



## REPORT

**Prepared for:**

Queensland Council of Social Service (QCOS)

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# Benchmark Retail Cost Index (BRCI) 2010-11: Comments on Draft Decision

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## 1. INTRODUCTION

This report has been prepared by Etrog Consulting Pty Ltd for Queensland Council of Social Service (QCOSS). It comments on the Draft Decision on the Benchmark Retail Cost Index (BRCI) for Electricity for 2010-11 which was published by the Queensland Competition Authority (the Authority) on 18 December 2009.<sup>1</sup>

The Authority has requested that submissions to the Draft Decision should be received by 12 February 2010. This report is being provided to QCOSS with the understanding that QCOSS is intending to include this report in its submission to the Authority on the Draft Decision.

The remainder of this report is structured as follows:

- Section 2 comments on two specific issues in the Authority's Draft Decision, and considers what the BRCI increase would have been in the Draft Decision, based on our commentary.
- Section 3 makes a general comment on the Authority's consultation process between its Draft Decision and Final Decision.

There are other aspects of the BRCI framework on which Etrog Consulting could comment, but which are outside the scope of this report. The Authority has given consideration to many of those matters in its recent Review of Electricity Pricing and Tariff Structures.<sup>2</sup>

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<sup>1</sup> The Draft Decision on the BRCI for 2010-11 has been published along with reports from ACIL Tasman and other supporting data on the Authority's website at [www.qca.org.au/electricity-retail/NEP1011/draftdec.php](http://www.qca.org.au/electricity-retail/NEP1011/draftdec.php).

<sup>2</sup> Further information of the Authority's recent Review of Electricity Pricing and Tariff Structures can be found at [www.qca.org.au/electricity-retail/RevEPandTS](http://www.qca.org.au/electricity-retail/RevEPandTS).

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## 2. TWO SPECIFIC ISSUES IN THE AUTHORITY'S DRAFT DECISION

This report section discusses two specific issues in the Authority's Draft Decision. These relate to:

- Use of a modelling factor in the calculation of the cost of energy; and
- Customer acquisition costs.

Both these issues arise from the fact that the Authority has stated: "In making this 2010-11 Draft Decision, the Authority has applied the framework established in its 2009-10 Final Decision, which reflected the outcome of the judicial review of the Authority's 2008-09 BRCI Decision."<sup>3</sup>

The Authority stated similarly in its Interim Consultation Notice on the BRCI for 2010-11, which was published in October 2009, that it proposed to adopt the same methodology in calculating the BRCI for 2010-11 as it used in 2009-10, and to follow the same process for calculating the 2010-11 BRCI as was adopted in 2009-10 following the judgment of the Queensland Supreme Court. Readers of the Interim Consultation Notice were referred to the Authority's BRCI Final Decision for 2009-10 for a comprehensive description of the process to be followed.

The Authority also noted in its Interim Consultation Notice that it had engaged ACIL Tasman (ACIL) to provide expert advice on the Cost of Energy component of the BRCI for 2010-11, as against having used CRA International (CRA) with input from ACIL to provide expert advice on the Cost of Energy component of the BRCI for 2009-10. The Authority noted that it would require ACIL to replicate as best they could the 2009-10 energy cost calculations that were produced by CRA and then apply the same approach to calculating the 2010-11 energy cost component.<sup>4</sup>

We believe that in regard to the specific issues that are discussed in this report section the Authority has not taken exactly the same approach and is not following exactly the same methodology in calculating the BRCI for 2010-11 as it did for 2009-10.

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<sup>3</sup> This is stated in the Preamble on page ii of the Authority's Draft Decision.

<sup>4</sup> See section 2.2 of the Authority's Interim Consultation Notice on the BRCI for 2010-11, which has been published at [www.qca.org.au/electricity-retail/NEP1011/intconsnote.php](http://www.qca.org.au/electricity-retail/NEP1011/intconsnote.php).

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## 2.1. USE OF A MODELLING FACTOR IN THE CALCULATION OF THE COST OF ENERGY

ACIL's calculations for the Authority for 2010-11 have estimated the Long Run Marginal Cost (LRMC) of energy to be \$58.51/MWh<sup>5</sup> and the energy purchase costs to be \$58.72/MWh.

These are ACIL's best estimates of each of these values for 2010-11, and on that basis they would appear to meet the requirements of the BRCI framework. We would therefore have expected the Authority to apply the 50% weighting to each of these factors, as in previous years, to produce a weighted result of **\$58.61/MWh**.

Instead, the Authority has applied a "modelling factor" to adjust ACIL's cost estimates for 2010-11. This results in "adjusted" values for LRMC and energy purchase costs of \$58.13/MWh and \$61.80/MWh respectively. The Authority has then weighted these adjusted values to provide an adjusted weighted result of **\$59.96/MWh**.

A comparison of these results is shown in Table 1 below.

**Table 1: Energy cost component of BRCI for 2010-11**

Cost item	ACIL Tasman calculations	The Authority's "adjusted" values
LRMC	\$58.51	\$58.13
Energy purchase costs	\$58.72	\$61.80
<b>Energy: results of weighting LRMC (50%) with energy purchase costs (50%)</b>	<b>\$58.61</b>	<b>\$59.96</b>

Source: Etrog Consulting reporting of ACIL Tasman and Queensland Competition Authority analysis

The Authority's stated justification for introducing a modelling factor to adjust ACIL's results is that it is intended to compensate for the fact that ACIL's best endeavours to reproduce CRA's calculations in 2009-10 have still resulted in there being differences between the two consultants' results for that year. In particular:

- CRA's estimate of LRMC for 2009-10 is 0.65% lower than ACIL's, and therefore the Authority has decreased ACIL's estimate of LRMC for 2010-11 by 0.65%.
- CRA's estimate of energy purchase costs for 2009-10 is 5.25% higher than ACIL's, and therefore the Authority has increased ACIL's estimate of energy purchase costs for 2010-11 by 5.25%.

<sup>5</sup> This value of \$58.51 appears in several places on page 18 of the Authority's Draft Report, and is consistent with the figure of \$58.51 which appears on page 3 of ACIL's report on the calculation of energy costs in the BRCI for 2010-11. However, it is inconsistent with ACIL's report page 23 which states that "ACIL Tasman achieved a result for the LRMC of electricity in Queensland in 2010-11 of \$58.27/MWh". We have confirmed with the Authority that the figure of \$58.27 on page 23 of ACIL's report is a mistake, and should read \$58.51.

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We have concerns with this approach, for the following reasons:

- The Authority's adjustments for 2010-11 assume that the ratio of CRA's estimates to ACIL's estimates for each of these two cost components in 2009-10 would apply equally in 2010-11. Had comparisons been made over several years and provided the same results (i.e. CRA's estimate of LRMC is always 6.5% lower than ACIL's, and CRA's estimate of energy purchase costs is always 5.25% higher than ACIL's) each year over several years, then there may be some basis for this assumption. But we do not believe that comparison of a single set of calculations by each consultant for a single year provides a sufficiently robust basis to justify the Authority's underlying assumption.
- Even if the assumption of a consistent ratio between the two consultants' results were valid (which we do not believe has been proven), there would still be no basis for the Authority to introduce the modelling factor to adjust ACIL's results. The legislation and regulation that underpins the BRCI calculation do not provide for such a modelling factor. Rather, in regard to the cost of energy, section 107 of the *Electricity Regulation 2006* sets out:

107 Consistency of framework with previous tariff years

(1) The theoretical framework must be the same, or substantially the same, from tariff year to tariff year unless—

(a) the pricing entity considers that there is a clear reason to change it; and

(b) the pricing entity has, under section 99, published draft decision material about the reason for the change.

(2) If the pricing entity changes the theoretical framework, the pricing entity must work out what the benchmark retail cost index for the previous tariff year would have been based on the changed framework.

It is our view that the Authority needs to decide whether the change from using CRA to using ACIL has constituted a change in the theoretical framework for the calculation of the cost of energy in the BRCI. If the decision is positive, then recalculation of the BRCI for 2009-10 is required. If, as we expect, the decision is negative, then the framework has not changed, and the Authority should simply use the best available estimates from ACIL for 2010-11.

As mentioned above, the Authority stated in its Interim Consultation Notice that it would require ACIL to replicate as best it could the 2009-10 energy cost calculations that were produced by CRA, and then apply the same approach to calculating the 2010-11 energy cost component. It appears to us that ACIL has done just that, and therefore ACIL's results should stand as they are, unadjusted. In contrast, the adjusted results do not represent any consultant's best view of the cost components for 2010-11.

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Further, we note that the Authority has stated that should it be required to adjust notified prices for a further year (2011-12) using the BRCI approach, and ACIL is again engaged to provide advice on the cost of energy, the relevant comparison points from 2010-11 will be the unadjusted ACIL calculations shown in Table 1 above, and not the Authority's adjusted calculations. This proposed approach would create a further discontinuity in the BRCI calculations through using different energy cost inputs for 2010-11 when calculating notified prices for 2011-12 than those that are being used now for calculating notified prices in 2010-11. This might again breach the BRCI framework requirements that are set out in legislation and regulation.

All these issues of compliance with the legislation and regulation can be resolved if the Authority uses the results of ACIL's calculations without any adjustment. We suggest that the Authority's Draft Decision should have been based on the unadjusted ACIL calculations shown in Table 1 above, and not the Authority's adjusted values. The Authority's Final Decision should similarly be based on unadjusted calculations for 2010-11, and not on values that are adjusted in this manner.

## 2.2. CUSTOMER ACQUISITION COSTS

In the calculation of the BRCI for 2009-10, customer acquisition costs that related to transfers of customers between retailers were based on an assumption that 217,536 customers would transfer between retailers in that year. The Authority also previously assumed that 217,536 customers would transfer between retailers in its calculation of the BRCI for 2008-09.

On that basis, given that the Authority had proposed to adopt the same methodology in calculating the BRCI for 2010-11 as it used in 2009-10, it might have been expected that in its Draft Decision for 2010-11 the Authority would again assume that **217,536** customers would transfer between retailers. Instead, the Authority has assumed that **461,000** customers would transfer between retailers.

The Authority's derivation of this new estimate is explained in its Draft Decision by saying that "based on the average monthly rate of growth in the number of customers switching retailers over the last 12 months of 3.2%, the Authority has estimated that 22.7% (some 461,000) of total customers will switch retailer in 2010-11".

Table 2 below shows our analysis of the same AEMO Market Settlement and Transfer Solution (MSATS) statistics that the Authority has used to determine that the average monthly rate of growth in the number of customers switching retailers over the last 12 months was 3.2%. This table shows monthly statistics from July 2007 when FRC commenced in Queensland. The final two rows are shown in italics, because they include data that has been published by AEMO since the Authority finalised its Draft Decision.

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**Table 2: Analysis of AEMO MSATS statistics<sup>6</sup>**

Month	Monthly MSATS transactions	Increase in transactions over previous month (%)	Simple average of monthly % increases in transactions over the last 12 months	Average monthly % increase corresponding to the increase in transactions over the last 12 months
July 2007	1,095	-	-	-
August 2007	12,475	-	-	-
September 2007	18,205	-	-	-
October 2007	26,355	-	-	-
November 2007	22,508	-14.6%	-	-
December 2007	21,469	-4.6%	-	-
January 2008	23,218	8.1%	-	-
February 2008	22,850	-1.6%	-	-
March 2008	19,297	-15.5%	-	-
April 2008	27,725	43.7%	-	-
May 2008	37,532	35.4%	-	-
June 2008	38,015	1.3%	-	-
July 2008	41,256	8.5%	-	-
August 2008	29,161	-29.3%	-	-
September 2008	26,026	-10.8%	-	-
October 2008	22,263	-14.5%	-	-
November 2008	17,545	-21.2%	0.0%	-2.1%
December 2008	19,966	13.8%	1.5%	-0.6%
January 2009	18,940	-5.1%	0.4%	-1.7%
February 2009	20,509	8.3%	1.2%	-0.9%
March 2009	20,533	0.1%	2.5%	0.5%
April 2009	21,428	4.4%	-0.8%	-2.1%
May 2009	23,231	8.4%	-3.0%	-3.9%

<sup>6</sup> Due to the uncharacteristic nature of the first few months at the commencement of FRC, comparison data between months is only shown from November 2007, and hence only from November 2008 for twelve-month comparisons.

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Month	Monthly MSATS transactions	Increase in transactions over previous month (%)	Simple average of monthly % increases in transactions over the last 12 months	Average monthly % increase corresponding to the increase in transactions over the last 12 months
June 2009	23,814	2.5%	-2.9%	-3.8%
July 2009	26,622	11.8%	-2.6%	-3.6%
August 2009	25,547	-4.0%	-0.5%	-1.1%
September 2009	26,772	4.8%	0.8%	0.2%
October 2009	26,948	0.7%	2.0%	1.6%
November 2009	25,001	-7.2%	<b>3.2%</b>	<b>3.0%</b>
December 2009	27,517	10.1%	2.9%	2.7%
January 2010	21,509	-21.8%	1.5%	1.1%

Source: Etrog Consulting analysis of AEMO MSATS statistics

Other than the month column, the four columns of Table 2 should be interpreted as follows:

- Monthly MSATS transactions (column 1):** These are sourced directly from AEMO.
- Increase in transactions over previous month (%) (column 2):** This column shows the increase in monthly MSATS transactions from the previous month. A negative value indicates a decrease in the number of MSATS transactions from the previous month. Thus for example, in November 2009, the number of MSATS transactions (25,001) was 7.2% lower than in the previous month (26,948).
- Simple average of monthly % increases in transactions over the last 12 months (column 3):** These values have been calculated based on a simple average of the twelve entries in column 2 up to and including the current month. The Authority calculated the figure of 3.2%, which is shown in bold, as the simple average of the twelve values in column 2 from December 2008 (13.8%) to November 2009 (-7.2%) inclusive.
- Average monthly % increase corresponding to the increase in transactions over the last 12 months (column 4):** These values show our alternative method of finding an average % increase in the number of transactions over the last twelve months. Instead of taking the simple average of twelve separate % increases, we have instead calculated in column 4 for each month the average monthly increase that would compound to the total growth rate over the past 12 months. Thus our alternative value for November 2009 of 3.0%, which is also shown in bold, has been calculated as the monthly growth rate in MSATS transactions that would give 25,001 transactions in November 2009, as against the starting point 12 months earlier, in November 2008, of 17,545 transactions.

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Our calculation in column 4 would be preferable to the Authority's calculation in column 3, because:

- Our calculation provides a better representation of reality over the last 12 months over which the data is being modelled: starting from 17,545 transactions in November 2008, our growth rate of 3.0% correctly results in 25,001 transactions in November 2009, whereas the Authority's growth rate of 3.2% incorrectly results in a higher number of transactions in November 2009.
- Our calculation better approximates to the purpose to which the Authority then puts the growth rate: to create compound growth in the number of transactions from December 2009, right through to June 2011 inclusive.

Whichever method is used, the monthly growth rate in the number of transactions is very volatile. The figures of 3.2% and 3.0% for November 2009 are historically the highest seen in Queensland (excluding the first few months for which data is not shown), and therefore would both seem to be substantial over-estimates of the monthly growth in transactions that might be expected from now to June 2011. The two additional rows of Table 2 which are in italics show that more recent data would also have substantially reduced the monthly growth rate estimates.

The Authority anticipates releasing its Final Decision on the BRCI for 2010-11 in late May 2010. We doubt that the volatility in the underlying data will have decreased substantially by then, and therefore we question the robustness of using AEMO MSATS data to estimate a growth rate in the number of MSATS transfers.

A further concern arises from the fact that the MSATS transaction statistics on which the Authority has based its estimates of the number of customers transferring between retailers may over-state the number of customer transfers, for the following reasons:<sup>7</sup>

- The number of transferred consumers reported in these statistics represents the number of completed change requests in MSATS for a change of retailer **or to create a new second tier connection point**. This latter point is particularly significant in Queensland, because all consumer connection points physically located in the Energex distribution network have a Local Retailer of Sun Retail. The Queensland Government sale of Sun Retail and Powerdirect Australia created a split of the consumers in the Energex distribution network. Approximately 400,000 consumers in the Energex distribution network were transferred to Powerdirect Australia, and subsequently sold to AGL in early 2007, but the Local Retailer for these NMIs is still Sun Retail, as it is for consumer connections in the Sun Retail area where the retail business was sold to Origin Energy. Thus all new connection points in Queensland that are initially assigned to a retailer other than Origin Energy are included in these MSATS statistics, even if they are in the Powerdirect Australia and registered with AGL as their retailer.

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<sup>7</sup> For more information see the AEMO publications at [www.aemo.com.au/data/retail\\_transfers.html](http://www.aemo.com.au/data/retail_transfers.html)

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- A completed change request in MSATS is not necessarily a change of retailer. A completed change request may have a Change Request Code that indicates the reversal of a previous transaction. Each MSATS transaction of this nature indicates that the number of transferring customers has been over-stated by two: the previous transaction which is now being reversed should not have been counted, and the transaction that actually does the reversal of the previous transaction should not be counted either.
- There may be other reasons why the MSATS statistics count records that do not actually relate to a change of retailer. Previous attempts were made with the assistance of NEMMCO staff to “cleanse” the early AEMO (then NEMMCO) data of these spurious records, which at that time included completed change requests of various types. See for example the following extract from Section 4.3.1 in CRA’s Addendum Report on the Calculation of the BRCI for 2007-08 and 2008-09, dated 26 May 2008:

*Since the Workshop, we have reassessed the transfer data published by NEMMCO with the assistance of NEMMCO staff. We now understand that each transaction that is counted and reported as a completed transfer is perhaps better described as being a completed change request. Some of those change requests are changes in NMI details rather than customer transfers, and some are instructions to reverse a previous change request that may have been entered in error. We have analysed the detailed transaction data that sits behind the published transfer data and have concluded that the number of actual customer transfers between retailers was smaller than we had reported in the Draft Report. Our revised estimates on small customer transfers between retailers in Queensland are shown in Table 19 below. Data from the commencement of FRC in Queensland in July 2007 until 31 March 2008 is an actual number of transfers based on our analysis of the detailed NEMMCO transaction data.*

We have not reproduced here Table 19 of that CRA report, but spot checking shows that the number of customers switching retailer in 2007-08, based on cleansed data at that time, was lower than is now shown in Table 2 in this report, on which the Authority is now relying. This may mean that some of the earlier data cleansing efforts have been lost.

We suggest that if the Authority wishes still to use the MSATS transaction data to support its Final Decision on the BRCI for 2010-11, it should seek first to remove any inappropriate statistics from its estimation of the numbers of customer transfers, based on the principles discussed above, and possibly with the assistance of AEMO staff.

Alternatively, and possibly preferably, we recommend that in the absence of more robust data and a new robust methodology, the Authority should retain in its Final Decision for 2010-11 its assumption from previous years, i.e. that **217,536** customers will transfer between retailers.

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Finally we note the Authority's comments that compare the rate of switching retailer in Queensland to the switching rates in Victoria and South Australia. The relevant switching rate to be compared as between Queensland and other States is not the overall Queensland value that the Authority estimates at 22.7%, but rather the Authority's estimate that the switching rate is 35.5% in South East Queensland. This distinction is appropriate because in Queensland switching retailer is in practice restricted to South East Queensland, because of the way the Uniform Tariff Policy has been implemented in Queensland. This is in contrast to other States, where switching is happening State wide. The figure of 35.5% seems high, compared to the values of 20-30% that the Authority quotes for South Australia and Victoria.<sup>8</sup> Further, we would expect more vigorous competition in Victoria than in Queensland because in Victoria there is no price regulation, whereas in Queensland retailers have stated in previous submissions that their margins are being eroded under the BRCI framework, and that this is hampering competition. Certainly there are fewer competing retailers active in Queensland than in Victoria. We therefore question whether competition really is "more vigorous" in Queensland.

### 2.3. EFFECTS ON THE BRCI CALCULATIONS

The Authority's Draft Decision has calculated an increase in the BRCI of **13.83%** between 2009-10 and 2010-11.

Had the Authority instead:

- Not adjusted ACIL's calculations for 2010-11, as discussed in section 2.1 above; and
- Retained its previous estimate of the number of customers transferring between retailers, as discussed in section 2.2 above; then
- We estimate that the increase in the BRCI between 2009-10 and 2010-11 in the Draft Decision would instead have been **11.88%**.

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<sup>8</sup> It is also possible that the reported statistics for South Australia and Victoria are themselves over-stated, for the reasons discussed in this report in regard to the Queensland data.

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### **3. COMMENT ON THE AUTHORITY'S CONSULTATION PROCESS BETWEEN DRAFT DECISION AND FINAL DECISION**

The Authority anticipates releasing its Final Decision on the BRCI for 2010-11 in late May 2010. We understand that once submissions have been made in response to the Draft Decision, to be received by the Authority no later than 12 February 2010, there may be no further formal opportunity for stakeholder consultation and stakeholder input to the Authority before the Final Decision is released.

In order to ensure that the Final Decision is as accurate as possible, we believe that it is important for the Authority to give stakeholders further opportunity to input into the process, before the Final Decision is released.