



REPORT

Prepared for:

Queensland Council of Social Service (QCOS)

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Benchmark Retail Cost Index (BRCI) 2011-12: 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 2011-12 which was published by the Queensland Competition Authority (the Authority) on 17 December 2010.¹

The Authority has requested that submissions to the Draft Decision should be received by 11 February 2011. 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.

As we write this report, we also would like to say that our thoughts and hearts are with the people and businesses of Queensland, as we have been shocked by the devastation that has been wrought on the State through flooding, including the loss of life and the effects on people's lives and on the State as a whole.

It is too early to say what the effects of the flooding may be on future electricity prices, and we have not taken any particular account of the flooding in our comments in this report.

The remainder of this report comments on some specific issues in the Authority's Draft Decision as follows:

- Section 2 discusses the long term US dollar (USD) – Australian dollar (AUD) exchange rate in the calculation of the long run marginal cost (LRMC) of energy;
- Section 3 discusses the costs of compliance with the Queensland Gas Scheme;
- Section 4 discusses Renewable Energy Target (RET) scheme costs; and
- Section 5 discusses various aspects of retail operating costs.

¹ The Draft Decision on the BRCI for 2011-12 has been published along with supporting data and a draft report from ACIL Tasman on the calculation of energy costs on the Authority's website at www.qca.org.au/electricity-retail/NEP/draftDec.php.

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2. THE LONG TERM US DOLLAR (USD) – AUSTRALIAN DOLLAR (AUD) EXCHANGE RATE IN THE CALCULATION OF THE LONG RUN MARGINAL COST (LRMC) OF ENERGY

Though we are not privy to the ACIL Tasman (ACIL) detailed model and calculations of the long run marginal cost (LRMC) of energy, we understand that many of the input costs are forecast and estimated based on US dollar (USD) amounts, and these are converted to Australian dollars (AUD) for the LRMC calculation.

The Authority's Draft Decision notes on page 10:

ACIL has also reviewed the components of the weighted average cost of capital (WACC) to make sure they remain current and has considered the impact of the significant appreciation of the Australian dollar against the US dollar in recent months. ACIL decided not to adjust its long term exchange rate assumption of \$A1 buying \$US0.75 in its LRMC model on the basis that the LRMC is a long term analysis and there is no reason to assume that the exchange will not trade within its usual historic range over the longer term.

Table 2 on page 9 of the supporting ACIL report² shows key assumptions used within the ACIL analysis. From that table it is clear that the other assumptions of long term values are based as we would expect on reputable long term forecasts:

- The inflation (CPI) forecast is based on RBA's target and Treasury forecasts for coming years. It is not based on averaging of observed previous inflation rates over past years.
- International oil price forecast is based on EIA forecast, and not on averaging of previous years' actual oil price.
- Internationally traded thermal coal price is a projection of price in coming years, not an averaging of past price.
- LNG export facilities are similarly based on assumed projects, not on averaging of previous export facilities.

The one exception is the USD/AUD exchange rate where ACIL writes:

The estimated future average exchange rate is based on the average since the float of the Australian dollar in 1984 (0.73) and since 2000 (0.72) and the observation that the exchange rate has been close to 0.75 for between 20 and 25 per cent of the time during these periods.

² *Calculation of energy costs for the 2011-12 BRCI* – Includes the calculation of energy purchase costs, LRMC, and other energy costs, Draft Report, 16 December 2010

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We find it difficult to understand why ACIL has chosen to use only averages and other observations of historic values rather than reputable forecasts as it has in the case of other parameters. It is especially surprising given the current rate being well above the value assumed.

Some current reputable forecasts from Australian banks that ACIL could use as the basis for a long term estimate of the AUD-USD exchange rate are shown in Table 1 (quarterly forecasts) and Table 2 (annual forecasts) below. We believe that using these or similar such forecasts would be consistent with the way that ACIL has forecast long-term inflation and other parameters, while the current method based on historic range is inconsistent.³

Table 1: AUD-USD exchange rate quarterly forecasts

AUD-USD exchange rate quarterly forecasts	ANZ	Westpac	St George Bank
December 2010	0.95	-	0.95
March 2011	0.94	1.00	0.97
June 2011	0.98	1.02	0.98
September 2011	1.00	0.99	0.95
December 2011	0.98	0.96	0.98
March 2012	-	0.95	-

Sources:

ANZ Australian Economic Toolbox, 5 November 2010, page 13

Westpac Australia & NZ weekly, 21 January 2011, page 11

St George Bank Aussie Dollar Outlook, 26 November 2010, page 9

Table 2: AUD-USD exchange rate annual forecasts

AUD-USD exchange rate annual forecasts	National Australia Bank
2010-11 Fiscal Year	1.05
2011-12 Fiscal Year	0.96
2010 Calendar Year	1.00
2011 Calendar Year	0.98
2012 Calendar Year	0.94

Source: National Australia Bank, Global & Australian Forecasts, 14 December 2010, page 16

³ Because some of these forecasts were published two months ago, they are already superseded in part (for calendar year 2010 and quarter December 2010) by actual outturns. We would expect ACIL to use the latest available forecast data from these or similar sources at the time of finalising its input to the Authority's Final Decision, rather than the figures shown here.

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3. THE COSTS OF COMPLIANCE WITH THE QUEENSLAND GAS SCHEME

We are pleased to see that in its draft decision the Authority has decided to base its estimates of complying with the Queensland Gas Scheme on the market costs of purchasing Gas Electricity Certificates (GECs) rather than on the annual penalty charge which retailers would face for not surrendering sufficient GECs.

We endorse and commend this decision for all the reasons stated in the Draft Decision.

However, we are concerned at the way this decision has been implemented in this transition year.

In the BRCI Final Decision for 2010-11, the Authority estimated the cost of compliance with the Queensland Gas Scheme in 2010-11 to be \$2.84/MWh. Now the Authority is estimating the cost of compliance with the Scheme in 2011-12 to be \$0.56/MWh. We believe that the Authority should therefore in its BRCI calculations for 2011-12 retain the calculation of the cost of compliance with the Scheme in 2010-11 at \$2.84/MWh, and use the figure of \$0.56/MWh in its calculations for 2011-12. This would maintain the integrity of the BRCI calculation as an **index**.

Instead, the Authority has chosen to recalculate the compliance cost in 2010-11 as \$1.20/MWh, and to use that in a recalculation of the BRCI for 2010-11.⁴ This recalculation is justified in the Draft Decision as follows:

The Authority has accepted ACIL's advice to move to a market-based approach using AFMA data to estimating the cost of the Queensland Gas Scheme rather than using the previous penalty price approach. However, as this constitutes a change in methodology under the BRCI framework, the Authority will need to re-estimate the cost of the Queensland Gas Scheme in 2010-11 using this new method as required by section 107 of the Electricity Regulation.

In this regard, only AFMA GEC price data that would have been available at the time of the 2010-11 BRCI Final Decision will be used in recalculating the 2010-11 Queensland Gas Scheme cost. Table 2.1 includes the re-calculated Queensland Gas Scheme cost for 2010-11 using AFMA data that would have been available as at 31 March 2010, the last cut-off date for all market data used in the 2010-11 BRCI Final Decision.

⁴ These figures are shown in Table 2.1 on page 13 of the Draft Decision.

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In recalculating the cost for 2010-11 the Authority has sought to calculate the difference in the cost of compliance with the Scheme between 2010-11 and 2011-12. Such a recalculation was discussed in some detail in the Authority's Final Decision on the BRCI for 2010-11, in the context of a change in energy costs due to a change of consultant.⁵ There, the Authority referred to the judgment of McMurdo J in *AGL Energy Ltd v Queensland Competition Authority; Origin Energy Retail v Queensland Competition Authority* [2009] QSC 90, and noted that this judgment "permits the Authority to recalculate the preceding year's index if it considers that it is necessary in order for it to meet the objects of the BRCI indexation regime".

We agree with that principle, but we do not believe that the Authority has correctly applied that principle in regard to the Queensland Gas Scheme in the Draft Decision.

The costs of the Scheme have been estimated in each year for which the BRCI has been calculated, commencing at \$2.14/MWh in 2006-07, rising each year thereafter, and as mentioned above, reaching \$2.84/MWh in 2010-11.

The original figure, which has been indexed since, was based on the Authority's view of the best estimate at the time of what a retailer's cost would be in meeting the requirements of the Scheme – which was through paying the penalty price. Now the Authority has taken the view, which we support, that the best estimate of the same cost for 2011-12 is obtained from market data. Thus the cost of \$2.14/MWh from 2006-07 has reduced over the years, due to market forces creating the required GECs and making them available to retailers, such that the estimate of costs for 2011-12 is now \$0.56/MWh. There is no discontinuity in this index. It is the same cost of meeting the same requirements of the same Scheme that was estimated for 2006-07 that is now being estimated for 2011-12.

There is no need in this case to recalculate the preceding year's index in order to meet the objects of the BRCI indexation regime, since those objects are fully met without any recalculation. However, if the Authority were to undertake its recalculation in its Final Decision it would be creating a discontinuity in the index, since the index would no longer represent the moving cost of Scheme compliance over the years of calculation of the BRCI.

We believe the Authority may have erred in its Draft Decision in seeking to estimate simply the best year-on-year change in the cost of complying with the Scheme as between 2010-11 and 2011-12, as against the changes over several years. We refer the Authority to the judgment of McMurdo J at [82], which refers to "the object of the indexation regime, which is to have the notified prices vary over several years commensurately with variations in the relevant costs".

⁵ *Benchmark Retail Cost Index for Electricity: 2010-11*, Final Decision, May 2010, pages 8-11

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Further, at [96], the judgment discusses recalculation by the Authority and states:

But by necessary implication, that exercise would have to be for a purpose which is consistent with the objects of the legislation. In particular it would have to be directed to arriving at new notified prices, so that they involved an increase from the prices originally fixed under s 90 which was commensurate with increases in the relevant costs over that same period of years.

We believe that in this case it is through no recalculation of the previous year's BRCI that this object is achieved (though in this case the change is a decrease rather than an increase).

The only reason we can see for the Authority choosing to do a recalculation for change of methodology at this juncture would be if the original cost of complying with the Scheme in 2006-07 bore no resemblance to the cost estimate of \$2.14/MWh at the time. If it were the case that there were two separate curves, one representing the penalty price of RECs and one representing the market price of RECs, then, clearly, moving from one curve to the other there would be a change of methodology, and a consequential need for recalculation of the BRCI.

To see if this is the case, we need to revisit the Authority's decision on the BRCI for 2007-08, which incorporated the calculation for 2006-07, and the report of CRA International on which the Authority relied at the time. That year, the final decision and supporting documentation did not restate calculations that were unchanged from the draft decision, and therefore it is the draft decision for that year that we must now consider. In its advice to the Authority at the time, CRA International stated:

For retailers in Queensland, the cost of purchasing energy will include the cost of purchasing GECs for 13% of their retail load. The current price for GECs in Queensland reflects the level of supply and demand for GECs. Supply is limited by the historically low level of gas fired generation in Queensland, which has recently begun to increase since the inception of the GEC scheme.

The costs to retailers for complying with the 13% Gas Scheme have been based on GEC prices published by AFMA, and information on historic prices from market participants. Prices have typically traded within a narrow band at or near the penalty price, although the market is typically thinly traded. Therefore, the penalty price has been used in calendar years 2006, 2007 and 2008 to estimate the price of GECs and the movement in the price from one year to the next.⁶

⁶ Calculation of the Benchmark Retail Cost Index for 2006-07 and 2007-08, CRA International, 7 May 2007, page 34

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The Authority directly accepted this advice in its draft decision at the time:

The costs to retailers of complying with the 13 per cent gas scheme was estimated using the penalty price to retailers for not surrendering sufficient Gas Electricity Certificates (GECs), on the basis that the price of GECs have typically traded within a narrow band at or near the penalty price.⁷

In other words, the sequence of events of what has happened is as follows:

1. In the original BRCI calculations for 2006-07 (and 2007-08), the costs of complying with the Scheme were fairly high, due to historically low level of gas fired generation in Queensland. CRA International found that GECs typically traded within a narrow band at or near the penalty price. But the market was thinly traded, and therefore year-on-year price changes could be severely distorted if only thinly traded market prices were used. Therefore the penalty price was used to estimate the price of GECs, and the movement in the price from one year to the next. It is important to emphasise here that the penalty price did indeed at that time reflect the market price when the BRCI was first calculated.
2. Over the years since, the Authority chose to continue to use the penalty price instead of the market price to estimate a retailer's cost of compliance with the Scheme. The penalty price rose as the market price fell. Thus over these years the BRCI calculations did not reflect the true cost or the year-on-year change in the true cost of compliance with the Scheme. We consider this to have been a temporary aberration.
3. Now that the Authority is again using actual market data, that temporary aberration is coming to an end, and the Authority is returning to using market prices that reflect actual costs, as it did in effect in its original calculations of the BRCI for 2006-07 and 2007-08 (though penalty prices were used initially as a proxy for market costs, as they were the same or nearly the same for 2006-07).

It should be clear from the above why no recalculation of the costs of compliance with the Queensland Gas Scheme for 2010-11 should now be undertaken. It is necessary for no recalculation to be undertaken in order to maintain the integrity and object of the index over the full period from 2006-07 to 2011-12, as required by the judgment of McMurdo J. To recalculate would destroy that integrity, and entrench the temporary aberration of the last few years, turning it into a permanent aberration.

⁷ *Benchmark Retail Cost Index for Electricity: 2006-07 and 2007-08, Draft Decision, May 2007, page 11*

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4. RENEWABLE ENERGY TARGET (RET) SCHEME COSTS

We concur with the view of the Authority that market data should be used wherever available to estimate the Renewable Energy Target (RET) scheme costs and the changes in the costs from year to year.

We also concur with the Authority that the BRCI does not provide for any “catch up” in RET costs for the period January to June 2011, notwithstanding the views of some retailers to the contrary.

Consistent with our views of the Queensland Gas Scheme described above, we also concur with the fact that the Authority has not recalculated the BRCI for 2010-11 to take into account changes that have occurred to the scheme, as that would also have destroyed the integrity of the index as is the case for the Queensland Gas Scheme cost component of the BRCI.

5. RETAIL OPERATING COSTS

5.1. OVERALL COMMENT ON RETAIL OPERATING COSTS

We concur with the Authority's view that it should have a single benchmark value for retail operating costs which is adjusted for inflation from year to year, as against a component for Customer Acquisition and Retention Costs (CARC) which was separately calculated in the past. The matters we wish to raise therefore concern the actual figures used in the Draft Decision rather than the concept of the escalation of a single figure.

For 2010-11, the Authority had a figure of \$126.41 per customer in total for retail operating costs, comprising \$85.89 for general retail operating costs, and \$40.52 for CARC.

For 2011-12, the Authority is proposing to escalate this to \$132.35 per customer. This figure includes an allowance of \$2,957,000 in total for regulatory fees in 2011-12.

5.2. REGULATORY FEES

We are surprised to see that the Authority has increased the retail operating costs in 2011-12 to give a specific allowance for the regulatory fees that the Authority is imposing on retailers. This is a departure from the Authority's previous position.

It has always been recognised that retailers face various fees, and no particular allowance has been made for those in the BRCI calculations. This is due to the benchmarking rather than cost build-up approach. In other jurisdictions that have been benchmarked, various such fees also arise, and the Authority has never attempted to itemise the various extra fees that may be incurred by retailers in Queensland as against other jurisdictions. If the Authority is going to take this more forensic approach of allowing for specific fees, that would be more consistent with an overall cost build-up approach to estimating retail operating costs in the BRCI. We do not advocate such an approach, largely because of its complexity, but we note that the Draft Decision to itemise regulatory fees does not sit well with the overall benchmarking approach. It is incongruous to itemise actual regulatory fees while benchmarking the rest of the components of the retail operating costs in a very broad manner without individual itemisation.

The Draft Determination states:

The aggregate of the fees to be paid to the Authority by electricity retailers in Queensland was calculated by the Authority based on its estimate of the annualised actual cost of performing its functions over the five-year period from 1 July 2010 to 30 June 2015. On this basis, the annual fee to be paid by retailers in 2010-11 was \$2,795,000 and is estimated at \$2,957,000 for 2011-12.

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In its correspondence with retailers on this matter, the Authority acknowledged that the fee would add a small amount to retail costs and that this would be reflected in the 2011-12 BRCI retail cost component. Therefore, despite the fee being payable in both 2010-11 and 2011-12, the Authority has not adjusted the 2010-11 base for this year's BRCI calculation as the fee was not incorporated in the 2010-11 BRCI calculation.

We wonder regarding the due process of the Authority writing to retailers and telling them that a cost would specifically be reflected in the 2011-12 BRCI retail cost component. That correspondence does not appear to have taken place within the overall required consultation framework for the BRCI. On that basis, we suggest that there is no place under the *Electricity Act 1994* or the *Electricity Regulation 2006*, which together set the basis for the BRCI calculations, for such correspondence to have any weight in the Authority's Draft Decision or Final Decision, and therefore we are surprised to read that statement in the Draft Decision.

More particularly, we take issue with the Authority's statement that "the fee was not incorporated in the 2010-11 BRCI calculation". We believe that it was implicitly included.

There have been several previous occasions in the history of the BRCI where retailers have suggested that new costs should be explicitly allowed in the retail operating cost element of the BRCI. We believe one example will suffice, as follows.

Integral Energy previously noted in a submission to the Authority the recent introduction at the time of the Home Energy Emergency Assistance Scheme and the Queensland Government Solar Bonus Scheme. No administration fee was payable with respect to these schemes. Accordingly, Integral Energy stated that the costs of implementation and administration directly impacted the level of retail operating costs, and this should be recognised in the benchmarking of retail operating costs.⁸

CRA International responded as consultant to the Authority at the time to the effect that various jurisdictions have government initiative schemes such as concession schemes which electricity retailers are required to administer, and in the benchmarking approach the costs of administering each individual scheme are not itemised or allowed as a separate cost estimate. Some of the schemes, such as the Community Ambulance Cover scheme may be unique to Queensland. CRA International stated that it was not aware that the administrative burden of schemes in Queensland was materially different from the burden of schemes elsewhere in Australia, and therefore saw no reason to amend the benchmarking approach to give any special attention to Queensland schemes.⁹

⁸ Submission on First Consultant's Report: Calculation of the BRCI 2009-10, 22 August 2008

⁹ *Calculation of the Benchmark Retail Cost Index 2009-10*, Final Second Report, 1 December 2008

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The Authority accepted the advice of CRA International at the time, and did not make a specific allowance for administration fees.

We submit that the situation now with regulatory fees is analogous. Other jurisdictions also charge regulatory fees to retailers, in one form or another. Those have already been included implicitly in the original \$75 benchmark, from which the 2010-11 BRCI benchmark allowance for retail operating costs has evolved. If the Authority were to include an additional allowance in 2011-12 this would effectively be double counting through both an implicit and explicit allowance.

We submit therefore that the Authority's allowance for retail operating costs in its Final Decision should exclude the allowance for regulatory fees of \$2,957,000 for 2011-12.

5.3. CUSTOMER ACQUISITION AND RETENTION COSTS

We noted in our report to QCOSS on the BRCI a year ago that we were concerned that the Authority was over-estimating the number of switches of customers between retailers.

Given the changes that have been made to the data by AEMO, we suggest that the Authority should confirm with AEMO that its data as used in the 2010-11 BRCI calculations represent only changes of retailer and do not include any changes between Participant IDs of the same organisation, or any MSATS transactions that are actually simply reversing 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.

If this request for confirmation results in agreement with AEMO that numbers were previously over-stated, we suggest that a corresponding downwards adjustment to the starting point for the 2011-12 BRCI retail operating costs estimate would be appropriate.

We also concur with the view of QCOSS that increases in customer switching and transfer rates are likely to include switches and transfers occurring as a result of inappropriate marketing tactics. These would not be efficient costs, and therefore should not be counted in the BRCI calculations. For example, the Energy and Water Ombudsman Queensland reported last July a significant increase in energy marketing complaints. The Ombudsman illustrated how customers were being influenced to change retailer based on conduct that would not meet the requirements of the Marketing Code of Conduct for energy retailers.¹⁰

To the extent that switching has occurred based on such marketing and thus boosted the statistics for customer switching, a downwards adjustment to account for this could again be appropriate.

¹⁰ *The five fibs of energy marketing*, 19 July 2010