12 February 2010

Mr Gary Henry
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Dear Gary

**DRAFT DECISION: BENCHMARK RETAIL COST INDEX 2010-11**

Origin Energy (Origin) welcomes the opportunity to make submission to the Queensland Competition Authority (QCA) regarding its *Draft Decision: Benchmark Retail Cost Index for Electricity: 2010-11* (Draft Decision).

Origin acknowledges that this review has been complicated by:

- a late start to the consultation owing to the review of electricity pricing and tariff structures that the Queensland Competition Authority (QCA) has also conducted; and
- the difficulties arising from having a new consultant in ACIL Tasman (ACIL) that is required to replicate the methodology for calculating the cost of energy component of the benchmark retail cost index (BRCI).

As such, Origin commends the QCA on providing a Draft Decision that has largely managed to maintain:

- a consistency of methodology for the components of the 2010-11 BRCI compared with previous BRCI calculations; and
- an adequate level of transparency by providing the many datasets (e.g. load data, pool price and contract price forecasts) used for the 2010-11 Draft Decision that enable stakeholders such as Origin to replicate and verify the calculations of the methodology despite the use of new models.

Origin understands that with the continuation of the BRCI format for 2010-11, none of the necessary tariff reforms identified by the QCA in its reports, *Final Report: Review of Electricity Pricing and Tariff Structures – Stage 1* and *Final Report: Review of Electricity Pricing and Tariff Structures – Stage 2* will be incorporated into the 2010-11 process.

However, Origin also acknowledges that the Minister's new Delegation of 5 February 2010 indicates the possibility of this occurring in 2011-12. .

Origin is pleased that this BRCI process may be the final one undertaken and that the structural and policy reforms identified by the QCA can then be taken into account for 2011-12.

It is with that expectation for reform in the following year that Origin is generally encouraged by the QCA's Draft Decision as the 2010-11 BRCI appears to be in line with changes to the cost of supplying electricity to south east Queensland customers and should ensure that the adjustment to retail tariffs will prevent further deterioration in their cost reflectivity. By establishing this position in 2010-11, the difficult process of tariff reform in 2011-12 will be facilitated.

Although the headline figure is significant, Origin would again highlight that 8.4 per cent (or almost 65 per cent of the increase) is again due to increases in network charges reflecting the investment in infrastructure to secure Queensland's electricity supply into the future.

Origin's comments on the specific cost components of the Draft Decision follow.

<u>Cost of Energy</u>

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

Given that the methodology remains the same, Origin would specifically note with regard to aspects of the cost of energy calculation that:

- it supports the calculation by ACIL of the 2009-10 LRMC and energy purchase cost estimates and subsequent calibration of ACIL's proprietary models. In this manner, the QCA has avoided a change of methodology and any significant issues that may have arisen through the change in expert consultants and new modelling;
- although ACIL's calculation of the 2009-10 energy purchase cost varies considerably from the original modelling of CRA, Origin has replicated ACIL's 2010-11 calculation and therefore takes comfort that its modelling of 2009-10 is reasonable;
- it is generally supportive of the LRMC model specifications used for the 2010-11 BRCI and is pleased to see the QCA continue to utilise the most recent input data in the calculation. Origin therefore agrees with the use of capital and fuel cost derived from ACIL's April 2009 report, *Fuel resource, new entry and generation costs in the NEM*. In saying this, Origin still has issue with specific cost estimates such as long-term gas fuel costs and OCGT generation capital costs but can accept the cost estimates as reasonable inputs to the LRMC and understands the use of estimates derived from a consistent and independent source;
- it has reviewed the load and price traces provided by the QCA and although Origin would like ACIL to check the occurrence of low demand periods in the load trace, has concluded that the price and demand correlation appears to be more realistic than in previous calculations;
- for the purposes of the 2010-11 Determination, it agrees with the QCA that it is difficult to incorporate the cost of carbon into the LRMC calculation at present

while details of the Carbon Pollution Reduction Scheme (CPRS) remains unspecified; and

- the derivation of the costs of Queensland Gas Electricity Certificates (GECs) and Renewable Energy Certificates (RECs) are consistent and reasonable.

## Network Costs

The BRCI methodology for calculating network costs has previously, and still does, utilise the network costs of the whole of Queensland. Origin has previously submitted that this methodology needs to be corrected by legislative change. Following the Minister's letter to the QCA and associated Delegation of 5 February, Origin sees the best opportunity for this legislative change to occur is as part of the adoption of a new methodology for 2011-12. Consequently, Origin expects that this issue of assessing network costs will be resolved at that time.

For 2010-11, based on the initial draft decision of the Australian Energy Regulator (AER) on the Queensland distribution networks, it appears that this issue may not have the negative impact on retail margin and competition that was experienced in previous years and some balance is restored.

However, Origin would highlight that, as the QCA is aware, this does not resolve the issue that arises from annual rebalancing of network tariffs with distributors able to increase network tariffs to small and residential customers by greater than the average increase used in the BRCI calculation.

## Retail Cost and Margin

Origin has previously and continues to support the QCA's straightforward approach of escalating the original annual retail cost benchmark using well known indices such as the Consumer Price Index (CPI) and the Wage Price Index (WPI). This is generally in accord with change in cost expectations and has avoided intrusive and unnecessary build-up of retail cost data. Origin is surprised with the use of a CPI figure of 2.25 per cent but understands that this and many other figures in the Draft Decision will be updated in the final determination to reflect the most recent data.

Origin has also accepted the method used for calculating customer acquisition costs given that the BRCI is an index and it is the quantum of change not the actual cost derivation that is important in this process.

This element has two components:

- the costs of switching and transferring customers which have also been suitably escalated by CPI and WPI; and
- the number of switches and transfers which Origin cannot easily reconcile for the 2010-11 calculation.

Origin encourages the QCA to revisit the estimates of switches and transfers in the final determination as Origin is not comfortable with only 5 per cent of non-market customers transferring to a market contract with their current retailer despite the large number of switches estimated by the QCA.

With regard to retail margin, Origin has previously submitted previously that the BRCI requires an appropriate retail margin to cover the retailer for its risk-weighted investment. Origin does not believe that the net margin of 5 per cent of sales, even defined as an EBIT margin, is sufficient given the retailer risks around energy purchasing and customer acquisition but expects this issue will need to be resolved in the future reform of retail tariffs.

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

Yours sincerely

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Retail Executive Directions and Growth