origin

9 November 2009

Mr Gary Henry
Queensland Competition Authority
GPO Box 2257
Brisbane Qld 4001

electricity@qca.org.au

Dear Gary

INTERIM CONSULTATION NOTICE: BENCHMARK RETAIL COST INDEX 2010-11

Origin Energy (Origin) acknowledges the recommendations on regulated electricity pricing made by the Queensland Competition Authority (QCA) in its *Final Report: Review of Electricity Pricing and Tariff Structures - Stage 1.*

Origin provided detailed submissions to the QCA throughout this review process and highlighted that it was unrealistic for the QCA's recommendations to be adopted in Queensland legislation, consulted upon and then implemented effectively prior to the setting of regulated electricity prices for 1 July 2010.

Given that the QCA's recommendations have yet to be adopted at this time, Origin believes that the commencement of a benchmark retail cost index (BRCI) process for 2010-11 is both reasonable and prudent. The postponement of a 3 year determination until 2011-12 will provide the necessary time to ensure that the selected methodology is consulted upon sufficiently and implemented effectively.

The postponement of the 3 year determination may limit the scope for some reforms in 2010-11 such as the necessary structural reform of retail tariffs. However, Origin is encouraging the Queensland Government to make the required legislative changes to remove access to regulated tariffs for Large customers (consuming greater than 100 MWh) in south east Queensland. Origin believes this can and should be completed prior to 1 July 2010.

Furthermore, the major issue now for the QCA and industry is to ensure that the BRCI process for 2010-11 is effective in adjusting retail tariffs in line with the change in the cost of supplying electricity to south east Queensland customers. Failure to accomplish this will lead to further deterioration in the cost reflectivity of retail tariffs and compound the issues to be faced in any subsequent 3 year determination.

In essence, Origin highlights that:

- the BCRI methodology for 2010-11 must take full account of the change in network costs in south east Queensland (Energex and Powerlink network costs) and cannot allow any significant cost change to be muted by differing cost changes in the rest of Queensland (Ergon network cost); and

- that the QCA continue to follow the methodology adopted in calculating the BRCI for 2009-10 for the remaining components of the BRCI, namely the retail and cost of energy components. Origin will, however, require additional transparency of the datasets and calculations used for 2010-11, especially given the shortened timeframe and that new consultants will be attempting to replicate the current methodology using new models.

As such, this submission considers the approach that Origin believes needs to be taken in calculating the BRCI for 2010-11 to address these issues in a manner that complies with good regulatory practice.

Network Cost

The current BRCI methodology utilises the network cost of the whole of Queensland. In short, it uses an average of the network costs faced by Energex customers in south east Queensland with those faced by Ergon customers in the rest of Queensland.

This has been a significant issue to date and may be an even greater issue for the 2010-11 BRCI given both Ergon and Energex are in the midst of new revenue determinations by the Australian Energy Regulator (AER).

The significance of the issue is readily shown when considering the impact that any variation between increases in Energex and Ergon network charges would have through the BRCI. An increase in network charges for Energex of 20 per cent compared to an increase for Ergon of 10 per cent would result in an average network increase in the BRCI in the order of 15 per cent. This would be reflected in a 7.5 per cent increase in retail tariffs.

However, the increase in actual Energex network costs faced by retailers to south east Queensland would still be 20 per cent so regulated retail tariffs would have been escalated by around 2.5 per cent less than that required for cost reflectivity in south east Queensland. Given regulated retail tariffs currently provide only a 5 per cent retail margin, the averaging of network cost in 2010-11 would therefore be untenable if Energex and Ergon's network charges vary and the Government wished to sustain a competitive energy market in south east Queensland.

Origin recognises that the QCA cannot specifically address this issue but believes there are several options available to Government and industry to avoid this situation, namely that:

1. the Government address the network issue through legislative change to require the QCA to estimate the network component by only considering south east Queensland network charges. Origin believes this may be completed through a new regulation rather than any significant changes to the *Electricity Act 1994;* or alternatively
2. the QCA and industry approach the distributors and the AER to ensure that the increases in network tariffs in 2010-11 are aligned between the two distributors. This would avoid the deterioration of retail tariffs in 2010-11 but Origin recognises that this would only be a short-term solution and would not be possible if the BRCI continues on after 2010-11.

If one of these options is not implemented, it is extremely likely that:

- Queensland retailers will face significantly reduced or negative margins in contrast to the objectives of the BRCI;
- non-incumbent Queensland retailers may exit the Queensland electricity market; and therefore
- the growth in competition in the Queensland energy market that has occurred since May 2009 will not be sustained.

Cost of Energy

Origin agrees with the QCA continuing the methodology used in the 2009-10 BRCI for estimating the cost of energy in the 2010-11 BRCI.

However, Origin will require the QCA to provide transparency to the datasets and calculations used for the cost of energy in 2010-11. Origin understands that the QCA did not release all the datasets of the final 2009-10 BRCI because of the time pressures at that time. Given that new consultants will be attempting to replicate this methodology in 2010-11 using new models, Origin believe it is imperative that the QCA provide the transparency that was evident for much of the 2009-10 BRCI determination process. Namely, access needs to be provided to all necessary data including the 10POE, 50POE and 90POE load and price traces used in the energy purchase calculation.

Furthermore, the fundamental basis for an index is consistency with previous years so a change in methodology in 2010-11 would necessitate the recalculation of 2009-10. If that was to occur, Origin would also require the final data sets for 2009-10.

Origin would also note with regard to other aspects of the cost of energy calculation that:

- it has previously submitted that the 50:50 weighting of LRMC and purchase costs is arbitrary and does not sufficiently recognise the actual purchase costs in any one year. This is correct, however Origin agrees that it is a legitimate method of smoothing the cost of energy over time and believes the 50:50 weighting should remain for 2010-11 so as to maintain consistency across years for the BRCI calculation;
- in the past Origin has argued for point to point estimation of the Long Run Marginal Cost (LRMC) estimation because it better reflects current generation entry costs. Origin accepts that the QCA' s trend analysis has smoothed the fluctuations in LRMC over the last few years and given it has been used to smooth the peaks in capital and input costs of recent years, accepts the continuation of the trend analysis for the 2010-11 BRCI calculation of LRMC;
- it generally agrees with the gas and coal fuel forecast costs used in the 2009-10 BRCI calculation of LRMC. However, the QCA has not yet made it clear whether these will be revised for the 2010-11 BRCI determination. Origin will comment further on fuel input costs after the draft determination is published;
- it requests that the QCA revisit the calculation of LRMC to ensure that there has not been a step change in the capital cost of gas-fired generation. Origin is the largest developer of gas fired turbines in the NEM, with over 1100MW of self build generation in Queensland, and is very experienced in costing gas-fired generation. Origin believes the CCGT capital cost estimation in the QCA's 2009-10 BRCI determination ($1200/kW) was too low and also queries the capital cost of OCGTs. Origin has purchased or built several relatively large OCGT generation units in the last two years at a cost in excess of $900/kW. Origin will comment further on all aspects of the LRMC calculation once the draft determination is available for comment;
- its mass market average demand has been substantially supported by its investment in Queensland generation and other long term contracts with Queensland generators. Origin still must procure seasonal volume, caps and other traded products to hedge its total position to take into account risk limits and customer churn. However, in circumstances where contract prices fall below LRMC, it is clear that the BRCI does not recompense Origin's investment given Origin has increased its exposure on the LRMC component to greater than the arbitrary 50:50 weighting;
- it agrees with the QCA that it is difficult to incorporate the cost of carbon into the LRMC calculation while details of the Carbon Pollution Reduction Scheme (CPRS) remains unspecified but believes a CPRS is now more assured than in previous years. Given it will

necessitate a different mix of generation in the LRMC analysis, Origin supports modelling LRMC based on some credible scenarios of CPRS so that, if it is clear before the final determination that the final make-up of CPRS is known, then CPRS can be incorporated into the LRMC calculation for the 2010-11 BRCI;

- it supports the methodology used for calculating the energy purchase cost in the 2009-10 BRCI calculation to be consistently used for the 2010-11 BRCI determination. i.e. the purchase cost should be estimated based on a combination of contract and spot market energy purchases that a prudent and efficient retailer operating in the Queensland market could be expected to purchase; and
- agrees that the QCA should use a consistent methodology with the 2009-10 BRCI to estimate the cost of Queensland Gas Electricity Certificates (GECs) and Renewable Energy Certificates (RECs) in the 2010-11 BRCI.

Subject to consideration of these issues and access to all datasets and applicable calculations, Origin is comfortable with this type of approach continuing into 2010-11.

Retail Cost and Margin

Origin continues to support the QCA's use of retail cost benchmarks and their subsequent approach of escalating annual retail cost using well known indices as an appropriate method for setting the operating cost component of the BRCI.

However, although Origin accepts the QCA's use of its 2009-10 methodology for estimating customer acquisition and retention costs, it would encourage the QCA to resolve the inadequacies of the data used to make its forecast of customer switches and transfers given the doubts raised over the figures used for the 2009-10 final decision.

Origin has also submitted previously that the BRCI requires an appropriate retail margin to cover the retailer for its risk-weighted investment. Origin continues to question that the benchmark net margin of 5 per cent of sales is sufficient and that all other risks surrounding energy purchasing and customer acquisition are fully taken into account in the BRCI.

Origin's concerns are, of course, exacerbated by the network cost issue and its potential impact on customer profitability and will remain until this issue is resolved.

If you have any queries, please do not hesitate to call myself, or Patrick Whish-Wilson on (07) 3867 0620.

Yours sincerely

[redacted]

Duncan Permezel
Retail Executive, Directions and Growth