Hon Stephen Robertson MP
Member for Stretton

Queensland Government

Minister for Natural Resources,
Mines and Energy and
Minister for Trade

MBN2772

12 FEB 2010

Mr Brian Parmenter
Chairman
Queensland Competition Authority
GPO Box 2257
BRISBANE QLD 4001

Dear Mr Parmenter

The Queensland Government welcomes the opportunity to provide comment on the Queensland Competition Authority's (QCA) Draft Decision on the Benchmark Retail Cost Index (BRCI) for Electricity: 2010-11 ('the Draft Decision').

The Government is deeply concerned about the rising costs of electricity supply and the pressure this is placing on household budgets. The Government is also strongly of the view that only genuine increases in costs should be passed on to consumers through the application of the BRCI.

The price of electricity in Queensland has always been competitive when compared to other States and it is important to maintain this position. Currently, Queensland has the third lowest retail electricity prices for domestic customers of all states and territories.

To protect vulnerable customers, the Queensland Government maintains a regulated maximum uniform price for electricity. South-east Queensland residents may also be able to negotiate a lower-cost electricity supply with a retailer by entering into a contractual arrangement.

The Queensland Government has reviewed the Authority's Draft Decision and has provided a submission for your consideration.

Consistent with previous submissions, the Government wishes to emphasise that only genuine increases in costs should be passed on to consumers through the application of the BRCI. As such, the Government has some concerns about certain aspects of the Authority's approach to determining the BRCI for 2010-11. The submission focuses on the following key areas of the Draft Decision:

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- **Cost of energy** – the application of a modelling adjustment factor to the cost of energy calculations;
- **Network costs** – the inclusion of certain network costs that were excluded from the BRCI calculations in previous years; and
- **Retail costs** – the increased allowances provided by the Authority to retailers to acquire new customers and the rate of customer switching.

In particular, the Government disagrees with the Authority's application of a modelling adjustment factor to calculate energy costs and maintains this should not be taken into consideration in determining the cost of energy component in the BRCI for 2010-11.

The Government also considers the Authority's approach to determining retail costs for 2010-11 is flawed, arguing that customer acquisition costs have been over-estimated and that retail operating costs should be estimated using the same data as used in previous decisions.

The Government provides a range of initiatives and rebates to assist the State's most vulnerable consumers and to promote greater business and household energy efficiency and awareness of energy usage patterns, including:

- The Queensland Government Electricity Rebate - eligible senior and concession card holders are entitled to receive the rebate, which was increased in the last budget to $190.85 a year (including GST);
- The Home Energy Emergency Assistance Scheme, through which the Government provides $3 million to those experiencing difficulty paying their home energy bills due to unforseen emergency. Up to $720 per household per year for two years is available under the Scheme;
- The Electricity Life Support Concession Scheme, a concession for consumers using life support machines;
- The ClimateSmart Home Service, which helps households reduce their home's carbon footprint and save on water and energy bills; and
- The Queensland Solar Hot Water Program, where eligible participants can replace their existing electric hot water system with a solar hot water system, reducing their carbon footprint and their electricity bills.

In addition, the Government will continue to support regional Queenslanders via the Community Service Obligation, to ensure they pay no more for electricity than consumers in south-east Queensland. In the 2008-09 financial year, this commitment totalled around $460 million.

I thank you for your consideration of these matters. Should you have any queries regarding my advice to you, Ms Kathie Standen, Acting Director, Electricity Policy of the Department of Employment, Economic Development and Innovation will be pleased to assist you and can be contacted on telephone 3225 8256.

Yours sincerely

[redacted]

STEPHEN ROBERTSON MP

Submission to the Queensland Competition Authority

Response to the Draft Decision on the Benchmark Retail Cost Index (BRCI) for Electricity 2010-11

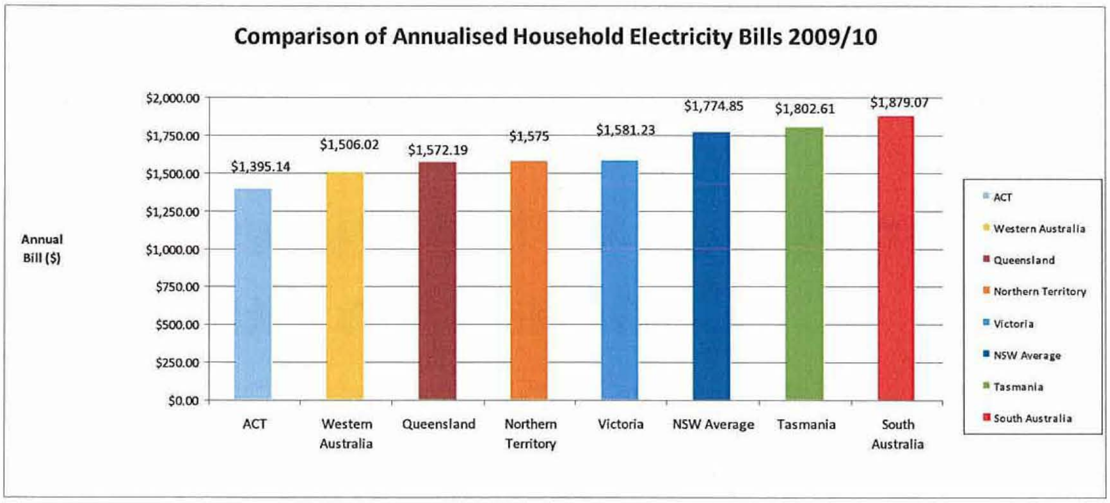
Prepared by the Department of Employment, Economic Development and Innovation

February 2010

INTRODUCTION

The Queensland Government welcomes the opportunity to provide comment on the Queensland Competition Authority's (QCA) *Draft Decision on the Benchmark Retail Cost Index (BRCI) for Electricity: 2010-11* (the Draft Decision).

The Government is deeply concerned about the rising costs of electricity supply and the pressure this is placing on household budgets. The Government is also strongly of the view that only genuine cost increases should be passed onto consumers through the application of the BRCI. The price of electricity in Queensland has always been competitive when compared to other States and it is important to maintain this position.



Based on annual consumption of 7,882 kilowatt hours per year, Queensland consumers currently benefit from the third lowest electricity bills in Australia.

The Government is committed to supporting a competitive retail market for the supply of electricity in Queensland, whereby the economy and customers derive the benefits of a competitive energy sector. Market competition provides electricity retailers with an incentive to offer customers cheaper and more varied energy supply options that a monopoly would not. Energy market reform is a national priority driven through the Council of Australian Governments (COAG).

The Government is also very aware of the challenges facing the energy sector, including the transition to cleaner forms of energy generation. At the same time, energy demand, particularly peak demand, is growing at rates well in excess of population growth. As a result, 15% of the network in South East Queensland is used for less than 100 hours a year. These cost pressures are being reflected in electricity prices. For its part, the Government will continue to encourage and assist electricity consumers to conserve energy and reduce their carbon footprint through increased energy efficiency and greater awareness of energy usage patterns.

In line with previous submissions to the QCA, the Government reiterates that notified electricity prices are an important feature of Queensland's electricity market. This 'safety net' policy is especially important for customers in regional and remote locations where the cost of supply is higher than the notified prices and as a result, the Queensland Government subsidises the supply of electricity to these customers.

The value of this subsidy runs into hundreds of millions each year and in 2008-09 totalled around $460 million.

The QCA must apply the BRCI as prescribed under the *Electricity Act 1994*.

In this context, the Government considers it is imperative that the QCA's methodology for calculating the BRCI ensures only genuine and defensible supply cost increases are passed through to retail electricity prices. This submission focuses on the following areas:

- **cost of energy** – particularly the application of a modelling adjustment factor to the cost of energy calculations;
- **network costs** – only those costs borne by the electricity network businesses that are associated with supplying connected customers should be included in the distribution calculations; and
- **retail costs** – particularly concerns about the increased allowances provided to retailers to acquire new customers.

ENERGY COSTS

Energy generation costs across Australia are increasing. This is due to a number of factors including the progressive transition to lower emissions technologies, the effects of higher construction costs for new power generators and the increase in fuel costs, both coal and gas.

Adjustments to the cost of energy due to the 'modelling factor'

In preparing the remade 2008-09 BRCI Decision and the 2009-10 BRCI Decision, CRA International (CRA), with input from ACIL Tasman (ACIL), provided expert advice on the cost of energy component of the BRCI.

The QCA's Interim Consultation Notice (October 2009) indicated that, for the 2010-11 BRCI, the Authority had engaged ACIL to advise on the cost of energy component of the BRCI. The QCA indicated it would require ACIL to replicate as best it could the 2009-10 energy cost calculation provided by CRA, and then apply the same approach to calculating the 2010-11 energy cost component.

The Government acknowledges the QCA's concerns that different proprietary models can generate different energy cost forecasts, and the QCA's strong desire to maintain consistency in forecast estimates from year to year. The Government also recognises the challenge faced by the QCA in calculating the costs of energy for 2010-11 using a consistent approach between the CRA and ACIL models.

The *Electricity Act 1994, Electricity Regulation 2007* and the associated Ministerial delegation provide some direction about the circumstances in which the data for the preceding tariff year should be updated in calculating prices for the current tariff year. The relevant circumstances include where the pricing entity (the QCA) considers there is a clear reason to change the methodology, or data set. However, the QCA is still required to exercise a degree of judgement about these circumstances.

Interpretation of the legislative requirements applying to situations involving a change to the methodology and data assumptions were at the core of the *AGL Energy Ltd v Queensland Competition Authority & Anor; Origin Energy Retail Ltd v Queensland Competition Authority & Anor* Supreme Court proceedings in 2009.

The QCA has endeavoured to ensure that the methodology and data used for the 2010-11 BRCI estimate are the same as the arrangements for 2009-10. However, the QCA expressed concerns about the potential difference the CRA and ACIL Tasman models may generate and, on the basis of '*calibrating the output of the two models in relation to the 2009-10 estimates*', applied an adjustment factor to ACIL's 2010-11 modelling.

The Queensland Government does not support the QCA's proposal to apply a 'modelling factor' to its calculation of the costs of energy components in the Draft Decision for the following reasons:

1. The QCA would not be able to prove that running the CRA model for 2010-11 would, in fact, generate the same results as the 'adjusted' ACIL model estimates. Using a straight adjustment factor to modelling results generated by a dynamic model may not accurately reflect the differences that would have arisen if the original model was 'rerun'. Effectively, the QCA is assuming, without any evidence, that there is a systematic and reproducible variance between the two models, and that the variation observed for 2009-10 is due to that variance.

2. It is not clear that a 'modelling factor' is required to meet the intent of the *Electricity Act 1994*. The Supreme Court considered at length the intent of recalculating the BRCI index from year to year, and the circumstances where it would be appropriate for the QCA to use data which had not been used in working out the costs in the preceding year, when calculating the cost increases for the new tariff year. In this case, the change of the proprietary model is neither a change of methodology nor a change in data set. The running of the models in each year was in fact simply a means of determining a 'best' estimate of the energy purchase costs for the relevant year. In this instance, the need for a predictive index would suggest that a modelling factor should not be included.

Removing the modelling adjustment factor from the Draft BRCI Decision for 2010-11 would mean the long run marginal cost (LRMC) of energy would increase by 9.8% rather than 9.1%, and the purchase cost of energy for 2010-11 would increase by 1.8% rather than 7.1% (as shown in the table below).

Draft Decision			
Cost component	**2009-10 CRA**	**2010-11 ACIL Tasman (adjusted)**	**Change between 2009-10 and 2010-11**
	$/MWh	$/MWh	%
LRMC	53.28	58.13	9.1
Purchase cost of energy	57.70	61.80	7.1
Weighting 50% LRMC:50% purchase cost of energy	55.49	59.97	8.1

Draft Decision Excluding Modelling Factor			
Cost component	**2009-10 CRA**	**2010-11 ACIL Tasman (unadjusted)**	**Change between 2009-10 and 2010-11**
	$/MWh	$/MWh	%
LRMC	53.28	58.51	9.8
Purchase cost of energy	57.70	58.72	1.8
Weighting 50% LRMC:50% purchase cost of energy	55.49	58.62	5. 6

<u>The Queensland Gas Scheme</u>

In 2008, CRA recommended a transition to market quoted prices, rather than penalty prices in future years. The QCA retained the penalty price approach in its 2009-10 BRCI Decision.

The Queensland Government is concerned that continued use of the penalty price (ACIL estimate $18.84/MWh for 2010-11) overestimates the actual costs faced by retailers to purchase Gas Electricity Certificates (GECs). The spot price for GECs has been reducing with the GEC price in December 2009 of between $2.50/MWh and $3.50/MWh.

The Queensland Government urges the QCA to apply a market estimate to calculate the cost of compliance with the Queensland Gas Scheme on the basis that it more accurately reflects the actual costs retailers incur to meet this obligation. This should also mean that, to the extent that market prices are below the penalty rate, electricity customers are also able to share in the benefit from lower priced GECs.

<u>Mandatory Renewable Energy Target (MRET)</u>

The Queensland Government acknowledges that the QCA has continued to apply the CRA methodology for the estimation of the costs of MRET compliance for 2010-11. However, the estimated $49.57/MWh for compliance in 2010, and $47.04/MWh in 2011, is well above the spot market price of Renewable Energy Certificates (REC). In particular, REC market prices have been below these estimates since early 2009.

The Queensland Government anticipates that estimated RET compliance costs will be even lower when the QCA releases its Final Decision on the 2010-11 BRCI in May 2010.

The Queensland Government urges the QCA to apply a market estimate to calculate its 2010-11 REC estimates. This should reflect the costs retailers are likely to be incurring through MRET compliance, and allow electricity customers to also benefit from lower REC prices.

NETWORK COSTS

Network costs are increasing due to the significant capital expenditure on the network to meet additional demand, ensure system reliability, and reflect the increase in costs of capital, labour and commodity prices.

Network costs are, in effect, a cost pass-through of Powerlink, Energex and Ergon Energy's annual revenue requirements. 2010-11 is the first year in which the network cost component of the BRCI will be based on the Australian Energy Regulator's (AER) estimates of the energy distribution costs, although the AER has been responsible for setting Powerlink's maximum allowable revenue since 2007.

The Queensland Government also notes that, unlike previous years, Ergon Energy's network revenue increase for 2010-11 is higher than that for Energex.

Previously excluded network costs

In its previous decisions, the QCA has excluded the costs of non-Distribution Use Of Service (DUOS) charges from the regulated revenues used for Energex and Ergon Energy. The QCA also excluded Mt Isa network costs from the calculation of Ergon Energy's network costs, as the Mt Isa network is not part of the National Electricity Market (NEM), as it is connected to Powerlink's network.

It would appear that the QCA has inadvertently included these costs in the 2010-11 Draft BRCI Decision. These costs should be excluded in the Final Decision.

RETAIL COSTS

The Queensland Government is very concerned about the increase in the retail cost component of the BRCI.

Retail cost allowance – operating costs

In the 2008-09 BRCI decision, the QCA adopted CRA's recommendation that retail operating costs should be set at $75 per customer, based on the IPART retail operating cost benchmark.

The QCA has escalated these costs using a weighted average of the Consumer Price Index (CPI) and the Wage Cost Index (WCI) for the intervening years, with the retail operating cost estimate now at $85.42 for 2010-11.

The Queensland Government notes that, just prior to the QCA's release of the 2010-11 Draft BRCI Decision, IPART released its *Review of regulated retail tariffs and charges for electricity 2010-13 - Draft Report and Determination (December 2009)*. The IPART Draft Determination recommends that the retail operating cost allowance be re-based to $74.80 in 2010-11.

IPART's draft findings were that customer acquisition and retention costs are lower due to the requirement to consider the retail costs of an efficient 'standard retailer', rather than a mass market new entrant (as for the 2007 determination). A mass market entrant needs to acquire all its customers, while a standard retailer will acquire some new customers and retain its existing customer base. IPART commented that this is significant because acquisition and retention costs per customer are now lower than the acquisition costs per customer included in the 2007 determination.[1]

In making this decision, IPART did not agree with the views of some retailers that the costs of serving customers would increase significantly over the pricing period to 2013. IPART also found that retail operating costs are lower because the standard retailer's actual operating costs over the last years were less than those allowed for in the 2007 determination.[2]

IPART's requirement to consider the retail costs of an efficient standard retailer are consistent with the Electricity Act requirements for the QCA to consider costs in relation to a representative retailer which has a significant share of the market, is efficient and has a customer base that is representative of all customers in Queensland connected to the NEM.

Given the QCA has previously set its benchmark for retail operating costs on the IPART allowance, the Queensland Government considers the QCA should adopt the updated retail operating cost allowance determined by IPART for 2010-11.

The escalated retail cost allowance is appropriate to use where an estimate of the actual cost has not been determined. Given that IPART has recalculated this cost component, the updated retail cost allowance estimate can be assumed to be more accurate than an index escalation and should be the estimate used.

This would mean that, rather than escalating the 2009-10 allowance from $83.19 per customer to $85.42 per customer, the benchmark should be reduced to $74.80 per customer which results in a reduction in this component of 10.1 per cent (as opposed to the 2.7 per cent increase included in the Draft Decision).

Retail cost allowance – customer acquisition costs

The Queensland Government does not consider that it is reasonable to pass-through to customers remaining on notified tariffs the size of the customer acquisition costs (CAC) estimated for 2010-11.

In 2008-09, the QCA considered the rationale for inclusion of CAC in the retail cost element of the BRCI calculation was that retailers must incur costs to retain customer share and the same operating scale. Acquisition and retention costs would only be incurred to win or retain customers to the extent that other retailers may be able to win them away from the standard retailer under consideration. CRA concluded that acquisition and retention costs are directly related to the extent of competitive activity and churn rates.

[1] IPART, *Review of regulated retail tariffs and charges for electricity 2010-13 - Draft Report and Determination (December 2009) pg 12*
[2] IPART 2009, pg 11-12

The Queensland Government is very concerned about the CAC estimates being generated by the new 'simple approach' proposed by the QCA for estimating market churn. The approach adopted for estimating CAC results in a 67% increase in this cost estimate for 2010-11. The majority of this cost increase is due to the changed assumptions about the number of customers switching retailers, as well as the increase in the estimate of the number of customers changing retailers.

Summary of customer acquisition costs

	2008-09 (Final)	**2009-10 (Final)**	**2010-11 (*Draft*)**
CAC for transfers between retailers	$20.08	$19.99	$42.41
CAC for transfers to market contract with the same retailer	$6.57	$6.54	$1.79
Total	$26.65	$26.53	$44.20
Number of transfers between retailers as a percentage of total transfers	64%	64%	93%

The Queensland Government notes that this would mean that the QCA's estimate of $44.20 per customer for customer acquisition costs is well above the $32.80 estimated by IPART for the 2010-2013 New South Wales Draft Determination.

The Queensland Government considers that the percentage (93%) of customers transferring between retailers as a proportion of the total number of transfers is extremely high, particularly considering that Queensland is in its fourth year of Full Retail Competition (FRC) when, typically, market churn rates would be expected to be lower. Previously, the ESCOSA estimated customer switching rates of 82.1% in the first year of FRC and only 56.1% in the second year. These estimates were used by the QCA in the absence of more reliable data.

Given the above, the Queensland Government considers the QCA should review its approach for estimating CAC by either:

1. Revising its estimates of customers changing retailers and switching to market contracts with the same retailer to reflect a better balance between acquisition of new customers and retention of existing customers, with a stronger emphasis on retaining existing customers; and/or

2. Using a fixed CAC cost per customer, thereby removing volatility in this component of retail costs from year to year. Given the relative maturity of the retail electricity market in Queensland, the Queensland Government does not consider that notified electricity prices should be sensitive to the rate of customers switching retailers and, for an efficient electricity retailer with a significant share of the retail electricity market, CAC should be relatively stable.

Further, under section 81 of the Electricity Regulation, a retailer is able to impose a one-off transfer fee to customers that are forced to transfer to the retailer of last resort (ROLR) as a result of their retailer ceasing operation in the market. This fee should not include factors that would be taken into account in the calculation of notified prices. In the recent case involving the retailer Jackgreen Energy, it is important that the QCA ensure the fee paid by affected consumers with the forced transfer to a new retailer is not duplicated in the 2010-11 BRCI Final Decision.

CONCLUSION

The Queensland Government acknowledges that if prices do not rise in line with supply costs, the secure provision of electricity to Queensland consumers - including households and businesses - is at risk. The Government also acknowledges the QCA has a responsibility to ensure the maintenance of headroom in notified prices. Nevertheless, the Government emphasises the overriding importance of ensuring that only genuine increases in the cost of supply are passed on to electricity consumers in the notified prices.