



**Draft Guideline - Approval of standing offer prices in  
accordance with the 2013 Standing Offer Determination**

**Consultation Paper**

**March 2014**

Printed March 2014

Office of the Tasmanian Economic Regulator

Level 5, 111 Macquarie Street, Hobart TAS 7000

GPO Box 770, Hobart TAS 7001

Phone: (03) 6166 4422 Fax (03) 6233 5666

ISBN 978-0-7246-5285-3

Copyright

© Office of the Tasmanian Economic Regulator

# TABLE OF CONTENTS

<b>GLOSSARY .....</b>	<b>II</b>
<b>1 BACKGROUND AND PURPOSE .....</b>	<b>3</b>
1.1 BACKGROUND .....	3
1.2 PURPOSE .....	4
<b>2 METHODOLOGY FOR ESTIMATING THE WHOLESALE ELECTRICITY PRICE.....</b>	<b>5</b>
2.1 OVERVIEW.....	5
2.2 PROPOSED METHODOLOGY .....	6
<b>3 METHODOLOGY FOR REVISING THE NOTIONAL TARIFF BASE .....</b>	<b>9</b>
3.1 OVERVIEW.....	9
3.2 PROPOSED METHODOLOGY .....	9
<b>4 RESPONDING TO THIS CONSULTATION PAPER .....</b>	<b>11</b>

## GLOSSARY

“**Absolute Minimum Capacity Offer Volume**” has the same meaning as in the **Wholesale Contract Regulatory Instrument**;

“**Authorised Retailer**” has the same meaning as in the *Electricity Supply Industry Act 1995*;

“**audited wholesale pricing model**” means the model used to calculate wholesale contract prices that **Hydro Tasmania** provided to the Regulator on 20 December 2013 and as revised from time to time;

“**draft Guideline**” means the draft Guideline, *Approval of standing offer prices in accordance with the 2013 Standing Offer Determination*.

“**Load Following Swap**” has the same meaning as in the **Wholesale Contract Regulatory Instrument**;

“**Period 2**” means the period from 1 July 2014 to 30 June 2015;

“**Period 3**” means the period from 1 July 2014 to 30 June 2015;

“**Regulator**” has the same meaning as in the *Economic Regulator Act 2009*;

“**regulatory period**” means the period from 1 January 2014 to 30 June 2016;

“**Supplementary Offer Capacity Volume**” has the same meaning as in the **Wholesale Contract Regulatory Instrument**;

“**Wholesale Contract Regulatory Instrument**” means the instrument that specifies the regulated contracts **Hydro Tasmania** must offer to **Authorised Retailers**. The instrument is:

- (i) the approval made by the Minister for Finance on 29 July 2013 (as amended from time to time), in accordance with sections 43G and 43O of the *Electricity Supply Industry Act 1995* and Regulation 20 of the *Electricity Supply Industry (Pricing and Related Matters) Regulations 2013*, having taken into account the principles set out in section 43H of the *Electricity Supply Industry Act 1995*; or
- (ii) the approval made by the Regulator (as amended from time to time), in accordance with section 43G of the *Electricity Supply Industry Act 1995*, having taken into account the principles set out in section 43H of the *Electricity Supply Industry Act 1995*.

“**2013 Standing Offer Determination**” means the *Interim Price-regulated Retail Service Price Determination* issued on 29 July 2013 as amended by the Regulator in accordance with the *Electricity Supply Industry (Pricing and Related Matters) Regulations 2013*.

# 1 BACKGROUND AND PURPOSE

## 1.1 Background

Standing offer prices are the prices that a regulated offer retailer may charge small customers on mainland Tasmania (including Bruny Island) for services provided under standard retail contracts. Standing offer prices are effectively a fallback contract available for those customers choosing not to enter into a market retail contract.

Under section 41 of the *Electricity Supply Industry Act 1995*, standing offer prices are not to be fixed unless a draft of the standing offer price has been approved by the **Regulator**.

It has been the **Regulator's** past practice with respect to electricity determinations to prepare and release a guideline setting out Aurora Energy's obligations and the Regulator's responsibilities with respect to the determination.

Additionally, under clause 5 of the 2013 Standing Offer Determination:

Draft standing offer prices are to be submitted to the Regulator for approval in accordance with the *Electricity Supply Industry Act 1995* and the annual standing offer price approval process.

The draft Guideline sets out the annual process by which the Regulator will adjust standing offer prices. The draft guideline broadly follows the format of previous guidelines in terms of obligations, responsibilities, timeframes and the format of the annual pricing proposal (including certifications). However the guideline has been modified to account for the different treatment of the various Notional Maximum Revenue (NMR) components under the 2013 Determination as compared to previous determinations. The components of the NMR include:

- the notional tariff base (NTB) which includes the number of customers and their load;
- electricity loss factors when electricity is transmitted and distributed across the electricity network;
- the operational cost to serve per customer (Cost to serve);
- the wholesale electricity price (WEP);
- network costs;
- Australian Energy Market Operator (AEMO) charges for market participation and ancillary services;
- renewable energy target (RET) costs; and

- over or under recoveries from a previous period covered by this Determination in relation to changes in network costs, RET costs and AEMO charges attributable to the notional tariff base as approved by the Regulator; and
- retail margin.

Under previous electricity determinations, the only NMR components that were able to be varied during the regulatory period covered by the determination were RET costs, AEMO charges and Network costs (the latter two items being pass-throughs).

In contrast, under the 2013 Standing Offer Determination, all NMR components with the exception of the Cost to Serve and Retail Margin may be varied for each of Period 2 (2014-15) and Period 3 (2015-16). Whilst methodologies are already in place to vary the majority of the NMR components, the Regulator has been required to develop new methodologies to estimate the revised WEP and the NTB.

It is these two latter matters that the **Regulator** is specifically seeking stakeholder comments on.

## 1.2 Purpose

The purpose of this paper is to discuss issues associated with the draft **Guideline** and seek feedback from stakeholders.

The paper is structure as follow:

- Chapter 2 discusses the proposed methodology the **Regulator** intends adopting in estimating the Wholesale Electricity Price in each of Periods 2 and 3; and
- Chapter 3 discusses the proposed methodology the **Regulator** intends adopting in estimating the Notional Tariff Base in each of Periods 2 and 3.

Information on how to provide comment on the draft **Guideline** is provided in Chapter 4.

## 2 METHODOLOGY FOR ESTIMATING THE WHOLESALE ELECTRICITY PRICE

Clause 2.5 of the draft **Guideline** discusses the method the **Regulator** intends adopting to estimate the WEP in each of Periods 2 and 3.

### 2.1 Overview

During the investigation of maximum prices to apply under the standing offer determinations which were made on 29 July 2013 the Regulator was required to estimate the WEP using the (now) **audited wholesale pricing model**. This model was developed by the Government to calculate regulated wholesale financial contract prices which **Hydro Tasmania** is required to offer as the price of its regulated wholesale contracts. The **audited wholesale pricing model** effectively takes forward contract prices from Victoria, adjusts these for differences in the Tasmanian market including hydrological risk and load profiles and converts the result into the regulated price for regulated products that **Hydro Tasmania** must offer authorised retailers operating on mainland Tasmania. At the time of the investigation, the Regulator was required by the Government to use a point-in-time estimate of forward contract prices as the estimate of the WEP for Period 1.

During the Government's sale process in connection with Aurora's customer base in late 2013 potential purchasers raised concerns about the impact of the WEP being revised for Period 2 and 3 at a point-in-time.

Specifically, retailers considered that estimating the WEP at a point-in-time as the Regulator was required to do for Period 1, may present risks for retailers in Period 2 and Period 3 as:

- an efficient retailer is unlikely to seek to hedge its exposures by purchasing a single block of contracts at one point in time; and
- even if a retailer did choose to adopt this approach, Hydro Tasmania may not be obliged to contract for such a volume under the volume release mechanism in the Wholesale Contract Regulatory Instrument.

The Regulator also recognised that an efficient retailer adopting a prudent hedging approach was more likely to progressively build its contract book over a period of time such that an efficient retailer's operating costs may reflect a mix of:

- transitional hedging contracts associated with the divestment of Aurora Energy;

- regulated Load Following Swap (LFS) contracts purchased for quarters in Period 2 and/or Period 3 that were purchased prior to the annual tariff approval(s); and
- regulated LFS contracts that would be purchased by the retailer after the tariff approval is made, for quarters that have not yet commenced.

Concept Consulting Group Limited, the Department of Treasury and Finance's consultant on the reform project, advocated a weighted average approach to revising the WEP.

Despite the sale of the Aurora's customer base not proceeding, the Regulator considers that Aurora now faces the same risks as those expressed by the potential retailers.

## 2.2 Proposed methodology

In determining the WEP for Period 2 and Period 3 the Regulator proposes using a weighted average of regulated offer LFS prices. This would involve:

1. weighting historical observable regulated LFS offer prices by past Absolute Minimum Capacity Offer Volumes each week;
2. using the regulated LFS offer price for each quarter for future prices at the point in time that the Regulator calculates the WEP; and
3. weighting the prices observed in 2. above by the remaining residual minimum offers per quarter.

With respect to the use of the LFS prices to estimate the WEP the Regulator considers this approach relatively simple and transparent. An alternative option is to use a combination of other regulated products (base load swaps, peak swaps and caps) to build up a deemed efficient contract book. However, the Regulator considers that this would require considerable judgement as to a retailer's risk appetite. Furthermore, the Regulator notes that the use of such an approach would likely lead to a lower estimate than that using LFS prices. Given that part of the Regulator's role is to promote competition when regulating standing offer prices, the Regulator considers that adopting such an approach would be inconsistent with that objective.

With respect to the weights to be used, the Regulator considers that the use of the Absolute Minimum Capacity Offer Volumes is appropriate because the Regulator understands that the intention of these offers was to provide retailers with sufficient regulated contracts to meet small customer volumes. Furthermore, these volumes are provided weekly which allows for the incorporation of prices each week without creating a bias towards a particular week. In reality the volume used by retailers to serve small customers may be purchased during any number weeks through a combination of **Absolute Minimum Capacity Offer Volume** contracts, **Supplementary Offer Capacity Volume** contracts or unregulated contracts. Consistent with the previous paragraph the Regulator does not consider it should

pre-empt what the purchasing strategy of a retailer may be. Rather, the Regulator considers it should use a consistent and transparent approach to provide certainty for retailers when they are purchasing contracts having regard to how the WEP is reset for each of Periods 2 and 3.

The **Regulator** also considers that the use of a point-in-time price at the time of updating the WEP for future prices is also appropriate (point 3. above). The Regulator notes that the observable LFS prices are forward derivative prices which are the market's estimate of what the future price will be for a particular quarter. These future prices are based on the best available information at the time as to what the future price may be. It would therefore appear logical that the point-in-time estimate is the most appropriate consideration for the future price in the methodology outlined in points 1. to 3. Inclusive above.

The Regulator appreciates that this point-in-time estimate may be subject to outlier bias depending on the week at the time of the WEP update. However, if the Regulator was to not use the observable forward price then the Regulator would need to conclude that the market was not operating correctly in its estimate and would also need to determine a new estimate and justify why that estimate was superior to the current market estimate.

An alternative approach would be to provide an historical average of previous future prices as the estimate of the price in the future. The benefit of this approach is that it may smooth out any anomalies that may occur at the time in which the point in time future price is used. However, at least theoretically, this would tend to suggest information that the market considers no longer relevant is being factored into the future price. Whilst this approach therefore has the potential to minimise any impact of an outlier estimate, conceptually it would appear to be incorrect as it would not be using the most up to date and relevant market information.

Finally, the Regulator considered whether a premium should be placed on top of the final WEP estimate to reflect additional risk and uncertainty Aurora Energy faces. This is because the Regulator understands that the LFS may not necessarily be a risk free product for Retailers in that there may be pricing and load risk. In this regard the Regulator understands that other jurisdictions allow regulated retailers to recover a prudential risk or volatility allowance.

The Regulator notes that the wholesale regulatory framework was not meant to be riskless for retailers. Rather the WEP is intended to reflect the efficient wholesale costs incurred by a retailer purchasing electricity to supply to regulated customers. In this light the intention is not to remove Aurora Energy's exposure to risk with respect to potential movements in wholesale electricity prices but to reflect the risks faced by similar retailers operating in the NEM on mainland Australia. Furthermore, the Regulator notes in determining the WEP, it proposes to adopt the lowest risk/highest price contract option rather than a deemed efficient contracting strategy as adopted by regulators in other jurisdictions. Given this, the Regulator does not propose adding a risk premium to its WEP estimate.

The Regulator is seeking feedback on:

- the proposed approach to estimating the wholesale electricity price for each of Periods 2 and 3.

## 3 METHODOLOGY FOR REVISING THE NOTIONAL TARIFF BASE

Clause 2.5 of the draft **Guideline** discusses the method the **Economic Regulator** intends adopting to revise the Notional Tariff Base in each of Periods 2 and 3.

### 3.1 Overview

In previous electricity determinations, the NTB (ie customer numbers and load) has remained static for the duration of the determination. However, with full retail contestability (FRC) commencing on 1 July 2014, and the prospect that other retailers will enter the Tasmanian market and attract customers away from Aurora, the Regulator does not consider it appropriate that the NTB remains unchanged for the duration of the regulatory period.

In previous determinations the NTB was likely to change each year due in part to fluctuations in the number of small retail customers in Tasmania and mostly due to differences in customers' consumption patterns. However, with the introduction of FRC Aurora's NTB could also be reduced due to customers transferring to market contracts offered by Aurora itself and / or by new retailers. The implication of this is that the actual NMR would be significantly different than originally forecast.

### 3.2 Proposed methodology

As alluded to in section 3.1, the NTB is likely to change due to underlying general trends (the number of small customers connected to the electricity network and their consumption patterns) and the number of customers that move onto market contracts (known as churn). Whilst Aurora Energy would have a reasonable amount of information on the general trends of the NTB, Tasmania does not at present have any experience with customer churn for small customers. Given this the Regulator proposes two different methodologies to update the NTB for Period 2 and Period 3 respectively:

- for Period 2 the Regulator proposes adjusting Aurora's forecast NTB (not taking into account customer churn) for Period 2 by 3.75 per cent to reflect the estimated rate of customer churn during that period. With respect to the churn rate to apply, the Regulator considers a churn rate of 7.5 per cent by the end of 2014-15 to be appropriate, which leads to the average churn rate being 3.75 per cent during the period. This is based on analysis undertaken during the 2013 standing offer determination investigation where the Regulator considered that the likely start-up churn rate for Tasmania would be higher

than five per cent but lower than 10 per cent given experience in other jurisdictions<sup>1</sup>; and

- for Period 3 the Regulator proposes assessing Aurora’s forecast NTB for Period 3 which would take into account Aurora’s expected customer churn rates for Period 3 based on an analysis of the level of churn experienced during Period 2.

The Regulator notes that one of the major reasons for updating the NTB is to ensure that Aurora Energy is not financially advantaged or disadvantaged through having to provide regulated standing offer contracts, particularly as a result of under or over recovery of regulated charges. Specifically, under the 2013 Standing Offer Determination, Aurora Energy is permitted to recover from customers any difference in RET costs and any differences in the amounts AEMO levies for market and ancillary charges. With the introduction of FRC Aurora Energy’s regulated customer base is likely to change each year. If the NTB is not updated each year to reflect this then any under-recovery of these charges by Aurora would be spread over a larger customer base which would dilute the per customer charge and the amount of under-recovery Aurora Energy can recoup.

Conversely, the Regulator also considers that Aurora Energy should not gain a financial advantage from undertaking the role of standing offer retailer and notes that if the NTB was not updated each year any over-recoveries would result in a windfall gain for Aurora Energy.

The Regulator notes that in some respect this may appear inequitable because a smaller customer base may be paying for or receiving the benefit of any under or over-recovery relating to a larger customer base in the previous year. However, this is unlikely to be material to customers and ensures that Aurora is not financially advantaged or disadvantaged by undertaking the role of regulated offer retailer.

The Regulator is seeking feedback on:

- its proposed approach to revising the Notional Tariff Base for each of Periods 2 and 3.

---

<sup>1</sup> Tasmanian Economic Regulator, *Report on the investigation of maximum prices for interim price-regulated electricity retail services for small customers on mainland Tasmania* (July 2013), p.84.

## 4 RESPONDING TO THIS CONSULTATION PAPER

The Regulator invites written comment on the draft Guideline and other issues in this Consultation Paper. Submissions will be considered prior to the draft Guideline being finalised and must be received by **close of business on Friday 11 April 2014**.

It is normal practice for all submissions to be published on the Regulator's website unless the author of the submission requests confidentiality in relation to the submission (or any part of the submission). Those parts of a submission that are requested to be kept confidential should be submitted as an attachment to that part suitable for publication.

The Regulator will not publish submissions which contain material that the Regulator believes is, or could be, derogatory or defamatory.

If you would like further information on the treatment of confidential submissions, please refer to the Economic Regulator's *Policy on the treatment of confidential submissions* document on its website.

Submissions by email are preferred to assist in publishing submissions on the website.

Submissions and enquiries may be made to:

office@economicregulator.tas.gov.au

or to

Glenn Bounds (Assistant Director – Price and Service)

Office of the Tasmanian Economic Regulator,

GPO Box 770,

Hobart 7001

Telephone: 03 6166 4422

Facsimile: 03 6233 5666

A copy of the draft Guideline and this Consultation Paper may also be found on the Economic Regulator's website: [www.economicregulator.tas.gov.au](http://www.economicregulator.tas.gov.au)