Benchmark Retail Cost Index 2010/11 Interim Consultation Notice

AGL submission to the Queensland Competition Authority

Date: 12 November 2009

1. Executive Summary

AGL welcomes the opportunity to comment on the Interim Consultation Notice released by the Queensland Competition Authority (***QCA***) on the 2010/11 Benchmark Retail Cost Index (***BRCI***). AGL is looking forward to working closely with the QCA and its consultants, ACIL Tasman (***ACIL***) in determining the 2010/11 BRCI.

AGL appreciates the work done by the QCA in conducting its recent review of the pricing methodology in its Review of Electricity Pricing and Tariff Structures (***the Review***). AGL understands that given the time constraints, and the absence of any further indication from the government as to an alternate remit, the QCA is required to commence this consultation on the 2010/11 BRCI. AGL acknowledges the significant challenge this process will present for all stakeholders in such a truncated timeframe.

AGL is supportive of the QCA's proposal to adopt the same methodology as used for 2009-10 to ensure consistency with the judgement and associated orders of the QLD Supreme Court, following its judicial review of the 2008-09 BRCI Final Decision. Given the truncated timeframe for the 2010-11 review it will be critical to ensure methodology, inputs, and assumptions underlying all calculations and modelling are fully transparent and publicly available to enable stakeholders to rapidly review and assess outputs.

1.1. Pricing methodology review and removal of networks from retail tariffs

AGL is largely supportive of the recommendations of the QCA in respect of the review of the regulated pricing methodology and the review of tariffs, particularly with reference to the need to remove the network costs from the 'bundled' retail tariff. Whilst AGL is of the view that a 'transitional year' to implement a new methodology is warranted, AGL is of the view that the Government must amend the BRCI methodology for 2010-11 year to allow, *at a minimum*, the pass through of the actual network costs faced by retailers. To continue with the BRCI without making any adjustments in relation to network costs will come at a significant cost to both retailers in Queensland and effective competition in Queensland over the 2010-11 period.

1.2. Provision of Data and the Consultation Process

AGL considers it essential that the QCA and its consultants provide stakeholders with the same information that the QCA provided in respect of the Draft 2009/10 process, namely the results of the load modelling, spot price forecasting and detailed workings of the BRCI calculations. The information being requested by AGL is further detailed in Annexure 1. Further, AGL believes that the consultation process followed in respect of the 2009/10 BRCI Draft was a very constructive one, and should be replicated in this process – whereby the draft findings of ACIL are provided and consulted on prior to the publication of the QCA's draft determination.

AGL notes that when this information was provided and consulted on prior to the publication of the Draft Determination, stakeholders were able to make a very valuable contribution to the veracity of the BRCI process, identifying and rectifying issues with the modelling work performed by CRA. This same transparency was not afforded in respect of the Final Determination, which AGL understands from the QCA was attributable to timing reasons.

AGL looks forward to receiving detailed information in respect of the calculation of the BRCI, and recommends the same consultation process for both the draft and final determination as was adopted in respect of the Draft 2009/10 BRCI Determination.

1.3. Wholesale Costs

Long Run Marginal Cost

AGL encourages the QCA and ACIL to consider the following:

- The LRMC analysis should be conducted on the basis of a stand-alone, green fields single year or 3 year approach. The current approach of modelling a 9 year view of the entire NEM introduces an unwarranted degree of complexity to the analysis.
- The ACIL 2009 Report[1] should be used as the input data for the LRMC analysis. AGL notes in this context the fact that the Concept Economics report was not consulted on at the time of its use in the Final 2009/10 BRCI and the subsequent closure of Concept Economics consulting business;
- In any event, whichever data set is to be used, it is essential that the regression analysis be conducted over a significantly shorter period of time than was conducted in the Concept Economics report. As noted in AGL's submission dated 28 August 2009 to the QCA in relation to its Stage 1 Draft Paper a structural break in the capital costs of plant has been proved. The regression analysis can therefore only validly be conducted back to the point of the structural break.

Energy Purchase Costs

AGL accepts the general approach adopted by the QCA and its former consultants (CRA) in respect of the 2009/10 BRCI. However, AGL is not in a position to provide comment on the actual methodology adopted by the QCA and CRA in respect of determining the Final 2009/10 BRCI. While a pleasing degree of transparency was provided in respect of the Draft 2009/10 BRCI, this transparency was not provided in respect of the Final 2009/10 BRCI, which the QCA attributes to issues of timing. AGL looks forward to a greater degree of transparency in respect of the 2010/11 process, particularly in respect of energy purchase costs. AGL notes in this respect that stakeholders were able to make a very valuable contribution to the determination of the energy purchase costs in the Draft 2009/10 BRCI process, and also notes that ACIL will be conducting this complex modelling task for the first time in a BRCI process.

AGL makes the following comments in respect of the methodology determining the energy purchase costs:

- AGL reiterates the points it made in its submission to the QCA dated 13 November 2008 and the comments made by AGL's consultants, Creative Energy Solutions (CES), in respect of the forecast of the NEM Load. Attached at Annexure 1 is a copy of the CES report which AGL submitted to the QCA prior to the Final Determination. AGL remains of the view that any forecast which suggests the NEM Load is becoming less, not more, peaky does not accord with all other evidence .;
- AGL notes the issues experienced by CRA in determining the energy purchase costs, particularly in respect of developing a spot price forecast. AGL encourages ACIL to consider these issues, particularly in respect of the necessary degree of

[1] ACIL Tasman, Fuel Resource, New Entry and Generation Costs in the NEM, April 2009

correlation between price and demand, and the appropriate means of calibrating results, and would welcome an opportunity to discuss these matters with ACIL.

1.4. Retail Operating Costs

In calculating the retail operating costs, the QCA should:

› continue to use the 'benchmarking' approach;

› forecast the churn rate for 2010/11 in line with the churn observed in functioning competitive markets such as South Australia and Victoria; and

› make sufficient provision for the increased cost of capital in the retail operating costs.

AGL does again seek transparency in the escalation calculations to ensure stakeholders are able to fully understand the applied process.

1.5. Network Cost

Due to the lack of legislative reform aimed at removing the network tariffs from the bundled retail tariff, retailers continue to face a very significant risk that the network component permitted to be passed through in the BRCI will not equate to the charges imposed on each customer class by the network operators. AGL will continue to discuss with the Government ways in which this risk can be mitigated in the 2010/11 BRCI process.

2. General Comments on QCA Process

2.1. QCA Review and removal of networks

AGL notes and appreciates the significant amount of work the QCA has done in respect of the Review of Electricity Pricing and Tariff Structures (***the Review***). AGL is very supportive of the recommendation of the QCA that the network costs be removed from 'bundled' tariffs and passed through to customers to provide a greater degree of cost reflectivity and allow networks prices signals to be passed through to customers.

AGL understands that the QCA is constrained by the current legislation and has no alternative but to utilise the BRCI process contained therein.

2.2. Provision of information necessary for fair and reasonable consultation process

AGL notes that in the 2009/10 consultation process, the QCA made specific provision for an opportunity for stakeholders to comment on the draft consultant's report prior to the QCA's release of its Draft Decision. AGL found this process to be an extremely helpful and valuable one. AGL suggests that a similar consultation process be adopted by the QCA for 2010-11 so as to include consultative workshops that were a feature of the 2009/10 consultation process.

AGL remains of the view that unless the consultants are required to provide their methodology, inputs and the detailed results of their modelling, stakeholders will not be provided with a reasonable opportunity to analyse and comment on the consultant's work, which forms the basis of the QCA's decision. AGL requests that the QCA provide stakeholders with the same information in respect of the calculation of the 2010/11 BRCI as was provided in respect of the Draft 2009/10 BRCI Determination, namely:

- Details of the forecast of the relevant loads (both in respect of the LRMC calculation and the NEM Load used in the calculation of energy purchase costs);
- Details of the load and spot simulation, the theoretical hedge volumes;
- Input data used in the calculation of the LRMC, and the detail of the calculations performed in determining the BRCI.

The provision of this information by the QCA in respect of the Draft 2009/10 BRCI enabled stakeholders to properly analyse the modelling work performed by the QCA's former consultants (CRA), and indeed to identify issues with that modelling work. This part of the consultation process was extremely valuable and enabled significant errors to be rectified. In contrast, the QCA did not provide this information in respect of the 2008/09 Remade Decision, nor the Final 2009/10 BRCI. AGL is of the view that this precluded a full and fair consultation, and would be very concerned if the QCA does not provide the detailed information being sought for the 2010/11 BRCI.

Further, the QCA has appointed new consultants who have not previously been involved in the modelling of the energy purchase costs for the Queensland regulated pricing process. AGL requests that ACIL consider all of AGL's previous comments on the modelling work performed by QCA and CRA in respect of the 2009/10 process. AGL would welcome the opportunity to discuss the issues experienced in these previous modelling exercises with ACIL, so to ensure an efficient and robust outcome from the modelling process for the 2010/11 BRCI.

It is regulatory best practice to provide stakeholders with direct access to the model of consultants engaged by regulators. AGL draws the QCA's attention to the practice adopted by the Australian Competition and Consumer Commission (***ACCC***) in 2007 in developing the regulated price for Mobile Termination Access charged by Telstra, Vodafone and Optus. In that matter, interested parties were provided with direct access to the model developed by the economic consultants and the inputs used by those consultants. AGL recognises in regulatory price processes that pricing models often comprise intellectual property. However, AGL believes that the legitimate interests of consultants are appropriately protected if parties who have access to the models are required to enter into confidentiality deeds.

2.3. Direction to substantially maintain headroom

The QCA does not presently appear to be currently subject to any Delegation from the Minister for Energy. In all previous BRCI processes, the QCA has been subject to Delegations which have required, amongst other things, that the QCA must have regard to the following policy objectives in determining the BRCI:

> *"(a) the annual indexation of electricity tariffs by the index should ensure that existing retail headroom in the tariffs at the date of this delegation (as modified by condition 2 below) remains relatively stable, although not necessarily the same from year to year*
>
> *(b) the policy of enabling small market customers to revert to notified prices should not result in a retail entity providing customer retail services to non-market customers at a loss".*

The genesis of this direction was a letter from the Queensland Government to prospective bidders for the retail businesses, dated 1 November 2007, which stated that:

> *The overall policy intent of the annual indexation of tariffs by the benchmark retail cost index is to ensure that the actual increases in (the total) electricity costs are reflected in the level of tariff increases. This approach will, amongst other things, ensure that the competitive headroom in Queensland remains relatively stable. Additionally, the intent is to ensure that the reversion policy does not result in retailers providing services at a loss to customers*

AGL notes that the Government has clearly indicated its intention that these policy directives form an integral part of any future pricing methodology, as the Direction to the QCA dated 24 June 2009:

> *Prices should also support the continued implementation of full retail competition with sufficient headroom to foster a competitive electricity market. Headroom should remain relatively stable and the Queensland Government policy of enabling small market customers to revert to notified prices should not result in a retail entity providing customer retail services to small non-market customers at a loss.*

On this basis, AGL suggests that the QCA proceed on the basis that this remains the policy objective of the indexation process.

3. Wholesale Energy Costs

3.1. Long Run Marginal Cost

AGL is of the view that the LRMC should be modelled on a 'greenfields', stand-alone basis where the relevant load is modelled over a 1 to 3 year period, rather than over a 9 year period. AGL notes that this is the approach that is being adopted in NSW by IPART/Frontier, and does not see any reason the QCA and its consultants could not embrace a similar approach. AGL does not believe the adoption of this modelling approach for the purpose of calculating the 2010/11 LRMC would constitute a change in methodology.

AGL remains concerned that attempting to model a period of 9 years over an interconnected region introduces an unnecessary level of complexity. Not only does this require forecasting the entire Queensland load over a 9 year period, which alone is a very difficult task, but it requires making assumptions as to the load in all other regions of the NEM, the build in those regions and the related transmission costs, the interconnection constraints and complex issues of coincident demand.

LRMC Load

AGL suggest that attempting to model the Queensland load over a 9 year period is unnecessarily complex and fraught with difficulty. The shorter the period of time of a forecast, the more reliable a forecast will be.

AGL believes that a period of 1 year would suffice for the purposes of a single-year LRMC analysis, or at most a 3 year period. AGL would be interested in understanding the QCA's and ACIL's views on this.

AGL notes in this context that the QCA has not previously considered an adjustment to the period of time over which the load is modelled to constitute a change in methodology.

Input Assumptions

AGL reiterates its view that the ACIL 2009[2] data set should form the basis of the LRMC analysis. AGL has a significant number of concerns with the approach taken by Concept Economics, and notes in this respect that the Concept Economics report was not the subject of any consultation prior to its use in the Final 2009/10 BRCI. In fact, stakeholders were not even aware that the QCA had commissioned this report prior to the publication of the Final Report. Concept Economics has ceased operating as a business, and AGL suggests in all these circumstances it would be inappropriate to use the Concept Economics report as a source of input data in an LRMC analysis.

In the event the QCA does believe the Concept Economics report does provide a basis for input data, AGL is very firmly of the view that the regression analysis performed on that data is incorrect. Attached at Annexure 3 is AGL's analysis of the Concept Economics report, with specific reference to its finding that there was no structural break coal and gas plant capital costs. As noted in this report, the data used in the Concept Economics report does in fact support a finding of a structural break, contrary to the conclusions drawn by Concept Economics. On this basis, the Concept Economics data set should be formulated on the basis of a regression analysis which excludes all data prior to the structural break, which occurred around mid 2006.

Tax treatment of interest during construction and the WACC

CRA have modelled the LRMC in the past using a 'greenfields' approach, whereby the analysis is focussed on the system required to supply the Queensland load as a hypothetical complete new build, with the capital costs of the new plant included in the resultant LRMC.

The consequence of this approach is that none of the hypothetical new build is part of any portfolio.[3] Hence, interest costs incurred through funding such projects with debt cannot be used to offset income for taxation purposes until the new generation actually produces a net profit before tax. In other words, during the construction phase there is no income for this interest cost to offset.

Therefore the WACC should not assume any benefit from a tax shield prior to a positive taxable income.

If the QCA uses ACIL Tasman's LRMC analysis in its 2010/11 BRCI, including its WACC, it's important to note that in ACIL Tasman's LRMC calculation the tax shield benefit of debt is

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2 ACIL Tasman, Fuel Resource, New Entry and Generation Costs in the NEM, April 2009

3 AGL supports this approach given that, the theoretical nature of this modelling where it contemplates construction of a complete new generation fleet to meet the regulated customer load, any assignment of new build to any particular portfolio would be an arbitrary and subjective modelling decision.

implicitly assumed to have immediate cash flow impact when the interest is incurred rather than when benefit is utilised. This is correct when the project is part of a portfolio but not when the project is standalone, as would be the case in the green fields approach.

Given this, AGL suggests that the timing of the tax shield benefit be modelled in each project's cash flow such that the assumption of standalone new build is correctly incorporated. As stated below, this is supported by ACIL Tasman[4]:

> *"As the Officer WACC formula includes the interest tax shield and imputation credits, there is potential for inaccuracies to exist as it is essentially a simplification. This is particularly so in the case of finite projects which have different amounts of depreciation and tax payable throughout the project life. A more accurate means of accounting for these elements can be achieved by incorporating them explicitly into the cash flows and using a Vanilla WACC."*

Treatment of IDC for Determination of Fixed Costs

It is important that the derivation of the fixed costs in the LRMC calculation includes interest during construction (IDC) in the upfront capital costs and therefore the determination of the fixed costs of new generation plant. IDC is a non-trivial component of the cost of a new plant and therefore must be included in any calculation of LRMC. It is not clear how the QCA/CRA has taken IDC into account in the past.

AGL's view is that to be consistent with standard industry practice for project-financed standalone projects, the estimation of generation fixed costs (for use in the modelling of LRMC) should treat IDC (and prior to the production of a net profit before tax) as fully capitalised and thus subsequently included in the determination of the average cost of new plant.

CPRS and LRMC

It is appropriate for the purposes of the LRMC analysis for the year 2010/11 to exclude consideration of the CPRS, as the CPRS will not commence until 1 July 2011. However, AGL reiterates that the analysis proposed by CRA in respect of the 2009/10 process was flawed and should not be adopted by the QCA and ACIL.

3.2. Energy Purchase Costs

The QCA has requested comments on the methodology used to calculate the Energy Purchase Costs (***EPC***). AGL is not in a position to make comprehensive comment on the approach adopted by the QCA and its consultants in the Final 2009/10 BRCI, as it was not provided with sufficient information in respect of the modelling work performed by CRA. Stakeholders were not provided with the detail necessary to understand the actual methodology applied in simulating load and spot forecasts, or any detail which supported the veracity of the final spot and load traces.

AGL again notes that the level of transparency provided in respect of the Draft 2009/10 BRCI was pleasing to all stakeholders, and permitted comprehensive analysis which assisted the QCA and its consultants to identify issues with the draft modelling work. This transparency was not adopted in relation to the Final 2009/10 process. AGL requests the

[4]ACIL Tasman, Fuel Resource, New Entry and Generation Costs in the NEM, April 2009, page 7. Available on the Australian Energy Market Operator's website, www.aemo.com.au

QCA to ensure that the 2010/11 process is transparent and permits a full, fair and robust analysis, particularly in respect of the energy purchase costs.

AGL does note in this respect the errors made by CRA in the previous BRCI processes, and the fact that stakeholder analysis was key to the remediation of these errors. In these circumstances, AGL considers it imperative that the data requested above be provided to stakeholders prior to the QCA's draft decision being published

NEM Load

AGL again reiterates the points made in respect of the NEM Load forecasts developed by ACIL for the Final 2009-10 BRCI. The CES report which AGL submitted to the QCA prior to the Final Determination. AGL suggests that a number of the issues raised in AGL's correspondence with, and submissions to, the QCA and the CES Report require further exploration if the same methodology is to be used in the 2010/11 process. A NEM Load forecast which suggests the NEM Load is 'flattening', does not accord with the evidence which demonstrates that the NEM Load has become peakier over the relevant period. Further, that the Statement of Opportunities (***SOO***) and Powerlink Annual Performance Report (***APR***) have consistently forecast, by reasonable implication, a degradation in the load factor in the NEM Load. AGL would expect to see such a trajectory reflected in any NEM Load trace.

Price trace

AGL draws attention to the issues identified by stakeholders in respect of the spot price modelling work performed by CRA, as follows:

<u>Correlation between price and demand</u>

CRA experienced a number of difficulties in achieving the appropriate degree of correlation between spot prices and demand. CRA accepted that there should be a high correlation between incidents of high price and high demand. This degree of correlation should also be present in any spot price simulations produced by ACIL.

<u>Calibration methodology</u>

AGL has not fully understood the calibration process undertaken by CRA, and AGL (and other stakeholders) had previously suggested that the pool price forecast had been calibrated to achieve a weighted average price by an adjustment in the number of incidences of high prices, rather than by reference to underlying prices. AGL is happy to discuss this issue further with ACIL with a view to understanding more about any proposed calibration process.

Hedge Position and the Marginal Loss Factor (MLF)

There was some contention previously over the manner in which CRA appeared to be applying the MLF. It appeared that the MLF was being applied after the hedged load was determined. The appropriate manner in which to determine hedging for the hypothetical retailer is to apply the MLF to the forecast load prior to the 'acquisition' of hedges. This aligns with the approach taken by retailers operating in the market, and ensures the hedge position provided to the hypothetical retailer aligns with the hedging strategy proposed in the modelling approach.

3.3. Other costs

MRET / ERET

There are two key calculations involved in determining the cost of a retailer's compliance with the Renewable Energy Target. These are the retailer's Renewable Power Percentage (***RPP***) and the price for Renewable Energy Certificates (***REC***).

The RPP value determines the volume of RECs a retailer has to acquire to satisfy its compliance obligations, and the cost incurred by a retailer is a function of the RPP value and the cost of the RECs.

AGL notes that recent changes to the RET scheme following the legislative change to expand the RET, have led to a significant degree of uncertainty as to the RPP and REC price. This is due to the overall targets, the liable industries, and therefore the overall supply and demand balance of RECs being altered.

AGL notes that the regulations and policies which provide certainty on the RET obligations of participants have not been finalised, and may not be finalised before March 2010. The areas of uncertainty include:

- the final form of the 20% RET contains an additional component for the inclusion of eligible waste coal mine generation. AGL observes that in modelling the REC cost, this additional target and cost will need to be included;
- the electricity loads that are liable given the partial exemption for trade exposed industries from the expanded target;
- the appropriate RPP for each retailer; and
- the partial assistance offered to trade exposed industries for costs incurred above $40/MWh for the original MRET component of the 20% RET.

In the 2009/10 BRCI process, QCA/CRA determined a RPP value inclusive of the forecast change following the expanded RET taking effect from 1 January 2010, and estimated the REC price using weekly market prices for REC's published by AFMA.

AGL supports any RPP calculation including the increase volume resulting from the changes under the Expanded RET scheme. However, as outlined above, the RPP may need to be forecast in an environment of uncertainty. Therefore it is vital that retailers be given the opportunity to provide their views on their RPP.

In relation to the cost of RECs, AGL continues to hold the view that RET compliance costs should be determined with reference to the LRMC of generation for assets eligible to create RECs. This is because any retailer with a significant REC liability will need to enter into long term power purchase agreements (PPAs) in order to fulfil their liability. Given that the QCA calculates the LRMC of black energy using the RET scheme as a constraint, it should be able to determine the LRMC of RECs without much difficulty.

4. Networks

AGL accepts that the QCA is currently bound by the existing legislative framework, which continues to expose retailers to a significant risk that the network component permitted in the bundled tariff that results from the application of the BRCI will be lower, and can be significantly lower, than the actual network tariff imposed by Energex in respect of regulated customers. AGL will continue to pursue this issue with the Queensland Government.

5. Retail Operation Costs

AGL continues to support the ‘benchmarking’ approach taken by the QCA in respect of the calculation of retail costs in 2008/09.

AGL seeks full transparency in the calculations of the escalation factors and increases in retail operating costs, customer acquisition and retention costs for 2010-11 as the escalation process described for 2009-10 BRCI does not appear to yield the escalation factor used in the 2009-10 Final Decision. In the 2009-10 BRCI, this escalation factor was calculated to be 2.8% and was based on a 40/60 weighting of CPI and wage inflation[5]. Based on AGL’s calculations these assumptions should have produced an escalation of 3.04%.

In the 2009-10 BRCI, total customer acquisition and retention costs were estimated to increase by 2.1% from $51.4 million in 2008-09 to $52.5 million in 2009-10[6]. However, the stated 2.1% increase is not consistent with a weighted average calculation based on the stated inflation and wages forecast and the customer switching and transfer numbers used for both the 2008-09 and 2009-10 BRCI. It would appear that the increase in customer acquisition and retention costs in 2009-10 should have been escalated at the rate of 3.04%.

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5 Inflation forecast for 2009-10 of 2.5% was sourced from RBA (8 May 2009 statement) and wage forecast of 3.4% sourced from ANZ Economic Outlook (6 April 2009).

6 Page 45 of 2009-10 BRCI Final Decision

Annexure 1

Information Required for 2010-11 BRCI

LRMC

- The forecast half-hourly system load traces for all regions modelled
- All assumptions used in the calculation, including but not limited to:
    - A detailed breakdown of all fixed and variable generation costs assumed, and all relevant assumption as to availability and energy limitations
    - The detail of any regression analysis performed on a data set, and the reasons for that analysis
    - Detail of assumptions as to reserve requirements for each region modelled
    - Detail of the assumptions underpinning the WACC, with particular reference to the issues raised in respect of Interest During Construction and the treatment of tax shields
    - Any assumptions made as to interconnecter flows and constraints and co-incident demand (if not modelled on a stand alone basis)
    - The detail of the modelled supply mix outcomes

Energy Purchase Costs

- The NEM Load trace at a half hourly resolution
- The Qld Load trace and the Direct Connect load trace used to derive the NEM Load trace, at a half hourly resolution
- The simulated spot price data, at half hourly resolution
- The assumed prices and volumes of hedge cover assumed for each half hour
- The contract data used in the calculation
- The spreadsheet calculation of the energy purchase cost based on the above information

Retail Operating Costs

- The spreadsheet calculation of the rate of change in retail operating costs.