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# RETAILER OF LAST RESORT CUSTOMER CHARGES

# FINAL DECISION

MAY 2008

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# PREFACE

This Final Decision – Retailer of Last Resort Customer Charges brings up-to-date the Essential Service Commission's 2006 final decision on the tariff component of an electricity and gas retailer of last resort (RoLR) scheme for Victoria.

A RoLR scheme in the electricity and gas sectors is intended to maintain continuity of electricity and/or gas to customers' premises by requiring another retailer to sell electricity and/or gas to these customers when their existing retailer is unable to do so. There is no evidence that the likelihood of a widespread RoLR event in the Victorian energy market structure is high, but the Commission is required under legislation to develop and implement a workable RoLR scheme.

In the 2006 final decision, the Commission determined that the RoLRs' costs could be best be recovered through charges comprising the standing offer tariff and a once-off supply fee. The calculation of the supply fee comprises the additional retail operating costs and the additional wholesale costs incurred by a RoLR in the event of a retailer failure. The Allen Consulting Group (ACG) was engaged to advise on the additional wholesale costs, which was calculated by applying probability weights to a range of pricing scenarios

In updating the wholesale costs for this 2008 final decision, the Commission acknowledges the submissions that there are alternative ways of imposing the RoLR costs on customers. Specifically, the RoLRs considered that it was more appropriate to set the charges depending on the wholesale costs incurred at the time of the failed retailer and allocating these costs according to the size and nature of the event.

Consumer advocates considered that the costs of a RoLR event should be borne by all customers through a managed fund oversighted by the Government. There was also concern that low income and vulnerable customers may be further disadvantaged in a RoLR event.

There are a number of principles guiding the Commission's decisions in implementing the RoLR scheme. The key principles are for the Commission to reach a balance between ensuring that the designated retailers of last resort (the local retailers) sufficiently cover their costs in supplying the customers of a failed retailer and ensuring that customers understand that these costs are fair, simple and transparent.

The Commission has carefully considered all the proposals submitted by stakeholders against its guiding principles. It recognises that all the alternative approaches have merit and all are consistent with some of the principles. Overall, however, the Commission has decided to maintain the approach of the 2006 final decision for setting customer charges in a RoLR event. The Commission considers that this final decision provides certainty and transparency to customers on the

charges they may face in the event of their retailer failing while providing adequate compensation to the local retailers in carrying out its RoLR obligations.

The Commission notes that the Ministerial Council of Energy (MCE) is currently developing a national RoLR scheme for implementation by the national regulators from 2010. Therefore, the Commission expects that its RoLR scheme will only be in place for approximately 18 months. However, the Commission will review the RoLR customer charges in mid-2009 if necessary. The Commission also supports that alternative approaches to the RoLR scheme are examined during the MCE consultations

Greg Wilson
**CHAIRPERSON**

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# 1 INTRODUCTION

## 1.1 Background

Part 2 division 8 of the *Electricity Industry Act 2000* (EI Act) and part 3 division 6 of the *Gas Industry Act 2001* (GI Act) establish a retailer of last resort scheme (RoLR) for electricity and gas in Victoria. A RoLR scheme in the electricity and gas sectors is intended to maintain continuity of electricity and/or gas to customers' premises by requiring another retailer to sell electricity and/or gas to these customers when their existing retailer is unable to do so. The EI and the GI Acts define what type of retailer failure will trigger the operation of the RoLR scheme, that is, when:

- a retailer's licence to sell electricity and/or gas is revoked or
- a retailer's right to acquire electricity and/or gas in the wholesale market is suspended.[1]

The EI and GI Acts also determine the maximum duration of the RoLR's obligation to supply (three months), and confers on the Essential Services Commission (the Commission) broad discretion to develop and implement the remaining features of the electricity and gas RoLR schemes. These features include whether retailers or distributors will be the RoLR and the tariffs, terms and conditions for customers in the event of a retailer failure.

In February 2006, the Commission made its final decision on an electricity and gas RoLR scheme for Victoria (2006 final RoLR scheme decision).[2] The key decisions made by the Commission were:

- RoLR responsibilities were assigned to the three local retailers, AGL Sales (AGL), Origin Energy (Origin) and TRUenergy
- the standing offer terms and conditions that apply under the EI and GI Acts, including the provisions of the Energy Retail Code, will form the basis of the terms and conditions for the provision of RoLR services to residential and small business customers (RoLR customers) and
- RoLR customer charges would comprise the standing offer tariff and a once-off supply fee of $44 for electricity and $30 for gas.

Therefore, if a retailer failure occurs, AGL, Origin and TRUenergy will be required to supply electricity and/or gas to the failed retailer's residential and/or small

[1] Section 49D(5) of the EI Act and section 51D(5) of the GI Act.

[2] Essential Services Commission 2006, *Energy retailer of last resort final decision*, February

business customers in the local retailers' designated areas under tariffs, terms and conditions approved by the Commission.[3]

## 1.2 Commission's 2006 final decision on RoLR customer charges

In the 2006 final RoLR scheme decision, the Commission stated that the tariff and charges under which RoLR customers should be supplied with electricity and/or gas would comprise:

- the standing offer tariff, which was the price approved by the Victorian Government under its four year retail price path agreement with the local retailers and
- a supply fee of $44 per electricity RoLR customer and $30 per gas RoLR customer.

The Commission considered that the standing offer tariff would allow the local retailers to recover most of the supply costs caused by a retailer failure. The standing offer tariff provides both return to the local retailers and for the recovery of energy costs, network charges and market fees, and retailer operating costs.[4]

However, the Commission also acknowledged that the cost of purchasing energy in the wholesale market at the time of a retailer failure may be higher than the wholesale costs allowed for in the standing offer tariff. The Commission further acknowledged that the local retailers are likely to incur additional retail operating costs, such as administration and staffing costs associated with billing and providing information to RoLR customers.

Therefore, the Commission considered that the supply fee would be the simplest mechanism for the local retailers to recover from RoLR customers the additional wholesale energy and retail operating costs above those already incorporated in the standing offer tariff.

In setting the supply fee, the Commission considered two elements: additional retail operating costs and additional wholesale costs associated with a retailer failure.

*Additional retail operating costs.* The Commission understood that the standing offer tariffs allowed the local retailers to recover retail operating costs of $92 per customer per annum. As the maximum period of the local retailers' RoLR obligations is three months, the Commission considered that the local retailers should be entitled to recover an additional 25 per cent above the $92 per customer

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[3] It is possible that a local retailer failure could occur, in which case, the Commission determined that the remaining local retailers would share the RoLR responsibilities. Refer to the Commission's 2006 final RoLR scheme decision for more information.

[4] Essential Services Commission 2006, *Energy retailer of last resort final decision*, February, pp.34–35.

per annum that is allowed for under the retail price path agreement. This amounted to $23 per electricity and gas RoLR customer.

*Additional wholesale costs.* The Allen Consulting Group (ACG) was engaged to advise the Commission of the additional wholesale costs the local retailers may incur in having to purchase more electricity and/or gas to supply RoLR customers.[5] To calculate the additional wholesale electricity costs, ACG applied probability weights to six pricing scenarios. ACG estimated that the additional wholesale electricity cost per customer based on 2006 circumstances would be $20.60.

The Commission, therefore, decided to establish a supply fee of $44 per electricity RoLR customer, which allows the local retailers to recover:

- $23 in additional retail operating costs and
- $21 in additional wholesale electricity costs.

To calculate the additional wholesale gas costs, ACG applied probability weights to six price and two load scenarios. ACG estimated that the additional wholesale gas cost per customer based on 2006 circumstances would be $6.57.

Based on ACG's analysis, the Commission set the supply fee for gas at $30, which would allow the local retailers to recover:

- $23 in additional retail operating costs and
- $7 in additional wholesale gas costs.

## 1.3 Framework for approving RoLR tariffs, terms and conditions

The EI and GI Acts specify that the tariffs, terms and conditions upon which the RoLR will supply electricity and/or gas to RoLR customers, are those approved by the Commission after the RoLR's proposed tariffs, terms and conditions have been submitted for the Commission's approval.[6] In September 2007, the local retailers submitted their proposed RoLR customer charges to the Commission.[7]

The Commission also has discretion to specify tariffs, terms and conditions under certain circumstances. Section 49E(2)(b) of the EI Act and section 51E(2)(b) of the GI Act provide that the tariffs, terms and conditions specified by the Commission will be the approved tariffs, terms and conditions if the RoLR:

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[5] A detailed explanation of ACG's methodology is contained in the Commission's 2006 final RoLR scheme decision available on the Commission's website at www.esc.vic.gov.au under Energy, Regulation & Compliance and Decisions & Determinations.

[6] Section 49E(2)(a) of the EI Act and section 51E(2)(a) of the GI Act.

[7] The local retailers' non-price terms and conditions of supply to RoLR customers, which are required to be consistent with the Energy Retail Code, was approved in a separate process in March 2008.

- submits tariffs, terms and conditions that do not include any changes proposed by the Commission within a month of the Commission proposing these changes or
- fails to submit proposed tariffs, terms and conditions to the Commission after being provided with at least one month's notice to comply with the Commission's request.

In accordance with its powers, the Commission has assessed the local retailers' proposed RoLR customer charges against the criteria that RoLR customer charges should:

1. not be tied to particular circumstances that are assumed to apply at the time of a retailer failure, but should be flexible enough to cope with a wide range of circumstances
2. protect financial flows within the energy industry and take account of reasonable risks and costs associated with the provision of RoLR services
3. protect the interests of customers; prices should be simple, understandable and ensure that RoLR customers pay a fair price and that the RoLR recovers the costs it incurs to provide the RoLR service
4. minimise the administrative costs required to finalise, implement and operate the RoLR scheme
5. maximise regulatory certainty by facilitating transparent and robust regulatory decision making
6. ideally, continue to insulate customers from volatility in wholesale prices and
7. ideally, be capable of being implemented using existing data and systems capabilities.[8]

These criteria are expanded in Appendix A.

*Developments on a national framework for energy regulation*

The Commission understands that the Ministerial Council on Energy is currently considering a national RoLR scheme, which it intends to introduce with the National Retail Rules in the last quarter of 2009.[9] In addition, the energy retail functions and powers of the jurisdictional regulators are expected to be transferred to the national regulators by 1 January 2010.

Nonetheless, until a national RoLR scheme is implemented and the Commission's energy retail functions transferred to the Australian Energy Regulator, the Commission has a role in approving tariffs under the current legislative framework. The Commission, therefore, has assessed the local retailer's proposed RoLR

[8] Essential Services Commission 2006, op. cit., pp. 23-24.

[9] Ministerial Council on Energy 2008, *Energy market reform bulletin no. 114: retail policy working group update and retailer of last resort consultancy*, 13 February.

customer charges recognising that a national RoLR scheme will likely be in place by 2010.

The Commission's final decision regarding the local retailers' proposed RoLR customer charges reflects the importance the Commission has placed on having RoLR customer charges that are simple, understandable, and maximises regulatory certainty.

## 1.4 Draft decision and submissions

In February 2008, the Commission published its draft decision on the local retailers' proposals. The draft decision was that the local retailers' proposed RoLR customer charges should not be approved.

Consistent with the discretion provided to the Commission under section 49E(2)(b) of the EI Act and section 51E(2)(b) of the GI Act, the Commission's draft decision was that the approved RoLR customer charges will comprise:

- the standing offer tariff and
- a supply fee of $59 per electricity RoLR customer and $36 per gas RoLR customer.

The additional wholesale cost that the Commission believed local retailers should recover was based on ACG's analysis and estimation of the costs local retailers are likely to incur in carrying out its RoLR obligations when a retailer fails. The ACG methodology is summarised in section 2 with the detailed explanation in Appendix B of this final decision.

The Commission released its draft decision for stakeholder consultation. Five submissions were received from AGL, Consumer Action Law Centre (CALC), Origin, Energy and Water Ombudsman (Victoria) (EWOV) and TRUenergy.

The key issue in all submissions is the calculation and application of the supply fee. CALC and EWOV expressed concerns about the impact of the fee on low income and vulnerable customers. Local retailers, however, believed that a fixed supply fee would not sufficiently protect financial flows within the energy industry and were critical of ACG's methodology and analysis. These issues are addressed in sections 2 and 3 of this final decision.

## 1.5 Structure of this final decision

The remainder of this final decision is structured as follows:

- Section 2 summarises the methodology used to calculate the additional wholesale costs and retail operating costs
- Section 3 sets out the Commission's draft decision on the local retailers' proposed RoLR customer charges
- Section 4 sets out the Commission's final decision on RoLR customer charges and
- Appendix A describes the criteria used to assess the local retailers' proposed RoLR customer charges

- Appendix B contains ACG's methodology for calculating the wholesale electricity and gas costs

# 2 ADDITIONAL RETAIL OPERATING AND WHOLESALE COSTS

This section summarises the methodology used by ACG to calculate the additional wholesale costs and sets out how the retail operating costs were determined. Matters raised in stakeholder submissions on the methodology are addressed and the Commission's final decisions on the additional retail operating and wholesale costs local retailers.[10]

## 2.1 Draft decision

In the Commission's draft decision, a supply fee of $59 per customer in the event of an electricity retailer failure and $36 per customer for a gas retailer failure was used as a basis to assess the local retailers' proposed RoLR customer charges.[11]

The Commission considered that a supply fee of:

- $59 for a retailer failure in the electricity industry allows the local retailer to recover:
  - $35 per RoLR customer for the additional wholesale electricity cost and
  - $24 per RoLR customer for the additional retail operating costs.
- $36 for a retailer failure in the gas industry allows the local retailer to recover:
  - $12 per RoLR customer for the additional wholesale gas cost and
  - $24 per RoLR customer for the additional retail operating costs.

The supply fee is intended to allow local retailers to recover the extra costs of having to purchase electricity and/or gas at above normal prices as well as the recovery of additional retail operating costs, which are likely to be incurred at the time of a retailer failure.

[10] The key issues in submissions relate to the assumptions underlying ACG's methodology. ACG was not able to undertake further analysis for the Commission. Therefore, the Commission provided all the necessary data and information to Deloitte Economics, who provided advice on the matters arising from the submissions.

[11] The costs have been rounded to the nearest dollar.

## 2.2 Additional wholesale costs

ACG was engaged to advise the Commission of the additional wholesale costs, taking into consideration the impact of the failure of Energy One on the wholesale market and higher wholesale electricity and gas prices prevailing at the time.[12]

The Commission's draft decision contained detailed information about ACG's methodology for estimating the additional wholesale costs. Nevertheless, two retailers submitted that the Commission should independently release the ACG report, expressing concern that the Commission's draft decision "…does not contain the full supporting information and assumptions that ACG used and/or relied upon to reach its final prices in the various scenarios."[13]

The Commission did not publish the report separately because ACG consulted with participants in the market who provided information on a confidential basis. These sources are cited in the ACG report. However, in light of stakeholder submissions, the Commission will release the ACG report with these sources de-identified.[14]

Notwithstanding the view that the details of the ACG report were insufficiently visible, the Commission considers that comprehensive information on the methodology used by ACG was provided in the draft decision (and summarised again in this final decision). The Commission considers that stakeholders were given the necessary information to make informed submissions. Further, the spot price data used by ACG to inform the draft decision was publicly available and could have been used by stakeholders to independently evaluate the methodology and assumptions.

### 2.2.1 Wholesale electricity costs

The additional wholesale electricity cost that local retailers may incur was calculated by subtracting from the benchmark wholesale cost for each of five pricing scenarios. Average customer consumption was used to determine the additional wholesale cost per customer. Probability weights were then applied to the additional wholesale costs for the pricing scenarios, which were subsequently totalled. The scenarios are described briefly below.

The Commission received a number of submissions on the methodology.

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[12] On 22 June 2007, NEMMCO issued a suspension notice to Energy One prohibiting Energy One from purchasing electricity in the National Electricity Market. This triggered a RoLR event.

[13] TRUenergy 2008, *TRUenergy response to ESC draft decision: retailer of last resort customer charges*, February, p. 3.

[14] The ACG report will be published on the Commission's website following the publication of this final decision.

*Pool Price scenarios 1, 2 and 4*

Three of the five scenarios (scenarios 1, 2 and 4) assumed that the RoLR could purchase from the pool at prevailing pool prices. The three pool price scenarios took account of moderate, high and very high pool prices. The moderate and high pool price scenarios have probability weights of 30 per cent each, with a 5 per cent probability weight applied to the very high pool price scenario.

AGL submitted that higher probability weights should be applied to the high price scenarios as a moderate pool price is unlikely to be associated with a retailer failure. In its submission, AGL suggested that scenario 1 should have a probability of 10 per cent while scenarios 2 should be assigned a probability of 40 per cent (AGL also considered that the probability weighting for scenario 5 should be 40 per cent).[15]

ACG's analysis of data from the National Electricity Market Management Company (NEMMCO) following the failure of Energy One does not support AGL's view. The load weighted average pool price 90 days after the failure of Energy One was calculated by ACG to be $102.35 per MWh. Between January 2006 and September 2007 the pool price reached $102.35 per MWh only 9 per cent of the time. Therefore, assigning a higher probability to scenario 2, which assumes a high pool price for up to 40 per cent probability is not supported by the data.

*Administered Price scenario 3*

Scenario 3 took account of the possibility that a retailer failure occurs at the time of extreme market conditions triggering the administered price cap (APC), which is currently at $100 per MWh in peak periods (7am to 11pm each day) and $50 per MWh at all other times. For this scenario, ACG applied a probability weight of 5 per cent to the load weighted price of $75.25 per MWh.

TRUenergy submitted that "…ACG may have misunderstood the operation of the Cumulative Price Threshold and has under-estimated the price of $75.25 per MWh by up to $100."[16] TRUenergy further submitted that, in their view, the maximum period for application of the APC should be one week, not three months as assumed in ACG's methodology.[17]

The Commission confirmed with NEMMCO that, as the market operator, it can apply the APC for a full three month period if the market conditions warrant,[18] that is, if the sum of spot prices in a single region for the previous 336 trading intervals (seven days) continues to exceed the cumulative price threshold (CPT), which is currently set at $150 000. In practice, however, market participants are unlikely to

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[15] AGL 2008, *Retailer of last resort customer charges*, February, p. 3.

[16] TRUenergy 2008, op. cit., p. 4.

[17] Graeme Hamilton, Regulatory Manager, TRUenergy, email comm., 31 March 2008.

[18] Under clause 3.14.2 of the *National Electricity Rules*, NEMMCO must notify market participants of the commencement and closing of the period in which the APC will apply.

keep bidding at such levels that would require NEMMCO to keep applying the APC (as this would prevent market participants from maximising revenue).[19]

Based on the submissions and NEMMCO's advice, it is agreed that the initial assumption that the APC will apply for three months is not correct. Therefore, scenario 3 has been amended to assume that the APC would apply for five days as follows:

- the price for one day is set at the average CPT spot price of $446.43 per MWh
- for the next five days, the price is set at the APC peak price of $100 per MWh and
- the remaining 84 days under this scenario has the high price of scenario 2 of $106.86.

The impact of these changes is to increase the cost for this scenario from $75.25 to $110.25 per MWh.

*Hedge Contracting scenario 5*

For scenario five, it was assumed that the RoLR will be able to purchase contracts to hedge the risks of purchasing electricity for their newly acquired customers. This hedge contracting scenario was assumed to be as equally likely as scenarios 1 and 2. Therefore, ACG applied a 30 per cent probability weight to scenario 5.

AGL considered that the assumption a RoLR would be able to enter into hedge contracts after a retailer failure particularly unlikely.[20] On the other hand, TRUenergy contended that ACG should use contract prices in its methodology rather than relying on spot market prices as it considered that a retailer is more likely to rely on contracts rather than be exposed to the spot market.[21]

There does not appear to be agreement amongst the local retailers as to the likelihood of hedge contracts being available in a RoLR situation. Nevertheless, a RoLR may be able to directly negotiate a three month hedge contract with a generator. Depending on the inherited load shape and size, and the market circumstances at the time of the retailer failure, however, the RoLR may have to pay a premium above market quoted prices to the generator. ACG included a premium of $40 per MWh above the average pool price in this hedge contracting scenario, which may be considered to be generous in the circumstances.

Irrespective of the above, AGL submitted that the most prudent approach to allocating the additional wholesale costs for customers in a RoLR event should be determined by adopting this hedge contracting scenario only. It considered,

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[19] NEMMCO applied the APC on 18 March 2008 when price peaks in South Australia resulted in the threshold of $150,000 being exceeded. The APC was in place from 17:30hrs on Monday 17 March to 04:00hrs on Wednesday 19 March. This single example, demonstrates that an administered price period is unlikely to be in place for three months.

[20] AGL 2008, op. cit., p. 3.

[21] TRUenergy 2008, op. cit., p. 3.

however, the costs to RoLR customers should be determined at the time of the retailer failure so that the actual wholesale costs could be applied. AGL argued that this approach may result in lower wholesale costs applying at the time, resulting in lower costs to consumers. [22]

The Commission acknowledges that the ACG methodology is based on assumptions about the probability of certain wholesale costs applying at the time of a retailer failure. It is also acknowledged that the wholesale costs at the time of an actual retailer failure may be higher or lower than the probability weighted average cost derived from this methodology.

However, the Commission retains the view that the ACG approach and assumptions are preferable to an approach which exposes customers to pool price volatility and uncertainty (with a likelihood of high wholesale prices).

*Consumption*

Average annual customer consumption of electricity was used in ACG's methodology to translate the additional wholesale cost for each scenario into a cost per RoLR customer. The draft decision noted that the consumption figure was calculated by dividing total consumption figures reported by electricity distributors with the number of small customers on main tariff only. In its submission, Origin sought clarification in regard to:

- whether the average consumption numbers used reflected both residential and small business customer consumption and
- the meaning of the phrase 'main tariff'. [23]

The customer consumption data is based on actual and forecast of electricity residential customer numbers and their consumption, detailed in the 2007 Network Tariff Reports submitted by Powercor, AGL Electricity (now Alinta AE), United Energy and CitiPower.[24] The phrase "main tariff" refers to the typical residential tariff; for example, Powercor's small single rate, United Energy's low voltage small 1 rate, AGL's A100 rate and CitiPower's residential single rate.

In response to Origin's submission, the Commission reviewed the average annual customer consumption. This review revealed that the initial customer numbers included residential customer consumption only. Given that the Commission is approving terms and conditions for both residential and small business customers, the additional wholesale costs therefore have been revised to include small business customers. This has resulted in quarterly average consumption increasing from 1.45 MWh to 1.58 MWh, which has led to an increase in the additional wholesale electricity cost per customer.

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[22] AGL 2008, op. cit., p. 3.

[23] Origin 2008, *Retailer of last resort customer charges – draft decision*, February, p. 3.

[24] These tariff reports can be found on the Commission's website at www.esc.vic.gov.au under Energy, Regulatory & Compliance, Decisions & Determinations, and 2007 Electricity Tariffs.

*Summary*

The analysis of the submissions has led to an amendment to the calculation of the administered price methodology (scenario 3) and average annual customer consumption. This results in an increase of $6.02 in the additional wholesale electricity cost per RoLR customer, from $34.50 to $40.52 based on average annual consumption of 6.33 MWh.

Table 2-1 shows the scenario prices, probability weights and contribution per customer for each scenario.[25]

**Table 2-1 Additional wholesale electricity costs**

| *Scenario* | *Price[a] ($/MWh)* | *Probability weights* | *Contribution ($) per customer* |
|---|---|---|---|
| 1. Moderate pool price | 50.67 | 30% | -7.42 |
| 2. High pool price | 106.86 | 30% | 19.26 |
| 3. Administered price | 110.25 | 5% | 3.48 |
| 4. Very high pool price | 182.73 | 5% | 9.21 |
| 5. Hedge contracting | 100.00 | 30% | 16.00 |
| **Additional wholesale electricity cost per customer** | | | **40.52** |

**a** This is the price at which the RoLR would have to purchase electricity in the wholesale market after a retailer fails.

Source: Allen Consulting Group.

### 2.2.2 Wholesale gas costs

In the draft decision, the additional wholesale gas cost a RoLR may face after a retailer failure was set out. Probability weights were applied to five price and two load scenarios (high and low load). The high load scenario occurs in the winter peak period, July to September, and the low load scenario applies for the remainder of the year. The high load period has a weighting of 33.3 per cent and the low load period a weighting of 66.7 per cent.

The probability weighted average costs for each of the five price and two load scenarios were then totalled.

*Spot Price scenarios 1 and 2*

The first two price scenarios took account of the possibility that a RoLR has to purchase from the spot market for three months following a retailer failure. The prices were based on spot market price data from January 2006 to October 2007 and allowed for moderate and high spot prices. ACG assigned a probability

[25] An explanation of how these prices were determined can be found in Appendix B.

weighting of 12 per cent each to scenario 1 and 2 as these scenarios are considered to be equally likely.

TRUenergy submitted that it was not appropriate to use gas spot market data that pre-dated February 2007 "…because the old market design is not an accurate reflection of gas wholesale market prices."[26]

The Commission understands that from 1 February 2007, VENCorp introduced gas wholesale pricing for five intervals per day to replace the previous system when there was a daily market price. The Commission sought further advice from Deloitte Economics, who advised that a change in the frequency of pricing intervals should not lead to a material change in actual gas prices over ten months.[27] Therefore, the Commission considers that the period of time used by ACG as the basis for the spot price scenarios is reasonable.

*Administered price scenario 3*

The third price scenario allows for the possibility that a RoLR may have to purchase gas from the spot market in an extreme spot price event, which requires VENCorp to apply the administered price cap (APC).[28] This could arise from the cause or outcomes of a retailer failure, from changed behaviours in the market or from an unrelated event. A probability weight of 1 per cent was applied to this scenario even though ACG advised such an event has not occurred in the market to date.

This scenario assumes that the gas spot market price reaches $800 per GJ for one day,[29] and that VENCorp then sets the APC of $80 per GJ for a further five working days, so that the maximum market price during that time is $80 per GJ. AGL submitted that this scenario was not tenable as a "…high price *per se* is not a trigger for VENCorp to apply the APC. It is conceivable that the price remains at VoLL for consecutive days."[30]

The Commission sought advice from VENCorp as to how it applies the APC in the circumstances described above. Currently the gas market rules only allow VENCorp to apply an APC in three situations, that is, as a result of a force majeure event, market suspension and if VENCorp is unable to publish a price schedule by the required time. Therefore, AGL is technically correct in its submission that the price may remain at VoLL for consecutive days.

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[26] TRUenergy 2008, op. cit., p. 4.

[27] Deloitte Touche Tomatsu, *Memorandum of advice to the Essential Services Commission*, 16 April 2008

[28] Under the Victoria gas industry's *Market and System Operation Rules* (MSOR), VENCorp is required to apply the administered price cap if there is a force majeure event, market suspension or if VENCorp is unable to publish the price schedule by a required time.

[29] This is known in the MSOR as the value of lost load or VOLL and is the maximum spot market price allowed in the gas wholesale market.

[30] AGL 2008, op. cit., p. 4.

However, VENCorp has also advised the Commission that a new administered pricing procedure will be in place by June 2008, which will enable two further triggers for an APC.[31] These triggers are a retailer failure or the cumulative price (CP) exceeding a certain threshold. The latter trigger is that assumed in the ACG model. Given that this new administered pricing procedure will by in place by June 2008, the Commission considers ACG's third scenario is realistic.

*Commodity and Capacity Contracts scenarios 4 and 5*

Scenarios 4 and 5 took account of the situation in which a RoLR is able to purchase gas supply contracts. In scenario 4, ACG assumed that a RoLR can enter into a commodity contract at a price equivalent to historical market prices. Under scenario 5, ACG assumed much less competition because supply contract volumes for commodity and capacity are tightly held. As this would not normally be an issue during low load periods when gas supplies are readily available, ACG limited this scenario to the high load periods.

The relative probability weightings for scenarios 4 and 5 depend on the market situation at the time of a retailer failure, which will depend on customer load and time of year. During high load periods, competition is assumed to be limited and so ACG assigned equal weighting of 12.5 per cent to each of scenario 4 and 5. During low load periods, competition for supply is much more likely and so ACG allocated a 50 per cent weighting to scenario 4 and zero weighting to scenario 5.

TRUenergy noted that the main determinant of the gas supply fee is the assumption that a RoLR would be able to enter into gas contracts to supply RoLR customers (commodity contract scenario 4). TRUenergy considered this assumption highly unlikely as a retailer failure is more likely to occur in a period of high demand for gas than a period of low demand.[32] Therefore, the RoLRs may not be able to purchase contracts in these circumstances.

The Commission acknowledges this submission. However, in the absence of a gas retailer failure from which ACG could draw information, ACG's methodology addresses TRUenergy's concerns by assigning a lower probability weighting in periods of high demand compared to the probability weightings assigned in periods of low demand.

*Winter gas consumption*

ACG used average annual consumption to calculate the additional gas wholesale cost on a per customer basis. The average annual customer consumption of 61 GJ was based on an average of Multinet's actual and forecast residential customer

[31] Under clause 3.2.5 of the MSOR, VENCorp is required to establish an administered pricing procedure by 1 June 2008.

[32] TRUenergy 2008, op. cit., p. 4.

gas usage, which was then apportioned into winter consumption of 25 GJ and other quarters' consumption of 12 GJ per quarter.[33]

For the purpose of determining the additional wholesale gas cost per customer, only residential gas customer usage can be relied upon as the gas tariff structure for non-residential customers does not differentiate between small and medium to large businesses and includes customers consuming up to 10,000 GJ per annum.

AGL submitted that winter consumption should be in the range of 34 to 37 GJ, on the basis that these consumption figures derive from its analysis of customers' bills.[34] This higher consumption figure would increase the wholesale gas costs incorporated into the supply fee.

The Commission sought VENCorp's verification of AGL's estimates. VENCorp advised that it is not possible to distinguish residential customers from the large industrial and commercial customers in providing data on gas winter consumption.

Therefore, given that ACG used actual consumption data published by a distributor and the absence of small business gas consumption data, the Commission considers that the 25 GJ used in ACG's methodology reflects winter gas consumption of residential customers.

*Summary*

Without a retailer failure in the gas market to draw information from, the Commission considers that the assumptions made by ACG about a range of likely scenarios that a RoLR could face when purchasing gas from the wholesale market when a retailer fails are reasonable in the circumstances.

Consequently, the Commission accepts ACG's advice that the additional wholesale gas cost per customer is $11.78.[35]

~~Further, the Commission does not consider that the submissions provided sufficient reasons for it to change the basis on which the additional gas wholesale costs which may apply in the event of a failed retailer should be determined.~~

Table 2-2 shows the scenario prices, probability weights and contribution per customer for each scenario.[36]

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[33] This apportionment is based on VENCorp's load data, which can be found on VENCorp's website at www.vencorp.vic.gov.au, under Gas, Wholesale and Information & Data.

[34] .AGL also sought clarification on how TRUenergy's standard price for contracted gas capacity of $190 per GJ was converted to $5.96 per GJ in a RoLR event and whether this is inclusive of commodity contracts. This advice has been separately provided to AGL.

[35] An explanation of how ACG calculated this consumption figure is set out in Appendix B.

[36] An explanation of how these prices were determined can be found in Appendix B.

**Table 2-2 Additional gas wholesale costs**

| *Scenarios* | *Prices[a] ($/GJ)* | *Probability weights (%)* | | *Contribution ($) per customer* |
|---|---|---|---|---|
| | | *Low load scenario* | *High load scenario* | |
| 1. Moderate spot prices | 3.37 | 8.0 | 4.0 | -0.98 |
| 2. High spot prices | 5.65 | 8.0 | 4.0 | 3.52 |
| 3. Administered prices | 18.13 | 0.7 | 0.3 | 2.35 |
| 4. Commodity contracts | 3.91 | 50.0 | 12.5 | 0.36 |
| 5. Commodity and capacity contracts | 5.96 | 0.0 | 12.5 | 6.54 |
| **Additional wholesale gas cost per customer** | | | | **11.78** |

[a] This is the price at which the RoLR would have to purchase gas in the wholesale market after a retailer fails.

Source: Allen Consulting Group.

### 2.2.3 Transfers by RoLR customers

In the 2006 final RoLR scheme decision, the Commission considered that a three month moratorium on transfers by RoLR customers could be appropriate as it would promote stability in the energy market following a retailer failure.[37] This moratorium would prevent customers from transferring from the RoLR to another retailer for the three month period.

However, subsequent to the 2006 final RoLR scheme decision, the moratorium on customer transfers was determined to be unenforceable under the EI and GI Acts. Consequently, RoLR customers are able to transfer away from the RoLR at any time.

Both TRUenergy and AGL submitted that this outcome has implications for the additional wholesale costs derived under the ACG methodology.[38] [39] AGL also noted that ACG's methodology assumes customers will be held for a full three month period and if that assumption is not correct, the costs of supplying RoLR customers with energy are likely to increase.

There are a number of reasons why the Commission considers the fact that customers can transfer from the RoLR at any time has limited material impact on the additional wholesale costs allowed under the ACG methodology, including:

[37] Essential Services Commission 2006, op. cit., p. 35.

[38] TRUenergy 2008, op. cit., p. 2.

[39] AGL 2008, op. cit., p. 3.

- The maximum duration of a RoLR's statutory obligations is three months.[40] Therefore, ACG's methodology assumes that a RoLR would prudently purchase, either through the spot market or contract, sufficient energy for a three month period. This is because the RoLR would not be able to predict how many customers would remain with it for the full three months or transfer to another retailer within three months.
- In practice, it would be difficult to predict the level of customer switching following a retailer failure. There has been only one such failure in Australia and there is no data publicly available about rates of switching following this event. Therefore, there is no practical experience on which any assumptions could be made about likely transfer rates.
- Even if a customer chooses to transfer to another retailer within the RoLR's three months obligation period, the practical implications of the transfer process would probably mean that the customer would stay with the RoLR for a substantial time period. That is, the current Victorian rules are that customers can only be transferred on actual meter reads, which could be any time up to two months for gas and three months for electricity.

### 2.2.4 Additional retail operating costs

The Commission's 2006 final RoLR scheme decision established that the additional retail operating costs the local retailers should be allowed to recover would be $23 per RoLR customer. These costs were based on the retail operating costs local retailers were allowed to recover under the standing offer tariff, which was $92 per customer per annum. Given the maximum period of the local retailers' RoLR obligations of three months, the local retailers were allowed to recover 25 per cent of the $92 per customer per annum.

The 2006 final RoLR scheme decision also indicated that this fee be escalated by CPI. Between the March 2006 quarter and the December 2007 quarter, Australia's CPI for all groups increased 5.4 per cent.[41]

Therefore, the updated additional retail operating costs set out in the draft decision was $24.24 per RoLR customer.

Origin noted that the Independent Pricing and Regulatory Tribunal (IPART) has recommended a fee of $35 per customer in New South Wales, which does not include the wholesale energy costs, and recommended that the Commission examine IPART's analysis of its RoLR fee.[42]

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[40] See section 49D(6) of the EI Act and section 51D(6) of the GI Act.

[41] ABS 2008, *Consumer Price Index, Australia*, cat. no. 6401.0, Canberra. This can be downloaded at no charge from the ABS website at www.abs.gov.au under Consumer Price Index and Details.

[42] Origin 2008, op. cit., p. 3.

IPART advised the Commission that it requested the retailers to provide an estimate of the administrative costs incurred as a result of the Energy One failure and a hypothetical retailer failure as the basis for its RoLR administrative fees. This information was provided on a commercial-in-confidence basis.[43] The Commission is unable to access this information.

However, given that the 2006 decision was based on the retail operating costs local retailers were allowed to recover under the standing offer tariff, the Commission considers that the retail operating costs, inflated by CPI, are reasonable.

## 2.3 Final decision

Taking into consideration the issues raised in the submissions, the Commission continues to accept the basis for ACG's methodology and analysis. However, because of the change in assumptions to the administered price scenario, which applied the APC for only five days instead of three months, and the inclusion of small business customers in the consumption data, the Commission concludes that the additional wholesale electricity cost calculated for 2007 is $40.52 per customer and the additional wholesale gas cost for the same period is $11.78 per customer.

The additional retail operating costs for both sectors should be $24.24.

Consistent with section 49E(2)(b) of the EI Act and section 51E(2)(b) of the GI Act, the Commission's draft decision was to specify the following RoLR customer charges as the approved RoLR customer charges:

- standing offer tariff and
- a one off, up front supply fee of:
  - $65 per electricity RoLR customer and/or
  - $36 per gas RoLR customer

[43] IPART 2007, *Review of retailer of last resort supply fee for small retail customers, Electricity – draft report*, November, p. 19.

# 3 DRAFT DECISION ON RETAILERS' PROPOSALS AND SUBMISSIONS

This section sets out the Commission's draft decision on the local retailers' proposed RoLR customer charges, the submissions received in response to the draft decision and the Commission's consideration of these submissions.

## 3.1 Draft decision

The Commission's draft decision was to not approve the RoLR customer charges proposed by the local retailers. The Commission assessed these proposals against ACG's conclusions that the additional wholesale costs the local retailers will likely incur in the event of a retail failure would be $34.50 per customer for electricity and $11.78 per customer for gas. On this basis, the Commission's draft decision was that the Commission would not be meeting its primary objective of protecting the long term interests of Victorian consumers by approving the local retailers' proposed RoLR customer charges.

The following sections outline the reasons for the draft decision against each retailer's proposal and the Commission's consideration of the submissions received.

## 3.2 AGL

The structure of the RoLR customer charges for electricity and gas proposed by AGL is similar to the Commission's final decision; that is, AGL proposed that its RoLR customers would be charged the standing offer tariff and a one off, up front supply fee.

However, AGL proposed imposing conditions on the different amounts of supply fees it will charge. AGL submitted that it was not possible to set a single price at which RoLR customers could be supplied energy while still ensuring it remains financially viable as a retailer. Rather, AGL submitted that the RoLR customer charges should incorporate the 'worst case scenario' while providing:

> *…a degree of discretion around the imposition of those terms, so that in the event there is a ROLR episode which has a milder impact than is contemplated…the full terms and conditions are not applied.*[44]

[44] AGL submission 2007, Retailer of Last Resort – Tariff, Terms and Conditions, 31 August

AGL, therefore, proposed two sets of electricity and gas supply fees with a lower fee for a retailer failure that has less impact on the market. These proposals are outlined below:

- For electricity RoLR customers, if a retailer failure involves:
  - less than 10 000 customers, the proposed supply fee is $44 ($23 retail operating costs and $21 wholesale costs)
  - more than 10 000 customers, the proposed supply fee is $44 plus a pool price pass through. The amount of the pool price pass through will be based on the three month average pool price following a retailer failure.
- For gas RoLR customers, if a retailer failure involving less than 20 000 customers occurs:
  - between September and May, the proposed supply fee is $30
  - between June and August, the supply fee is $128. AGL submits that if a retailer failure occurs during winter when demand for gas is likely to be high, it may not have sufficient gas supply for RoLR customers and would incur a penalty (an uplift charge) in the wholesale gas market, which it would seek to recover from RoLR customers.[45]

The Commission assessed AGL's proposed RoLR customer charges against the framework set out in Appendix A and ACG's analysis of the additional wholesale costs the local retailers would likely incur in the event of a retailer failure. The Commission concluded that, overall, the proposed RoLR customer charges did not meet key assessment criteria.

However, the Commission accepted that AGL's proposals were based on its contention that RoLR customer charges should:

- protect financial flows in the energy industry and take account of reasonable risks and costs associated with the provision of RoLR services and
- enable the RoLR to recover the costs it incurs.

The Commission acknowledges that for a retailer failure involving less than 10 000 electricity customers and less than 20 000 gas customers outside of the winter period, the supply fee proposed by AGL was lower than the supply fee in the draft decision (for electricity, $15 lower and for gas, $6 lower). However, the Commission was concerned that for all other scenarios, RoLR customers would be subject to significantly higher RoLR fees than those proposed in the draft decision.

The Commission also carefully considered AGL's proposal for a higher gas supply fee proposed in the winter months to reimburse AGL for the uplift charges incurred in the wholesale gas market for having insufficient gas supply. This proposal had particular relevance for the circumstances which occurred in winter 2007. The Commission concluded that the risk of charges in the conditions such as those in

[45] AGL did not propose a RoLR customer charge for a retailer failure that involves more than 20 000 gas customers, stating that it would need to give further consideration to that scenario at the time.

winter 2007 is a risk that should be managed and mitigated by market participants and appeared to have been adequately factor into the revised standing offer prices which took effect from 1 January 2008.[46]

The Commission also considered that the inclusion of the pool price pass through in the electricity supply fees for a retailer failure involving more than 10 000 customers did not insulate customers from volatility in wholesale prices, nor was it sufficiently simple for RoLR customers to understand how they will be charged.

Overall, the Commission's draft decision was that AGL would appear to recover more than the costs it would incur in the event of a retailer failure. Further the draft decision was that the proposal also did not meet key assessment criteria.

AGL submitted that the Commission's draft decision:

- did not sufficiently consider nor analyse the information provided by retailers as to their likely level of their costs, but simply assessed these costs and the proposed structures against the assessment criteria
- was wrong to assess AGL's proposal or fee structure as being too difficult for customers to comprehend. In its view, "a RoLR event will be by its nature very difficult for anyone to understand, including customers. It is therefore a matter of clear and concise communication...AGL is confident that AGL's proposal can be communicated sufficiently to ensure impacted customers receive a simple yet informative message."[47]

The Commission confirms that AGL's costs were considered, analysed and subsequently compared to the additional wholesale costs calculated by ACG. It was on the basis of comparing AGL's costs with ACG's advice that the Commission did not consider AGL's proposed RoLR customer charges satisfied the assessment criteria.

Further, AGL's proposed fee structure was assessed as being complicated for customers. This is because AGL's proposal is based on a series of supply fees that would be applied depending on the number of customers involved in a retailer failure. The RoLR customer charges also differentiated between a fixed supply fee and a variable pool price pass-through. The Commission wished to achieve a higher degree of certainty for customers in the circumstances involving a failed retailer.

As the Commission is unable to accurately predict the wholesale price following a retailer failure, AGL's proposal does not maximise regulatory certainty. It would raise difficulties for the Commission at the time of a RoLR event to determine whether AGL's proposed RoLR customer charges were reasonable and achieved a fair outcome in terms of the cost burden on RoLR customers.

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[46] Media Release 'Drought to Impact on Power Prices', Minister of Energy and Resources, Friday, November 30, 2007

[47] AGL 2008, op. cit., p. 2.

## 3.3 Origin

Origin's proposed RoLR customer charges differed significantly from the Commission's 2006 final RoLR scheme decision. It comprised:

- a fixed administration charge to recover the costs of establishing RoLR customers in Origin's billing and information systems and
- a variable energy charge, which would reflect spot market prices at the time of a retailer failure and would be charged on a cents per usage basis.

Origin proposed a fixed administration charge of $24.16 per electricity and gas RoLR customer to recover the costs of establishing RoLR customers in its billing and information systems. This charge was consistent with the Commission's approach to determining these costs.

The variable electricity charge would be calculated by adding on to the standing offer tariff a residual amount reflecting the additional wholesale costs it would have incurred as a result of a retailer failure. This residual amount would depend on the difference between the benchmark wholesale electricity costs and average (load weighted) electricity spot price for Victoria three months after a retailer failure.[48]

For a RoLR customer consuming an average of 1500 kWh of electricity per quarter, the total electricity bill for that quarter would be $317.25, which comprises:

- $24.16 in fixed administration charge and
- $293.08 in variable electricity charge (1500 kWh electricity consumption at 19.539c/kWh).

The variable gas charge would be determined by applying weights to the additional wholesale gas cost Origin would incur as a result of a retailer failure. The additional wholesale gas cost would be calculated by averaging the gas spot prices after a retailer failure and deducting from them the benchmark wholesale gas cost; that is, if the benchmark wholesale gas cost is $3.77 per GJ[49], the additional wholesale gas cost would be:

- average top 25 per cent of post RoLR event gas spot prices minus $3.77
- average next 50 per cent of post RoLR event gas spot prices minus $3.77
- average bottom 25 per cent of post RoLR event gas spot prices minus $3.77

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[48] For example, if Victoria's load weighted average electricity spot price for three months after a retailer failure is 10c/kWh and the benchmark wholesale cost is 6.461c/kWh[48], the additional wholesale cost Origin would face after a retailer failure would be 3.539c/kWh. This additional cost would be added to the standing offer tariff. Therefore, if the standing offer tariff is 16c/kWh, RoLR customers would pay a variable electricity charge of 19.539c/kWh.

[49] This is the average wholesale gas cost of $3.50 per GJ, from the Commission's 2004 review of full retail competition in electricity and gas, increased by the inflation rate to express it in 2007 dollars.

Under Origin's proposal, weights of 40, 40 and 20 per cent would be applied to the three sets of additional wholesale gas costs, and then summed up to give the variable gas charge. Origin submitted that higher weights applied to the two highest categories of prices reflect the additional risk it faces with uncontracted gas exposure in the spot market when a retailer failure occurs and it is obliged to act as the RoLR.

Origin provided a number of examples to demonstrate the calculation of the variable gas charge. These examples were detailed in the draft decision.[50]

In its draft decision, the Commission accepted that Origin had attempted to achieve equity in its RoLR tariffs, that is, that the variable costs were based on consumption rather than a fixed fee for all customers irrespective of consumption. In principle, this approach was supported. The Commission also accepted that Origin based its proposal on the criteria that the RoLR customer charges should:

- protect the financial flows within the energy industry and takes account of reasonable risks and costs associated with the provision of RoLR services and
- enable the RoLR to recover the costs it incurs.

However, the Commission found that overall

- all electricity customers at consumption levels of 1500 kWh, or greater, per quarter would pay more using the Origin approach than ACG's methodology and analysis[51]
- gas customers would pay marginally less using Origin's proposed approach.[52]

Therefore, the Commission considered that Origin would recover more than the costs it would incur in the event of a failed retailer in the electricity sector, but acknowledged that small gas customers would, on average, incur lower charges under the proposed Origin approach.[53]

Further, the Commission considered that Origin's proposed RoLR customer charges did not satisfy key elements of the assessment criteria and would add complexities to the administrative and customer billing systems.

In its submission, Origin raised a number of concerns regarding the Commission's draft decision.[54] These concerns, and the Commission's consideration of the issues, are set out below.

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[50] Essential Services Commission 2008, *Retailer of last resort customer charges draft decision*, February, pp.25-26.

[51] The Commission reviewed Origin's proposal using the increased additional wholesale electricity costs It found that RoLR customers with consumption of 1500 kWh or more would continue to pay more under Origin's proposed RoLR customer charges.

[52] Essential Services Commission 2008, op. cit., p. 27.

[53] Media Release 'Drought to Impact on Power Prices', Minister of Energy and Resources, Friday, November 30, 2007

[54] Origin 2008, *Retailer of last resort customer charges – draft decision*, February.

- *RoLR customers would only pay the fees and tariff proposed under the Origin model if the average pool price three months after a retailer failed is lower than the benchmark wholesale cost, assumed by Origin as $64.61 per MWh.*

  There are insufficient examples in the market on which to base the assumptions about the average pool price applying in a RoLR event. However, the Commission notes that the load weighted average pool price three months after the market suspension of Energy One was $102.35 per MWh.[55] Hence, it is considered unlikely that the average pool price in the months following a retailer failure would be lower than the benchmark wholesale cost.[56]

- *The consumption scenarios used by the Commission to compare its proposal against the ACG methodology were unrealistic. That is, the Commission's analysis of customers consuming 6MW, 8MW and 12MW per annum was based on too high consumption levels.*

  The Commission acknowledges that modelling customers with lower consumption levels could result in some customers incurring a lower fee than in the Commission's draft decision.[57] However, whether or not customers will pay more or less under the Origin proposal will depend on the average electricity spot price three months after the retailer failure. Therefore, the Origin proposal has a large degree of uncertainty for customers.

- *To protect financial flows in the energy sector, it is appropriate to tie the RoLR charges to circumstances following a retailer failure given the additional, unhedged risk confronting a RoLR.*

  In this final decision, the Commission considers that it has reached a balance between ensuring that the local retailers are able to recover costs associated with the RoLR accountabilities whilst at the same time protecting the long-term interests of consumers. Allowing local retailers to set RoLR customer charges based on the spot price after a retailer failure would not insulate RoLR customers from volatility in wholesale prices or provide regulatory certainty to the Commission.

- *The proposed approach to RoLR charges is relatively straightforward as there is an administration charge and the replacement of one benchmark of wholesale costs with a publicly available alternative.*

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[55] Allen Consulting Group 2007, *Wholesale electricity and gas costs for retailer of last resort*, November, p. 11.

[56] This assumption is based on the fact that a failed retailer event is more likely to occur at a time of high wholesale energy costs. The Commission however acknowledges concerns that retailers may be able to exit the market using the RoLR scheme at a time when the energy wholesale market costs are relatively low. The Commission considers that this is more related to the framework which may enable retailers to exit in these circumstances. For this reason, the Commission intends to examine the exit mechanisms available to retailers to determine if any further licence provisions are required (noting that the functions will be transferred to the national regulators in 2010). The Commission will publish an Issues Paper on this matter in late 2008.

[57] It is noted that average consumption is 6.33MWh.

The Commission does not agree that the proposal is ‘straightforward’ as it involves the calculation of a variable charge based on the difference between the wholesale benchmark costs and the three month rolling average price after the RoLR event, and then adding the difference to the standing offer tariff. This involves a calculation at the time of the RoLR event, which presumably would need to be communicated to customers.

In contrast, whilst acknowledging that the ACG methodology to determine the RoLR customer charges is complex, the outcome is a fixed supply fee, covering additional wholesale and retail operating costs. This outcome can be more simply explained to customers.

- *The notion that overall the Origin proposal creates a degree of uncertainty for customers is not agreed. Once the wholesale market prices at the time of the RoLR event are known, then customers have certainty because that price is reflected in their RoLR customer charges.*

  The Commission accepts this argument, but, as stated above, is concerned to ensure certainty for customers prior to the RoLR event by foreshadowing in advance the amount of the charge in these circumstances.

## 3.4 TRUenergy

The structure of RoLR customer charges proposed by TRUenergy was similar to the structure proposed by the Commission in its 2006 final RoLR scheme decision. TRUenergy proposed charging RoLR customers the standing offer tariff and a one off, up front supply fee.

The maximum duration of a RoLR’s obligation required under the legislation is three months. However, section 49E(6) of the EI Act and section 51E(6) of the GI Act provide that the RoLR terms and conditions may include a condition setting out the circumstances in which a RoLR must continue to supply to that customer after the obligation comes to an end. Therefore, TRUenergy proposed supply fees that were dependent on how long a RoLR customer stayed with TRUenergy in accordance with this legislative provision.

A RoLR customer would have to pay a higher supply fee if transferring to another retailer within 12 months, but no supply fee would be charged if the RoLR customer transferred to another retailer after 12 months or to another TRUenergy market product.

TRUenergy submitted that its proposed supply fee was a maximum fee based on the worst case commodity market conditions for a retailer failure. TRUenergy also indicated that it would assess whether it would charge RoLR customers the maximum fee, a proportion of it or waive it altogether depending on market conditions at the time a retailer failure occurred.

The supply fee would be additional to the standing offer tariff imposed on customers for the three month period.

The Commission was unable to comprehensively evaluate the proposal in the draft decision as it did not have sufficient supporting material. TRUenergy advised that

the supporting material would have been made available on request, and subsequently provided it for consideration in the final decision.

TRUenergy advised that its proposed supply fees reflect their ~~purchasing strategy~~approach to purchasing energy in response to a retailer failure, which is to purchase from the spot market for two weeks and through contracts for the remaining 11 weeks. In support of this ~~strategy~~approach, TRUenergy provided~~, in confidence, their~~ historical ~~projections of the~~ spot price and contract price data applying at the time of the Energy One failure ~~that they would use~~ to determine the RoLR customer charges.

The Commission's role is not to comment on the strategy proposed by TRUenergy in purchasing energy in a RoLR event. The Commission's role is to consider whether the customer charges generated by the strategy meet its assessment criteria in approving these charges. The Commission retains its view that the charges proposed by TRUenergy, which remain the same as those assessed in the draft decision, are not reasonable in terms of the cost burden on RoLR customers. The Commission considers that TRUenergy would recover more than the costs it would incur in the event of a failed retailer.

The Commission also notes that TRUenergy is proposing that no fee should be charged if RoLR customers transfer to a TRUenergy market product or stay with TRUenergy for 12 months. The Commission would be concerned if TRUenergy would attempt to use the RoLR fee as an incentive to encourage customers to remain with this retailer. This would not be in accordance with the Commission's legislative objectives to facilitate effective competition and promote competitive market conduct.

TRUenergy also submitted that while the Commission assessed the local retailers' proposals against the assessment criteria, it did not demonstrate that ACG's methodology satisfied the same criteria. The Commission considers that the supply fee determined under the ACG methodology balances the risks and costs faced by local retailers against the requirements to protect the interests of consumers. Using probability weights and scenarios as set out in the methodology reflects the uncertainty about the possible wholesale market outcomes leading into and following a retailer failure.

In the Commission's view, the outcomes reached using the ACG methodology meet all the assessment criteria determined by the Commission for assessing the reasonableness of RoLR customer charges.

## 3.5 Other submissions

Two other submissions were received, from CALC and EWOV. Both were concerned that the supply fee will be harmful to low income and vulnerable consumers.[58]

Further, CALC was concerned that the supply fee:[59]

- does not satisfy the assessment criteria that customer charges represent a fair price and insulates customers from volatility in wholesale prices
- may be unfair to consumers in that it allows a RoLR to recover the costs incurred when customers are "forced to change retailers" and that its imposition places the risk of market volatility onto consumers".[60]
- would inhibit competition because consumers will not switch retailers, because of the fear of potential retailer failure.

CALC also expressed concerns about the possibility of customers having to pay a supply fee to a new retailer when a retailer fails due to "poor business practices". This concern is based on a retailer deciding to exit the market for strategic reasons, and using the retailer of last resort provisions as a mechanism.[61]

EWOV and CALC proposed alternative means of allowing the local retailers to recover the costs of fulfilling their RoLR obligations. EWOV advocated a Government rebate or concession on the supply charge for customers experiencing financial hardship.[62] CALC proposed the Government establish a managed fund to which all retailers would contribute and would be accessed when a retailer fails.[63]

*Response to submissions*

The Commission considers that the methodology proposed by ACG has reached a balance between the risks and costs associated with retailers providing RoLR services whilst at the same time insulating customers from volatility in the wholesale market through the fixed supply fee. The retailer operating costs have also been minimised.

The Commission understands that the CALC proposal for the Government to establish a managed fund to operate in a RoLR event is a mechanism to protect customers from any costs associated with a failed retailer event. The Commission

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[58] CALC 2008, *Retailer of last resort customer charges – draft decision*, February, p. 2, and EWOV 2008, *Retailer of last resort customer charges: draft decision (February 2008)*, February, p. 2.

[59] CALC 2008, op. cit., pp. 1-2.

[60] Ibid., p. 1.

[61] Ibid., p. 1.

[62] EWOV 2008, op. cit., p. 2.

[63] CALC 2008, op. cit., p. 3.

acknowledges the intention of this proposal, but retains the approach adopted in the 2006 final decision taking into account the following:

1. A managed fund of this nature would require all customers (through their retail charges) to contribute to the costs of the scheme rather than only those who are the customers of a failed retailer.

2. ~~The existence of a managed fund would ensure that no customer would bear the full consequences of not taking sufficient care in choosing between retailers. As the competitive market matures and more information is available to customers, customers are increasingly becoming more equipped to make informed choices.~~[64]

3. ~~2.~~ Such a fund could have the effect of reducing the incentives on retailers to assess their risk-taking behaviour relative to their competitors.

4. ~~4.~~ There would be significant initial and on-going transaction costs in such a fund given the expected ad hoc nature of RoLR events.

4. It would be more efficient to protect customers in financial hardship through the energy concession assistance schemes and the local retailers' financial hardship programs currently available – also detailed in the following paragraphs – than to bear the transaction costs of establishing a fund to which all customers would ultimately have to contribute.

Notwithstanding the above, the Commission acknowledges the concern expressed by CALC that a retailer may choose strategically to exit the market and take advantage of the RoLR mechanisms in that regard. It would be unfair for customers to be subject to charges which incorporate additional wholesale costs if these were not evident to any large degree at the time. Therefore, as noted in footnote 56~~56~~~~55~~, the Commission will examine this matter and prepare an Issues Paper for consultation in late 2008.

In relation to customers with payment difficulties and those in financial hardship, the Commission expects that the existing mechanisms will be available to customers impacted by a RoLR event. That is, the local retailers will be required to offer instalment plans, as required by the Energy Retail Code, and customers must be given the opportunity to participate in their financial hardship programs. Importantly, there are also comprehensive energy concession assistance, including utility relief grants for customers who unable to pay their utility bills due to a temporary financial crisis.

Therefore, given that there are existing Government assistance programs available to RoLR customers experiencing financial hardship, and given the low probability

[64] The Commission appreciates that customers require increasingly comprehensive information about the volatility of the energy market, particularly taking into account issues such as climate change and drought. The Commission's 2008-09 work program will include information and education strategies to improve customers' knowledge in this regard.

of a retailer failure, the administration costs of establishing more specific RoLR concessions programs are not considered justified.

# 4 FINAL DECISION – ROLR CUSTOMER CHARGES

## 4.1 Overview

From the submissions, it is concluded that the RoLRs will react to a retailer failure depending on a variety of factors, including their particular hedging strategy, the number of customers inherited as a result of the retailer failure and the market circumstances at the time when a retailer fails. Retailers also had differing views as to whether they would base their RoLR customer charges on spot market prices or hedge contracting strategies.

Given these different views, and the inherent level of uncertainty about likely outcomes following a retailer failure, the Commission considers that ACG's methodology is more appropriate, in the interim, for determining the RoLR's wholesale energy supply costs, because they account for various purchasing scenarios available to the local retailers. By assigning probabilities to the scenarios, ACG was able to account for the likelihood of occurrence of each scenario.

Further, the Commission considers that ACG methodology meets the assessment criteria against which the proposed RoLR customer charges must be evaluated.

## 4.2 Final decision

Consistent with the discretion provided to the Commission under section 49E(2)(b) of the EI Act and section 51E(2)(b) of the GI Act, the Commission's final decision is that the RoLR customer charges proposed by AGL, Origin and TRUenergy should not be approved.

The Commission acknowledges that local retailers' proposed RoLR customer charges are based on methodologies that differed from the methodology used by ACG. There may be merits in their methodologies, but, in light of developments on a national RoLR scheme and with the impending transfer of the Commission's energy retail functions to the Australian Energy Regulator, the Commission considers that it is important to have RoLR customer charges in place in the interim that are simple, easy to understand and provides certainty should there be a retailer failure prior to the implementation of a national RoLR scheme.

Further, ~~T~~the Commission would not be meeting its primary objective of protecting the long term interests of Victorian consumers by approving AGL's and Origin's proposed RoLR customer charges, which:

- involve scenarios the Commission cannot predict
- are not simple and easy for RoLR customers to understand

- do not enable the Commission to determine whether it would be reasonable and fair in terms of the potential cost burden on RoLR customers as the approach relies on wholesale prices after a retailer failure
- do not maximise regulatory certainty and
- expose RoLR customers to volatility in wholesale prices.

In regards to approving TRUenergy's proposed RoLR customer charges, the Commission would not be meeting its primary objective of protecting the long term interests of Victorian consumers for the following reasons:

- The charges would enable TRUenergy to recover significantly more than the costs it would have incurred, based on the ACG analysis and methodology.
- The proposal not to charge fees to customers who stay longer with TRUenergy or who transfer to another TRUenergy product does not promote competitive market conduct.

## 4.3 Publication of final decision

Under section 49E(3) of the EI Act and section 51E(3) of the GI Act, if the Commission specifies the RoLR customer charges, then the Commission must arrange for the approved RoLR customer charges to be published in the Government Gazette.

Therefore, in accordance with the legislation, the approved RoLR customer charges in this final decision will be published in the Government Gazette in May 2008. Upon publication in the Government Gazette, the local retailers will apply the approved RoLR customer charges to RoLR customers in the event of their retailer failing.

The customer charges to be published will be:

- the standing offer tariff as it applies to each local retailer and
- a one off, up front supply fee of:
  - $65 per electricity RoLR customer and/or
  - $36 per gas RoLR customer

## 4.4 Review of RoLR customer charges

Origin submits that the Commission's methodology will require frequent re-determination.[65] The Commission considers that it would be prudent to review RoLR customer charges to ensure that changes in market conditions and market structure can be reflected in the charges in a timely manner. In normal circumstances, the Commission considers that a review in June 2009 would be appropriate.

[65] Origin 2008, op. cit., p. 6.

However, the Commission notes that a national RoLR scheme is currently being developed and the Ministerial Council on Energy intends to introduce this with the National Retail Rules in the last quarter of 2009.[66]

Further, the energy retail functions and powers of the jurisdictional regulators are expected to be transferred to the national regulators by 1 January 2010. Therefore, the Commission will review the matter in the second quarter of 2009 to determine whether further analysis on the customer charges which should be applied in the event of a failed retailer require review and amendment, taking into account the national developments and timeframe.

The Commission will publish its position on a review in May 2009.

[66] Ministerial Council on Energy 2008, *Energy market reform bulletin no. 114: retail policy working group update and retailer of last resort consultancy*, 13 February.

# APPENDIX A FRAMEWORK FOR ASSESSING ROLR CUSTOMER CHARGES

In its 2006 final RoLR scheme decision, the Commission established a set of criteria by which it would assess various options for RoLR customer charges. These criteria provide a basis for assessing the RoLR customer charges proposed by the local retailers. In its review of the effectiveness of competition in Victoria's electricity and gas retail markets, the Australian Energy Market Commission also commented that:

> *…these [pricing] criteria provide a good basis for the ESC to decide on RoLR prices in a competitive environment without retail price regulation.*[67]

This section outlines the criteria by which the local retailers' proposed RoLR customer charges were assessed.

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## Assessment criteria

In its 2006 final RoLR scheme decision, the Commission stated that RoLR customer charges should:

1. not be tied to particular circumstances that are assumed to apply at the time of a retailer failure, but should be flexible enough to cope with a wide range of circumstances
2. protect financial flows within the energy industry and take account of reasonable risks and costs associated with the provision of RoLR services
3. protect the interests of customers; prices should be simple, understandable and ensure that RoLR customers pay a fair price and that the RoLR recovers the costs it incurs to provide the RoLR service
4. minimise the administrative costs required to finalise, implement and operate the RoLR scheme
5. maximise regulatory certainty by facilitating transparent and robust regulatory decision making

[67] AEMC 2007, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria*, Second Draft Report, 19 December 2007, Sydney, p. 27.

6. ideally, continue to insulate customers from volatility in wholesale prices and
7. ideally, be capable of being implemented using existing data and systems capabilities.

The Commission considers that these criteria continue to provide a reliable and comprehensive framework for assessing the appropriateness of RoLR customer charges for the following reasons.

*RoLR customer charges should not be tied to particular circumstances*

Given the difficulty of accurately predicting the prevailing market conditions at the time a retailer fails, RoLR customer charges should allow for a variety of circumstances that may change the characteristics of the market such as fluctuations in the wholesale market, different competitive environments and changes in the overall structure of the market.

*RoLR customer charges should protect financial flows in the energy industry*

The Commission is required under section 8(2)(b) of the *Essential Services Commission Act 2001* (ESC Act) to facilitate the financial viability of regulated industries in Victoria. Therefore, RoLR customer charges should take account of reasonable risks and costs associated with the provision of RoLR services and protect the RoLR from failing as a result of performing its obligations. RoLR customer charges that satisfy this criterion should provide confidence to the public that the market can return to a normal operating state as soon as possible.

*RoLR customer charges should protect the interests of customers and the RoLR should recover the cost it incurs to provide the RoLR service*

It is important for RoLR customer charges to be sufficiently simple for customers to understand how they will be charged for electricity and/or gas if their retailer fails. While RoLR customer charges should allow the RoLR to recover their costs, they should be reasonable and achieve a fair outcome in terms of the potential cost burden on customers.

*RoLR customer charges should minimise administrative costs*

It is important for both the implementation and operation of the RoLR scheme that, where possible, administrative costs are minimised so as to decrease the cost burden on the RoLR and customers. To the extent that this is achieved, the cost recovery needs of the RoLR would be lower, and the impact on RoLR customer charges would be minimised. Administrative costs may be minimised by ensuring that unnecessary obligations are not imposed on the RoLR.

*RoLR customer charges should maximise regulatory certainty*

Regulatory decisions should be transparent and robust. Regulatory certainty, through the establishment of clear rules and obligations in advance, benefits both consumers and industry, and facilitates informed and focused debate.

*RoLR customer charges should insulate customers from volatility in wholesale prices*

Where possible, customers should be protected from the direct volatility of wholesale energy prices. In the Commission's view, retailers are better able to manage wholesale market volatility than small customers.

*RoLR customer charges should use existing data and system capabilities*

RoLR customer charges should be able to be implemented using existing data and retail systems, particularly since a retailer failure is highly unlikely and the RoLR has already invested significant resources in developing its existing data and retail systems.

# APPENDIX B ACG METHODOLOGY

Since the Commission's 2006 final RoLR scheme decision, there have been a number of events which have impacted on the wholesale electricity and gas prices in Victoria.

Victoria experienced its first retailer failure on 22 June 2007. The National Electricity Market Management Company (NEMMCO) issued a suspension notice to Energy One prohibiting Energy One from purchasing electricity in the National Electricity Market (NEM).[68] The failure of Energy One provides more recent information about the wholesale electricity price that local retailers could face after such an event.

Pool prices[69] in the NEM have risen because the drought has reduced availability of some hydro and thermal generation. Prices in the Victorian gas wholesale market have risen, in part because more gas is being used to generate electricity. The rise in energy market prices has contributed to the recent increase in the standing offer price in Victoria.[70]

The Commission engaged ACG to update the additional wholesale costs to take account of these developments. This section explains the methodology used by ACG, which is consistent with the methodology used for the 2006 final RoLR scheme decision, to arrive at the additional wholesale costs used in this final decision. This section also explains how the additional retail operating costs have been updated for 2007.

## Wholesale electricity costs 2007

ACG revised the additional wholesale electricity cost that local retailers may incur by applying probability weights to five pricing scenarios, and then summing up the probability weighted average cost across those five scenarios. Table B.1 shows the

[68] At the time of its retail failure, Energy One had a very small number of large business customers in Victoria.

[69] Pool prices refer to the prices at which generators produce electricity and retailers purchase electricity in the NEM.

[70] Refer to the media release issued by the Department of Primary Industries in November 2007. This is available on the Department of Primary Industries website at www.dpi.vic.gov.au under Energy, Consumer Information and Pricing.

scenario prices and probability weights. ACG's reasons for using these scenarios, prices and probability weights are explained below.

**Table B.1 Scenario prices and probability weights**

| *Scenario* | *Price[a] ($/MWh)* | *Probability weights* |
|---|---|---|
| 1. Moderate pool price | 50.67 | 30% |
| 2. High pool price | 106.86 | 30% |
| 3. Administered price | 75.25 | 5% |
| 4. Very high pool price | 182.73 | 5% |
| 5. Hedge contracting | 100.00 | 30% |

**a** This is the price at which the RoLR would have to purchase electricity in the wholesale market after a retailer fails.

Source: Allen Consulting Group.

*Scenarios 1 and 2: moderate and high pool price*

These scenarios take account of the possibility that the RoLR elects to purchase from the pool for three months following a retailer failure. Scenario 1 assumes a moderate pool price and scenario 2 assumes a high pool price.

Using NEMMCO's pool price data for the period January 2006 until September 2007[71], ACG estimates that the three month rolling average load weighted pool price[72] varied between the low price of approximately $23 per MWh and a high price of approximately $110 per MWh. The load weighted average pool price for 90 days after Energy One's failure was calculated by ACG to be $102.35 per MWh. ACG estimates that the pool price reached $102.35 per MWh only 9 per cent of the time between January 2006 and September 2007.

Scenario 1 was allocated a price of $50.67 per MWh, which ACG calculated by taking the average of all the three month rolling load weighted prices between the low price of $23 per MWh and the 90 day post-Energy One pool price of $102.35 per MWh. Scenario 2 was allocated a price of $106.86 per MWh, which is the average of the three month rolling load weighted prices between the high price of $110 per MWh and the 90 day post-Energy One pool price of $102.35 per MWh.

The probability weight of 30 per cent was applied to scenarios 1 and 2 each. ACG advised that as there is no clear basis for estimating the combined probabilities, scenarios 1 and 2 are assumed to be equally likely.

[71] ACG advises that this period includes the drought and therefore should provide a reasonable guide to possible pool prices in 2008.

[72] This is a statistical method of smoothing fluctuations in prices using the demand profile for electricity.

*Scenario 3: administered price*

This scenario takes account of the possibility that a retailer failure occurs at the time of extreme market conditions triggering administered prices, which are currently $100 per MWh for peak periods and $50 per MWh for off peak periods.[73] The load weighted price under this scenario is $75.25 per MWh.

This scenario assumes the worst case, namely that administered prices continue for three months. In practice, ACG considers that administered prices should not last for more than one week because generators that were unavailable could return to service, or mothballed capacity may be able to come online. Also, ACG advises that studies of the NEM have shown price spikes generally last for a very short period of time (less than one per cent of the hours in the year).

As administered prices have not been observed in the NEM since its inception, ACG applied a probability weight of 5 per cent to this scenario and considers this is likely to overstate the risk.

*Scenario 4: very high pool price*

Under the fourth scenario, ACG assumes that the failed retailer's hedge contracts were cancelled, leaving the market significantly under-hedged. Generators are assumed by ACG under this scenario to seek to replace hedge contracts quickly. ACG set the pool price for this scenario at $300 per MWh for every peak period in the three months which returns to moderate pool prices (as in scenario one) for off peak periods. The load weighted price under these conditions is $182.73 per MWh.

This scenario has not been observed in the NEM since its inception. Therefore, ACG applied a probability weight of 5 per cent.

*Scenario 5: hedge contracting*

For scenario 5, ACG assumed that the RoLR will be able to purchase contracts to hedge the risks of purchasing electricity for their newly acquired customers.

ACG assumed that the average price for the 2008 calendar year swap contracts traded[74] during the third quarter of 2007 was $60.45 per MWh. An additional price premium is needed to represent the cost of meeting peak loads — the Commission's 2006 final RoLR scheme decision allowed $40 per MWh premium. The sum of the swap contracts and the premium is a reasonable proxy for optimal portfolio price for this scenario, (estimated by ACG to be approximately $100 per MWh).

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[73] Refer to the website of the Australian Energy Markets Commission at http://www.aemc.gov.au/electricity.php?r=20071105.151356.

[74] Swap contracts are those contracts to purchase electricity where one party agrees to purchase electricity at a certain price and the other party agrees to supply the electricity at that price.

Scenario 5 is assumed to be as equally likely as scenarios 1 and 2. Therefore, ACG applied a 30 per cent probability weight to scenario 5.

*Calculating the additional wholesale electricity cost*

ACG calculated the additional wholesale electricity cost per customer in three steps:

- Firstly, subtract from the wholesale electricity price under each scenario the updated benchmark wholesale electricity cost to calculate the additional wholesale cost.
  - The Commission's 2004 review of the effectiveness of retail competition in gas and electricity estimated an average wholesale electricity cost in the range of $55 per MWh to $65 per MWh.[75] ACG updated the midpoint of this benchmark wholesale electricity cost ($60 per MWh) by 10.5 per cent inflation rate.[76] This gives $66.30 per MWh.
- Secondly, multiply the additional wholesale cost by average customer consumption to determine the additional wholesale cost per customer.
  - ACG divided average annual consumption of 5.79 MWh[77] per customer by four to give average consumption per customer of 1.45 MWh during a three month period.
- Thirdly, calculate weighted average cost.
  - ACG applied the probability weighting to the cost per customer of each scenario to arrive at the contribution per customer for each of the scenarios.

The additional wholesale electricity cost per RoLR customer is $34.50, as shown in Table B.2.

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[75] For the 2004 review of the effectiveness of retail competition and consumer safety net in electricity and gas, the Commission estimated a reasonable spread of average wholesale costs that retailers would have to pay in 2004. Origin's submission and ACG's methodology of calculating the additional wholesale costs rely on this range of wholesale costs. The Commission estimated that the average wholesale cost of electricity supply was within the range of $55 to $65 per MWh and the average wholesale cost of gas supply was $3.50 per GJ. See Essential Services Commission 2004, *Final report to Minister – Special investigation: review of effectiveness of retail competition and consumer safety net in electricity and gas, background report*, June.

[76] Inflation rate from June 2004 to December 2007, forecasted by ACG in September 2007. On 23 January 2008, the Australian Bureau of Statistics (ABS) release the Consumer Price Index (CPI) for the December 2007 quarter showing that inflation for the period June 2004 to December 2007 is 10.57 per cent, which is slightly above ACG's forecast, but does not have a significant impact on the additional wholesale costs and the supply fee. The benchmark wholesale cost is $66.34 per MWh using ABS' latest CPI figures compared with $66.30 per MWh using ACG's forecast.

[77] Average customer consumption has been estimated by ACG from total consumption figures reported by electricity distributors, divided by the number of small customers on main tariff only.

**Table B.2 Additional wholesale electricity costs**

| *Scenarios* | *Cost ($/MWh) above wholesale benchmark* | *Total cost per customer* | *Contribution per customer* |
|---|---|---|---|
| 1. Moderate pool price | -15.63 | -22.62 | -6.78 |
| 2. High pool price | 40.55 | 58.66 | 17.60 |
| 3. Administered price | 8.94 | 12.93 | 0.65 |
| 4. Very high pool price | 116.43 | 168.42 | 8.42 |
| 5. Hedge contracting | 33.69 | 48.74 | 14.62 |
| **Sum** | | | **34.50** |

Source: Allen Consulting Group.

## Wholesale gas costs 2007

ACG also revised the additional wholesale gas cost a RoLR may face after a retailer failure applying probability weights to five price and two load scenarios. The probability weighted average cost for each of the five price and two load scenarios were then summed up.

Table B.3 shows the prices and probability weights ACG applied to the five price and two load scenarios for gas. The high load period occurs in the winter peak period, July to September, which comprises 33.3 per cent of a year. The high load period therefore has a weighting of 33.3 per cent and the low load period has a weighting of 66.7 per cent.

The remainder of this section describes the scenarios ACG used for gas, and explains how the conclusions were reached.

**Table B.3 Scenario prices and probability weights**

| | | *Probability weights (%)* | | |
|---|---|---|---|---|
| *Scenarios* | *Prices[a] ($/GJ)* | *Low load scenario* | *High load scenario* | *Overall* |
| 1. Moderate spot prices | 3.37 | 8.0 | 4.0 | 12 |
| 2. High spot prices | 5.65 | 8.0 | 4.0 | 12 |
| 3. Administered prices | 18.13 | 0.7 | 0.3 | 1.0 |
| 4. Commodity contracts | 3.91 | 50.0 | 12.5 | 62.5 |
| 5. Commodity and capacity contracts | 5.96 | 0.0 | 12.5 | 12.5 |
| **Total** | | **66.7** | **33.3** | **100.0** |

[a] This is the price at which the RoLR would have to purchase gas in the wholesale market after a retailer fails.

Source: Allen Consulting Group.

*Scenarios 1 and 2: moderate and high spot price*

These scenarios take account of the case that a RoLR has to purchase from the spot market for three months following a retailer failure. The prices are based on historical spot market prices under the following two possible cases:

- moderate spot prices and
- high spot prices.

ACG used historical spot market price data from January 2006 to October 2007 as a guide to future spot prices. Although a gas retailer failure has not occurred in Australia, there was an electricity retailer failure (discussed above in this Appendix B). In view of the convergence between gas and electricity markets, the Commission accepts that it is reasonable to assume that the movement of gas prices will mirror the movement of electricity prices following a retailer failure.

Using the spot market price data for the period January 2006 to October 2007, ACG estimated that the three month rolling average spot market price for that period varied between a low price of approximately $2.50 per GJ to a high price of approximately $5.75 per GJ. ACG estimated that 9 per cent of the time within this period, the gas spot market price reached $5.45 per GJ.

The moderate price scenario 1 was allocated a price of $3.37 per GJ, which is the average of the entire three month rolling average price between the low price of approximately $2.50 per GJ to $5.45 per GJ, the price observed 9 per cent of the time. The high price scenario 2 was allocated a price of $5.65 per GJ, which is the average of the three month rolling average price between the high price of $5.75 per GJ and $5.45 per GJ.

ACG assigned a probability weighting of 12 per cent each to scenarios 1 and 2 as these scenarios are considered to be equally likely. In selecting a probability weight of 12 per cent, ACG took into consideration the percentage of gas that is currently being purchased from the spot market.

*Scenario 3: extreme spot price*

A RoLR may have to purchase gas from the spot market in an extreme spot price event. An extreme price event has not been observed in the Victorian gas spot market to date, but it could arise from the cause or outcomes of a retailer failure, from changed behaviours in the market or from an unrelated event.

Therefore, the price in this scenario was estimated by ACG as a price shock added to the high spot price. As there is no history for guidance, ACG assumes the price reaches $800 per GJ[78] for one day, and then is set by VENCorp to the administered price of $80 per GJ for a further five working days.[79] Prices for the

[78] $800 per GJ is the maximum bid price and the maximum spot price allowed in the gas wholesale market.

[79] The administered price for gas is published on VENCorp's website at www.vencorp.com.au under Gas, Wholesale Market and Information & Data.

remaining three months are assumed to be the same as the high spot price scenario (scenario 2).

ACG estimated that the price for this scenario is $18.13 per GJ and assigned a probability of 1 per cent even though such an event has not occurred in the market to date.

*Scenarios 4 and 5: Contract for supply*

Scenarios 4 and 5 take account of the situation in which a RoLR is able to purchase gas supply contracts.

Under scenario 4, ACG assumes a high degree of supply competition, with suppliers willing to replace contracts at current prices so that a RoLR can enter into a commodity contract at a price equivalent to historical market prices on which standing offer tariffs are based.

ACG estimated that the price for this scenario is $3.91 per GJ. ACG used the benchmark wholesale gas cost of $3.50 escalated for inflation of 10.5 per cent from June 2004 until December 2007. ACG then added a 1 per cent transaction cost, which gives $3.91 per GJ.

Under scenario 5, ACG assumes much less competition because supply contract volumes for commodity and capacity are tightly held. As this would not normally be an issue during low load periods when gas supplies are readily available, ACG limits this scenario to the high load periods. In this situation, a RoLR may be concerned that spot market prices could be driven well above normal levels and would seek contracts for additional capacity.

As public prices for capacity contracts are not generally available, ACG used the contracted capacity price of $190 per GJ that TRUenergy publishes for its underground storage facility. ACG assumes that a RoLR pays the full price of $190 per GJ for this scenario. ACG also assumes that a RoLR purchases sufficient capacity to meet peak load. ACG estimated a price of $5.96 per GJ for this scenario.

The relative probability weightings for scenarios 4 and 5 depend on the market situation at the time of a retailer failure, which will depend on customer load and time of year. During high load periods, competition is assumed to be limited and so ACG assigned equal weighting of 12.5 per cent to each of scenario 4 and 5. During low load periods, competition for supply is much more likely and so ACG allocated a 50 per cent weighting to scenario 4 and zero weighting to scenario 5.

*Calculating the additional wholesale gas cost*

ACG calculated the additional wholesale gas cost per customer using the method to calculate the additional wholesale electricity cost per customer.

- Firstly, subtract from the wholesale gas price under each scenario the updated benchmark wholesale gas cost to determine the additional wholesale cost.

- The Commission's 2004 review of the effectiveness of retail competition in gas and electricity estimated an average wholesale gas cost of $3.50 per GJ. For the first step, ACG updated this amount by 10.5 per cent inflation.[80] This gives $3.87 per GJ.

- Secondly, multiply the additional wholesale cost by average customer consumption.
  - ACG calculated average customer consumption by dividing consumption figures reported by utilities with the number of small customers on main tariff only. Average consumption of 61 GJ per small customer is separated into winter consumption of 25 GJ and other quarters' consumption of 12 GJ per quarter.
- Thirdly, calculate weighted average cost.
  - ACG applied the probability weighting to the cost per customer of each scenario to arrive at the contribution per customer for each of the scenarios.

The additional wholesale gas cost per customer is $11.78, as shown in Table B.4.

**Table B.4 Additional wholesale gas costs**

| *Scenarios* | *Cost above wholesale benchmark* | *Total cost* | | *Contribution per customer* |
|---|---|---|---|---|
| | | *Low load* | *High load* | |
| | $ per GJ | $ per customer | | |
| 1. Moderate spot prices | -0.49 | -6.02 | -12.35 | -0.98 |
| 2. High spot prices | 1.78 | 21.71 | 44.51 | 3.52 |
| 3. Administered prices | 14.26 | 173.97 | 356.63 | 2.35 |
| 4. Commodity contracts | 0.04 | 0.47 | 0.97 | 0.36 |
| 5. Commodity and capacity contracts | 2.09 | 0 | 52.30 | 6.54 |
| **Sum** | | | | **11.78** |

Source: Allen Consulting Group.

[80] Inflation rate from June 2004 to December 2007, forecasted by ACG in September 2007. On 23 January 2008, the Australian Bureau of Statistics release the Consumer Price Index for the December 2007 quarter showing that inflation for that period is 10.57 per cent, which is slightly above ACG's forecast, but does not have a significant impact on the additional wholesale costs and the supply fee. For instance, increasing the benchmark wholesale cost by 10.57 per cent inflation amounted to $3.86995 per GJ, which would still be rounded up to $3.87 per GJ.