2016 Standing Offer Investigation Draft Report, Draft Determination and Standing Offer Price Approval Draft Guideline

Consultation Paper

February 2016

Printed February 2016
Office of the Tasmanian Economic Regulator
Level 3, 21 Murray Street, Hobart TAS 7000
GPO Box 770, Hobart TAS 7001
Phone: (03) 6166 4422

ISBN 978-0-7246-5392-8

TABLE OF CONTENTS

1 INVITATION FOR SUBMISSIONS

This consultation paper has been prepared to assist interested persons in making submissions and comments on the 2016 Standing Offer Investigation Draft Report (the Draft Report), 2016 Standing Offer Draft Determination (the Draft Determination) and Draft Standing Offer Price Approval Guideline (the Draft Guideline).

It is the Economic Regulator's policy to publish all submissions on the Office of the Tasmanian Economic Regulator's (OTTER) 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 confidential should be submitted as an attachment to that part suitable for publication.

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

Submissions should be received by close of business on **15 March 2016**.

To facilitate the publication of submissions on OTTER's website, submissions by email are preferred. Submissions and enquiries may be made to:

office@economicregulator.tas.gov.au

or to

Todd Newett (Principal Policy Analyst – Price and Service)
Office of the Tasmanian Economic Regulator,
GPO Box 770,
Hobart 7001
Telephone: 03 6166 4422

A copy of this consultation paper, as well as the Draft Report, Draft Determination and Draft Guideline may also be found at OTTER's website www.economicregulator.tas.gov.au.

2 BACKGROUND AND PURPOSE

2.1 Background

The purpose of a pricing investigation is to gather information to assist the Economic Regulator in determining the maximum prices that may be charged by a Regulated Offer Retailer under standard retail (standing offer) contracts. 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.

This investigation is to be conducted in accordance with the *Electricity Supply Industry Act 1995* (the ESI Act) and the *Electricity Supply Industry (Pricing and Related Matters) Regulations 2013* (Pricing Regulations).

The previous determination, the 2013 Interim Price-Regulated Retail Service (Standing Offer) Price Determination, expires on 30 June 2016. The Economic Regulator is therefore required to make a new price determination which is to commence on 1 July 2016 in respect of standing offer prices.

In accordance with Regulation 9 of the Pricing Regulations the Economic Regulator is required to conduct a pricing investigation prior to making a price determination.

Under section 40AB of the ESI Act the Economic Regulator must, in determining the maximum prices a regulated offer retailer may charge small customers under standard (standing offer) contracts:

(a) estimate the operational costs of the retailer in providing standard retail services; and

(b) take into account the principle that the maximum prices that may be imposed by the retailer under standard retail contracts in respect of small customers are to be such as will enable the retailer, after the operational costs are taken into account, to make a reasonable return on its investment in respect of the provision of standard retail services, taking into account the risk of making that investment; and

(c) take into account the principle that small customers should be protected from the adverse effects of the exercise of substantial market power by –

a. the Hydro-Electric Corporation; or

b. the regulated offer retailer in relation to prices, pricing policies and standard of service in respect of the provision of standard retail services by regulated offer retailers; and

(d) take into account the principle that, for the purpose of benefitting the public interest, there is a need for efficiency in the provision of standard retail services.

The phased introduction of retail contestability commenced on 25 July 2005. From 1 January 2014 Aurora Energy was able to offer market retail contracts to all residential and small business customers on mainland Tasmania. From 1 July 2014, full retail contestability was introduced, ie other retailers were able to offer market retail contracts to all residential and business customers and all customers on mainland Tasmania have the option of entering into a market retail contract with Aurora Energy or a new entrant retailer.

The Economic Regulator notes that while full retail contestability has been in place since 1 July 2014, as of January 2016, no other retailer has opted to operate in the residential electricity market in mainland Tasmania. The presence or potential presence of retail competition is an important consideration in the calculation of maximum revenue limits. In the absence of competition, Aurora Energy would only need a revenue which reflected the efficient costs of providing services to its existing customer base. However in both competition scenarios, Aurora Energy would only need to be provided with sufficient revenue to cover its efficient costs.

Given these circumstances, the Economic Regulator sees three potential approaches to setting Aurora Energy's maximum revenue limits:

1. assume that no retail competition will eventuate during the regulatory period;

2. assume that effective retail competition will eventuate soon after the Determination is made; or

3. adopt a mixed approach, acknowledging that while competition does not currently exist, it is possible that competition may emerge during the regulatory period.

These options reflect the Economic Regulator's competing objectives under the ESI Act which include promoting efficiency and competition while at the same time protecting the interests of electricity consumers. In balancing these competing objectives, the Economic Regulator must therefore be mindful of ensuring that prices do not restrict competition, but are set at a level which reflects efficient costs.

Further, the Economic Regulator considers its role is not to predict the future level of competition in the Tasmanian market, but to set the NMR independently of what may occur in the future so as not to impede competition.

The Economic Regulator has decided that the next regulatory period will be for a period of three years, ie from 1 July 2016 until 30 June 2019. The Final Report is to be completed by 29 April 2016.

2.2 Purpose

The purpose of this paper is to discuss issues associated with the Draft Report, Draft Determination and Draft Guideline and seek feedback from stakeholders. It is intended that this paper be read in conjunction with the Draft Report, Draft Determination and Draft Guideline.

3 APPROACH TO SETTING STANDING OFFER PRICES

The Economic Regulator is required to balance the competing objectives of promoting competition and efficiency in the electricity supply industry whilst also protecting the interests of consumers.

In each of the Economic Regulator's previous five retail price determinations, maximum prices for small customers have been set by reference to the notional maximum revenue (NMR) that may be earned when the proposed standing offer prices are applied to a notional tariff base (NTB). The NTB comprises the forecast customer numbers and forecast load for all small customers connected to the distribution network that are eligible to take supply under a regulated price.

The Economic Regulator is proposing to adopt the same form of regulation as that applied in the previous retail tariff price determinations ie regulating prices by reference to a NMR.

In calculating the NMR, the Economic Regulator estimates the efficient costs of supplying standard retail services to small customers. These costs include the cost of energy (wholesale electricity cost), network charges (transmission and distribution charges, both of which are regulated by the Australian Energy Regulator (AER)), retail costs as well as Renewable Energy Target (RET) costs, Australian Energy Market Operator (AEMO) charges and metering charges.

Retail costs include the cost to provide retail services such as billing and account management and a retail margin intended to provide the retailer with a commercial return, taking account of risk and a required profit margin.

The Economic Regulator has discretion only with respect to the retail margin, the retail cost-to-serve (together retail costs) and the calculation of RET costs (with the exception of the inputs which are set by the Clean Energy Regulator).

In calculating the NMR, the Economic Regulator seeks information from Aurora Energy on its estimation of costs and conducts its own research and seeks information from other relevant parties to validate the information provided by Aurora Energy.

Standing offer prices are determined on the basis that if the price for each tariff were to be applied to the NTB for each period, the aggregate of the results ie the notional revenue for that period, will not exceed the NMR calculated in accordance with the Determination.

The NMR components and standing offer prices are calculated each year in accordance with the Determination. The process for approving standing offer prices during the regulatory period covered by the 2016 Standing Offer Determination will be set out in a standing offer price approval guideline.

More information on the Economic Regulator's proposed approach to setting standing offer prices is contained in Chapter 2 of the Draft Report.

The **Economic Regulator** is seeking feedback on:

- the proposed approach to setting standing offer prices.

4 PARAMETERS AND METHODOLOGY

The NMR is determined using a formula, where the individual components are the costs estimated to be incurred by Aurora Energy in supplying standard retail services to standing offer customers.

The NMR is an estimated value for a future period. The NMR components are therefore estimates of the costs for a specific period and are calculated using a methodology specified by the Economic Regulator.

More information on the Economic Regulator's proposed NMR formula and methodology for calculating the NMR is contained in Chapter 3 of the Draft Report.

The **Economic Regulator** is seeking feedback on:

- the proposed NMR formula and methodology for calculating the NMR;
- the proposed approach to setting the NTB for the purpose of calculating the NMR; and
- the proposed approach to calculating the NMR for Periods 1, 2 and 3.

5 WHOLESALE ELECTRICITY COSTS

A key input into the calculation of the NMR is the estimate of the wholesale electricity cost (WEC). The WEC is based on the wholesale electricity price (WEP), forecast standing offer customer load and the distribution loss factor.

The ESI Act requires the cost of electricity to account for the regulated offer retailer entering into a regulated load following swap with Hydro Tasmania with the load following swap contract price determined using the Wholesale Contract Regulatory Instrument.

The Regulator developed a load following swap weighted average methodology for calculating the WEP for the regulatory period covered by the 2013 Standing Offer Determination and proposes using the same methodology for the 2016 Standing Offer Determination.

More information on the Economic Regulator's proposed approach to calculating the WEC and the WEP is contained in Chapter 4 of the Draft Report.

The **Economic Regulator** is seeking feedback on:

- the proposed approach to calculating the WEC and the WEP.

6 RETAIL COST-TO-SERVE

In determining the maximum prices for small customers, the Economic Regulator makes an allowance for the cost to provide services to customers. The cost-to-serve is the allowance provided to enable the retailer to cover its operating costs. These operating costs includes costs associated with billing and revenue collection, some marketing expenditures, providing a customer call centre (providing advice and answering customer queries), an appropriate allocation of corporate overheads, and regulatory compliance.

The cost-to-serve is set to reflect the efficient costs that would be incurred by a retailer in providing its retail services to its customers. It is generally expressed as a dollar amount per customer per annum.

In previous investigations, the Economic Regulator adopted a benchmarking approach to setting the allowance for the cost-to-serve. Benchmarking involves comparing Aurora Energy's cost-to-serve allowances with the most recent allowances approved by regulators in other Australian jurisdictions.

The Economic Regulator considers that there is no comparable retailer for Aurora Energy to be benchmarked against. Currently, Aurora Energy is the only Regulated Offer Retailer in Tasmania and it faces constraints that differ markedly from other retailers.

The Economic Regulator proposes adopting a combination approach in determining a cost-to-serve allowance for the regulatory period from 1 July 2016 to 30 June 2019. This approach will consist of calculating a cost-to-serve allowance via a cost build-up approach and then checking the result of this calculation against the cost-to-serve figure in select other Australian jurisdictions to ensure that the figure calculated by the Economic Regulator was broadly in line with the allowances approved by regulators in other jurisdictions.

The Economic Regulator undertook an operating cost build-up by analysing Aurora Energy's forecast operating costs for the regulatory period. The Economic Regulator also considered whether there were any external cost pressures that may increase or decrease operating costs even in the absence of any change in activity.

The Economic Regulator revised the estimate of Aurora Energy's efficient operating cost figure by excluding a number of costs relating to small contract customers, bad debts and pay on time discounts.

More information on the Economic Regulator's proposed approach to determining Aurora Energy's cost-to-serve allowance is contained in Chapter 5 of the Draft Report.

The **Economic Regulator** is seeking feedback on:

- the proposed approach to determining Aurora Energy's cost-to-serve allowance; and
- the proposed indexation of that figure for each of Periods 2 and 3, applying the prescribed inflation factor methodology.

7 RETAIL MARGIN

The retail margin is intended to compensate an electricity retailer for the investment it makes in its retail business and for the risks it assumes in providing retail services to standing offer customers.

An electricity retailer's gross margin is equal to its revenue less energy purchase costs, network charges and other fees ie it is inclusive of retail operating costs (cost-to-serve). The net retail margin is equal to the gross margin less the cost-to-serve.

In previous investigations, the Economic Regulator adopted a benchmarking approach to setting the retail margin, taking account of the risks Aurora Energy faced in delivering retail services to the non-contestable customer base. That is, the retail margin took into account the differences in risks faced by Aurora Energy compared to the risks faced by the benchmark retailers.

In determining Aurora Energy's retail margin for this Draft Report and the associated Draft Determination the Economic Regulator has considered the retail margins set in other jurisdictions and has not identified any evidence to suggest that the risks facing a Regulated Offer Retailer operating in Tasmania are greater than the risks facing a Regulated Offer Retailer operating in other Australian states and territories.

Consequently, in the absence of any evidence suggesting otherwise, the Economic Regulator can see no reason to allow a higher retail margin than that provided in other jurisdictions.

The Economic Regulator proposes providing Aurora Energy with a net retail margin of 5.7 per cent per annum on total costs for each Period of the regulatory period.

More information on the Economic Regulator's proposed approach to determining net retail margin is contained in Chapter 6 of the Draft Report.

The **Economic Regulator** is seeking feedback on:

- the proposed benchmarking approach to determining net retail margin; and
- the proposed net retail margin of 5.7 per cent per annum.

8 PASS THROUGH COSTS

Pass though costs include network costs, the cost of complying with the Australian Government's mandatory renewable energy schemes, metering costs and the costs of operating in the NEM.

Electricity retailers have no control over these costs such that the Economic Regulator proposes that these costs are passed through directly to customers. As the costs in the NMR are estimates for a future period, the Economic Regulator proposes allowing adjustments in a future period to account for differences between the actual costs and the estimated costs. These under/over recoveries from previous periods will be included in the NMR formula in the components CF_y and K_y.

More information on the Economic Regulator's proposed treatment of pass through costs is contained in Chapter 7 of the Draft Report.

The **Economic Regulator** is seeking feedback on:

- the proposed treatment of pass though costs.

9 NOTIONAL MAXIMUM REVENUE

The majority of the NMR components for the 2016 Standing Offer Determination are subject to change in Period 2 and Period 3. Additionally, forecasts of network, metering and AEMO costs rely on third parties providing information which is usually not available until after the Economic Regulator's draft and final investigation reports have been published. In order to reflect the most up-to-date information available the Economic Regulator proposes calculating the NMR for Periods 1, 2 and 3 during the annual standing offer price approval process in June each year and only providing an illustrative NMR for Period 1 in the Final Report to be published in April 2016.

More information on the Economic Regulator's proposed treatment of NMR is contained in Chapter 8 of the Draft Report.

The **Economic Regulator** is seeking feedback on:

- the proposal to calculate an illustrative NMR for Period 1; and
- the proposal to calculate NMRs for each of Period 1, 2 and 3 during the respective annual price approval processes in June each year.

10 STANDING OFFER PRICE REFORM

The legislative requirement to maintain the existing level and structure of standing offer prices will end with the expiry of the 2013 Standing Offer Determination on 30 June 2016. The Economic Regulator has therefore required Aurora Energy to submit a Standing Offer Draft Price Strategy for the regulatory period covered by the 2016 Standing Offer Determination.

The Draft Strategy is to include Aurora Energy's proposals with respect to its intended changes to the existing standing offer tariff structure, standing offer prices and the price transition mechanisms it intends applying during the regulatory period.

The Economic Regulator will also be seeking submissions and comments on Aurora Energy's Standing Offer Draft Price Strategy which it will release for public consultation in March 2016. The Standing Offer Draft Price Strategy and an associated consultation paper will be available on the Economic Regulator's website: www.economicregulator.tas.gov.au.

More information on standing offer price reform is contained in Chapter 9 of the Draft Report.

11 STANDING OFFER PRICE APPROVAL GUIDELINE

The Standing Offer Price Approval Draft Guideline sets out Aurora Energy's obligations including the timeframes for the submission of its standing offer pricing proposals for Periods 1, 2 and 3 of the regulatory period together with the Economic Regulator's responsibilities under the 2016 Standing Offer Draft Determination and the ESI Act.

More information on Standing Offer Price Approval Guideline is contained in Chapter 9 of the Draft Report. The Guideline is available on the Economic Regulator's website: www.economicregulator.tas.gov.au.

The **Economic Regulator** is seeking feedback on:

- the proposed requirements relating to Aurora Energy's annual pricing proposals; and
- the proposed approach to approving Aurora Energy's proposed standing offer prices.

12 NEXT STEPS

The Economic Regulator is seeking submissions and comments from interested parties on the Draft Report, Draft Determination and Draft Guideline. Submissions will be considered prior to the Economic Regulator making its final decision, which will be published in a Final Report.

The Economic Regulator will also be seeking submissions and comments on Aurora Energy's draft Standing Offer Price Strategy which it will release for public consultation in March 2016. The draft Standing Offer Price Strategy and an associated consultation paper will be available on the Economic Regulator's website www.economicregulator.tas.gov.au.

After completing the Final Report, the Economic Regulator will make a determination that regulates the maximum prices that may be charged by, and specifies the pricing mechanisms imposed on, Aurora Energy in relation to standing offer prices in respect of standard retail services provided to small customers.

Aurora Energy will then be required to submit its proposed standing offer prices for Period 1 of the regulatory period (ie 1 July 2016 to 30 June 2017) for the Economic Regulator's consideration and approval.

Submissions should be received by close of business on **15 March 2016**.

For further information on how to make a submission or comment please refer to the details provided on page one of this consultation paper.