



## Benchmark Retail Cost Index

AGL submission to the Queensland Competition Authority

Date: 16 February 2010





# 1. Executive Summary

AGL welcomes this opportunity to comment on the *Draft Decision Benchmark Retail Cost Index for Electricity:2010-11(Draft Decision)*. AGL is appreciative of the level of transparency offered by the QCA and its consultants, ACIL Tasman, in respect of the methodology and calculations underpinning this Draft Decision. AGL believes the level of transparency afforded by the QCA is appropriate and consistent with good regulatory practice.

AGL is largely supportive of the approach taken by the QCA, and believes the Draft Decision is broadly cost reflective (if adjusted to take account of certain issues specified in the body of the submission). AGL agrees with, and supports, the QCA's approach in adopting a 'calibration' approach to account for the issues associated with changing consultants and their specific models between years, thereby ensuring the legislative provisions of the *Electricity Act 1994* are appropriately applied.

AGL acknowledges the significant increase to electricity prices signalled in the Draft Decision, and understands the impact such price increase may have on customers. Without detracting from the significance of the increases, particularly for those customers experiencing financial hardship, it is necessary to note that over 61% of the increase is attributable to network increases. Further, this percentage may increase if the networks choose to rebalance into the small customer segment.

AGL remains firmly of the view that legislative and retail tariff reform is necessary in order to ensure the regulated prices appropriately reflect the costs of supplying electricity, including network costs, and that the retail tariffs are cost reflective and provide customers with incentives to use electricity more efficiently. As noted in previous public submissions, AGL is largely supportive of the recommendations made by the QCA in its reports *Review of Electricity Pricing and Tariff Structures Stage 1* and *Review of Electricity Pricing and Tariff Structures Stage 2*. AGL looks forward to working with the QCA and the Queensland Government to progress this essential reform process.



## 2. General Comments

### Transparency and Data Provision

AGL acknowledges and appreciates the level of transparency provided by the QCA and ACIL in the Draft Determination. AGL is pleased to note the provision of all information previously requested, and notes this has allowed AGL to fully consider the methodology and calculation of the wholesale energy costs component of the BRCI. Such an approach facilitates an open and constructive consultation process.

### Compliance with legislative provisions through 'calibration'

AGL supports the 'calibration' approach adopted by the QCA and ACIL in order to ensure there is consistency between the relevant years, and that the BRCI is calculated in accordance with the legislative provisions and purpose of the *Electricity Act 2004*.

## 3. Cost of Energy

### 3.1. Load Data

AGL notes that the entire system load and NEM load as modelled by ACIL does not reflect a deterioration in load factor – ie the load is forecast to become peakier across the year. This deterioration accords with AGL's observations and expectations.

AGL also notes ACIL have used the AEMO 2009 ESOO as a basis for determining sent out energy and maximum demand forecasts. AGL submits that these forecasts are overly pessimistic having been compiled at the time of the Global Financial Crisis and do not reflect the improved economic conditions Australia that have resulted since. AGL notes that Frontier Economics in their recent report to IPART<sup>1</sup> for the purpose of determining electricity costs in NSW have used the high economic growth scenario in recognition that the AEMO's 2009 forecasts are somewhat outdated. AGL would encourage the QCA to consider this approach. It is AGL's view that by using the medium economic forecast, the demand forecasts used in the modelling are understated.

### 3.2. Long Run Marginal Cost

#### 3.2.1. Use of ACIL data

AGL is pleased to note that the QCA has accepted ACIL's advice and used the ACIL 2009 Report as the appropriate input data set.

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<sup>1</sup> Consultant Report – Frontier Economics – Energy Purchase Costs – A Draft Report for IPART – December 2009



### **3.2.2. Interest During Construction**

AGL appreciates the response provided by ACIL to issues raised previously in respect of the treatment of interest during construction. AGL does however note that there may remain an issue as ACIL appear to apply immediate utilisation of the interest tax shield. AGL suggests this may not be consistent with the assumption of a stand-alone, project-financed new entrant.

### **3.3. Energy Purchase Costs**

#### **3.3.1. Settlement of contracts against forecast price and load outcomes**

AGL agrees with the overall approach to the calculation of the energy purchase costs, and appreciates the transparency provided in respect of these calculations. AGL notes that many of the issues evident in previous years have been avoided in this Draft Decision. While AGL has identified some issues, AGL is confident that if these issues are investigated and remedied, the energy purchase costs calculated by ACIL Tasman represent a WEC that is broadly cost reflective.

#### Spot Price Forecasts

ACIL's spot price forecasts seem low relative to historical analysis. AGL is concerned that in using the medium economic growth forecasts presented by AEMO in the 2009 ESOO, the modelled spot price is on average too low. Whilst AGL notes that additional generation capacity is expected to be available during this period, spot prices modelled in the forecast have been premised on an overly pessimistic economic growth scenario (as discussed above), and are therefore lower than they should be.

AGL notes that the spot price forecasts ACIL has produced do not align with market expectations. For example, ACIL has forecast the highest spot prices will occur in Q3 2010 and Q2 2011. This is contrary to market expectation, with the highest contract prices occurring in Q1 2011 and Q4 2010. Historical analysis shows that typically the highest pool prices occur in quarter 1 and quarter 4, which are the periods in which maximum demand occur<sup>2</sup>. Annexure 1, tables 1 and 2 illustrates this.

AGL notes that the spot price forecast contains a number of extreme price events (>\$1000/MWh) at times of relatively low demand<sup>3</sup> and would ask that these be investigated and explained in further detail. As the OCA would be aware from previous determinations, to the extent that there are high price events being modelled at low demand (when a retailer will have excess contracts) large difference payments accruing to the retailer will result. This is a rare circumstance in reality. Annexure 1 table 3 shows the impact of these extreme price events at low demand and represents the amounts accruing to the theoretical retailer as a result of favourable difference payments. These amounts are directly reducing the energy purchase cost of the theoretical retailer.

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<sup>2</sup> Queensland has a summer peaking load profile

<sup>3</sup> AGL is assuming demand below the highest 10%, that is, NEM load of less than 7000MW.



### 3.4. Other costs

#### MRET/NRET compliance costs

AGL notes that ACIL have used a market based cost for Renewable Energy Certificates (RECs). AGL supports the use of Long Run Marginal Costs in the determination of REC costs, rather than market based costs, as this is a better representation of the costs that a retailer will have to pay for the majority of its REC purchases. Large scale renewable energy projects generally require offtake agreements in order to achieve project financing. As such RECs from large scale renewable energy projects do not tend to trade on market. Thus, a large proportion of a retailer's RECs to satisfy their obligation will be acquired from large scale projects for which a retailer will be incurring the LRMC of the project costs.

In addition, it appears that ACIL has not appropriately forecast the Renewable Power Percentages (RPP). It appears that ACIL may not have accounted for the part exemption of the Emission Intensive Trade Exposed (*EITE*) customers. This exemption will place a greater burden on electricity retailers which will push up the RPP, which may not have been factored into the forecast RPPs. AGL would be happy to assist the QCA / ACIL in forecasting the appropriate RPP.

#### NEM Fees and Ancillary Services

AGL has not identified any issues with ACIL's calculation of the NEM fees or the ancillary services.



## 4. Networks

AGL notes that the QCA have calculated the network component in accordance with the legislative framework. As stated by the QCA, the network increases (which are premised on the Draft AER determination) presently account for an increase of 8.43% in the BRCI (61% of the total increase). AGL notes that the increase attributable to the networks could in fact be a higher proportion of the final adjusted tariffs, once the network re-balance.

AGL reiterates its concerns in respect of the manner in which the network component is treated in the calculation of the BRCI, namely that:

- In using the average Energex and Ergon AARR, the BRCI does not accurately capture the increase that has been incurred in Energex's patch 2010/11; and
- The BRCI makes no allowance for the ability of Energex to re-balance its tariffs within the AARR increase.

AGL encourages the Queensland Government to continue with the proposed reform of the pricing regulation framework and the structure of the retail tariffs.

## 5. Retail Operation Costs

### 5.1. Benchmark costs

AGL reiterates its support for the 'benchmark' approach adopted by the QCA in assessing the operating costs of retailers. However, AGL again notes that while it is happy to accept the level of operating costs determined by the QCA for the purposes of establishing a 'rate of change' between years, it does not accept that the operating costs determined by the QCA reflect the cost incurred by retailers.

### 5.2. Acquisition costs

AGL acknowledges that the data submitted by AGL to the QCA in respect of churn figures has created some confusion, and regrets any inconvenience this has caused the QCA in respect of the BRCI process. AGL notes that:

- The number of customers switching between a regulated contract and a market contract with the same retailer appears to be lower than expected; and
- The total number of customers churning appear to be higher than expected.



## 6. Margin

AGL believes that a retail margin of 5% is too low to cover the associated costs and risks of being an electricity retailer in Queensland with an obligation to supply regulated customers. This is particularly important at a time when there is uncertainty regarding the introduction of the CPRS and the impact of the global economic situation.

In determining an appropriate margin, at a **minimum** the QCA should apply a 5.4% margin which was the recent conclusion of IPART<sup>4</sup>.

IPART determined a retail margin of 5.4% based on the simple average of the midpoint of the three methods to estimating margin used by its expert consultants – SFG. The methods employed by SFG and their results were:

- the expected returns approach - 4.5%;
- benchmarking approach - 6.7%; and
- bottom-up approach - 5.2%.

Despite the above finding of IPART, AGL believes that an appropriate regulated retail margin should be in excess of 6%, which is consistent with the middle to upper end of the IPART range. However, we believe that an increase in the margin by the QCA of 0.4% would be an appropriate 1<sup>st</sup> step.

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<sup>4</sup> IPART: "Review of Regulated Retail Tariffs and Charges for Electricity 2010-2013", December 2009, p.104.



## Annexure 1

Table 1 shows historical pool prices averaged by quarter in contrast to the ACIL forecast. Typically, historical pool prices are highest in quarter 1 or quarter 4, rarely do spot prices peak in quarter 2 or quarter 3 as ACIL have forecast.

**Table 1**

|                   |       | Qtr 1   | Qtr 2    | Qtr 3   | Qtr 4   | Annual  |
|-------------------|-------|---------|----------|---------|---------|---------|
| Historical Prices | 2000  | \$68.25 | \$52.10  | \$41.27 | \$40.14 | \$50.39 |
|                   | 2001  | \$50.64 | \$33.39  | \$26.39 | \$29.76 | \$34.96 |
|                   | 2002  | \$32.92 | \$52.43  | \$49.63 | \$56.02 | \$47.82 |
|                   | 2003  | \$21.65 | \$23.33  | \$25.68 | \$19.42 | \$22.52 |
|                   | 2004  | \$39.85 | \$27.90  | \$25.76 | \$44.51 | \$34.51 |
|                   | 2005  | \$23.25 | \$22.10  | \$20.92 | \$34.32 | \$25.17 |
|                   | 2006  | \$33.96 | \$23.35  | \$24.62 | \$22.12 | \$25.97 |
|                   | 2007  | \$53.45 | \$109.02 | \$53.35 | \$51.70 | \$66.84 |
|                   | 2008  | \$67.94 | \$36.36  | \$34.39 | \$36.98 | \$43.87 |
|                   | 2009  | \$34.60 | \$30.00  | \$25.05 | \$46.82 | \$34.13 |
| ACIL              | 50POE | \$29.02 | \$31.95  | \$37.15 | \$25.91 | \$31.01 |
|                   | 90POE | \$25.82 | \$29.65  | \$33.93 | \$25.17 | \$28.65 |
|                   | 10POE | \$57.68 | \$32.19  | \$40.68 | \$29.85 | \$40.03 |

Table 2 illustrates that ACIL have also forecast the maximum pool price occurring in quarter 3 and the highest number of half hours with a spot price greater than \$1000/MWh occurring also in quarter 3. This modelling does not accord with historical outcomes where maximum spot prices generally occur in quarters 1 or 4 as does the highest number of pool prices greater than \$1000/MWh



**Table 2**

|                   |       | Maximum RRP |          |          |          | Number of Half Hours where RRP>\$1000 |       |       |       |
|-------------------|-------|-------------|----------|----------|----------|---------------------------------------|-------|-------|-------|
|                   |       | Qtr 1       | Qtr 2    | Qtr 3    | Qtr 4    | Qtr 1                                 | Qtr 2 | Qtr 3 | Qtr 4 |
| Historical Prices | 2000  | 5,000.00    | 4,094.90 | 2,307.50 | 1,755.69 | 34                                    | 26    | 5     | 4     |
|                   | 2001  | 2,169.78    |          |          | 2,542.56 | 11                                    |       |       | 6     |
|                   | 2002  | 3,122.08    | 7,572.79 | 6,764.51 | 8,136.38 | 3                                     | 29    | 24    | 39    |
|                   | 2003  | 1,676.96    | 7,741.62 | 8,942.60 | 5,005.64 | 3                                     | 5     | 10    | 2     |
|                   | 2004  | 8,280.05    |          | 1,834.44 | 4,343.60 | 15                                    |       | 5     | 14    |
|                   | 2005  | 7,312.25    | 2,575.24 | 3,332.43 | 7,867.33 | 4                                     | 1     | 1     | 11    |
|                   | 2006  | 9,157.27    | 3,359.47 | 4,499.15 | 1,682.29 | 10                                    | 2     | 2     | 1     |
|                   | 2007  | 7,938.97    | 8,339.16 | 2,047.43 | 6,000.52 | 17                                    | 26    | 3     | 21    |
|                   | 2008  | 9,920.99    | 1,729.00 | 8,058.07 | 5,061.39 | 30                                    | 3     | 3     | 10    |
|                   | 2009  | 2,999.59    | 3,491.65 | 1,678.69 | 8,388.30 | 7                                     | 2     | 2     | 22    |
| ACIL              | 50POE | 1516.5      | 3519.07  | 5954.73  |          | 2                                     | 6     | 10    |       |
|                   | 90POE |             | 1871.15  | 3523.90  |          |                                       | 2     | 8     |       |
|                   | 10POE | 7515.98     | 2929.72  | 11451.08 | 2408.33  | 43                                    | 7     | 11    | 7     |

Table 3 shows the impact as assessed by AGL of the identified high price events which have been suggested occur at times of low demand.

**Table 3**

|    | Demand / Price Scenario |         |        |
|----|-------------------------|---------|--------|
|    | 50 POE                  | 10 POE  | 90 POE |
| Q3 | \$8.0m                  | \$10.5m | \$4.3m |
| Q4 | \$0.0m                  | \$0.0m  | \$0.0m |
| Q1 | \$0.0m                  | \$12.9m | \$0.0m |
| Q2 | \$5.7m                  | \$4.1m  | \$0.9m |