11 February 2011

Mr Gary Henry
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Queensland Competition Authority
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By email: electricity@qca.org.au

Dear Mr Henry

DRAFT DECISION: QUEENSLAND BENCHMARK RETAIL COST INDEX 2011-12

Origin Energy Retail (Origin) welcomes the opportunity to provide input to the Queensland Competition Authority (QCA) regarding its *Draft Decision for the Benchmark Retail Cost Index for Electricity: 2011-12* (Draft Decision).

Origin is generally pleased that the approach of the QCA in most respects mirrors the methodology applied in the 2010-11 BRCI and is supportive of the process undertaken.

However, Origin does have a serious concern that the costs arising from the introduction of the Small-scale Renewable Energy Scheme (SRES) on 1 January 2011 are not being fully recognised. The QCA has chosen to forecast the cost of SRES for the 2011-12 financial year which both ignores the known costs of the scheme arising in the first 6 months of 2011 as well as requiring the use of cost estimates for 2012.

Ideally, Origin would expect the costs for the first 6 months of the scheme in 2011 to be included in the 2011-12 retail tariffs as an additional cost pass through. This would be in line with the cost pass-through applications currently being considered by the Independent Pricing and Regulatory Tribunal (IPART) in New South Wales. Origin believes this may be achieved under the current Queensland pricing framework given the reduction in retail headroom that has occurred because of the scheme introductions on 1 January 2011. Origin encourages the QCA to explore this approach.

As a second best option, Origin believes the QCA should use the actual cost for the 2011 calendar year as the SRES cost input. By using this method, the cost recovery of the SRES in regulated retail tariffs would be delayed by 6 months but this is not prevented under the current framework as the BRCI methodology already uses energy prices and data from the previous 12 month period. Importantly, the BRCI would then be satisfying its intent to reflect changes in the cost of supplying electricity to Queensland customers. This issue is considered in further detail later in Origin's submission.

Origin has also highlighted a number of other concerns in this submission, namely that:

- the modified method for estimating the cost of purchasing Gas Electricity Certificates (GECs) is not a true representation of the cost to Queensland retailers and that there is less risk continuing with the current penalty price method;
- the estimated cost for the Large-scale Renewable Energy Target (LRET) in 2012 is lower than the 2011 cost. This outcome directly contradicts the Government's policy aim for amending the current Renewable Energy Target (RET) scheme and introducing the SRES. Furthermore, current recent market indicators suggest the LRET price has increased substantially in early 2011 with increases of up to 25 per cent;
- the estimated cost for SRES in 2012 is a large decrease from the 2011 cost based on a pessimistic view of small scale solar installations. This is not consistent with available market data. If the QCA were to persist with its current methodology for SRES then Origin would expect the consultant's medium scenario to be used at a minimum as there continues to be strong policy incentives to install small-scale technologies based on decreasing unit costs, consumer awareness of increasing power bills, energy efficiency initiatives and an established solar industry; and
- the current BRCI methodology to average network costs will mean the regulated retail price will not increase commensurate with Energex's network tariffs for 2011-12. Therefore, retailers supplying customers in South East Queensland (where the majority of electricity competition takes place) will face a reduction in margin. Origin continues to support a change to the methodology averaging of network costs for future determinations.

Origin has provided specific comments on the cost components in the BRCI Draft Decision below.

1. Cost of Energy

Origin supports a consistent approach for each BRCI and accepts the methodology for determining the cost of energy as a similar approach to that followed in recent decisions.

Origin notes the capital and fuel costs data used in the Draft Decision are based on a 2009 ACIL report[1]. This is the same input data used for the LRMC in the 2010-11 Final Decision with adjustments made to generation capital and fuel input costs. As submitted previously, Origin believes the input data must be sourced from the most recent available data to properly reflect cost changes from year to year and where more up to date data is available, the inputs should be based on that data. With this precept in mind, Origin notes that ACIL Tasman produced energy market modelling data for AEMO dated 13 September 2010[2] and this appears to be the most up to date and relevant supply input assumptions. In view of this, Origin seeks an explanation for ACIL continuing to use 2009 data albeit adjusted.

Consequently, Origin has reviewed the capital cost and gas fuel cost estimates provided by ACIL and makes the following comments:

- the generation capital cost estimates while reasonable, are from 2009 and need to be updated;

[1] ACIL Tasman, "Fuel resource, new entry and generation costs in the NEM", Final report prepared for Inter-Regional Planning Committee, April 2009

[2] Published report is available on AEMO website, www.aemo.gov.au/planning/scenarios.html, "Preparation of energy market modelling data for the Energy White Paper, Supply assumptions report, 13 September 2010.

- while the estimated gas fuel cost for both closed-cycle gas turbines (CCGTs) and open-cycle gas turbines (OCGTs) until 2013-14 are realistic, the estimated data from 2014 is too low and does not fully account for the significant impact of Queensland LNG exports. Origin expects domestic gas prices to move towards world parity from 2014 with the start of LNG exports from Gladstone (adjusted for transport and liquefaction costs). Consequently, this increased demand also increases the fuel costs for gas-fired generation plants in other NEM states given high volumes of this gas is sourced from Queensland;
- it is likely the price of crude oil may remain above $80/bbl putting further pressure on domestic gas prices. Gas prices for both flat load CCGTs and peaking OCGTs past 2014 are likely to exceed ACIL's current estimates and Origin believes that further consideration of gas price forecasts post 2014 is required; and
- ACIL does not appear to have fully considered the impact on domestic coal prices of expiring coal contracts as coal miners with export quality coal look for higher value in overseas markets.

Given that the LRMC estimate depends on assumed load shape, Origin requests that load shape data and spot price estimates be made available as for previous decisions.

2. Queensland Gas Scheme

To estimate the change in costs for the Queensland Gas Scheme, the QCA has modified its methodology for estimating the cost of Gas Electricity Certificates (GECs). The Draft Decision bases the cost estimate on a market based approach whereas the previous approach used the penalty price. In many instances, market data will be the best measure of the annual cost variation of a retailer's compliance costs for market based schemes; however the Queensland Gas Scheme is not a good example.

Most retailers' cover their long term liability for GECs so the need to trade regularly is removed. Retailers take up long term purchase agreements for GECs that provide for a fixed cost thereby avoiding short term price fluctuations. The AFMA data used by ACIL is based on the reported costs of GECs over a period. However, given the limited number of trades, there is a strong argument that this data is not a true reflection of the price paid by retailers.

The market for GECs is a unique market and is considered illiquid. Origin finds it hard to understand how the reliability of the AFMA data could dramatically improve from the 2010-11 BRCI decision when ACIL concluded there was limited market data available and what was available was unreliable.

Specifically, the AFMA data is based on a maximum number of 5 contributors (and the average may be based upon less than this number). Origin is therefore interested to understand the percentage of GEC liability covered by the data used by ACIL. This is important given that QCA has quoted in its Draft Decision that only 0.3 per cent of the total GEC liability attracted the shortfall price.

Origin acknowledges that selecting an appropriate costing method is a difficult issue because neither calculation is a true reflection of the actual change in retailer's costs. That being said, there is likely to be less risk of error by maintaining the current penalty price method used in previous BRCI decisions than by a methodological change. Especially given the methodology change relies on unreliable market data and produces a significant reduction in the cost of the scheme that does not align with the long-term contracting behaviour of a prudent retailer.

3. Renewable Energy Target (RET)

The introduction of the restructured RET scheme from 1 January 2011 has provided a new market scheme structure that effectively sees the RET scheme split into two separate schemes:

- the Large-scale Renewable Energy Target (LRET); and
- Small-scale Renewable Energy Scheme (SRES).

To fulfil the RET obligations retailers are obliged to surrender certificates for both markets. The introduction of the restructured scheme must be reflected in the tariff prices for 2011-12 and the new markets recognised in this equation. Origin supports a market-based approach for establishing the costs of both schemes; some specific views about the approach to measure the underlying costs are below.

Large-scale Renewal Energy Target

The change in the RET scheme was intended to increase the cost of Large-scale Generation Certificates (LGCs) to improve investment in renewable energies. The separation of SRES from the scheme was to reduce the uncertainty for large-scale renewable energy projects that was being created by the high demand for small-scale renewable technologies. The high demand for small-scale renewable technologies resulted in a flood of renewable energy certificates (RECs) in the market depressing the REC price as well as the pursuit of large-scale renewable energy projects. In effect, the RECs have been revised in substance and consequently value. A general assumption based on the policy position might be that the LGC price will increase over the medium term.

Origin does not believe the method used by the QCA for establishing the cost of the LRET scheme takes account of the transformed RET market and therefore does not reflect the opportunity cost of investing in renewable energy.

The QCA has estimated the cost of the LRET based on market prices for LGC however, the market prices for LGC are based[3] on historical REC market data. Presumably if the Government's policy intent is met then the 2012 average REC price will be higher than 2011; this was not the result of the forecast prices in the Draft Decision. This outcome is not supported by the recent market indicators (January 2011) showing increases in LGC prices by up to 25 per cent nor does it accord with ACIL's analysis provided in the QCA report.[4] The analysis supports future LGC prices to trend upwards and increase for 2012.

Origin requests the QCA revisit the LRET forecasts in light of current expectations but realises that the QCA may be unable to source more robust LGC data without methodological change. In this circumstance, Origin would support the alternative

[3] The ACIL report does not specify the period of prices from which the calculation of the average LGC prices for 2011 and 2012 is based. The methodology referred to in the CRA report is also not specific.

[4] "…..(a) the new RET legislation only applies until 2030. A wind farm which commences operation immediately will have to exist for the last five years of its life without any LGC subsidy. The longer the delay in construction of a renewable project, the fewer years of subsidy it will qualify for and the higher its threshold LRMC will be; (b) black energy prices are unlikely to remain flat in real terms over the next 25 years due to cost increases, regulatory changes and potential introduction of carbon pricing; (c) LGC prices will not be flat in real terms. Forward REC prices have exhibited a 5-8 per cent premium for future years; and (d) LRMCs for renewable technologies are unlikely to remain static. Even if wind is the dominant technology throughout, capacity factors are likely to reduce as the best sites are developed first, resulting in increasing LRMC estimates over time.", p15 of QCA Draft Decision.

approach of a wind-benchmarking scenario as submitted by AGL and TRUenergy as the most practical way to estimating medium term LRET liabilities.

Origin also note that the estimated cost of LRET prepared by ACIL[5] which uses an RPP of 5.08 per cent has not been adjusted to the Office of Renewable Energy Regulator (ORER) published RPP. The correct RPP for the 2011 compliance year is 5.62 per cent which will see a slight increase in the 2011 LRET price than exhibited by the ACIL report.

Small-scale energy scheme (SRES)

The QCA has based the SRES liability on a forecast financial year cost for 2011-12 but has not included the costs arising from the first 6 months of 2011. It is crucial that the QCA explore a methodology to include these costs in its calculations if the change in retail tariffs in 2011-12 is to adequately compensate for the actual change in costs and retail headroom is to be maintained.

The QCA has derived the SRES liability for 2011-12 by adding the known liability for the 6 month period from 1 July 2011 to 31 December 2011 to a QCA estimate of the possible cost for the first 6 months of 2012. Origin would understand the use of this forecasting approach, which will invariably be in error, if the QCA was to then include a cost pass through for the initial 6 month period of 2011. Failing this, the logical approach is to accept the actual cost for the 2011 calendar year as the SRES cost input for 2011-12.

SRES was established on 1 January 2011 and as acknowledged by ACIL, the small-scale technology percentage (STP) for 2011 is known to be 14.8 per cent with a resultant cost of $5.92 per MWh. Rather than establishing a forecast of the financial year cost for 2011-12 which will be open to interpretation, Origin proposes the use of the known 2011 cost. Such an approach will introduce a 6 month lag between costs and prices but has the advantages of:

- being reliable as it replicates the retailer SRES liability without the need for forecasting;
- meets the stated intent of the BRCI in replicating the change in costs. i.e. current retail tariffs assume zero cost for SRES but the actual cost to retailers on 1 July 2011 will be $5.92 per MWh; and
- removes the uncertainty of forecasting as ORER will publish an annual STP for each compliance year going forward which will provide an exact measure of year to year cost movements.

This was the method Origin envisaged in its submission in response to the Issues Paper (October 2010) when it commented that the retail price change on 1 July 2011 would adjust satisfactorily, despite the actual cost increase occurring on 1 January 2011. Origin notes that the QCA has interpreted this comment to suggest that the nature of the BRCI as an index would ensure that retail tariffs would adjust appropriately for the impact of the new RET scheme. This is partially correct but Origin's comment was predicated on the assumption that the QCA would include the SRES cost ($5.92 per MWh) for the 2011 calendar year in the index. Origin did not consider that the QCA would estimate a financial year cost for 2011-12 and ignore the first 6 months of 2011.

There is sufficient support in the *Electricity Act 1994* to use available accurate data compared with forecast data that requires adjustment in the following tariff year. The

[5] See page 44, Table 22, ACIL Report (16 December 2010)

proposed approach will reflect retailer costs as well as accurately measuring the rate of change between two tariff years.

In contrast, Table 1 effectively illustrates the timing issues that will exist with the QCA's current methodology of forecasting a financial year cost.

Table 1: Variation between SRES Cost and QCA Allowance

Period	SRES Cost ($/MWh)	QCA Allowance ($/MWH)	Variation (%)
1 Jan11 - 30 Jun11	$5.92	$-	-100%
1 Jul11 - 31 Dec11	$5.92	$4.73	-20%
1 Jan12 - 30 Jun12	$3.55 - $6.80[6]	$4.73	- 30% to +30%

The uncertainty with regard to the QCA's method is also clearly apparent when considering ACIL's forecast of SRES cost for the first 6 months of 2012.

ACIL has estimated the number of small-scale technology certificates (STC) expected to be created in 2012. However, this estimate is unconvincing as there is no justification for the basis of its high/medium/low scenarios, nor has ACIL presented the reasons for accepting the low scenario as the likely market outcome. Without an explanation for why the low scenario was chosen, the outcome appears unreasonable as ACIL estimates a large decrease for 2012 costs compared with 2011. Origin does not believe this decrease is likely given that strong incentives remain within the market to install small-scale technologies based on:

- decreasing unit costs which counterbalances the reductions in feed-in tariffs and the scheme's multiplier factors;
- consumer awareness of increasing power bills;
- consumers' desire to improve energy efficiency; and
- the strong hold of an established solar industry.

Based on these factors it is inconceivable to justify a sharp decline in solar installations in the short term. Origin considers the medium scenario is a more realistic value. Origin is concerned the approach taken by ACIL in establishing the forecast SRES costs takes a pessimistic view of the SRES liability and has the effect of further reducing the amount recoverable by retailers.[7]

As SRES was introduced during the current tariff year (2010-11) the costs associated with SRES were not available for the 2010-11 BRCI. Despite this, the actual costs of the SRES need to be taken into account and Origin strongly supports:

- the pass through of the SRES costs for the first 6 months of 2011 in addition to the forecast cost for 2011-12; or
- accepting the 2011 compliance year as the cost input for the 2011-12 BRCI to at least allow a lagged but full recovery of costs for the 2011 compliance year in 2011-12.

[6] Based on ACIL's low and high case for 2012 STCs.
[7] Noting the QCA has not taken into account the costs incurred for SRES in the current tariff year as supported by retailers.

4. Network Costs

It is worth noting that the QCA is no longer the economic regulator of Queensland electricity distribution services. Under the National Electricity Law, the Australian Energy Regulator (AER) is responsible for the economic regulation of electricity distribution services As such the AER prepared the electricity distribution determination for Queensland Distributors for the current regulatory period 1 July 2010 to 30 June 2015. The QCA no longer has a function overseeing the Queensland network determinations, future revenue adjustments or annual pricing reviews.

As noted in previous BRCI processes, Origin continues to be concerned with the manner in which the network component for the BRCI is calculated. Although the 2010-11 year allowed for a small rebalancing of the average, these concerns have returned for the 2011-12 tariff year. The average network costs for the two network distribution systems are lowered by the year on year change in network cost for Ergon's distribution network which is smaller than the growth in network cost for Energex.

The effect of this shift in costs will be to the detriment of retailers supplying customers in South East Queensland as the regulated price will not increase commensurate with the Energex's network tariff prices for 2011-12.

Given the recent Queensland floods and cyclones, it is likely that the distribution networks will make cost pass-through applications for recovery of costs associated with these disasters. As the QCA is aware, it is imperative these costs are included in the retail prices for customers at the same time the network businesses begin to pass-through the cost to retail businesses. For example, if network costs are included prior to 30 June 2011 then the regulated retail prices must include the pass-through costs from 1 July 2011. Where the cost pass-through for flood related expenditure is not determined prior to 1 July 2011 then commencement of the network cost pass-through should be delayed until 1 July 2012. At this point, the impact may be included within the regulated notified prices.

As noted above, the QCA is no longer responsible for the economic regulation of Queensland network businesses and has limited control over the network prices. However Origin seeks consideration of this issue, especially if any cost pass-through applications are made prior to 30 June 2011.

5. Retail Costs

Origin accepts the basis of the escalation of the retail operating cost base figure of $126.41 to reflect price inflation and wage growth with the most recent data used for the Final Decision.

Origin is generally against any methodological change but in this instance, Origin can see the reasoning behind the QCA's new method for estimating customer acquisition costs and retention allowance.

Origin believes that the cost allowance for customer acquisitions is now at an appropriate level for a mature competitive market and that the continued use of a methodology derived based on market activity would be out of place. Therefore, although churn rates have increased during 2010-11, Origin agrees with the QCA that the customer acquisition allowance needs to be maintained at its current level and not vary year to year depending on retail activity.

The retail component has increased in excess of CPI and increases in wages in 2011-12. However, Origin notes that this is because the 2011-12 retail cost takes into account the introduction of the QCA's new regulatory fee. The QCA introduced retail regulatory fees for the industry during the 2010-11 financial year and the impact of these fees have been dealt with correctly in the BRCI.

6. Erosion of Headroom

The QCA has a requirement to ensure that its annual indexation of electricity tariffs should keep retail headroom relatively stable.

First, as the QCA is aware, a result of the network component averaging calculation within the BRCI is a decline in headroom in 2011-12 for retailers supplying retail customers in South East Queensland. For the remainder of the current network determination, Energex's network costs are higher than those for Ergon. The effect upon the index will therefore be that the network cost component increases by the average distribution cost rather than the full network cost applicable in the Energex distribution area. This will reduce the level of headroom in 2011-12 and in later years.

Secondly and as mentioned previously, the introduction of SRES has already substantially reduced retail headroom in the current retail tariffs. Retailers are subject to an SRES cost of $5.92 per MWh for energy purchases from 1 January 2011 but any tariff increase acknowledging the increased cost will only become effective from 1 July 2011. The proposed QCA method of forecasting the 2011-12 financial year cost for SRES will both:

- enshrine the erosion in retail headroom that occurred in the first 6 months of 2011; and
- continue to erode retail headroom in the later part of the year.

Origin understands the QCA had been restricted by the BRCI framework from amending the erosion of retail headroom through the annual network calculation. However, this only increases the necessity of the QCA finding a method for including the cost of SRES into retail tariffs that limits its impact on retail headroom as well.

Origin believes a cost pass-through could be implemented under the current framework which would alleviate the issue but has also proposed the use of the 2011 compliance year cost for SRES as the BRCI input cost. This method would not completely resolve the reduction in headroom but retailers will at least recover their actual costs, albeit with a 6 month lag.

Thank you for the opportunity to provide input into this consultative process. If you have any questions, please contact me on (07) 3867 0620 or Madonna Mead on (07) 3028 5300.

Yours sincerely

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