draft Decision and has submitted for an additional average revenue increase of approximately 6.6% per customer. This application, in conjunction with the Draft Decision, should form the basis of the authority's estimate of transmission costs for 2007/08.

Retail Costs

In response to issues raised by the Authority, we make the following comments:

- Margin provides a return on risk, in addition to the recovery of costs. Costs are not "compensated for through the retail margin."
- In markets which have set regulated retail tariffs at levels which facilitate workable competition, regulators have provided retail margins in the 5-10% range.

- If regulated tariffs are set at cost-reflective levels, including a reasonable retail margin, customers will not revert back to the standard contract. If customers do revert, it is an indicator that regulated tariffs are not recovering costs.
- In the same manner that distributors are entitled to recover FRC costs, so too should retailers, be able to do so, including incumbents and new entrants. Retailer FRC costs should be accounted for in retail costs for 2007/08.

Consistent with the current IPART retail price review, the Authority will need to consider the costs of customer acquisition for the hypothetical retailer. This includes both the cost of establishing brand loyalty with existing customers, and contracting these customers onto a negotiated product, as well as acquiring new customers to replace those lost through competition. As competition grows, these customer acquisition costs will correspondingly increase over time.

Finally, labour costs represent a major component of retailer cost to serve. The most recent Australian Bureau of Statistics data on average weekly earnings shows an annual increase of 8.7% in Queensland (trend to November 2006, all employees, total earnings) which should be accounted for in the calculation of the Index.

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

Yours Sincerely,

Graeme Hamilton
Regulatory Manager