

# **Submission to the Tasmanian Economic Regulator on the First Retail Price Determination under FRC**

**May 2013**

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## Glossary

AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
CTS	Cost-to-serve
ESI Act	<i>Electricity Supply Industry Act 1995</i>
FRC	Full Retail Competition
IPART	Independent Pricing and Regulatory Tribunal, New South Wales
LFS	Load-following swap
LGC	Large-scale generation certificate
LRET	Large-scale renewable energy target
NEM	National Electricity Market
NMR	Notional Maximum Revenue
Regulator	Tasmanian Economic Regulator
RET	Renewable energy target
RNN	Regional Reference Node
ROR	Regulated Offer Retailer
RRP	Renewable power percentage
SRES	Small-scale renewable energy scheme
STC	Small-scale technology certificate
STP	Small-scale technology percentage
TSA	Transitional services agreement

## Introduction

The Government is implementing a package of reforms to the Tasmanian electricity supply industry aimed at introducing choice in electricity retailing for all Tasmanian customers and putting downward pressure on electricity prices. The key feature of the reform package is the introduction of full retail competition from 1 January 2014, facilitated by the sale of Aurora Energy's customers to private sector retailers.

The Government's reforms have been guided by four high-level policy objectives, which are established in the *Electricity Reform Act 2012*:

1. Lowest sustainable electricity bills.
2. Long-term safe, secure and reliable supplies of electricity.
3. Maximise the value of Tasmania's low carbon advantage and the brand benefits of clean Tasmanian electricity.
4. Financially viable state-owned electricity businesses that run efficiently and effectively and maximise the overall economic benefit to Tasmania.

## Retail price regulation under FRC

The transition from monopoly to competitive markets is a period of significant change for consumers, government and businesses, and the Government's reforms will impact on an essential of everyday life for all Tasmanians. Because of this, the Government's primary concern through the implementation process is to ensure that customers' rights are adequately protected and that the transition to a market that provides all consumers with choice is undertaken in a way that provides comfort and security to electricity customers and minimises confusion or uncertainty in the community.

In virtually every electricity market where full retail competition has been introduced, regulatory control of prices has applied for a period of time until it can be demonstrated that the competitive market is functioning effectively. Accordingly, the Government has decided to retain retail price regulation in Tasmania until it can be demonstrated that retail competition is sufficiently effective to remove the need for regulated price protection for customers.

The regulatory framework under which the Tasmanian Economic Regulator has previously determined electricity prices for Aurora Energy's regulated customer base has been largely maintained, with some small changes to provide for a multi-retailer environment and enable the initial price determination under FRC to be made at an appropriate stage of the customer divestment process.

## First retail price determination

The Government's decision to introduce FRC from 1 January 2014 requires a streamlined approach to making the first retail price determination that will apply under FRC. In particular, this determination must be completed by the Tasmanian Economic Regulator by 31 July 2013 to enable the Government to conduct the sale process for Aurora's customers in the second half of 2013.

Aurora Energy has historically provided a submission to the Regulator at the commencement of the price investigation process. However, as Aurora Energy will no longer be a retail business from the commencement of FRC, the Government is making the submission to the Regulator regarding the first price determination to ensure that the Regulator has the necessary inputs required to make the determination.

## Purpose of this submission

The purpose of this submission is to provide the Tasmanian Economic Regulator with sufficient information to enable the Regulator to make the first retail price determination by 31 July 2013.

The submission includes:

- the proposed approach and methodology for making the first retail price determination, as required by the ESI Act and supporting regulations;
- the period to which the first price determination relates; and
- an estimate of the appropriate allowance for each of the components of regulated electricity prices.

The Government's submission is supported by a report prepared by independent consulting firm, Ernst and Young.

## Contact person

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## Summary of submission

The table below provides a summary of the proposed position on the various elements of the first retail price determination. Further detail on these positions is provided later in this submission.

Elements of determination	Proposal
<b>Structure and methodology</b>	<ul style="list-style-type: none"> <li>• The Regulator is to maintain its existing price control mechanism of using a ‘building block’ approach to determine the notional maximum revenue (NMR) for each customer bundle.</li> <li>• The NMR should vary with changes in customer numbers and load supplied in each regulatory Period under Standard Retail Contracts by each Regulated Offer Retailer.</li> <li>• The price control instrument should therefore express each component of the NMR as a function of either estimated customer numbers, estimated consumption or both customer numbers and consumption.</li> </ul>
<b>Length of determination</b>	<ul style="list-style-type: none"> <li>• The Regulator is to make the determination for the period 1 January 2014 to 30 June 2016.</li> <li>• The determination is to include the following pricing periods:               <ul style="list-style-type: none"> <li>○ Period 1 – 1 January 2014 to 30 June 2014;</li> <li>○ Period 2 – 1 July 2014 to 30 June 2015; and</li> <li>○ Period 3 – 1 July 2015 to 30 June 2016.</li> </ul> </li> </ul>
<b>Tariffs and tariff structure</b>	<ul style="list-style-type: none"> <li>• Aurora Energy’s current schedule of tariffs is to be continued in the first determination as the standard offer prices for standard retail contracts of the Regulated Offer Retailers.</li> <li>• The Regulator is to approve standard offer prices under section 40 of the <i>Electricity Supply Industry Act 1995</i> that are consistent with the determination.</li> </ul>

Elements of determination	Proposal
<b>Wholesale energy allowance</b>	<ul style="list-style-type: none"> <li>• The Regulator is to estimate the wholesale energy allowance with reference to the price of the regulated load-following swap product that must be offered by Hydro Tasmania.</li> <li>• The Regulator is to use the approved pricing methodology established under an Order made by the Minister for Finance to estimate the price of the regulated LFS product.</li> <li>• The Regulator should take into account the potential for volatility in regulated retail prices that may arise from adopting the price of the regulated LFS product.</li> <li>• The wholesale energy allowance should be derived ex-ante with reference to the price of the load-following swap product as calculated at the time the Regulator approves standard offer prices for the next occurring Period under section 40 of the ESI Act.</li> </ul>
<b>Network costs</b>	<ul style="list-style-type: none"> <li>• The Regulator is to estimate the allowance for transmission and distribution costs by applying approved charges from relevant determinations by the Australian Energy Regulator to the notional tariff base for each Regulated Offer Retailer.</li> </ul>
<b>Retail cost to serve (CTS) allowance</b>	<ul style="list-style-type: none"> <li>• The Regulator should make an allowance for retail operating costs for Periods 1 and 2 at the estimated operating cost of the Transitional Services Agreement arrangements, being \$118 per customer per year.</li> <li>• For Period 3, a retail operating cost of \$108 is proposed.</li> <li>• Retail cost-to-serve should include a customer acquisition and retention cost which retailers in a competitive market incur, of \$42 per customer per year in Periods 2 and 3.</li> <li>• In Period 1, where customer transfers are more limited, a customer acquisition and retention allowance of \$21 per customer per year is proposed.</li> <li>• A total retail cost-to-serve of \$139 per customer per year in Period 1, \$160 per customer per year in Period 2 and \$150 per customer per year in Period 3 is therefore proposed.</li> </ul>
<b>Retail margin</b>	<ul style="list-style-type: none"> <li>• A retail margin of 6.0 per cent of total costs is proposed.</li> </ul>

Elements of determination	Proposal
<b>Other relevant costs</b>	<ul style="list-style-type: none"> <li>• The determination should allow for a range of reasonable other costs, including:               <ul style="list-style-type: none"> <li>- market fees; and</li> <li>- ancillary services; and</li> <li>- renewable energy scheme costs.</li> </ul> </li> <li>• Market fees and ancillary services should be assessed ex-ante and passed through to customers at the actual rate incurred by each Regulated Offer Retailer in proportion to load:               <ul style="list-style-type: none"> <li>- Period 1: 0.1082c/kWh</li> <li>- Period 2: 0.1109c/kWh</li> <li>- Period 3: 0.1137c/kWh</li> </ul> </li> <li>• Renewable energy scheme costs should be assessed ex-ante and passed through to customers at the actual rate incurred by each Regulated Offer Retailer in proportion to load:</li> </ul>

The table below provides an indication of the quantum of each component of the NMR as assessed by Ernst & Young and Treasury that would result from the application of the above proposals, if all small customers remain as standard retail contract customers across the period of the determination. This is the basis on which indicative pricing outcomes have been estimated.

Elements of determination	Proposal
<b>Wholesale energy allowance</b>	<ul style="list-style-type: none"> <li>• Wholesale energy costs for the three periods, are:               <ul style="list-style-type: none"> <li>- Period 1: \$76.62m</li> <li>- Period 2: \$150.44m</li> <li>- Period 3: \$155.70m</li> </ul> </li> </ul>
<b>Network costs</b>	<ul style="list-style-type: none"> <li>• Forecast network charges are:               <ul style="list-style-type: none"> <li>- Period 1: \$127.88m</li> <li>- Period 2: \$290.72m</li> <li>- Period 3: \$299.93m</li> </ul> </li> </ul>

Elements of determination	Proposal
<b>Retail cost to serve (CTS) allowance</b>	<ul style="list-style-type: none"> <li>• Estimated retail cost-to-serve of \$139 per customer in Period 1, \$160 per customer in Period 2 and \$150 per customer in Period 3, or:               <ul style="list-style-type: none"> <li>- Period 1: \$18.26m</li> <li>- Period 2: \$41.63m</li> <li>- Period 3: \$38.72m</li> </ul> </li> </ul>
<b>Retail margin</b>	<ul style="list-style-type: none"> <li>• Retail margin of 6.0 per cent of total costs, or:               <ul style="list-style-type: none"> <li>- Period 1: \$14.18m</li> <li>- Period 2: \$30.57m</li> <li>- Period 3: \$31.15m</li> </ul> </li> </ul>
<b>Other relevant costs</b>	<ul style="list-style-type: none"> <li>• Renewable energy costs to be:               <ul style="list-style-type: none"> <li>- Period 1: \$12.36m</li> <li>- Period 2: \$24.08m</li> <li>- Period 3: \$22.13m</li> </ul> </li> <li>• Market fees and ancillary services to be:               <ul style="list-style-type: none"> <li>- Period 1: \$1.15m</li> <li>- Period 2: \$2.64m</li> <li>- Period 3: \$2.68m</li> </ul> </li> </ul>
<b>Total Notional Maximum Revenue</b>	<ul style="list-style-type: none"> <li>• Total notional maximum revenue of:               <ul style="list-style-type: none"> <li>- Period 1: \$250.45m</li> <li>- Period 2: \$540.08m</li> <li>- Period 3: \$550.31m</li> </ul> </li> <li>• If applied across the entire small customer load and using the load forecasts prepared by Aurora Energy, this will translate into a modest price decrease across the determination period, in nominal terms.</li> </ul>

## Regulatory overview

The *Electricity Reform (Implementation) Act 2013* has been passed by the Tasmanian Parliament and received Royal Assent on 13 May 2013. This Act amended the *Electricity Supply Industry Act 1995* and the *National Energy Retail Law (Tasmania) Act 2012* to establish the new market arrangements arising from the Government's reforms.

The relevant sections of the *Electricity Supply Industry Act 1995*, as they relate to the determination of maximum standing offer prices for small customers, are outlined below.

### Section 38(5) – removing Aurora Energy's retail monopoly for small customers

This section provides for Aurora Energy's current monopoly on supplying electricity to small customers in Tasmania to cease immediately before full retail competition commences on 1 January 2014. This sunset clause will provide for full retail competition from this date.

### Section 38A – staged introduction of FRC

This section provides for FRC to be introduced in a staged manner in Tasmania from 1 January 2014. Transferring customers from Aurora Energy to private sector retailers and opening the retail electricity market to full competition involves significant change. The staged introduction of FRC will ensure that customers understand their rights and that systems are in place to support competing retailers.

### Section 38B – Regulated Offer Retailers

Section 38B provides for the Minister to declare an authorised retailer to be a Regulated Offer Retailer if that retailer has more than 50 000 small customers on mainland Tasmania. The standard retail contracts of Regulated Offer Retailers will be price-regulated by the Tasmanian Economic Regulator by retail price determinations. For the first retail determination, the two retailers that purchase Aurora Energy's customer bundles will be declared as Regulated Offer Retailers.

### Section 40AA – regulation of certain retail prices

This section requires the Tasmanian Economic Regulator to determine the maximum prices that may be charged by a Regulated Offer Retailer under standard retail contracts for small customers, or a method of determining maximum prices. This section also requires a separate determination to be made for each Regulated Offer Retailer.

## Section 40AB – principles for regulation of certain retail prices

Section 40AB establishes a number of principles that are to be taken into account by the Tasmanian Economic Regulator in determining maximum prices under section 40AA. Under this section, the Regulator is to:

- estimate the operational costs of the retailer in providing standard retail services;
- 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 should 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;
- take into account the principle that small customers should be protected from the exercise of substantial market power by Hydro Tasmania or a regulated offer retailer; and
- take into account the principle that, for the purpose of benefiting the public interest, there is a need for efficiency in the provision of standard retail services.

This section also outlines the relevant operational costs of a retailer for the purposes of providing standard retail services and the basis on which the Tasmanian Economic Regulator is to determine these costs.

## Section 40AC – role of the Minister in transitional arrangements

This section provides for regulations to be made that enable the Minister to make the submission to the Regulator in relation to the first retail price determination and the matters that may be specified in the Government's submission.

The section also provides that if the Minister makes a submission under the regulations, and the submission specifies the matters listed below, the determination is to be made in accordance with these matters:

- structure and methodology of the determination;
- the retail cost to serve;
- the period of the determination; and
- the pricing structure (schedule of tariffs).

## Electricity Supply Industry (Pricing and Related Matters) Regulations 2013

The *Electricity Supply Industry (Pricing and Related Matters) Regulations 2013* outline the process that is to be followed by the Tasmanian Economic Regulator in determining maximum prices for standard retail contracts offered by Regulated Offer Retailers.

Clause 6 of the regulations outlines the process that is to be followed in relation to the first determination. In particular, the Regulator is to:

- commence its investigation for the first retail determination upon receiving this submission;
- conduct its investigation in the manner it considers appropriate;
- take into account the submission made by the Minister; and
- make the first determination by 31 July 2013.

## Context to the submission

The first retail price determination made by the Regulator will be critical to the success of the Government's reform package, as it will:

- directly impact electricity prices for small customers in Tasmania, in two ways, by:
  - establishing the price for small customers that choose to remain on the standard retail contract offered by their purchasing retailer;
  - setting the benchmark price off which the competitive market offers of retailers are typically discounted, contributing to the level of retail competition that emerges in the Tasmanian retail market; and
- establish the initial level of gross revenue and risk for potential new entrant retailers to the Tasmanian retail market, therefore playing a key role in influencing whether retailers choose to bid for Aurora Energy's customer bundles.

Small Tasmanian electricity customers will benefit if the regulated retail pricing arrangements provide retailers with a sufficient level of profitability to enter the Tasmanian retail market and actively compete for customers. However, it is important to ensure that customers continue to be protected by the pricing arrangements and are paying an efficient price for electricity.

## Submission on form and standard offer pricing structure

### Structure and methodology

The Government submits that the Tasmanian Economic Regulator is to make the first determination using the following structure and methodology:

- a separate determination is to be made for the standing offer prices of the standard retail contract for each of the Regulated Offer Retailers;
- the price control mechanism is to be the determination of a Notional Maximum Revenue requirement for a notional tariff base comprising each customer bundle using a 'building block' approach that estimates an allowance for each component of electricity prices:
  - the wholesale purchase of electricity to supply the notional tariff base;
  - transmission and distribution costs (collectively, network costs);
  - the retail cost to serve;
  - the retail margin; and
  - any other costs the Regulator considers appropriate.

- the NMR should vary with changes in customer numbers and load supplied in each regulatory Period under Standard Retail Contracts by each Regulated Offer Retailer; and
- the price control instrument should therefore express each ‘building block’ of the NMR as a function of either estimated customer numbers, estimated consumption or both customer numbers and consumption.

### Duration and pricing periods

The Government submits that the Regulator make the first determination for the period 1 January 2014 to 30 June 2016, with this period split into three pricing periods:

- Period 1 – 1 January 2014 to 30 June 2014;
- Period 2 – 1 July 2014 to 30 June 2015; and
- Period 3 – 1 July 2015 to 30 June 2016.

This approach effectively introduces one additional price change on 1 January 2014, to coincide with the commencement of the transition to FRC, and then reverts to the existing pricing arrangements. This proposal has the following advantages:

- small Tasmanian customers have experienced movements in electricity prices on a financial year basis for the last several years;
- the proposal will align the first retail determination with the transmission and distribution determinations made by the Australian Energy Regulator; and
- the proposal aligns with the phased introduction of FRC for small Tasmanian customers.

### Pricing structure

To ensure a smooth price path for small Tasmanian customers during the transition to FRC, the Government submits that Aurora Energy’s current schedule of tariffs, as outlined in Appendix I, be maintained for the first determination as the schedule of standing offer prices for the standard retail contract of the Regulated Offer Retailers.

## Submission on cost components

### Wholesale energy allowance

A key feature of the Government's electricity reforms is that Hydro Tasmania will be required to offer a range of regulated wholesale market contracts for the small customer load in Tasmania, at prices produced from an approved pricing methodology.

Division 4A of Part 3 of the ESI Act provides for the regulation of Hydro Tasmania wholesale contracts in Tasmania. In particular, section 43G of the Act provides for the Regulator to approve:

- the types of regulated contract products that Hydro Tasmania is to offer to authorised retailers;
- a standard form or forms in relation to each regulated contract type;
- a methodology for calculating prices for each of the regulated contracts;
- a total period over which the regulated products are to be offered; and
- a formula, rule or methodology for determining the minimum total volume of electricity that Hydro Tasmania must make available to authorised retailers in regulated contract products.

Section 43(3) of the Act requires that an approval specifying the types of regulated contracts that Hydro Tasmania is to make available must always include a load-following swap (LFS) product, which will enable authorised retailers operating in Tasmania to manage their exposure to Tasmanian spot price risk.

Section 43O of the Act provides that the Minister for Finance may make any approval under Division 4A of Part 3, in the first six months after the Division commences, as if the Minister was the Regulator. The Government intends that that the Minister will make the initial wholesale regulatory instrument under section 43O and that this instrument will:

- run for a period of five years;
- be administered by the Tasmanian Economic Regulator;
- include a range of quarterly contract products consistent with products used throughout the National Electricity Market, including swap and cap products and the mandatory LFS product;
- include a pricing methodology that references Victorian contract prices and make a number of adjustments to reflect the supply/demand balance in Tasmania; and
- specify a minimum volume of regulated products referenced to total Tasmanian load and the volume of regulated and unregulated products already entered into by Hydro Tasmania.

In relation to the wholesale energy allowance in the determination, section 40(AB)(3) of the Act specifies that the wholesale electricity costs of a regulated offer retailer consist of the costs of purchasing electricity for the purpose of providing standard retail contracts, including any adjustment to these costs that would be made if the regulated offer retailer entered into a regulated load-following swap contract with Hydro Tasmania.

The estimate of the price of Hydro Tasmania’s regulated LFS product over the period of the determination is shown below.

	Period 1	Period 2	Period 3
Regulated LFS price (\$/MWh)	72.36	63.31	66.05

These prices have been produced from the pricing methodology that will be put to the Minister to consider making in the pricing Order. However, the Government submits that the Regulator should make its own estimate of the wholesale energy allowance for each pricing period of the determination using the approved pricing methodology at an appropriate time.

This is because a number of input assumptions to the approved pricing methodology, such as Victorian contract prices, are dynamic, which means that the prices of Hydro Tasmania’s regulated products will change often. This will introduce a new degree of volatility into the wholesale energy allowance that the Government submits should be taken into account by the Regulator in estimating the wholesale energy allowance.

The Government submits that the appropriate time would be an ex-ante assessment made at the same time that standing offer prices are approved in advance of each pricing period.

It is proposed that wholesale energy costs (WEC) be calculated as:

$$WEC_y = (\text{forecast notional tariff base}_y \times WEP_y \times DLF_y \times TLF_y)$$

Where:

$WEP_y$  is the wholesale energy price for period  $y$ , as derived by the Regulator under the prescribed methodology at the point of approving prices for period  $y$

$TLF_y$  is the approved load weighted average transmission loss factor at the reference node for Tasmania for period  $y$ , calculated using a methodology approved by the Regulator

$DLF_y$  is the approved load weighted average distribution loss factor for period  $y$ , calculated using a methodology approved by the Regulator

If applied to the total small customer load at the prices estimated above, Ernst & Young analysis shows that the total cost would be:

	Period 1	Period 2	Period 3
WEC total cost (\$million)	76.62	150.44	155.70

### Transmission and distribution costs

Section 40(AB)(4) of the Act requires the Regulator to estimate transmission and distribution costs in accordance with any relevant distribution or transmission determination made under the National Electricity Rules. The Regulator will therefore be required to adopt distribution and transmission costs from the respective determinations made by the Australian Energy Regulator.

The Government notes that transmission and distribution prices for 2013-14 will be approved by the Australian Energy Regulator in June 2013. Whilst the supporting analysis from Ernst & Young estimates total network costs for 2013-14 of \$127.88m, the Government submits that the Regulator should determine the allowance for transmission and distribution costs by applying the charges approved by the AER to the notional tariff base of each Regulated Offer Retailer.

$$NC_y = (\text{forecast notional tariff base}_y \times \text{network tariffs}_y)$$

If applied to the total small customer load, Ernst & Young analysis shows that the total cost would be:

	Period 1	Period 2	Period 3
NC total cost (\$million)	127.88	290.72	299.93

### Retail cost to serve (CTS) allowance

Retail cost-to-serve comprises:

- retail operating costs, which are the cost of services provided by a retailer to its customers; and
- customer acquisition and retention costs, which are primarily marketing costs associated with acquiring new customers, retaining existing customers and transferring customers.

The Government expects the cost-to-serve for large mainland electricity retailers to be less than the current Aurora Energy cost-to-serve. However, to support the sale of Aurora Energy's retail customer base and FRC, a Transitional Services Agreement (TSA) will be

provided to the purchasing retailers. The TSA will provide a range of back-office functions such as billing, credit and collections, connections and data and some customer services that the purchasing retailers will not be able to accommodate in their own operations by the date of sale completion. It is anticipated that the TSA will run for approximately 18 months, while customers are transferred from Aurora Energy's systems and incorporated into the new retailers' systems.

The TSA costs will be higher than normal operating costs in order to provide these services, and have been estimated at approximately \$110-\$120 per customer per annum, with set-up costs equating to approximately \$20 to \$30 per customer per annum.

An alternative approach to establishing an efficient CTS allowance is by benchmarking against other retailers' actual costs or against allowances made by other regulators. Analysis by Ernst & Young shows that an appropriate benchmarked estimate of retail operating costs is \$108 per customer per year.

Notwithstanding the benchmarking analysis, it is proposed that the retail operating cost allowance be set at \$118 for Period 1 and Period 2 (\$2013). This is because this will be the actual operating costs faced by retailers through this period.

For Period 3, the Government submits that it would be appropriate that customers share some of the benefit of scale that FRC and the divestment of Aurora Energy's customer base is expected to achieve. Given that for Period 3 the TSA arrangements will be complete, a retail operating cost allowance of \$108 per customer per year (\$2013) is proposed for Period 3.

Analysis conducted by Ernst & Young shows that a customer acquisition and retention cost allowance is necessary in competitive retail markets. If such an allowance is not made:

- regulated retailers are not provided with sufficient revenue to cover their efficient operating costs, as is required by the ESI Act; and
- retailers who seek to compete against the regulated retailers will be unable to make competitive price offers, because the regulated price has been set too low. A competitive market is thus very unlikely to emerge under this scenario, which is to customers' long-term detriment and is contrary to the Regulator's objectives under the ESI Act.

It is therefore proposed that the Regulator include a customer acquisition and retention cost allowance, which retailers in all other competitive markets incur. An allowance of \$42 per customer per year (\$2013) is proposed.

Transitional arrangements relating to the introduction of retail competition will apply in respect of Period 1, as specified in section 38A of the ESI Act. These provisions limit the ability of customers to transfer between retailers for the period 1 January 2014 to

31 March 2014 and allow transfers only between designated retailers for the period 1 April 2014 to 30 June 2014.

Because the legislative framework provides for the retention of customers to a considerable degree through Period 1, it is proposed that a customer acquisition and retention allowance of \$21 per customer per year is provided in this period.

	Period 1	Period 2	Period 3
Retail operating costs, \$/customer, \$2013	118	118	108
Customer acquisition and retention costs, \$/customer, \$2013	21	42	42
Total Cost-to-Serve, \$/customer, \$2013	139	160	150

It is therefore proposed that the cost-to-serve allowance be set as:

$$CTS_y = (\text{forecast customers}_y \times (ROC_y + CARC_y))$$

Where:

$ROC_y$  is the retail operating cost for period  $y$  as given in the following table

$CARC_y$  is the customer acquisition and retention cost for period  $y$  as given in the following table

	Period 1	Period 2	Period 3
$ROC_y$	118	118	108
$CARC_y$	21	42	42

If applied to the total small customer load, Ernst & Young analysis shows that the total cost would be:

	Period 1	Period 2	Period 3
CTS total cost (\$million)	18.26	41.63	38.72

## Retail margin

The retail margin represents the return that an electricity retailer requires in order to attract the capital needed to provide an electricity retailing service. It compensates investors for their capital investment and exposure to systematic (market) risks. An inadequate retail margin can deter entry into the Tasmanian market of new retailers and delay the development of effective competition.

Section 40AB(1)(b) of the ESI Act requires the Regulator to take into account the principle that the determination of maximum prices for standard retail contracts offered to small customers should provide for a reasonable rate of return for regulated offer retailers, after taking into account relevant operational costs.

Section 6(2)(b) of the ESI Act requires the Regulator to promote competition in the electricity supply industry. In this regard, it is important that the Regulator take account of the effect of the retail margin on the likelihood of new entrants being able to compete with the regulated standard retail contract.

The retail margin should represent an appropriate risk-adjusted return on the financial investment required to be made to deliver retail services to small customers. Where market risks are higher, a higher margin would be expected by a prudent investor. Similarly, where risks are lower, a lower margin would be tolerated by an investor.

In this context, the Government considers that there will be a range of uncertainties for retailers associated with entering the Tasmanian market in the initial stage of FRC and that the existing retail margin of 3.8 per cent on total costs is unlikely to be sufficient. The opening of the small customer segment of the retail market to competition will introduce significant additional risks for regulated retailers operating in Tasmania. Principal among these additional risks are:

- increased uncertainties relating to customer numbers.;
- wholesale purchasing risk.

Aurora Energy currently experiences some risk associated with customer numbers through projecting growth in the small customer load. However, retailers in a competitive market will have the additional risk of customers moving between retailers and it is expected that this risk will increase significantly in a competitive market.

Similarly, wholesale purchasing risk will also increase under the new arrangements. While the Government is regulating Hydro Tasmania's contract offers in the Tasmanian market, this form of regulation will not eliminate wholesale market risk for retailers and nor is it intended to. The Government's policy in this regard is to regulate to ensure that the Tasmanian NEM region has similar risks for retailers as those retailers would face in a competitive wholesale market.

To achieve this, the ESI Act establishes a framework within which a suite of contracts must be offered, where that suite is similar to those generally offered in competitive markets, and where the prices of those contracts are set by reference to competitive price outcomes in Victoria. Other provisions ensure that a sufficient volume of contracts is available for purchase.

In essence, this framework creates, by regulation, a liquid contract market that is intended to operate on a similar basis to competitive markets, with the specific risks unique to the Tasmanian market managed through the legislated arrangements. This means that retailers operating in Tasmania will not have their wholesale trading risks eliminated, but rather that they will have similar approaches available to managing risks as are available in competitive wholesale markets.

Retailers will still need to make decisions as to the construction of a hedge book; will still have to match forecast load to contract backing and will still purchase products from a dynamically priced contract market. In these regards, the risks in Tasmania are the same as those in other NEM regions. Importantly, retailers in Tasmania are unlikely to have access to some other risk mitigation approaches that are available in other NEM regions, such as vertical integration or reliance on the spot market to match actual load with a bought contract position.

The Ernst & Young report notes that retail margin estimates in Australia in 2012 are 5.4 per cent in South Australia, New South Wales and Australian Capital Territory, based on a weighted average of expected returns, benchmarking and bottom-up analysis.

Analysis undertaken by IPART considered data from a large number of comparable international firms and retailers in Australia, which estimated a range of 6.4 per cent to 6.9 per cent retail margin.

Ernst & Young has advised that although the regulation of wholesale energy prices potentially reduces retailer's risk, the Tasmanian market retail margin must be of sufficient size to ensure the retailer can cover its fixed capital-related costs. Ernst & Young has therefore estimated a retail margin at the upper end of the benchmark range at 6.9 per cent.

On balance, the Government submits that, notwithstanding Ernst & Young's advice that a retail margin at the higher end of observed benchmarks would be appropriate, there is insufficient basis on which to expect Tasmanian customers to pay a margin of this magnitude. The Government's view is that the risks that will be faced by retailers in Tasmania, together with recent estimates of appropriate margins in other markets, warrant a retail margin of 6.0 per cent of total costs.

## Other relevant costs – renewable energy schemes

Section 40AB(2)(d) requires that the Regulator is to include in the estimate of operational costs any other costs incurred by the regulated offer retailer in relation to the provision of standard retail services that the Regulator thinks fit.

The Government submits that there are a range of other costs that should be taken into account by the Regulator in the determination, including:

- market fees and ancillary services; and
- renewable energy scheme costs.

A national Renewable Energy Target (RET) scheme has been established by the Commonwealth Government which has two targets relating to Small-Scale (SRES) and Large-Scale (LRET) Renewable Energy Schemes. LRET places a legal liability on wholesale purchasers to contribute towards the generation of additional renewable electricity by purchasing Large-scale Generation Certificates. The number of these certificates to be purchased by liable entities each year is determined by the Renewable Power Percentage (RPP), which is estimated by the Clean Energy Regulator at 10.65 per cent for 2013.

SRES also places a legal liability on wholesale purchasers of electricity to proportionally contribute towards the costs of creating small-scale technology certificates (STC). The cost to a retailer of obtaining these certificates is assumed to be \$40 based on the STC Clearing House prices. The volume of STCs required to be purchased by retailers each year is implied through the Small-scale Technology Percentage (STP) that is set by the Clean Energy Regulator each year.

Historically, the RPP and STP that has been forecast on an ex-ante basis by the Clean Energy Regulator has fallen short of the final binding requirement. This presents a particular challenge for regulators in approving an appropriate allowance for the costs to retailers associated with the SRES and LRET schemes. Data provided by Aurora Energy shows that there has been a consistent bias towards under-recovery in this regard, as shown in the following table:

		2011	2012	2013
LRET	2010 Determination estimate, (per cent)	4.98	6.45	7.92
	Final binding requirement, (per cent)	5.62	9.15	10.65
SRES	2010 Determination estimate, (per cent)	8.5	10.24	12.00
	Final binding requirement, (per cent)	14.80	23.96	19.70
Total RECS	2010 Determination estimate, (per cent)	13.48	16.69	19.92
	Final binding requirement, (per cent)	20.42	33.11	30.35

The Government proposes that the Regulator considers the introduction of an additional RET allowance each year above the estimate that is derived from the liable load, forecast certificate cost and forecast STP and RPP requirements. It is proposed that this allowance be set at 40 per cent of the total REC allowance. If the additional allowance is not required once binding requirements are published, the excess collected through the additional allowance would be returned to customers in the following pricing period. This mechanism would recognise the systemic bias towards under-recovery that has historically occurred and assist to produce a regulated revenue allowance that more closely matches the retailers' actual costs. Importantly, this mechanism would not present any additional cost to customers and would assist to smooth out pricing outcomes, rather than embedding structural under-recoveries into the regulatory model.

The Government therefore proposes that the REC allowance be calculated as:

$$REC_y = (Load\ LRET_y \times RPP_y \times LGC(P)_y \times 1.4) + (Load\ SRES_y \times STP_y \times STC(P)_y \times 1.4)$$

Where:

*Load LRET<sub>y</sub>* is the load associated with the notional tariff base for each RoR that is liable to generate a liability under the LRET scheme

*Load SRES<sub>y</sub>* is the load associated with the notional tariff base for each RoR that is liable to generate a liability under the SRES scheme

*RPP<sub>y</sub>* is the forecast Renewable Power Percentage in year y

*STP<sub>y</sub>* is the forecast Small-scale Technology Percentage in year y

*LGC(P)<sub>y</sub>* is the LGC price, as shown in the table below

*STC(P)<sub>y</sub>* is the STC price, as shown in the table below

	2H2013-14	1H2014-15	2H2014-15	1H2015-16	2H2015-16
LGC(P)	37.16	37.16	38.91	38.91	40.82
STC(P)	40.00	40.00	40.00	40.00	40.00

If applied to the total small customer load and multiplying the Ernst & Young estimates by 1.4, the total cost would be:

	2H2013-14	2014-15	2015-16
REC total cost (\$million)	12.36	24.08	22.13

## Other relevant costs – market fees and ancillary services

The Ernst & Young analysis estimates market fees and ancillary service costs at a Budget Unit Cost as shown in the following table, to be applied to the notional tariff base of each RoR as adjusted by relevant loss factor (1.0893) to apply at the RNN.

$$AEMO_y = (\text{forecast notional tariff base}_y \times BUC_y)$$

Where:

$BUC_y$  is the Budget Unit Cost for period  $y$  as given in the following table:

	Period 1	Period 2	Period 3
Budget Unit Cost (c/kWh)	0.1082	0.1109	0.1137

If applied to the total small customer load, Ernst & Young analysis shows that the total cost would be:

	Period 1	Period 2	Period 3
AEMO total cost (\$million)	1.15	2.64	2.68

## Determination of Notional Maximum Revenue

The Government submits that the Regulator should adopt the following formula for determining the notional maximum revenue:

$$NMR_y = (WEC_y + CTS_y + NC_y + AEMO_y + REC_y + K_y) \times (1 + Margin)$$

Where:

<b>y</b>	is the relevant period
<b>NMR</b>	is the permitted maximum revenue to be earned from the loads and customer numbers given in the Schedules to the Determination
<b>WEC</b>	is the wholesale energy purchase cost for the relevant period
<b>CTS</b>	is the cost-to-serve for the relevant period
<b>NC</b>	is the network charges for non-contestable customers
<b>AEMO</b>	is the AEMO forecast fees and ancillary services charges for each notional tariff base
<b>REC</b>	is the cost of acquiring Renewable Energy Certificates in respect of each notional tariff base
<b>Tax<sub>y</sub></b>	is the allowable tax event adjustment calculated in accordance with a methodology approved by the Regulator
<b>K<sub>y</sub></b>	represents any differences between actual costs and the values for those costs estimated in the Determination (where applicable)
<b>Margin</b>	is the retail margin of 6.0 per cent of total costs

The total notional maximum revenue is estimated to be:

- Period 1: \$250.45m
- Period 2: \$540.08m
- Period 3: \$550.31m

If applied across the entire small customer load and using the load forecasts prepared by Aurora Energy, this could translate into a modest price decrease across the determination period, in nominal terms.

The Government considers that this submission, if adopted by the Regulator, would place downward pressure on prices, protect customers from adverse price impacts and support competition by encouraging the entry of national retailers into the Tasmanian market

## Submission on adjustments and pricing approval process

The Government recognises that the following aspects of the arrangements for retail price regulation under FRC present a unique set of challenges for the Tasmanian Economic Regulator:

- the requirement to complete the first determination six months prior to its commencement;
- the requirement to make the determination for regulated offer retailers, which are not yet known; and
- the volatility that will be introduced in determining the wholesale energy allowance using an approved pricing methodology that is market-based.

The Government submits that these challenges can be largely addressed through the process undertaken by the Regulator to approve the maximum prices for regulated offer retailers that are consistent with the Regulator's determination.

In particular, the Government submits that:

- the Regulator conduct the price approval for Pricing Period 1 by 31 July 2013, based on this submission and any additional information required by the Regulator;
- the Regulator conduct tariff approvals for Pricing Period 2 in May/June 2014 and for Pricing Period 3 in May/June 2015, based on submissions from the Regulated Offer Retailers; and
- in conducting each tariff approval process, the Regulator make allowance for any material changes in costs that have arisen since the determination was made.

## Appendix I – Retail Tariff Structure

Tariff Number	Category	Description
31	Residential	Light and power
41	Residential	Hot Water
61	Residential	Off Peak afternoon boost
62	Residential	Off Peak night only
42	Residential	HydroHeat (hot water and space heating)
22	Business	General
34	Business	Nursing Home light and power
43	Business	Institutional hot water
73	Business	Irrigation low rate
74	Business	Irrigation high rate
75	Business	Irrigation (Time-of-Use)
82	Business	Monthly kVA demand low voltage
83	Business	Industrial low voltage demand
85	Business	Monthly kVA demand high voltage
86	Business	Industrial high voltage demand