

February 2006 | **Final Decision:**
Energy RoLR

Energy Retailer of Last Resort

Final Decision

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Preface



A retailer of last resort (RoLR) scheme is intended to ensure that electricity and gas customers continue to receive electricity and gas supplies in circumstances where their existing retailer is unable to continue to provide that supply. This may be because the retailer ceases to be licensed to sell electricity or gas, so that it is legally prohibited from continuing the supply, or because it is unable to access electricity or gas in the wholesale market to supply its customers. The establishment of an effective RoLR scheme is an integral part of the institutional and regulatory framework for full retail contestability. There is a clear legislative intent in both the *Electricity Industry Act 2000* and the *Gas Industry Act 2001* for the Commission to develop RoLR schemes as part of the regulatory framework in both the electricity and gas supply markets.

This final decision paper contains final decisions regarding the energy RoLR scheme developed by the Commission. The paper considers the assignment of RoLR responsibility, terms and conditions, pricing, and implementation issues. Following the amendments to the RoLR legislative provisions that have been agreed between the Commission and the Department of Infrastructure, the Commission intends to commence a consultation process for the development of a RoLR regulatory instrument.

GREG WILSON
Chairperson

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EXECUTIVE SUMMARY

In October 2004, the Essential Services Commission (the Commission) released an issues paper regarding the development of an energy retailer of last resort (RoLR) scheme. The issues paper integrated the outcomes of the previous electricity and gas RoLR consultation processes. A draft decision paper released in July 2005 contained decisions about the assignment of RoLR responsibility, terms and conditions, pricing and implementation issues. This final decision paper completes the Commission's consultation in relation to the above issues. Following the amendments to the RoLR legislative provisions that have been agreed between the Commission and the Department of Infrastructure (DoI), the Commission intends to commence a consultation process for the development of a RoLR regulatory instrument.

A. Legislative framework

The Electricity Industry Act and the Gas Industry Act confer on the Commission a relatively broad discretion to develop and implement electricity and gas RoLR schemes. The energy RoLR scheme is triggered when an existing retailer's licence is revoked or a retailer loses its right to operate in the relevant wholesale markets. The Commission notes that the revocation of a retail licence would only be expected in response to breaches causing serious and immediate detriment to customers. Therefore, the RoLR scheme would be triggered only at the point where a retailer becomes legally or commercially incapable of continuing to supply its customers.

The Commission recognises the benefits of a consistent approach to RoLR in the Victorian electricity and gas markets. The Commission is also cognisant of the benefits of a consistent national approach to RoLR, and has considered the positions in other jurisdictions during the development of its energy RoLR scheme.

B. Assignment of RoLR responsibility

During the two previous RoLR consultation processes, the Commission made the following *final decisions*:

- In the event of a non-local retailer failure in the electricity industry, the local electricity retailers will be assigned responsibility to provide RoLR services. The customers of the failed non-local electricity retailer will be allocated to the electricity retailer who has the local retailer responsibility for the area where the customer is located.
- In the event of a non-local retailer failure in the gas industry, the local gas retailers will be assigned responsibility to provide RoLR services. The customers of the failed non-local gas retailer will be allocated to the gas retailer who has the local retailer responsibility for the area where the customer is located.
- In the event of a local retailer failure in the electricity industry, the remaining local electricity retailers will be assigned responsibility to provide RoLR services. The customers of the failed local electricity retailer will be allocated to the remaining local electricity retailers on the basis of TNI and market share.

In the draft decision paper, the Commission decided that the simplest and fairest basis on which to allocate the customers of a failed local gas retailer between the remaining local gas retailers is according to the gas distribution network area in which the customers are located. Since each of the three distribution network areas in the Victorian gas industry is aligned with two local retailer areas, the Commission considers that the customers of a failed local gas retailer should be allocated to the other local gas retailer within the relevant gas distribution network area.

Final decision

In the event of a local retailer failure in the gas industry, the remaining local gas retailers will be assigned responsibility to provide RoLR services. The customers of the failed local gas retailer will be allocated to the other local gas retailer within the relevant gas distribution network area.

If RoLR events occur simultaneously in relation to both fuels supplied by a dual fuel retailer (for example, if the retailer's electricity and gas retail licences are both revoked), the dual fuel customer contracts will be split into their separate electricity and gas components for RoLR purposes; the dual fuel customer will then be allocated to electricity and gas RoLRs according to the Commission's final decisions regarding the assignment of RoLR responsibility in electricity and gas for local and non-local retailer failure. If a RoLR event occurs in relation to only one of the fuels supplied by a dual fuel retailer, the dual fuel customer contracts will also be split into their separate electricity and gas components for RoLR purposes; however, the customers will then be allocated to RoLRs according to the Commission's final decisions regarding the assignment of RoLR responsibility only for the fuel that can no longer be supplied. The relevant retailer can continue to supply the fuel in respect of which there has not been a RoLR event.

A customer transfer in progress towards the failed retailer cannot proceed and must be cancelled by the relevant market operator; the customer will therefore remain with the existing retailer. A customer transfer in progress away from the failed retailer also should not proceed because the customer cannot be supplied by the failed retailer between the occurrence of the RoLR event and the time that the transfer is completed; the customer must therefore immediately be allocated to the RoLR so as to maintain continuity of supply.

C. Terms and conditions

The statutory framework for the RoLR scheme envisages that prospective RoLRs will submit RoLR terms and conditions to the Commission for its approval in advance of a RoLR event occurring. The Commission has not yet requested electricity or gas retailers to submit their proposed RoLR terms and conditions for approval, but anticipates doing so following the conclusion of the Commission's RoLR consultation processes.

The Commission considers that the standing offer terms and conditions applicable under the safety net provisions of the Electricity Industry Act and the Gas Industry Act should apply to relevant customers on the occurrence of a RoLR event. This approach satisfies the key elements of the RoLR pricing criteria – that administration costs should be minimised, a standard contract is in place that protects customer interests, there is a high degree of regulatory certainty, and implementation should be possible within existing system capabilities.

The Commission does not believe that it should approve or specify terms and conditions for the provision of RoLR services to large customers. The Commission has no role in relation to terms and conditions for large customers under normal circumstances – they are determined by commercial negotiation between the parties – and it may therefore lack the necessary expertise to approve or specify RoLR terms and conditions for large customers. It considers that the existence of fallback arrangements for large customers under the RoLR scheme is likely to reduce the incentive on the RoLR and/or each large RoLR customer to negotiate a contract. The RoLR legislative provisions envisage that the Commission will approve or specify RoLR terms and conditions for all classes of customers. To overcome this limitation, the Commission has obtained ‘in principle’ agreement from DoI that it will propose to Government that the current RoLR legislative provisions should be amended to provide the Commission with discretion to require prospective RoLRs to submit for the Commission’s approval proposed RoLR terms and conditions for different classes of RoLR customers. Following this legislative amendment, the Commission does not intend to approve or specify RoLR terms and conditions for large customers.

Final decisions

The standing offer terms and conditions that apply under the Electricity Industry Act and the Gas Industry Act, including the provisions of the Energy Retail Code, will form the basis of the terms and conditions for the provision of RoLR services to relevant customers. Any departure from these terms and conditions will require the Commission’s approval.

Subject to legislative amendments to provide the Commission with discretion to require prospective RoLRs to submit for its approval proposed RoLR terms and conditions for different classes of RoLR customers, the Commission will not approve or specify RoLR terms and conditions for large customers. The Commission considers that on the occurrence of a RoLR event, fair and reasonable terms and conditions for the provision of RoLR services will need to be agreed between the RoLR and each large customer.

D. Pricing

The statutory framework for the RoLR scheme envisages that prospective RoLRs will submit RoLR tariffs to the Commission for its approval in advance of a RoLR event occurring. The Commission has not yet requested electricity or gas retailers to submit their proposed RoLR tariffs for approval, but anticipates doing so following the conclusion of the Commission’s RoLR consultation processes.

(i) Pricing criteria

The Commission’s *final decision* in the issues paper regarding the energy pricing criteria provided that RoLR tariffs should:

1. not be tied to particular circumstances that are assumed to apply at the time of a RoLR event, 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 electricity prices
7. ideally, be capable of being implemented using existing data and systems capabilities.

These energy pricing criteria form the basis of the Commission's analysis of RoLR pricing options.

(ii) Risks and costs of providing RoLR services

A RoLR is likely to face risks and costs including the purchase of electricity or gas in the wholesale market, the payment of network charges and market fees, and meeting incremental retail operating costs.

The Commission considers that an electricity RoLR may face difficulties associated with obtaining contract cover for the additional RoLR customer load at reasonable prices and is likely to encounter risks – such as price, load and shape risk – due to unknown market conditions. The Commission therefore considers that a RoLR requires appropriate compensation for the wholesale cost of purchasing electricity to supply the customers acquired from the failed retailer on the occurrence of a RoLR event. The Commission engaged The Allen Consulting Group (ACG) to determine a reasonable range of these costs. The range of RoLR costs for wholesale electricity determined by ACG was \$60 to \$80 per MWh. The Commission's margin analysis in the FRC effectiveness review used a wholesale electricity cost in the range of \$55 to \$65 per MWh. This analysis of estimated additional RoLR wholesale electricity costs was used by the Commission to determine the wholesale electricity component of the up front RoLR supply fee (discussed at D (iii) of the executive summary).

In the issues paper, the Commission proposed to insert a provision in the retail licences of the local gas retailers requiring them to satisfy the Commission that they have put in place upstream arrangements – under the GASCOR agreements – to enable them to meet any future RoLR gas supply obligations. Noting the concerns about the Commission's proposal expressed by the local gas retailers, and that gas supplies under the GASCOR contracts represent a diminishing proportion of the total supplies because a greater variety of alternative gas supplies have become available, the Commission decided in the draft decision paper that the upstream gas arrangements should be resolved by commercial negotiations between a RoLR and gas producers or the administrator of the failed retailer. The submissions generally supported the Commission's draft decision.

Final decision

A gas RoLR will be required to source any additional gas supplies that it may require to satisfy its RoLR supply obligations from the wholesale gas market.

Due to the inherent lack of price volatility in the Victorian wholesale gas spot market and the confidential nature of the contractual upstream gas supply arrangements, the Commission stated in the draft decision paper that it was difficult to determine a range of RoLR costs for wholesale gas with any degree of certainty. The Commission thus decided not to make any provision in the RoLR supply fee for additional wholesale gas costs that may be incurred by a RoLR. In response to stakeholder concerns about this decision, the Commission obtained advice from ACG that it is possible to estimate the costs that a RoLR is likely to incur for the purchase of wholesale gas to supply its RoLR customers. ACG used an approach for estimating the wholesale gas cost that is similar to the approach used for electricity. The benchmark rate determined by ACG is based on a wholesale gas cost of \$3.50 per GJ from the Commission's margin analysis in the FRC effectiveness review.

The Commission considers that there is no need to develop a benchmark of network charges and market fees if the standing offer tariff is used as the basis for the RoLR tariff. Further, in gas, the commercial risks for distributors associated with the occurrence of a RoLR event were dealt with during the Commission's Review of Gas Access Arrangements 2003-2007. These arrangements also provide for distributors to recover costs associated with any additional RoLR obligations imposed on them during the access arrangement period via a change in tax event pass through mechanism. The cost pass through relates both to the cost of any up front activities required (such as installing systems) and to the cost of responding to a RoLR event (should such an event arise). In electricity, the Electricity Distribution Price Review 2006-2010 final decision allows electricity distributors to apply for a pass through for the incremental costs that arise from a 'declared' RoLR event where these are material and cannot be recovered through another mechanism.

The incremental retail operating costs that are likely to be incurred by a RoLR include administration and staffing costs associated with billing and providing information to RoLR customers. The Commission notes that it has obtained 'in principle' agreement from DoI that it will pursue within Government that the current RoLR legislative provisions should be amended to provide a RoLR with access to the failed retailer's customer information and other IT systems for the purposes of invoicing RoLR customers. The Commission considers that this approach will minimise the establishment costs that may be incurred by prospective RoLRs.

(iii) Energy pricing decision – relevant customers

The Commission considered in the draft decision paper that, for relevant customers, the RoLR tariff should be based on the standing offer tariff under the safety net provisions of the Electricity Industry Act and the Gas Industry Act. It also proposed that the RoLR should be entitled to recover the incremental administration and energy costs above those incorporated in the standing offer via a one off, up front RoLR supply fee that is designed to compensate it for all of the costs associated with its RoLR supply obligations.

The Commission continues to consider that a RoLR tariff for relevant customers based on the standing offer tariff, together with a one off, up front RoLR supply fee, most effectively satisfies the Commission's pricing criteria as it allows for the recovery of reasonable risks and costs associated with RoLR supply, protects the interests of customers, minimises the administrative costs of the RoLR scheme, and insulates customers from volatility in wholesale electricity prices.

The Commission also continues to consider that it may be difficult for a RoLR to recover its RoLR supply costs from RoLR customers who choose to transfer retailer shortly after the RoLR scheme is triggered. It will therefore mandate a moratorium on transfers by relevant customers of the RoLR (who have been transferred from the failed retailer) during the RoLR supply period. A moratorium on RoLR customer transfers will promote stability in the energy market following a RoLR event, particularly in the case of a local retailer failure. The Commission considers that a moratorium on transfers by relevant customers of a RoLR – together with a RoLR tariff comprised of the standing offer tariff and an up front RoLR supply fee – will provide substantial cash flow certainty to a RoLR. A three month moratorium on RoLR customer transfers, for example, would allow the RoLR to retain the RoLR customers for at least one billing cycle in both electricity and gas.

The risks and costs associated with a RoLR's obligations must be balanced against the potential benefits of acquiring new customers under the RoLR scheme. A customer base is a significant asset to a retailer and the acquisition of customers under a RoLR scheme provides a retailer with an opportunity to establish a long-term commercial relationship with those customers – and thus increase its market share – without the marketing costs that are normally associated with customer acquisition.

A number of stakeholders previously suggested that the Commission should develop a levy mechanism so that any shortfall in cost recovery experienced by a RoLR in meeting its RoLR supply obligations can be spread across all customers. The Commission's legal advice indicated, however, that under the RoLR provisions in the Electricity Industry Act and the Gas Industry Act, the RoLR tariffs can only be applied to the customers of the failed retailer; they cannot be applied to the RoLR's other customers or to customers generally. As an alternative to a market wide RoLR levy, the Commission discussed with DoI whether it would be possible to re-open the four year retail price path agreement between the Victorian Government and local retailers. As reflected in the draft decision paper, DoI advised the Commission that if a local retailer – acting in its capacity as a RoLR – experiences a material shortfall in cost recovery while satisfying its RoLR supply obligations, this may be able to be dealt with under the current retail price path arrangements if a RoLR demonstrated that its relevant net costs of supply have increased substantially.

In their submissions to the draft decision paper, stakeholders argued that a fallback mechanism for RoLR cost recovery that involves re-opening the retail price path agreement (1) is inequitable because it only recovers from customers on deemed and standing offer contracts and not from customers on market contracts and (2) will result in increased standing offer tariffs that may affect the competitive position of local retailers who have acted as RoLRs. In response to these concerns, both the Commission and DoI now consider that re-opening the retail price path agreement is not an appropriate fallback mechanism for RoLR cost recovery. The Commission proposed to DoI that a preferable option was for the RoLR legislative provisions to be amended to allow the Government to impose a RoLR levy on distribution use of system charges collected by distributors. Following discussions with the local electricity and gas retailers, DoI advised the Commission that it did not support a fallback mechanism that spreads any shortfall in RoLR cost recovery across all customers.

Having unsuccessfully explored all practical options, the Commission considers that it is unable to incorporate a fallback mechanism for RoLR cost recovery in the energy RoLR scheme at this

time. It believes, however, that the up front RoLR supply fee together with the benefits of acquiring new customers under the RoLR scheme should be sufficient to ensure that a RoLR will not experience a material shortfall in cost recovery in most – if not all – circumstances.

In determining the appropriate level of the RoLR supply fee, the Commission has taken into account potential offsets to the risks and costs that are likely to be faced by a RoLR, including (1) the cash flow certainty provided by a moratorium on transfers by relevant customers of a RoLR, (2) the benefits of acquiring new customers under the RoLR scheme and (3) the ability to access the failed retailer's customer information and other IT systems for the purposes of invoicing RoLR customers.

Noting the risks and costs associated with the purchase of electricity or gas in the wholesale market, and the analysis undertaken by ACG, the Commission concludes that the up front RoLR supply fee will incorporate an allowance of \$21 per customer for additional RoLR wholesale electricity costs and \$7 per customer for additional RoLR wholesale gas costs. These amounts are calculated as the additional RoLR wholesale electricity or gas costs for an average customer over the maximum RoLR supply period of three months. Given that the maximum RoLR supply period is three months, the up front RoLR supply fee will also include an additional 25 per cent above the \$92 per customer per annum for retail operating costs that is allowed under the retail price path agreement – that is, \$23 per electricity and gas RoLR customer.

Final decision

The RoLR tariff for relevant customers will comprise:

- *the standing offer tariff under the safety net provisions of the Electricity Industry Act and the Gas Industry Act; and*
- *a one off, up front RoLR supply fee of \$44 for electricity RoLR customers and \$30 for gas RoLR customers (escalated by the Consumer Price Index) for the recovery of incremental energy and retail operating costs above those incorporated in the standing offer tariff.*

The Commission will also mandate a moratorium on transfers by relevant customers of the RoLR (who have been transferred from the failed retailer) during the RoLR supply period. It will do this by inserting a new condition in each of the electricity and gas retail licences prohibiting each licensee – other than the RoLR – from supplying electricity or gas to relevant customers of the RoLR during the RoLR supply period.

(iv) Energy pricing decision – large customers

The Commission considers that it should not approve or specify a RoLR tariff for large customers. It notes that under FRC, retail tariffs for large customers are determined by commercial negotiation between the parties and there is no role for the Commission. The Commission therefore considers that it may lack the necessary expertise to approve or specify RoLR tariffs for large customers. It also considers that the existence of fallback arrangements for large customers under the RoLR scheme is likely to reduce the incentive on the RoLR and/or each large customer to negotiate a contract. Since there will be no moratorium on transfers by large RoLR customers, there will be an incentive for the RoLR to make competitive offers so that the customers do not transfer to other retailers. To overcome the limitations of the RoLR

legislative provisions which envisage that the Commission will approve or specify RoLR tariffs for all classes of customers, the Commission has obtained ‘in principle’ agreement from DoI that it will propose to Government that the current RoLR legislative provisions should be amended to provide the Commission with discretion to require prospective RoLRs to submit for the Commission’s approval proposed RoLR tariffs for different classes of RoLR customers. Following this legislative amendment, the Commission does not intend to approve or specify RoLR tariffs for large customers.

Final decision

Subject to legislative amendments to provide the Commission with discretion to require prospective RoLRs to submit for its approval proposed RoLR tariffs for different classes of RoLR customers, the Commission will not approve or specify RoLR tariffs for large customers. The Commission considers that on the occurrence of a RoLR event, fair and reasonable tariffs for the provision of RoLR services will need to be agreed between the RoLR and each large customer. The Commission will not mandate a moratorium on transfers by large customers of the RoLR (who have been transferred from the failed retailer) during the RoLR supply period.

E. Implementation

The Commission’s legal advice indicates that there is no inconsistency between the RoLR provisions in the Electricity Industry Act and the Gas Industry Act – including any scheme implemented under those provisions – and the external administration provisions of the Corporations Act. The RoLR provisions do not envisage a transfer of any property of the failed retailer to a RoLR, but instead envisage the creation of new contracts between a RoLR and the failed retailer’s customers.

The Commission decided, however, to clarify the ongoing status of a failed retailer’s customer contracts by amending the retail licences to require retailers to include a term in their customer contracts that the contracts will automatically terminate on the occurrence of a RoLR event. The draft decision dealt with single fuel customer contracts and single dual fuel customer contracts, but the Commission now considers that it should also deal with dual fuel customer contracts that comprise two separate contracts with a synchronised billing cycle. It now also believes that in the case of relevant customers, it may be preferable to impose the contract termination requirements via the Energy Retail Code. This issue will be discussed further during the consultation process for the development of a RoLR regulatory instrument.

Final decision

The Commission will clarify the ongoing status of a failed retailer’s customer contracts by amending the retail licences and/or the Energy Retail Code to require retailers to:

- *in the case of single fuel customer contracts, include a term that the contracts will automatically terminate on the occurrence of a RoLR event in respect of that retailer, without any penalty or exit fee payable by the customers*

- *in the case of single dual fuel customer contracts, include a term that:*
 - *if RoLR events in respect of that retailer occur simultaneously in relation to both fuels, the contracts will automatically terminate, without any penalty or exit fee payable by the customers*
 - *if a RoLR event in respect of that retailer occurs in relation to only one of the fuels (1) the contracts will automatically terminate in respect of the fuel that can no longer be supplied but continue in respect of the unaffected fuel and (2) the customers have an option to terminate the contract in its entirety by providing the retailer with seven days of notice, without any penalty or exit fee payable*
- *in the case of dual fuel customer contracts that comprise two separate contracts with a synchronised billing cycle, include a term that:*
 - *if RoLR events in respect of that retailer occur simultaneously in relation to both fuels, the contracts will automatically terminate, without any penalty or exit fee payable by the customers*
 - *if a RoLR event in respect of that retailer occurs in relation to only one of the fuels, the contracts in respect of the fuel that can no longer be supplied will automatically terminate, without any penalty or exit fee payable by the customers; the contracts in respect of the unaffected fuel will continue in accordance with their existing terms and conditions.*

The Commission has also addressed a number of practical implementation difficulties to ensure the workability of the RoLR scheme, including system capabilities and metering requirements.

The Commission understands that the electricity and gas retailers do not use standardised IT systems and therefore transferring the necessary customer information from the failed retailer to a RoLR in a short period of time following a RoLR event may be difficult. The Commission considers that the most cost effective and practical option to overcome these difficulties is to amend the RoLR legislative provisions to provide a RoLR with access to the failed retailer's customer information and other IT systems for the purposes of enabling the RoLR to invoice customers. The Commission's legal advice indicates that such legislative provisions may, however, be inconsistent with the Corporations Act because they may involve the transfer of a failed retailer's property in the context of insolvency or interfere with the power of insolvency officials to take control of the property of a failed retailer and carry on its business.

Following discussions with DoI, the Commission has obtained 'in principle' agreement from the Department that it will pursue within Government that (1) the current RoLR legislative provisions should be amended to provide a RoLR with access to the failed retailer's customer information and other IT systems for the purposes of enabling the RoLR to invoice customers and (2) the amended RoLR provisions should be declared to be 'Corporations legislation displacement provisions' for the purposes of s.5G of the Corporations Act. The application of s.5G limits the operation of the Corporations Act and ensures that the relevant State legislation prevails to the extent of any direct inconsistency.

The Commission considers that the systems and processes of each electricity and gas distributor should be capable of handling the information transfers that would be required in the event of a retailer failure, whether non-local or local. Each electricity distribution licence requires a distributor, on request by a RoLR, to disclose such customer or other information to the RoLR as

is necessary for the RoLR to act in that capacity. The Commission will replicate this requirement in the licences of gas distributors.

Final decision

The Commission will insert a provision in each of the gas distribution licences to require a gas distributor, on request by a RoLR, to disclose such customer or other information to the RoLR as is necessary for the RoLR to act in that capacity.

The Electricity Customer Transfer Code and the Gas Retail Rules currently only permit customer transfers on the basis of actual meter readings. The Commission considers that the time pressures associated with a RoLR event are likely to mean there would be insufficient time to conduct actual meter readings, and that RoLR customer transfers should therefore occur on the basis of estimated meter readings. The Commission proposes to make the necessary amendments via a RoLR regulatory instrument, and considers that the National Measurement Act does not present any obstacles to this approach. The Commission believes that estimated meter readings for RoLR customer transfers should be generated by distributors in the same way as conventional estimated meter readings.

Final decision

The Commission will permit RoLR customer transfers on the basis of estimated meter readings.

In the draft decision paper, the Commission discussed the inability of the automated RoLR process of NEMMCO's Market Settlement and Transfer Solution (MSATS) to handle certain RoLR scenarios, including the failure of a local retailer and the failure of a retailer in one jurisdiction only. The Commission noted that NEMMCO released a discussion paper during May 2005 setting out draft proposals for RoLR functionality and bulk participant change in MSATS. It will continue to work with NEMMCO on the capability of NEMMCO's systems to accommodate the Victorian RoLR scheme. The Commission also noted that VENCORP's systems can handle the transfer of customers in the event of a non-local or local gas retailer failure. It will continue to work with VENCORP and other relevant stakeholders to address any unresolved gas RoLR implementation issues.

The Commission considers that clear and consistent information must be provided to all parties affected by a RoLR event, and particularly to customers of the failed retailer. It has established a protocol with NEMMCO for dealing with market prudential events that may lead to an electricity RoLR event, and it is currently working with VENCORP to establish a similar protocol in relation to gas. The Commission will also convene a working group of relevant stakeholders to discuss RoLR communications issues that are currently unresolved, including the development of an effective RoLR communications strategy that outlines the responsibilities of market participants on the occurrence of a RoLR event.

1 Introduction

1.1 Background

In October 2004, the Essential Services Commission (the Commission) released an issues paper regarding the development of an energy retailer of last resort (RoLR) scheme.¹ The issues paper sought to integrate the outcomes of the previous electricity and gas RoLR consultation processes, confirm the decisions already made, identify further key issues that require stakeholder consultation and develop a comprehensive pricing framework for the energy RoLR scheme.

In July 2005, the Commission released an energy RoLR draft decision paper that contained draft and final decisions in relation to the energy RoLR scheme.² The paper considered the assignment of RoLR responsibility, terms and conditions for the provision of RoLR services, and RoLR implementation issues. In particular, it focused on the development of an administratively simple and workable approach to pricing for the energy RoLR scheme.

The Commission received submissions in response to the draft decision paper from the following stakeholders:

- ExxonMobil
- Energy and Water Ombudsman (Victoria) (EWOV)
- Origin Energy
- Victorian Energy Networks Corporation (VENCorp)
- AGL Retail

The Commission's energy RoLR decisions contained in this final decision paper have been developed after consideration of these submissions. Following the amendments to the RoLR legislative provisions that have been agreed between the Commission and the Department of Infrastructure, the Commission intends to commence a consultation process for the development of a RoLR regulatory instrument.

1.2 Legislative framework

The *Electricity Industry Act 2000* and the *Gas Industry Act 2001* (the Acts) confer on the Commission a relatively broad discretion to develop and implement electricity and gas RoLR schemes.³ The Commission is authorised under the Acts to specify the details of the schemes by way of retail or distribution licence conditions. The principal features of the schemes prescribed by the Acts are the trigger events for their operation and the maximum duration of a RoLR's obligation to supply.

The statutory trigger events are of particular significance.⁴ The RoLR scheme is triggered under the Electricity Industry Act when:

¹ Essential Services Commission 2004, *Energy Retailer of Last Resort – Issues Paper*.

² Essential Services Commission 2005, *Energy Retailer of Last Resort – Draft Decision Paper*.

³ The relevant provisions are contained in s.27 of the Electricity Industry Act and s.34 of the Gas Industry Act.

⁴ See Electricity Industry Act, s.27(5) and Gas Industry Act, s.34(5).

- (a) an existing retailer's licence is revoked; or
- (b) the right of a licensed retailer to acquire electricity from the wholesale electricity market is suspended or terminated.

Similarly, the RoLR trigger events under the Gas Industry Act occur when:

- (a) an existing retailer's licence is revoked; or
- (b) an existing retailer has been deregistered as a market participant in the category of retailer under the MSO Rules after a notice of suspension was issued to the retailer by VENCORP under those Rules.⁵

The intent of the statutory provisions is that on the occurrence of either of the specified trigger events another retail or distribution licensee designated by the Commission (the RoLR) will become obliged under its licence to sell electricity or gas to the failed retailer's customers at tariffs, and on terms and conditions, approved by the Commission. The Acts support this intent by deeming a contract to exist between the designated RoLR and the affected customers on those approved tariffs, terms and conditions.⁶ The deemed contract comes into existence immediately on the occurrence of a trigger event – without the need for any active steps to be taken by the RoLR, the failed retailer, or the affected customers – and takes effect despite any agreement or instrument to the contrary relating to the distribution, supply or sale of electricity or gas to the affected customers (which might include, for example, the existing contracts between the failed retailer and its customers).⁷

The Commission decided in previous consultations that retailers rather than distributors are best placed to provide RoLR services. As a result, the electricity and gas retail licences were amended to require electricity and gas retailers to provide RoLR services if so directed by the Commission. The Commission's final decisions regarding the assignment of RoLR responsibility are contained in section 2. The Commission notes that although the energy RoLR scheme applies to all customers, the Commission has taken into account the differing nature of small and large customers in formulating its RoLR positions. The maximum duration of the RoLR obligation is specified in the Acts as three months, although the Commission may require the RoLR to continue to supply customers after the end of this period at tariffs and on terms and conditions determined by the RoLR.⁸

AGL noted that the Ministerial Council on Energy is currently undertaking a work program to develop a national regulatory framework for distribution and retail, and to achieve national consistency in energy market regulation and operations, including RoLR arrangements. It submitted that the Commission should give consideration to the development of a nationally consistent regulatory framework as part of its RoLR consultation process.

Although it is envisaged that a national regulator will replace the existing jurisdictional regulators in the future, the Commission considers there is a clear legislative intent in both the Electricity Industry Act and the Gas Industry Act for it to develop electricity and gas RoLR

⁵ 'MSO Rules' is defined in s.3 of the Gas Industry Act as the rules made on 2 February 1999 under s.48N of the *Gas Industry Act 1994* as those rules are amended and in force for the time being.

⁶ See Electricity Industry Act ss.27(7)-(10); Gas Industry Act ss.34(8)-(11).

⁷ See Electricity Industry Act s.27(9); Gas Industry Act s.34(10).

⁸ See Electricity Industry Act ss.27(10A) and (10B); Gas Industry Act ss.34(11A) and (11B).

schemes. The research and analysis undertaken by the Commission in developing its energy RoLR scheme would be expected to be taken into account by the Australian Energy Regulator and/or the Australian Energy Market Commission as part of the development of a national energy RoLR scheme. As stated in the draft decision paper, the Commission is cognisant of the benefits of a consistent national approach to RoLR and has considered the positions in other jurisdictions during the development of its energy RoLR scheme. It notes, however, that the Commission has a different starting point than other jurisdictions; historical and legislative differences, for example, contribute to the difficulties of achieving national consistency. In addition, the electricity and gas markets across jurisdictions are at different stages of development, particularly in relation to full retail contestability (FRC).

1.3 Last resort nature of the scheme

As is apparent in the formulation of the trigger events contained in the Acts, the conditions under which a RoLR scheme may need to be activated are exceptional. They arise only at the point where a retailer becomes legally or commercially incapable of continuing to supply its customers. There is a range of factors, relating both to regulatory design and to the commercial incentives operating on equity providers and creditors, which suggest that retailers are most unlikely to experience the RoLR trigger events.

The most realistic scenario leading either to licence revocation or to a denial of access to wholesale electricity or gas markets is the retailer's financial failure. In this circumstance the retailer's financial condition might over time result in regulatory breaches which entitle or require the Commission to revoke the retailer's licence. Alternatively, it may lead to financial default under the relevant wholesale market rules, resulting in termination of the retailer's wholesale market access. However, both scenarios are likely to be rare, at least as sudden unanticipated events, even where a retailer is financially distressed.

The Commission notes that a range of factors can lead to a deterioration in a retailer's financial condition and, ultimately, to its insolvency. When those conditions arise, however, it will generally be in the interests of equity holders and creditors to maintain the business as a going concern rather than to permit the business to fail as a result of regulatory breach or financial default. This may occur through a managed sale process in which the business is supported financially while a sale is conducted under the informal supervision of its principal creditors. It may also occur following the appointment of a receiver and manager to the business by a secured creditor or the appointment of an administrator by a creditor or by the retailer's own board.⁹ In either case, on the impending or actual insolvency of the retailer its principal creditors or the insolvency administrator are likely to take immediate steps to preserve the retailer's ability to trade, recognising that if they fail to do so the value in the principal asset of the business – namely its customer contracts – is likely to be lost. Provided there is value in its operations, there is an incentive for creditors or an administrator to trade the business in order to realise that value through a sale. The Commission considers that the proposed energy RoLR scheme is a scheme of last resort; the RoLR trigger events do not preclude the trade sale of a retailer that is in financial difficulties.

⁹ The appointment of an insolvency administrator to a retailer does not of itself trigger the operation of the RoLR scheme. The scheme is only triggered if this leads to the occurrence of one of the specified trigger events.

1.4 Features of a successful RoLR scheme

As stated in the draft decision paper, the Commission's objectives in implementing a RoLR scheme in the electricity and gas markets are, to the extent possible, to:

- maintain continuity of supply to customers
- protect the interests of customers, with regard to the prices they pay for energy and the other terms and conditions on which it is supplied and sold
- maintain the integrity of payments for energy in the relevant wholesale markets, thereby protecting the interests of participants in those markets
- maintain continuity of payments to suppliers of distribution services, metering and data management agents and other ancillary services related to the supply and sale of energy
- ensure that the RoLR customers and other parties affected by the RoLR event are given timely and accurate information so that they are able to make informed decisions regarding their future supply of energy
- ensure that the RoLR scheme is compatible with the legislative and commercial framework that exists in Victoria
- ensure that the Commission and the relevant market operator (NEMMCO or VENCORP) have sufficient powers to carry out the necessary actions to ensure the transfer of customers can be effected smoothly and in accordance with agreed procedures
- achieve these objectives without encouraging retailers or customers to engage in overly speculative, high risk or reckless behaviour.

With these objectives in mind, the Commission considers that a successful RoLR scheme should exhibit the following features:

- set out clearly what triggers the transfer of customers to a RoLR, the roles and responsibilities in deciding that a transfer of customers should take place, and the processes for notifying relevant parties
- document the actions that then need to be taken to effect a smooth transfer of customers and who is responsible for carrying out those actions
- provide adequate information to market participants and RoLR customers
- set out fair pricing, terms and conditions for the supply and sale of energy by the RoLR to the RoLR customers
- result in the appointment of a retailer who has sufficient financial strength and infrastructure to carry on the activities of a RoLR
- set out clearly what core capabilities are required of a RoLR and what functions it will need to perform
- provide an immediate regulatory solution to a retailer's unplanned market exit
- not act to discourage ongoing participation by customers in the competitive market in the longer term

- operate smoothly if a RoLR event occurs
- not be unduly costly to administer and allow a RoLR to recover the costs incurred to provide the RoLR service
- be backed by the necessary instruments and commercial agreements in the industry and with customers so that those operating it have the legal and commercial authority to carry out the actions required of them.

EWOV appreciated the reasons behind the proposed RoLR framework and that the overriding concern is to secure continuity of supply, particularly for the customers of the failed retailer. It supported both the statement of objectives of the RoLR scheme and the features of the scheme set out in the draft decision.

1.5 Structure of this paper

The remainder of this final decision paper is structured as follows:

- Section 2 contains the Commission's final decisions regarding the assignment of RoLR responsibility in the event of a non-local or local retailer failure in the electricity or gas markets.
- Section 3 states the Commission's final decisions regarding the terms and conditions for the provision of RoLR services to relevant and large customers.
- Section 4 presents the Commission's final decisions regarding the prices that a RoLR will be able to charge the relevant and large customers it acquires from a failed retailer.
- Section 5 includes the Commission's final decisions regarding RoLR implementation issues and discusses additional implementation matters that need to be addressed in the future.

2 Assignment of RoLR Responsibility

This section contains the Commission's final decisions regarding the assignment of RoLR responsibility in the event of a non-local or local retailer failure in the electricity or gas markets. It also considers the effect of a RoLR event on dual fuel customer contracts and customer transfers that are in progress both towards and away from the failed retailer.

2.1 Previous final decisions

During the two previous RoLR consultation processes, the Commission made the following final decisions:

- In the event of a non-local retailer failure in the electricity industry, the local electricity retailers will be assigned responsibility to provide RoLR services. The customers of the failed non-local electricity retailer will be allocated to the electricity retailer who has the local retailer responsibility for the area where the customer is located.
- In the event of a non-local retailer failure in the gas industry, the local gas retailers will be assigned responsibility to provide RoLR services. The customers of the failed non-local gas retailer will be allocated to the gas retailer who has the local retailer responsibility for the area where the customer is located.
- In the event of a local retailer failure in the electricity industry, the remaining local electricity retailers will be assigned responsibility to provide RoLR services. The customers of the failed local electricity retailer will be allocated to the remaining local electricity retailers on the basis of TNI and market share.

AGL noted that the Commission's decisions for the assignment of a failed retailer's customers rely on the concept of incumbency and that local retailers are charged with the responsibility for taking on the customers of the failed retailer. It argued that this is a short term option because the concept of incumbency will be eroded over time as competition develops, thereby requiring changes to be made to the RoLR scheme. AGL also claimed that the Commission's RoLR arrangements do not provide for the possible failure of an incumbent retailer. It stated that any changes to the arrangements in the future will add to the costs that will ultimately be borne by customers.

AGL submitted that a more equitable and sustainable approach is for all remaining retailers to share responsibility for maintaining supply to the customers of the failed retailer, thereby sharing in both the opportunity and risk of a RoLR event. It stated that this approach also addresses the possible failure of an incumbent, and that customers could be allocated to the remaining retailers on the basis of the retailer's market share.

As stated in the draft decision paper, the Commission considers that local retailers are in the best position to provide RoLR services because of their market size, financial position, system capacity and ability to support taking on large numbers of customers at short notice. It notes that Origin Energy accepts that local retailers are the logical parties to provide ongoing retail services to customers of a failed retailer. The Commission will review the RoLR scheme at regular intervals in the future as the Victorian energy market develops.

The Commission does not agree with AGL's view that the RoLR arrangements do not provide for the possible failure of an incumbent retailer. As referred to above, the Commission has made a final decision regarding the assignment of RoLR responsibility in the event of a local retailer failure in the electricity market. The Commission's final decision regarding the assignment of RoLR responsibility in the event of a local gas retailer failure is discussed below.

2.2 Local retailer failure – gas

Draft decision

In the event of a local retailer failure in the gas industry, the remaining local gas retailers will be assigned responsibility to provide RoLR services. The customers of the failed local gas retailer will be allocated to the other local gas retailer within the relevant gas distribution network area.

Discussion

As stated in the draft decision paper, the Commission considers that the simplest and fairest basis on which to allocate the customers of a failed local gas retailer between the remaining local gas retailers is according to the gas distribution network area in which the customers are located. Since each of the three distribution network areas in the Victorian gas industry is aligned with two local retailer areas, the Commission considers that the customers of a failed local gas retailer should be allocated to the other local gas retailer within the relevant gas distribution network area. There were no comments regarding this issue in any of the submissions received in response to the draft decision paper. The Commission therefore confirms its draft decision.

Final decision

In the event of a local retailer failure in the gas industry, the remaining local gas retailers will be assigned responsibility to provide RoLR services. The customers of the failed local gas retailer will be allocated to the other local gas retailer within the relevant gas distribution network area.

2.3 Dual fuel customer contracts

The draft decision paper considered the effect of the assignment of RoLR responsibility on dual fuel customer contracts if a RoLR event occurs in relation to (1) both fuels supplied by a dual fuel retailer and (2) only one of the fuels supplied by a dual fuel retailer. If RoLR events occur simultaneously in relation to both fuels supplied by a dual fuel retailer (for example, if the retailer's electricity and gas retail licences are both revoked), the dual fuel customer contracts will be split into their separate electricity and gas components for RoLR purposes; the dual fuel customers will then be allocated to electricity and gas RoLRs according to the Commission's final decisions regarding the assignment of RoLR responsibility in electricity and gas for local and non-local retailer failure. The Commission notes that the failed retailer's dual fuel customers may ultimately be supplied by different electricity and gas RoLRs. If a RoLR event occurs in relation to only one of the fuels supplied by a dual fuel retailer, the dual fuel customer contracts will also be split into their separate electricity and gas components for RoLR purposes; however, the customers will then be allocated to RoLRs according to the Commission's final decisions regarding the assignment of RoLR responsibility only for the fuel that can no longer be supplied.

The relevant retailer can continue to supply the fuel in respect of which there has not been a RoLR event.

The effect of a RoLR event in relation to dual fuel customer contracts is discussed further in section 5.1.2.

2.4 Customer transfers in progress

VENCorp submitted that it is not clear what rules will apply to customer transfers involving the failed retailer that have already commenced at the time of a RoLR event. Following discussions with VENCorp and NEMMCO, the Commission considers that all customer transfers involving the failed retailer that are in progress on the occurrence of a RoLR event in respect of that retailer should be cancelled. It notes that a retailer's financial responsibility for the supply address of a customer does not commence until the customer transfer is complete. In the case of an incomplete customer transfer, the customer will not move to the new retailer and will therefore remain with the existing retailer.

The Commission has considered the effect of a RoLR event on customer transfers that are in progress (1) towards the failed retailer and (2) away from the failed retailer. A customer transfer in progress towards the failed retailer cannot proceed and must be cancelled by the relevant market operator; the customer will therefore remain with the existing retailer. A customer transfer in progress away from the failed retailer also should not proceed because the customer cannot be supplied by the failed retailer between the occurrence of the RoLR event and the time that the transfer is completed; the customer must therefore immediately be allocated to the RoLR so as to maintain continuity of supply.

3 Terms and Conditions

In this section, the Commission states its final decisions regarding the terms and conditions for the provision of RoLR services to relevant and large customers.¹⁰

The statutory framework for the RoLR scheme envisages that prospective RoLRs will submit proposed RoLR terms and conditions to the Commission for its approval in advance of a RoLR event occurring. If a prospective RoLR fails to submit RoLR terms and conditions within one month after being requested to do so, or if the terms and conditions submitted are not approved by the Commission, the Commission may itself specify the terms and conditions. Notice of the terms and conditions must be published in the Government Gazette and, on publication, are declared to be binding on the relevant licensee and the customers to which they apply. The Electricity Industry Act and the Gas Industry Act have the effect that, as soon as a RoLR supply obligation arises after the occurrence of a RoLR event, a RoLR and the customers to which it is required to supply are deemed to have entered into a contract on the terms and conditions that have been published in the Government Gazette.¹¹

The Commission notes that it has not yet requested electricity or gas retailers to submit their proposed RoLR terms and conditions for approval, but anticipates doing so following the conclusion of the Commission's RoLR consultation process.

3.1 Relevant customers

Draft decision

The standing offer terms and conditions that apply under the Electricity Industry Act and the Gas Industry Act, including the provisions of the Energy Retail Code, will form the basis of the terms and conditions for the provision of RoLR services to relevant customers. Any departure from these terms and conditions will require the Commission's approval.

Discussion

AGL supported the use of standing offer terms and conditions as an effective and efficient approach for small RoLR customers where the RoLR is the standard or local retailer. It stated that the RoLR arrangements should be designed to protect small retail customers. AGL also submitted that its proposal to allocate a failed retailer's customers to all participating retailers – including those who are not standard retailers – can be accommodated by ensuring that small RoLR customers are supplied under the terms and conditions that are generally available to small retail customers of the non-standard suppliers. It argued that this proposal will allow all retailers to participate in the RoLR scheme. For the reasons specified in section 2.1, the Commission considers that only local retailers should be assigned responsibility to provide RoLR services.

¹⁰ 'Relevant customers' are all domestic and small business customers who consume less than 160 MWh per annum of electricity or 10 TJ per annum of gas. 'Large customers' are all customers who consume more than 160 MWh per annum of electricity or 10 TJ per annum of gas.

¹¹ See Electricity Industry Act ss.27(7)-(10); Gas Industry Act ss.34(8)-(11).

As stated in the draft decision paper, the Commission considers that use of the standing offer terms and conditions applicable under the safety net provisions of the Electricity Industry Act and the Gas Industry Act satisfies the key elements of the RoLR pricing criteria – that administration costs should be minimised, a standard contract is in place that protects consumer interests, there is a high degree of regulatory certainty, and implementation should be possible within existing system capabilities. In particular, the Commission considers that use of standard terms and conditions will reduce the cost of the RoLR scheme because these terms and conditions are contained in local retailers’ existing standing offer and deemed contracts. It will also ensure that most customers – those who have chosen not to change retailer or enter into a market contract with their local retailer – will continue to be supplied on terms and conditions that are familiar to them.

The Commission further considers that relevant customers of a failed retailer may be in a vulnerable position with respect to terms and conditions because they are allocated to the RoLR rather than exercising an active choice. The application of standing offer terms and conditions provides the necessary protection for RoLR customers without placing them on more advantageous terms and conditions than similar customers served by other retailers. The Commission confirms its draft decision.

Final decision

The standing offer terms and conditions that apply under the Electricity Industry Act and the Gas Industry Act, including the provisions of the Energy Retail Code, will form the basis of the terms and conditions for the provision of RoLR services to relevant customers. Any departure from these terms and conditions will require the Commission’s approval.

3.2 Large customers

Draft Decision

The RoLR terms and conditions for large customers should be ‘fair and reasonable’. This assessment will be made by the Commission on receipt of the proposed RoLR terms and conditions from prospective RoLRs.

Discussion

In the draft decision paper, the Commission noted (1) the limited time available to determine RoLR terms and conditions immediately following a RoLR event and (2) the legislative requirement that prospective RoLRs submit their proposed terms and conditions to the Commission for its approval in advance of a RoLR event. The Commission decided that, in order to provide the certainty sought by stakeholders and envisaged by the legislation while at the same time ensuring that the terms and conditions are not inappropriate or onerous for large RoLR customers, it would assess the terms and conditions proposed by the prospective RoLRs on the basis of a ‘fair and reasonable’ test.

AGL submitted that large customers should not be covered under the provisions of a RoLR scheme – such as in the NSW gas market – and that they should procure alternative supply arrangements themselves in the event that their retailer fails. It accepted, however, that

transitional arrangements may be required for the period between a declared RoLR event and large customers entering into new supply arrangements. AGL stated that the gas market in NSW addresses this issue through adequate prudential requirements on retailers to provide cover during this period. Given that a major objective of the RoLR scheme is to maintain continuity of supply to the customers of a failed retailer on the occurrence of a RoLR event, the Commission considers that the RoLR scheme should apply to relevant and large customers. In particular, the Commission's decisions regarding the assignment of RoLR responsibility must apply to all customers. The Commission has, however, taken into account the differing nature of relevant and large customers in formulating its decisions regarding RoLR tariffs, terms and conditions.

AGL also submitted that terms and conditions and supply arrangements for large customers are unique, and that these arrangements are based on individual customers' consumption patterns and business needs. It stated that large customers – some of whom are larger than the retailers in the Victorian energy market – will be able to choose among a number of competing retailers to negotiate fair and reasonable terms and conditions. AGL argued that the regulatory requirement for the Commission to review and approve terms and conditions offered to large customers is unnecessary and impractical.

The Commission agrees with AGL that supply arrangements for large customers are often based on individual consumption patterns and business needs, and tend not to be as generic as those for relevant customers. The Commission notes that ordinarily it has no role in relation to terms and conditions for large customers – they are determined by commercial negotiation between the parties – and that it may therefore lack the necessary expertise to approve or specify RoLR terms and conditions for large customers. It considers that the existence of fallback arrangements for large customers under the RoLR scheme is likely to reduce the incentive on the RoLR and/or each large RoLR customer to negotiate a contract. Given the significant load of each large customer, the Commission believes that an incentive exists for the RoLR – as well as all other retailers, in the absence of a moratorium on transfers by large RoLR customers – to endeavour to quickly enter into longer term supply contracts with each large RoLR customer.

As stated in both the issues paper and the draft decision paper, and for the reasons discussed above, the Commission does not believe that it should approve or specify terms and conditions for the provision of RoLR services to large customers. The RoLR legislative provisions, however, do not distinguish between relevant and large customers; they envisage that the Commission will approve or specify RoLR terms and conditions for all classes of customers. To overcome this limitation, the Commission has obtained 'in principle' agreement from the Department of Infrastructure (DoI) that it will propose to Government that the current RoLR legislative provisions should be amended to provide the Commission with discretion to require prospective RoLRs to submit for the Commission's approval proposed RoLR terms and conditions for different classes of RoLR customers. Following this legislative amendment, the Commission does not intend to approve or specify RoLR terms and conditions for large customers – though the Commission will retain its current role in relation to relevant customers. The Commission considers that on the occurrence of a RoLR event, fair and reasonable terms and conditions for the provision of RoLR services will need to be agreed between the RoLR and each large customer.

Final decision

Subject to legislative amendments to provide the Commission with discretion to require prospective RoLRs to submit for its approval proposed RoLR terms and conditions for different classes of RoLR customers, the Commission will not approve or specify RoLR terms and conditions for large customers. The Commission considers that on the occurrence of a RoLR event, fair and reasonable terms and conditions for the provision of RoLR services will need to be agreed between the RoLR and each large customer.

4 Pricing

The purpose of this section is to present the Commission’s final decisions regarding the prices that a RoLR will be able to charge the relevant and large customers it acquires from a failed retailer. The section restates the energy RoLR pricing criteria that were finalised in the issues paper and discusses the risks and costs that are likely to be faced by a RoLR in order to satisfy its RoLR supply obligations – including the purchase of electricity or gas in the wholesale market, the payment of network charges and market fees, and meeting incremental retail operating costs. It then discusses the Commission’s final decision regarding the RoLR tariff for relevant customers, including the potential offsets to the risks and costs that are likely to be faced by a RoLR and the Commission’s assessment of the appropriate level of the RoLR supply fee. In addition, the section contains the Commission’s final RoLR pricing decision for large customers.

The statutory framework for the RoLR scheme envisages that prospective RoLRs will submit proposed RoLR tariffs to the Commission for its approval in advance of a RoLR event occurring. If a prospective RoLR fails to submit RoLR tariffs within one month after being requested to do so, or if the tariffs submitted are not approved by the Commission, the Commission may itself specify the tariffs. Notice of the tariffs must be published in the Government Gazette and, on publication, are binding on the relevant licensee and the customers to which they apply. The RoLR provisions of the Electricity Industry Act and the Gas Industry Act have the effect that, as soon as a RoLR supply obligation arises after the occurrence of a RoLR event, a RoLR and the customers to which it is required to supply are deemed to have entered into a contract on the tariffs that have been published in the Government Gazette.¹²

The Commission notes that it has not yet requested electricity or gas retailers to submit their proposed RoLR tariffs for approval, but anticipates doing so following the conclusion of the Commission’s RoLR consultation process.

4.1 Pricing criteria

In the issues paper, the Commission considered the energy pricing criteria that should form the basis of the Commission’s analysis of RoLR pricing options. The Commission’s final decision was that RoLR tariffs should:

1. not be tied to particular circumstances that are assumed to apply at the time of a RoLR event, 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

¹² See Electricity Industry Act ss.27(7)-(10); Gas Industry Act ss.34(8)-(11).

5. maximise regulatory certainty by facilitating transparent and robust regulatory decision making
6. ideally, continue to insulate customers from volatility in wholesale electricity prices
7. ideally, be capable of being implemented using existing data and systems capabilities.

4.2 Risks and costs of providing RoLR services

As stated in the draft decision paper, a RoLR is likely to face risks and costs while performing its RoLR responsibilities, including the purchase of electricity or gas in the wholesale market, the payment of network charges and market fees, and meeting incremental retail operating costs.

4.2.1 Wholesale market – electricity

The cost of purchasing electricity is a significant component of an electricity retailer's overall costs. The retailers purchase electricity from the wholesale market at a spot price that is determined by supply and demand conditions at a particular point in time. To manage fluctuations in the spot price, and thereby offer relatively stable tariffs to customers, retailers enter into contractual arrangements with counterparties – known as hedging contracts – to fix the price at which they purchase electricity. The choice of hedging strategy reflects a retailer's expectation of the balance between electricity demand and generating capacity, the load profile of its customer base, and its willingness to take risks through either over or under contracting for load. In previous consultations, the Commission acknowledged that a RoLR may face difficulties in obtaining appropriate contract cover for the additional RoLR customer load at reasonable prices. A RoLR is likely to encounter risks – such as price, load and shape risk – due to unknown market conditions.

The Commission considers that a RoLR requires appropriate compensation for the wholesale cost of purchasing electricity to supply the customers acquired from the failed retailer on the occurrence of a RoLR event. The level of compensation that is appropriate will depend on the prices prevailing in the market at the time and the purchasing strategies that can be used by a RoLR. The same issues arise in estimating an appropriate level of compensation for the wholesale cost of purchasing electricity to supply customers on standing offers. Hence, the methodology that is used to estimate future wholesale electricity costs for standing offer customers can also be used to estimate RoLR electricity costs.

The Commission engaged The Allen Consulting Group (ACG) to determine a reasonable range of costs that a RoLR is likely to incur for the purchase of wholesale electricity to supply its RoLR customers. ACG used the following approach to advise the Essential Services Commission of South Australia (ESCOSA) on wholesale electricity costs for standing contract customers from 2006 to 2008:¹³

- describe an appropriate set of scenarios
- estimate wholesale costs that would be incurred under the various scenarios

¹³ The Allen Consulting Group 2004, *Energy Wholesale Price Study – Final Report*; report to the Essential Services Commission of South Australia, available at: <http://www.escosa.sa.gov.au/webdata/resources/files/040913-R-WholesaleEnergyPriceStudy.pdf>

- assign reasonable probabilities of occurrence to each scenario
- calculate the weighted average cost.

In applying the above approach to RoLR customers in Victoria, ACG analysed scenarios, costs and probabilities covering a reasonable range of prices prevailing in the wholesale market at the time of a RoLR event and for the following three month period.

Origin Energy was the only stakeholder to comment on the analysis undertaken by ACG. ACG's responses to Origin's comments are detailed below.

Origin Energy submitted that it would need to further understand the assumptions about pool prices in the analysis undertaken by ACG in order to provide an informed comment. As stated in appendix 1 to the draft decision paper, ACG used Victorian pool price data from January 2004 to May 2005 to select actual historical time series corresponding to low, medium and high prices, in order to calculate load weighted prices.

Origin expressed concerns that the amount allocated for risk in the electricity up front supply fee may not be sufficient. To estimate the probable wholesale electricity price during a RoLR event, ACG employed a methodology that involved the analysis of six different scenarios to take account of a plausible range of risks and circumstances that might apply to RoLR wholesale electricity purchases. In particular, ACG examined three different pool price outcomes – low, average and high – with likelihoods of occurrence estimated from the actual distribution of prices over that period. The Commission agrees with ACG's view that the distribution of pool price outcomes includes sufficient risk allowance if pool prices following a RoLR event are similar to prices from January 2004 to May 2005. ACG also noted that Origin did not propose any alternative basis upon which probability weightings for pool price scenarios should be estimated.

The discussion below provides an overview of the scenarios, costs and probabilities chosen by ACG. These are discussed further in appendix 1.

Scenarios

ACG chose six scenarios to represent a plausible range of scenarios that might apply to RoLR wholesale electricity purchases. The first three scenarios represent situations in which the RoLR event does not result in any change to the wholesale electricity market, and the RoLR can therefore purchase from the pool at prevailing pool prices. These three pool price scenarios take account of low, average and high pool prices respectively. Together, the pool price scenarios are assumed to have at least fifty per cent probability, with the split between low, average and high prices based on the historical frequency of such prices. The cost under each of these scenarios is the load weighted cost.

The fourth scenario takes account of the likelihood that a RoLR will seek to purchase contracts to hedge the risks of purchasing electricity for its RoLR customers. ACG indicated that there is likely to be sufficient liquidity in the contract market at a price equal to the average pool price plus a premium of \$40 per MWh. The fifth scenario takes account of the possibility that a RoLR event may occur as a result of very high prices, which leads to administered prices under the NEM market rules. The sixth scenario assumes that pool prices are set at \$300 per MWh for

every peak period during the maximum RoLR supply period of three months, and remain at the same level as in scenario three during off peak periods.¹⁴

Origin argued that contract prices should be used as the base rather than spot prices because a prudent retailer would seek to hedge its position with contract cover rather than be exposed to the pool. In response, ACG noted that Origin did not indicate how contract prices might be estimated. ACG stated that the electricity market does not offer contracts that are appropriate to cover RoLR events on an ongoing basis and published prices for them are not available. Forward contracts for which brokers and the Australian Financial Markets Association (AFMA) currently publish prices have predetermined start and end dates. However, contracts that are required to cover a RoLR event will start and end on dates that are specified at the time the contracts are negotiated, and their prices will be determined with regard to these dates and the market conditions at the time. It is likely that a RoLR seeking to hedge its RoLR load will seek to purchase one or more 'immediate three month' contracts – that is, contracts that take effect at once and extend for a period of three months – perhaps with an option for some level of continuation.

ACG further stated that, if the short term contract market has sufficient liquidity, contracts should be available immediately and priced at the expected pool price because generators should be indifferent to receiving spot or expected spot prices over the next three months. Scenarios one to three took account of situations in which the contract market has sufficient liquidity for contract prices to equal expected pool prices for the cases of low, average and high prices. These scenarios had a combined weighting of 50 per cent.

ACG commented that scenario 4 also took account of the situation in which the contract market does not have sufficient liquidity and generators are not prepared to sell contracts at the expected spot price. Scenario 4 allowed a price premium of \$40 per MWh over the expected pool price, which would permit the purchase of (1) swap contracts at twice the typical forward price to induce liquidity or (2) cap contracts for the whole year at a premium of \$10 per MWh, even though the maximum RoLR supply period is only three months. This scenario had a weighting of 30 per cent.

ACG concluded that its analysis allowed for a prudent retailer to hedge its position with contract cover, with a 50 per cent likelihood that the short term contract market is liquid and that contracts are available immediately and priced at the expected pool price, and a 30 per cent likelihood that the RoLR will be required to pay a premium over the expected pool price.

Origin commented that the links between a RoLR event and contract and pool prices might also be better understood. It claimed that where a RoLR event has occurred and the failed retailer has significant customer numbers, the impact of the default on existing hedge contracts with generators may be material. Origin argued that this may lead to a generator being shorter and consequently pool prices increasing to reflect this position. It further argued that increased pool prices may then in turn create upward pressure on contract prices, which may also impact on credit and market liquidity.

¹⁴ The typical strike price for caps is \$300 per MWh, so generators have an incentive to keep prices below \$300 per MWh to avoid paying out on caps.

ACG noted that there have been few RoLR events in electricity markets, and so there is little guide to further linkages. In any event, ACG allowed for two scenarios in which RoLR events were linked with high pool and contract prices. Scenario 6, namely the RoLR event leading to generators increasing prices, assumed prices averaging \$227.20 per MWh with a weighting of 10 per cent. Scenario 5 assumed administered prices averaging \$86.80 per MWh, and also had a weighting of 10 per cent.

Conclusions

The sensitivity analysis contained in Table 4.1 indicates that the probability weighted average cost of wholesale electricity under these six scenarios for the base case is \$67.52 per MWh. Different choices of probabilities result in different probability weighted prices, but the price is likely to be within the range of \$60 to \$80 per MWh.

Table 4.1 Sensitivities

	Scenario	Load weighted cost (\$ per MWh)	Base case	Uniform probabilities	More realistic risk of high prices
1	Low pool prices	\$22.19	3%	17%	3%
2	Average pool prices	\$29.75	41%	17%	41%
3	High pool prices	\$38.63	6%	17%	6%
4	Contracted prices	\$69.75	30%	17%	40%
5	Administered prices	\$86.82	10%	17%	5%
6	Market power prices	\$227.24	10%	17%	5%
	Probability weighted cost		\$67.52	\$79.06	\$58.79

Source: The Allen Consulting Group analysis

As stated in the draft decision paper, the range of RoLR costs for wholesale electricity is therefore \$60 to \$80 per MWh. It should be noted that the Commission's margin analysis in the FRC effectiveness review of June 2004 used a wholesale electricity cost – which allowed for pool purchases, long-term contracts and other wholesale on costs such as ancillary service costs, levies and losses – in the range of \$55 to \$65 per MWh.¹⁵

The Commission supports the above analysis and responses to Origin's comments provided by ACG to determine a reasonable range of costs that a RoLR is likely to incur for the purchase of wholesale electricity. In section 4.3.2, the Commission applies the ACG analysis to determine the wholesale electricity component of the RoLR supply fee.

¹⁵ Essential Services Commission 2004, *Final Report to Minister – Special Investigation: Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity, Background Report, Attachment 4.*

4.2.2 Upstream arrangements – gas

Draft decision

The Commission will not impose a licence requirement on local gas retailers requiring them to satisfy the Commission that they have put in place upstream arrangements – under the GASCOR agreements – to enable them to meet any future RoLR gas supply obligations. Instead, a gas RoLR will be required to source any additional gas supplies that it may require to satisfy its RoLR supply obligations from the wholesale gas market.

Discussion

In the issues paper, the Commission proposed to insert a provision in the retail licences of the local gas retailers requiring them to satisfy the Commission that they have put in place upstream arrangements – under the GASCOR agreements – to enable them to meet any future RoLR gas supply obligations. The Commission anticipated that it would be difficult to negotiate a gas supply agreement in circumstances where the relevant parties are seeking to preserve or secure commercial advantages and the RoLR is uncertain of the volumes of gas it requires and the duration of its supply. It thus considered that the local gas retailers should make appropriate arrangements under the GASCOR agreements to enable them to satisfy any future RoLR gas supply obligations.

Noting the concerns about the Commission’s proposal expressed by the local gas retailers, the Commission decided in the draft decision paper that the upstream gas arrangements should be resolved by commercial negotiations between the relevant parties on the occurrence of a RoLR event. Under this approach, a RoLR would negotiate directly with gas producers or the administrator of the failed gas retailer in order to obtain access to sufficient gas to satisfy its RoLR supply obligations.

The Commission noted the views of some stakeholders that gas supplies under the GASCOR contracts represent a diminishing proportion of the total supplies available to satisfy Victorian gas consumption. It also noted, however, that demand on the majority of days during 2004 was able to be satisfied by the capacity available under the GASCOR contracts.¹⁶ The Commission acknowledged that additional gas supplies to those available under the GASCOR contracts may be required if a gas RoLR event occurs during the winter peak period. The Commission also noted that changes in the upstream gas supply market since the introduction of full retail contestability (FRC) have resulted in a greater variety of alternative gas supplies to GASCOR. In response to these changes, the Commission understands that retailers have entered into new upstream gas supply contracts with producers that are confidential in nature.

AGL and ExxonMobil supported the Commission’s draft decision that requires a gas RoLR to source any additional gas supplies that it may require to satisfy its RoLR obligations from the wholesale gas market. ExxonMobil stated that in the event of a retailer becoming insolvent or otherwise incapable of acting as a retailer in the Victorian market, it is reasonable to assume that the retailer’s supplies would be suspended by the various producers from whom they would

¹⁶ During 2004, the consumption of gas in Victoria was less than the 800 TJ capacity available under the GASCOR contracts on 253 days; information available at http://www.vencorp.com.au/docs/mibb/Price_and_Withdrawals_2004.xls

otherwise source their gas, and that the producers would require a creditworthy buyer. It commented that the gas which would normally have been available to the failed retailer would instead be available to other market participants, including the RoLR. ExxonMobil suggested that the commercial options open to the various producers in that circumstance would include seeking new bilateral sales agreements with the RoLR as well as offering the available supplies into the Victorian spot market. It claimed that either way, the RoLR would be able to service its additional retail market obligations and that, importantly for producers, a free market mechanism would be available to ensure they could continue to move their gas into the marketplace via creditworthy buyers.

ExxonMobil commented on the speed with which the market participants would be able to react in a RoLR situation. It claimed there would be some frantic market activity if the retailer failure occurred suddenly without notice; producers would suspend supplies and VENCORP would sense an imminent shortfall of supply versus market demand. ExxonMobil suggested that this imminent shortfall could be addressed by VENCORP advising market participants of the imbalance and calling for new injection nominations; producers could then offer to inject the otherwise suspended volumes. ExxonMobil submitted that if normal bilateral sales agreements were subsequently established by the RoLR to cover at least the three month moratorium period, the spot market injections by producers would be replaced by normal injections by the RoLR at the supply points. It stated that an outcome where VENCORP was obliged to 'direct' one or more producers to supply injection volumes because of an anticipated supply shortfall should be avoided as the producers involved would be unsure of the pricing basis of any gas they supplied, and the volumes involved could be significant.

VENCORP was concerned that the security of the gas transmission system is maintained – that is, there is adequate supply to meet demand if a RoLR event occurs. It submitted that if a local retailer fails during winter, then sufficient supplies of gas may not be made available to the market to meet demand during cold snaps. VENCORP argued there should be a mechanism to ensure that the gas supplies of a failed local retailer can continue to be made available to the market.

As stated in the draft decision paper, the Commission expects that on the occurrence of a RoLR event a RoLR would immediately commence negotiations with gas producers and/or the administrator of the failed retailer to obtain access to sufficient gas to satisfy its RoLR obligations. The Commission noted that if the gas supply available in the market is insufficient to meet demand – for example, because of contractual obligations – the Governor in Council may declare that the gas supply emergency provisions in part 9 of the Gas Industry Act are to apply. The relevant Minister may then, having regard to the needs of the community, give any directions that the Minister thinks necessary to regulate the use of the available supply of gas. The Commission considers that the gas supply emergency provisions are an adequate mechanism to ensure that, if necessary, the gas supplies of a failed retailer can continue to be made available to the market. It notes that the price of any gas supplied by producers in these circumstances is not a matter that is determined by the Commission.

Final decision

A gas RoLR will be required to source any additional gas supplies that it may require to satisfy its RoLR supply obligations from the wholesale gas market.

The Commission noted in the draft decision paper that, unlike the electricity spot market, the spot market in gas is a net market where only imbalance values are traded. The data available for the Victorian wholesale gas spot market suggested that there is a lack of price volatility, with the exception of the high demand days during the winter peak period.¹⁷ In addition, the confidential nature of the upstream gas supply contracts made it difficult for the Commission to determine a range of RoLR costs for wholesale gas with any degree of certainty. For these reasons, the Commission decided not to make any provision in the RoLR supply fee for additional wholesale gas costs that may be incurred by a RoLR.

AGL and Origin Energy expressed concerns about the Commission's draft decision that the RoLR supply fee would not provide for any additional wholesale gas costs that may be incurred by a RoLR. AGL stated that a RoLR event has the potential to increase volatility in the Victorian wholesale gas spot market. It claimed the fact that the Commission has not been able to undertake a review of gas costs due to the confidential nature of gas supply arrangements does not mean that a gas RoLR will not face additional risk and therefore incur additional costs. AGL argued that if the Commission adopted AGL's option of establishing an unders and overs account as part of the RoLR cost recovery mechanism, it would be less important to accurately determine the level of the up front RoLR supply fee. It suggested that the RoLR supply fee for gas could be set at the same level as for electricity given that any shortfall or over recovery would be addressed following a review of the RoLR's prudent costs. The unders and overs account option proposed by AGL is considered in section 4.3.1 under the fallback mechanism for RoLR cost recovery.

Origin suggested that the Commission's approach represents a misunderstanding of the gas market. It submitted that – in much the same way as electricity – while gas will be available in the market, price instability may still occur where a retailer does not have a physical hedge and gas producers see an opportunity to exploit the situation. Origin claimed that historical spot pricing in the gas market does not give an indication of the future supply or demand situation, in particular given VENCORP's new intra day locational pricing procedures. It suggested that the Commission should carry out further analysis of gas prices under market conditions.

In response to the above arguments supporting a RoLR supply fee that includes an allowance for additional wholesale gas costs that may be incurred by a RoLR, the Commission sought advice from ACG about whether it was possible to determine a reasonable range of such costs. ACG advised that it could estimate the costs that a RoLR is likely to incur for the purchase of wholesale gas to supply its RoLR customers. ACG used an approach for estimating the wholesale gas cost that is similar to the approach used for electricity (discussed in section 4.2.1), that is:

- describe an appropriate set of scenarios
- estimate wholesale costs that would be incurred under the various scenarios
- assign weightings that represent reasonable probabilities of occurrence to each scenario
- calculate the weighted average cost.

¹⁷ During the 2004 winter peak period (1 June - 30 September), the consumption of gas in Victoria exceeded 800 TJ per day on 89 days; information available at http://www.vencorp.com.au/docs/mibb/Price_and_Withdrawals_2004.xls

In applying the above approach to gas RoLR customers, ACG analysed scenarios, costs and weightings covering a reasonable range of purchasing strategies and prevailing prices in the gas wholesale market at the time of a RoLR event and for the following three months. A RoLR event will not affect the demand for gas, but may change the supply arrangements (depending on the terms of gas supply contracts) and the wholesale gas price. The discussion below provides an overview of the scenarios, costs and weightings chosen by ACG. These are discussed further in appendix 2.

Price scenarios

ACG chose six price scenarios to represent a plausible range of scenarios that might apply to RoLR wholesale gas purchases. Four of the scenarios represent situations in which a RoLR purchases gas through the spot market at market prices. The other two scenarios are contracting strategies where the retailer arranges gas supply contracts to reduce exposure to spot market prices.

Scenarios one to three assume that a RoLR purchases gas from the spot market and that the RoLR event does not affect the market significantly. The prices are based on historical spot market prices and take account of low, average and high spot prices respectively – plus a one per cent risk allowance. Scenario four assumes that a RoLR purchases gas from the spot market at the high spot price, but that a price shock pushes the price to VoLL (\$800 per GJ) for one day and is then set by VENCORP to the administered price (\$80 per GJ) for a further five days. The combined weighting of scenarios one, two, three and four is 25 per cent, and sensitivities have been calculated at 10 per cent and 40 per cent.

Scenario five 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 that for standing offers. Scenario six assumes much less competition because supply contract volumes for commodity and capacity are tightly held. Scenarios five and six have a combined weighting of 75 per cent.

Load scenarios

ACG considered two separate load scenarios – low load and high load. The low load period was determined using consumption during the January-March quarter and the high load period used consumption during the July-September quarter. The percentage seasonal split was calculated from the total VENCORP load, rather than from consumption directly attributable to mass market customers. The high load period occurs in the winter peak period – June 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. An equal weighting was attributed to scenarios five and six during high load periods, but scenario six has a zero weighting during low load periods because competition for supply is much more likely.

The wholesale gas component of the RoLR supply fee is discussed in section 4.3.2.

4.2.3 Network charges and market fees

As stated in the draft decision paper, the Commission recognises that a RoLR will incur additional network charges and market fees associated with the provision of RoLR services. The Commission considers that there is no need to develop a benchmark of network charges and market fees if the standing offer tariff is used as the basis for the RoLR tariff. The reason for this is that a RoLR tariff that incorporates the standing offer tariff already provides for the recovery of the network charges and market fees incurred during the provision of RoLR services.

4.2.4 Distributor costs

Commercial risks

AGL commented that, as part of the Electricity Distribution Price Review 2006-2010, the Commission is considering a request by distributors to recover the bad debts of a failed retailer following a RoLR event. AGL argued that the protection of distributors against the bad debts of a failed retailer should occur through appropriate prudential requirements or credit support, and that it is not appropriate for retailers in a competitive market to bear the cost of a failed retailer. It submitted that, for the integrity and stability of the energy market, any participant entering the market must be required to either demonstrate financial capacity such as an appropriate credit rating or provide parent company or bank guarantees. AGL stated that any decisions to allow the pass through of bad debts of a failed retailer could act as disincentive for prudent credit management by distributors, potentially increasing the costs to the market.

As stated in the draft decision paper, the Commission does not propose to deal with the above issues as part of the energy RoLR arrangements. These issues have already been considered and dealt with by the Commission; in gas during the Review of Gas Access Arrangements 2003-2007 and in electricity during the Electricity Distribution Price Review 2006-2010.

Processing costs

In their submissions to the issues paper, a number of stakeholders claimed that electricity and gas distributors require cost recovery for the extra manual processing that will be necessary – to acknowledge and recognise transfers, provide estimated meter reads, create data streams, provide customer details, manage service orders that are in progress and bill retailers out of normal meter read sequence – on the occurrence of a RoLR event. The Commission notes, as it did in the draft decision paper, that the 2003-2007 gas access arrangements provide for gas distributors to recover costs associated with any additional RoLR obligations imposed on them during the access arrangement period via a change in tax pass through mechanism. The cost pass through relates both to the cost of any up front activities required (such as installing systems) and to the cost of responding to a RoLR event (should such an event arise). The Electricity Distribution Price Review 2006-2010 final decision allows electricity distributors to apply for a pass through for the incremental costs that arise from a ‘declared’ RoLR event where these are material and cannot be recovered through another mechanism.

4.2.5 Retail operating costs

A retailer's operating costs typically include billing, call centre operations, administration, corporate overheads, regulatory compliance, marketing and advertising. As stated in the draft decision paper, the standing offer tariff allows electricity and gas retailers to recover the costs of providing retail services as well as an appropriate profit margin.¹⁸ The incremental retail operating costs that are likely to be incurred by a RoLR include administration and staffing costs associated with billing and providing information to RoLR customers.

In its submission to the issues paper, AGL stated that a RoLR will incur establishment costs prior to the occurrence of a RoLR event – to implement system changes and processes to potentially transfer large numbers of customers and provide communication capability – that will only be recoverable if a RoLR event occurs. It argued that these costs should be recognised as an additional cost of RoLR supply and passed through to customers as part of the current retail price path.

The Commission notes, as it did in the draft decision paper, that it has obtained 'in principle' agreement from the Department of Infrastructure that it will pursue within Government that the current RoLR legislative provisions should be amended to provide a RoLR with access to the failed retailer's customer information and other IT systems for the purposes of enabling the RoLR to invoice customers. The Commission considers that this approach will (1) overcome the difficulties associated with transferring customer information from the failed retailer to a RoLR in a short period of time on the occurrence of a RoLR event, (2) minimise the establishment costs that may be incurred by prospective RoLRs and (3) substantially reduce the customer transfer costs that may be incurred by a RoLR on the occurrence of a RoLR event. This issue is discussed further in section 5.2.1.

¹⁸ The Commission understands that the four year retail price path agreement between the Victorian Government and local retailers for electricity and gas standing offer tariffs over the period 2004-07 allows the local retailers to recover retail operating costs of \$92 per customer per annum. See Charles River Associates 2003, *Electricity and Gas Standing Offers and Deemed Contracts (2004-2007)*, pages 25, 28-29; report to the Victorian Department of Infrastructure, available at: <http://www.doi.vic.gov.au/DOI/Internet/Energy.nsf/AllDocs/462C48202A205DEDCA256E00007CD717?OpenDocument>

4.3 Energy pricing decision – relevant customers

Draft decision

The RoLR tariff for relevant customers will comprise:

- the standing offer tariff under the safety net provisions of the Electricity Industry Act and the Gas Industry Act; and
- a one off, up front RoLR supply fee of \$44 for electricity RoLR customers and \$23 for gas RoLR customers (escalated by the Consumer Price Index) for the recovery of incremental energy and retail operating costs above those incorporated in the standing offer tariff.

The Commission will also mandate a moratorium on transfers by relevant customers of the RoLR (who have been transferred from the failed retailer) during the RoLR supply period. It will do this by inserting a new condition in each of the electricity and gas retail licences prohibiting each licensee – other than the RoLR – from supplying electricity or gas to relevant customers of the RoLR during the RoLR supply period.

Discussion

The discussion below contains the Commission’s views regarding the RoLR tariff comprised of the standing offer tariff and an up front RoLR supply fee, the potential offsets to the risks and costs that are likely to be faced by a RoLR, and the appropriate level of the RoLR supply fee.

4.3.1 Standing offer tariff and up front RoLR supply fee

Origin Energy argued that an up front fixed supply fee added to the standing offer tariff will not appropriately capture or recover the costs that may be imposed on a retailer in its RoLR capacity. It claimed that the likely broad range of circumstances underpinning this extreme situation makes arriving at any fixed financial risk estimate inherently problematic. Origin commented, however, that its submission only discussed the level of the fixed fee given that the Commission has determined that it will proceed with a RoLR tariff comprised of the standing offer tariff and an up front RoLR supply fee. It stated that it is not comfortable that the level proposed by the Commission for electricity or gas will adequately recover RoLR costs.

AGL submitted that the RoLR pricing arrangements must provide for all costs associated with the provision of RoLR services to be recovered. It argued that the RoLR supply fee should also include any approved RoLR event related pass through costs by a distributor. The Commission does not consider that the RoLR supply fee should include distributor pass through amounts resulting from a RoLR event because the relevant amounts will not be known at the time of the RoLR event. It also notes that distributor pass through amounts are normally recovered from all customers and therefore all retailers – rather than only local retailers acting in their capacity as RoLRs – are likely to be affected.

The Commission considers – as it did in the draft decision paper – that a RoLR tariff for relevant customers based on the standing offer tariff, together with a one off, up front RoLR supply fee, is appropriate for a RoLR to recover the costs associated with its RoLR supply obligations in the first instance. The standing offer tariff is approved by the Victorian Government on the basis that

it provides a sufficient return to the electricity and gas retailers after allowing for the recovery of energy costs, network charges and market fees, and retail operating costs. It also provides customers with access to a fair and reasonable tariff. A RoLR tariff based on the standing offer tariff thus allows a RoLR to recover most of its RoLR supply costs and also protects the interests of customers. The Commission is cognisant that expiry of the safety net provisions may impact on a RoLR pricing structure that is based on the standing offer tariff, but it notes that the standing offer tariff could be indexed to determine the relevant RoLR tariff.

The Commission acknowledges that wholesale energy prices – and particularly wholesale electricity prices – at the time of a RoLR event may be higher than the prices on which the standing offer tariff is based. It also acknowledges that a RoLR is likely to incur additional retail operating costs such as administration and staffing costs associated with billing and providing information to RoLR customers. The Commission considers that an up front RoLR supply fee is the simplest mechanism for a RoLR to recover from its RoLR customers the incremental energy and retail operating costs above those incorporated in the standing offer. The stakeholder and Commission views regarding the appropriate level of the RoLR supply fee are discussed in section 4.3.2.

On balance, the Commission considers that a RoLR tariff comprised of the standing offer tariff and an up front RoLR supply fee most effectively satisfies the Commission’s pricing criteria. In particular, it allows for the recovery of reasonable costs associated with RoLR supply, protects the interests of customers, minimises the administrative costs of the RoLR scheme, and insulates customers from volatility in wholesale electricity prices.

The Commission notes that its approach to RoLR pricing is similar to the electricity RoLR pricing scheme that has been implemented in New South Wales and the scheme that is currently being proposed in South Australia. The NSW electricity RoLR scheme provides that a RoLR may require a RoLR customer to pay a last resort supply fee not exceeding \$50.¹⁹ In South Australia, ESCOSA has proposed that the RoLR tariff should comprise the standing contract rate plus either (1) a fixed component or (2) a percentage premium.²⁰ The Commission agrees with ESCOSA that it is not appropriate to subject small RoLR customers to the uncertainties associated with pass through of the NEM wholesale pool price.

Moratorium on RoLR customer transfers

As stated in the draft decision paper, it may be difficult for a RoLR to recover its RoLR supply costs from RoLR customers who choose to transfer to another retailer shortly after the RoLR scheme is triggered. The Commission thus decided to mandate a moratorium on transfers by relevant customers of the RoLR (who have been transferred from the failed retailer) during the RoLR supply period. It would do this by inserting a new condition in each of the electricity and gas retail licences prohibiting each licensee – other than the RoLR – from supplying electricity or gas to relevant customers of the RoLR during the RoLR supply period. A moratorium on RoLR customer transfers would promote stability in the energy market following a RoLR event, particularly in the case of a local retailer failure.

¹⁹ *Electricity Supply (General) Regulation 2001* (NSW), reg. 62(5). The last resort supply fee cannot be charged to a customer on a standing contract immediately prior to the RoLR event. The actual fee has been set at \$25 by Ministerial direction.

²⁰ Essential Services Commission of South Australia 2005, *Electricity Retailer of Last Resort – Discussion Paper*, section 4.2.

The Commission considers that a moratorium on transfers by relevant customers of a RoLR – together with a RoLR tariff comprised of the standing offer tariff and an up front RoLR supply fee – will provide substantial cash flow certainty to a RoLR. A three month moratorium on RoLR customer transfers, for example, would allow the RoLR to retain the RoLR customers for at least one billing cycle in both electricity and gas. The Commission also notes the commercial incentive on the RoLR to try to retain the customers that it has acquired under the RoLR scheme.

EWOV commented that RoLR customers will be adversely impacted by the inability to switch retailers during the RoLR supply period. AGL supported a moratorium on customer transfers where this can be achieved in a cost effective manner as it would help achieve stability in the market. It stated that the decision may need to be reviewed if the costs of implementing the moratorium outweigh the benefits. VENCORP submitted that the decision to impose a moratorium on customer transfers following a RoLR event, though feasible, may be difficult and costly to implement. The Commission will continue to consult with relevant stakeholders so that a moratorium on transfers by relevant customers of a RoLR can be implemented in a cost effective manner.

The Commission also decided in the draft decision paper that it will not mandate a moratorium on transfers by large customers of the RoLR (who have been transferred from the failed retailer) during the RoLR supply period. It considered that a RoLR will be in a better position to recover its RoLR supply costs from large customers without a moratorium than it will be from relevant customers because the RoLR tariff for large customers – which will be determined by agreement with each large customer – is likely to be more cost reflective than a RoLR tariff specified by the Commission. No submissions received in response to the draft decision paper commented on this issue.

Benefits of acquiring RoLR customers

As stated in the draft decision paper, the Commission considers that the risks and costs associated with a RoLR's obligations must be balanced against the potential benefits of acquiring new customers under the RoLR scheme. A customer base is a significant asset to a retailer and the acquisition of customers under a RoLR scheme provides a retailer with an opportunity to establish a long-term commercial relationship with those customers – and thus increase its market share – without the marketing costs that are normally associated with customer acquisition. The Commission noted that the acquisition of new customers pursuant to a RoLR scheme is likely to be more cost effective than the purchase of customers from a trade sale of an energy retail business. In July 2002, for example, AGL reportedly paid approximately \$820 for each customer of Pulse Energy; the amount paid per customer was considered to be consistent with previous industry acquisitions.²¹ The Commission also noted that although there is a risk that a predetermined RoLR supply fee may not fully compensate the RoLR during a period of very high wholesale energy prices, this risk is likely to be offset by the potential benefits to the RoLR of acquiring new customers pursuant to the RoLR scheme.

Origin Energy reiterated the comments from its submission in response to the issues paper. It argued that the value of the benefit to the RoLR of having a larger customer base cannot be

²¹ The Sydney Morning Herald website: <http://www.smh.com.au/articles/2002/07/02/1023864733126.html>

determined until after the RoLR event has transpired, the moratorium on transfers has ceased, transfers have occurred and the customers are set on the standing offer or new contracts and their energy demand is estimated. Origin further argued that the value may actually be negative, especially if wholesale prices are greater than anticipated, systems cannot handle the customer influx or demands, or if customers are not inclined to pay their newly increased bills. It stated that a RoLR event will place extreme pressure on retailers and to suggest that under recovery will be mitigated by the benefits is far from guaranteed, and may in fact place the RoLR in financial difficulty.

The Commission acknowledged in both the issues paper and the draft decision paper that it is difficult to accurately quantify the potential financial benefits to the RoLR of acquiring new customers under the RoLR scheme. In light of the analysis detailed below, the Commission continues to consider that these benefits are likely to be material and should at least partly offset the risks and costs associated with providing RoLR services. It notes that the new customers will have been acquired by the RoLR without the marketing costs that retailers would normally incur in a competitive market, such as those associated with research, discounting and promotion.

The margin analysis contained in the Commission's FRC effectiveness review indicated that for the highest cost acquisition channels, a customer may need to provide a margin of \$40 to \$50 per year over three years for a retailer to have an incentive to offer a competitive contract.²² These customer acquisition costs would not be incurred by a retailer who acquires new customers under the RoLR scheme. In addition, a RoLR may obtain benefits associated with improved economies of scale and increased profit margin per customer. A cost-benefit assessment conducted for the Queensland Office of Energy indicated that, relative to an assumed average retailer operating cost of \$50 per residential customer per year, the estimated variable cost of additional customers was in the range of \$25 to \$35 per year.²³ This assessment suggests that RoLR customers could be more profitable to a retailer than its existing customers.

Fallback mechanism for RoLR cost recovery

In their submissions to the issues paper, Origin Energy and AGL suggested that the Commission should develop a levy mechanism so that some of the costs associated with a RoLR event can be spread across all customers. The purpose of the levy would be to create a fund that could be drawn upon to satisfy any shortfall in cost recovery experienced by a RoLR in meeting its RoLR supply obligations. Origin supported a levy on use of system charges – similar to the arrangement adopted by Ofgem that allows a RoLR, in certain circumstances, to claim for the otherwise unrecoverable costs that it has incurred in being a RoLR – to distribute some of the costs of the failed retailer across all customers. AGL suggested that any shortfall in the recovery of energy costs by a RoLR could be recovered in the form of a levy placed on the entire market in the following twelve month period.

The Commission noted in the draft decision paper that in rare circumstances where sustained high energy prices are experienced during a RoLR supply period, the costs incurred by a RoLR

²² Essential Services Commission 2004, *Final Report to Minister – Special Investigation: Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity, Background Report*, page 81.

²³ McLennan Magasanik Associates 2003, *Gas FRC Cost-Benefit Assessment*, page 46; report to the Queensland Office of Energy, available at: <http://www.energy.qld.gov.au/images/mma%20gas%20frc%20report%2028mar03%20consultation.pdf>

may exceed the amount recovered from a RoLR tariff that comprises the standing offer tariff and an up front RoLR supply fee. The Commission considered whether it would be possible to impose a levy on all customers to (1) spread the costs of a RoLR event and (2) compensate a RoLR for any shortfall in cost recovery. The Commission's legal advice indicated that, under the RoLR provisions in the Electricity Industry Act and the Gas Industry Act, the RoLR tariffs can only be applied to the customers of the failed retailer; they cannot be applied to the RoLR's other customers or to customers generally.

The Commission noted that the options suggested by Origin and AGL involved the Commission imposing a levy on retail customers (either directly, or indirectly through use of system charges) and creating a fund of some kind (presumably administered by the Commission) to be applied for the benefit of the customers of a failed retailer. The Commission's legal advice indicated that such a levy would effectively involve the Commission imposing a compulsory charge on retail customers and would be in the nature of a tax. As a general proposition, the imposition of a tax requires statutory authorisation, and there is nothing in the Electricity Industry Act or the Gas Industry Act that would be sufficient authorisation for this purpose. Even if such a power could be inferred, there is nothing in either Act that would permit the Commission to constitute a fund into which the proceeds of the levy could be paid and applied; the levy would need to be paid into the Consolidated Fund in accordance with section 89 of the *Constitution Act 1975*.

As an alternative to a market wide RoLR levy, the Commission discussed with the Department of Infrastructure (DoI) whether it would be possible to re-open the four year retail price path agreement between the Victorian Government and local retailers. DoI advised the Commission that if a local retailer – acting in its capacity as a RoLR – experiences a material shortfall in cost recovery while satisfying its RoLR supply obligations, this may be able to be dealt with under the current retail price path arrangements. It indicated that a RoLR would be required to demonstrate that its relevant net costs of supply have increased substantially.

AGL argued that the RoLR supply fee needs to be supplemented by an unders and overs account to provide a RoLR with certainty that it can recover all prudent costs in providing RoLR services. It submitted that an unders and overs account would allow for variances from the estimated up front RoLR supply fee. AGL indicated that a similar option has been proposed by ESCOSA as part of the development of an electricity RoLR scheme in South Australia. The Commission notes that an unders and overs account may be used to determine the amount of any under or over recovery of RoLR costs, but it is not a RoLR cost recovery mechanism per se. AGL also claimed that the standing offer tariff could be replaced with a tariff that is generally available to small retail customers on 'evergreen' (no fixed term) contracts to accommodate RoLR services that may be provided by non-standard retailers or a regime which does not regulate retail prices for small customers.

Origin Energy stated that it recognises the difficulty in determining an appropriate fixed up front RoLR supply fee ahead of a RoLR event, and that it thus seems reasonable to also focus on developing a mechanism whereby actual costs which cannot be recovered through the pre-approved price structure can be recovered by other means. It supported a flexible means of recovering costs and welcomed any commitment from Government to be involved in ensuring cost recovery, but argued that re-opening the price path agreement between Government and the local retailers for RoLR purposes is not an appropriate solution and raises important questions of equity and risk management.

Origin submitted that the customers or shareholders of local retailers should not bear the bulk of the costs of a RoLR event. It commented that a RoLR event – although unlikely – will be a crisis that affects the whole market and it is therefore the responsibility of all those involved in the market (including those who benefit from it) to support it at such a time to maintain system integrity. Origin claimed that it is fundamentally unjust to expect only the RoLR’s customers – that is, the current deemed, standing offer and market contract customers, in addition to the customers transferred from the failed retailer – to pay for the poor commercial judgement of an unrelated business. It also claimed that such an outcome will have negative competitive effects on a RoLR because current customers will seek to shift to retailers with lower prices, and that a smaller customer base will impact on the RoLR’s ability to recover costs.

Origin stated that the following specific issues underpin its overall concern about the proposed RoLR fallback mechanism:

- The retail price path only applies to customers on deemed and standing offer contracts; it does not apply to customers on market contracts. It assumed that the Commission’s silence about market contract coverage is because market contracts are not subject to price regulation and retailers can therefore pass through cost increases to these customers if it is allowed by the contractual provisions.
- It is not clear whether the proposed fallback mechanism would apply to the regulated customers of only the RoLR in question or all local retailers. If the deemed and standing offer customers of only the RoLR have their prices increased to recover RoLR costs, the RoLR would be at risk of losing these customers to competitors. Alternatively, if for equity reasons – and to reduce the price increase per customer – all local retailers’ regulated customers have their prices increased to meet RoLR costs, it is unclear how the money would be recovered and delivered back to the retailer who is actually bearing the costs. It also notes that market contract customers – other than those of the failed retailer – will not contribute.
- The MoU that underpins the retail price path agreement between Government and the local retailers currently provides a specific range of allowed margins. It is possible that RoLR costs may impact on retailer margins but not actually trigger a re-opening of the price path. It is effectively asking retailers who have managed their commercial risks to subsidise retailers who have failed to manage their risks – for example, through unsound pricing or marketing practices.

Origin argued that, in summary, customers or shareholders of local retailers should not bear RoLR costs just because those costs were not anticipated by the Commission at the time of drafting its RoLR policy. It also claimed that, ideally, not even the customers of the failed retailer would pay all of the RoLR costs as they cannot be expected to have had perfect information about the failed retailer’s financial position or practices at the time when they made their decision.

Origin further submitted that as a small – but significant – risk to the market as a whole, Government should absorb any costs of a RoLR event that exceed a ‘reasonable’ amount charged to RoLR customers, such as the Commission’s standing offer tariff and RoLR supply fee proposal. It suggested that Government could recover these costs through a charge levied on all customers after the event or alternatively through consolidated revenue. Origin also suggested

that Government needs to provide stronger messages to industry about its willingness to manage unforeseen or additional costs resulting from a RoLR event. It stated that if this is not possible under existing legislation because RoLR costs can only be recovered from customers of the failed retailer, the legislation should be amended to explicitly make provision for Government to take responsibility for material RoLR costs that were not anticipated by the Commission at the time of setting the RoLR supply fee.

The Commission acknowledges that a fallback mechanism for RoLR cost recovery that involves re-opening the retail price path agreement is inequitable because it only recovers from customers on deemed and standing offer contracts, and not from customers on market contracts. It also notes the other concerns raised by Origin about the proposed RoLR fallback mechanism, including that increased standing offer tariffs may affect the competitive position of local retailers who have acted as RoLRs. In response to these concerns, both the Commission and DoI now consider that re-opening the retail price path agreement is not an appropriate fallback mechanism for RoLR cost recovery.

The Commission proposed to DoI that a preferable option was for the RoLR legislative provisions to be amended to allow the Government to impose a RoLR levy on distribution use of system charges collected by distributors. The purpose of the levy would be to create a fund that could be drawn upon to satisfy any material shortfall in cost recovery experienced by a RoLR in meeting its RoLR supply obligations. The Commission considers that it is reasonable to spread any shortfall in the recovery of RoLR costs across all customers because all customers benefit from an effective RoLR scheme that maintains the integrity of the electricity and gas markets.

Following discussions with the local electricity and gas retailers, DoI advised the Commission that it did not support a fallback mechanism that spreads any shortfall in RoLR cost recovery across the broad customer base. It stated that there is a major legal impediment: the imposition of levies across the energy industry in recent years has led to constitutional issues and claims that such levies effectively impose an excise tax on the industry. DoI commented that it is therefore unwilling to pursue a market wide RoLR levy. Further, DoI argued that sufficient market management tools are already in place to significantly mitigate the costs and risks associated with market disruptions that may be induced by a RoLR event. It stated that in most circumstances there are sufficient competitive tensions in the wholesale market to enable RoLRs to enter into new commercial arrangements. DoI argued that where the market disruption is not able to be managed commercially, the wholesale market rules administered by NEMMCO and VENCORP – together with the emergency declaration powers available to Government – enable timely market interventions that will reasonably address retailer concerns about these substantial cost events.

DoI commented that it is not aware of any significant pre-existing concerns among retailers and generators regarding the current market management tools that are designed to deal with potential market failure events. According to DoI, it is not evident that (1) the Commission's proposal for up front RoLR cost recovery, (2) the acquisition of new customers at low cost under the RoLR scheme and (3) the existing market management tools, do not address the key costs and risks identified to date by retailers. DoI suggested that if retailers are concerned about the adequacy of the factors specified above to deal with particular scenarios, these scenarios should be brought to light as soon as possible.

The Commission considers that it has explored all practical options for a RoLR fallback mechanism, but it has been unable to reach a satisfactory conclusion in relation to any of these options. The Commission is therefore unable to incorporate a fallback mechanism for RoLR cost recovery in the energy RoLR scheme at this time. It considers that the Government should review the need for a RoLR fallback mechanism at regular intervals in the future as the Victorian energy market develops.

4.3.2 Setting the RoLR supply fee

The Commission notes the risks and costs associated with providing RoLR services – including the purchase of electricity or gas in the wholesale market, the payment of network charges and market fees, and meeting incremental retail operating costs – that were discussed in section 4.2. It also notes the discussion in section 4.3.1 that supported a RoLR tariff comprised of the standing offer tariff and an up front RoLR supply fee, and indicated that the Commission’s proposed RoLR scheme contains some potential offsets to the risks and costs that are likely to be faced by a RoLR. In determining the appropriate level of the RoLR supply fee, the Commission has taken into account offsets including (1) the cash flow certainty provided by a moratorium on transfers by relevant customers of a RoLR, (2) the benefits of acquiring new customers under the RoLR scheme and (3) the ability to access the failed retailer’s customer information and other IT systems for the purposes of invoicing RoLR customers.

As stated in section 4.3.1, the up front RoLR supply fee is intended to compensate a RoLR for the incremental energy and retail operating costs above those incorporated in the standing offer tariff. The standing offer tariff will allow a RoLR to recover the additional network charges and market fees associated with supplying its RoLR customers. The Commission’s analysis regarding the appropriate level of the RoLR supply fee is contained below.

Wholesale electricity costs

As stated in section 4.2.1, the Commission’s margin analysis in the FRC effectiveness review used a wholesale electricity cost in the range of \$55 to \$65 per MWh. The analysis undertaken by ACG suggested that the range of RoLR costs for wholesale electricity is \$60 to \$80 per MWh.

Since a RoLR will be permitted to charge the standing offer tariff to its RoLR customers, ACG subtracted the allowance in the standing offer tariff for pool and contract purchases from the RoLR cost range for wholesale electricity in order to calculate the additional RoLR wholesale electricity cost. The lower end of the Commission cost range, namely \$55 per MWh, was subtracted as the allowance for pool and contract purchases in the standing offer tariff, leaving an additional RoLR wholesale electricity cost of \$5 to \$25 per MWh.

The ACG analysis suggests that a RoLR should be willing to accept compensation in the range of \$6.90 to \$34.40 per customer for the wholesale electricity cost of serving an average customer acquired on the occurrence of a RoLR event (in addition to the electricity standing offer tariff). This range is calculated as the additional RoLR wholesale electricity cost (\$5 to \$25 per MWh) multiplied by customer consumption of 1.375 MWh for three months, based on an average

customer consumption of 5.5 MWh per annum.²⁴ As the distribution of prices within the range is likely to be symmetric – that is, the probabilities of low prices are similar to the probabilities of high prices – the best estimate is the midpoint, namely \$20.60 per customer.

As stated in the draft decision paper, the Commission agrees with the methodology used and analysis undertaken by ACG to determine a reasonable range of costs that a RoLR is likely to incur for the purchase of wholesale electricity. It notes that the scenario probabilities used in the ACG analysis are likely to overstate the risks to a RoLR and that the amount of \$20.60 per customer is therefore likely to be conservative. The Commission also notes, however, that the pricing criteria require that RoLR tariffs should protect financial flows within the energy industry and take account of reasonable risks and costs associated with the provision of RoLR services. On balance, the Commission considers that a conservative estimate should be adopted and that a RoLR should be entitled to recover \$21 per customer for the additional RoLR wholesale electricity cost. It notes that the energy RoLR scheme no longer includes a fallback mechanism for RoLR cost recovery.

Wholesale gas costs

Given the inherent lack of price volatility in the Victorian wholesale gas spot market and the confidential nature of the contractual upstream gas supply arrangements, the Commission did not attempt in the draft decision paper to undertake the above analysis in relation to the RoLR costs for wholesale gas. It noted that the Commission's margin analysis in the FRC effectiveness review used a wholesale gas cost of \$3.50 per GJ.²⁵ The Commission decided not to make any provision in the RoLR supply fee for additional wholesale gas costs that may be incurred by a RoLR. It considered that if a local gas retailer – acting in its capacity as a gas RoLR – incurs wholesale gas costs that substantially exceed those incorporated in the standing offer tariff, those costs should be recovered under the retail price path arrangements with the Victorian Government. The Commission notes that the energy RoLR scheme no longer includes a fallback mechanism for RoLR cost recovery.

Consistent with the discussion in section 4.2.2, the Commission acknowledges that it is possible to make provision in the RoLR supply fee for additional wholesale gas costs that may be incurred by a RoLR. Further to the development of price and load scenarios, costs and weightings, ACG used four steps to calculate the wholesale gas cost per customer for inclusion in the RoLR tariff:

1. A benchmark rate of \$3.64 per GJ was determined by using the Consumer Price Index (1.039) to convert the wholesale gas cost used in the Commission's FRC effectiveness review margin analysis (\$3.50 per GJ) from June 2004 to December 2005 dollars.
2. The benchmark rate was subtracted from the wholesale gas cost for each price scenario to calculate the cost per GJ in addition to the benchmark rate.

²⁴ An average electricity consumption of 5.5 MWh per customer per annum is broadly consistent with the findings of the Victorian Utility Consumption Survey 2001 (for non-cardholder households) to which reference is made in Essential Services Commission 2004, *Final Report to Minister – Special Investigation: Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity, Background Report*, page 62.

²⁵ Essential Services Commission 2004, *Final Report to Minister – Special Investigation: Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity, Background Report*, Attachment 4.

3. The resulting cost per GJ for each price scenario was multiplied by the average customer usage during low and high load periods to determine the cost per customer. The outcomes of steps two and three are shown in table 4.2.²⁶
4. The cost per customer during low and high load periods was multiplied by the low and high load weightings respectively for each price scenario to determine their contribution to the final weighted additional cost per gas RoLR customer. The outcome of step four is shown in table 4.3.²⁷

Table 4.2 Costs per customer

	Price Scenario	Wholesale cost \$/GJ	Costs in addition to benchmark		
			\$/GJ	low load (12.4 GJ) \$/customer	high load (24.8 GJ) \$/customer
1	Low spot market price	\$2.96	-\$0.68	-\$8.31	-\$17.03
2	Average spot market price	\$3.04	-\$0.60	-\$7.31	-\$14.99
3	High spot market price	\$3.14	-\$0.50	-\$6.05	-\$12.40
4	Extreme spot market price	\$16.12	\$12.48	\$152.30	\$312.22
5	Contract - competitive suppliers	\$3.67	\$0.04	\$0.44	\$0.91
6	Contract - tight supply market	\$5.73	\$2.09	na	\$52.24

Source: The Allen Consulting Group analysis

²⁶ Table 4.2 shows that the range of possible additional RoLR costs varies between negative \$17 per customer (if a spot market strategy is chosen and the spot market price is low) and \$312 per customer (if full spot exposure is taken and there is an extreme price event).

²⁷ Table 4.3 shows the contribution of each price scenario to the final weighted additional cost of \$6.57 per gas RoLR customer. For example, extreme spot market prices contribute 0.67 per cent multiplied by \$152.30 (low load) plus 0.33 per cent multiplied by \$312.22 (high load) – or \$2.06 per customer – to the total cost.

Table 4.3 Scenario weightings and costings

	Price Scenario	Low load weighting	High load weighting	Low load \$/customer	High load \$/customer	Contribution
1	Low spot market price	4.00%	2.00%	-\$8.31	-\$17.03	-\$0.67
2	Average spot market price	8.00%	4.00%	-\$7.31	-\$14.99	-\$1.18
3	High spot market price	4.00%	2.00%	-\$6.05	-\$12.40	-\$0.49
4	Extreme spot market price	0.67%	0.33%	\$152.30	\$312.22	\$2.06
5	Contract - competitive suppliers	50.00%	12.50%	\$0.44	\$0.91	\$0.34
6	Contract - tight supply market	0.00%	12.50%	na	\$52.24	\$6.53
Weighted cost						\$6.57

Source: The Allen Consulting Group analysis

The wholesale gas cost analysis conducted by ACG, including its sensitivity assessment, is discussed further in appendix 2.

The ACG analysis suggests that a RoLR should be willing to accept compensation of \$6.57 per customer for the wholesale gas cost of serving an average customer acquired on the occurrence of a RoLR event (in addition to the gas standing offer tariff). The Commission accepts the methodology used and the analysis undertaken by ACG to determine the costs that a RoLR is likely to incur for the purchase of wholesale gas. Consistent with the wholesale electricity cost analysis, the Commission considers that a conservative estimate should be adopted and that a RoLR should be entitled to recover \$7 per customer for the additional RoLR wholesale gas cost.

Retail operating costs

As stated in section 4.2.5, the Commission understands that the four year retail price path agreement between the Victorian Government and local retailers for electricity and gas standing offer tariffs allows the local retailers to recover retail operating costs of \$92 per customer per annum. The Commission noted in that section that a RoLR is likely to incur additional administration and staffing costs associated with billing and providing information to RoLR customers.

Given that the maximum RoLR supply period is three months, the Commission's draft decision was that a RoLR should be entitled to recover an additional 25 per cent above the \$92 per customer per annum for retail operating costs that is allowed under the retail price path agreement – that is, \$23 per electricity and gas RoLR customer. It noted that this amount is conservative as a RoLR's incremental operating costs over a three month RoLR supply period are likely to be less than 25 per cent of a retailer's annual operating costs per customer. There were no comments about this issue in any of the submissions received in response to the draft decision paper.

As noted in section 4.2.5, the RoLR legislative provisions are likely to be amended to provide a RoLR with access to the failed retailer's customer information and other IT systems for the purposes of enabling the RoLR to invoice its RoLR customers. The Commission considers that this legislative amendment will minimise the establishment costs that may be incurred by prospective RoLRs. As stated in the draft decision paper, the Commission will therefore not allow for the recovery of any RoLR establishment costs as part of the RoLR supply fee.

Commission conclusions

In summary, having noted the risks and costs associated with the purchase of wholesale electricity and the analysis undertaken by ACG, the Commission concludes that the up front RoLR supply fee will incorporate an allowance of \$21 per customer for additional RoLR wholesale electricity costs and \$7 per customer for additional RoLR wholesale gas costs. The Commission also considers that an additional 25 per cent above the annual amount for retail operating costs that is allowed under the retail price path agreement – that is, \$23 per electricity and gas RoLR customer – should be included in the up front RoLR supply fee. The Commission notes that it has taken a conservative approach and erred in favour of the RoLR when setting the RoLR supply fee for relevant customers.

In reaching these conclusions, the Commission is mindful that the risks and costs associated with the provision of RoLR services that were identified by energy retailers cannot be viewed in isolation. As indicated earlier, the Commission considers that these risks and costs are potentially offset by two key elements of the proposed energy RoLR scheme, namely (1) the moratorium on transfers by relevant customers of a RoLR and (2) the ability of a RoLR to access the failed retailer's IT systems. Both of these offsets should reduce the costs and cash flow exposure that may be faced by a RoLR. The Commission is also mindful of the inherent long-term benefits to a RoLR of acquiring a significant number of new customers who are likely to remain with the RoLR into the future.

Final decision

The RoLR tariff for relevant customers will comprise:

- the standing offer tariff under the safety net provisions of the Electricity Industry Act and the Gas Industry Act; and
- a one off, up front RoLR supply fee of \$44 for electricity RoLR customers and \$30 for gas RoLR customers (escalated by the Consumer Price Index) for the recovery of incremental energy and retail operating costs above those incorporated in the standing offer tariff.

The Commission will also mandate a moratorium on transfers by relevant customers of the RoLR (who have been transferred from the failed retailer) during the RoLR supply period. It will do this by inserting a new condition in each of the electricity and gas retail licences prohibiting each licensee – other than the RoLR – from supplying electricity or gas to relevant customers of the RoLR during the RoLR supply period.

4.4 Energy pricing decision – large customers

Draft decision

The RoLR tariff for large customers should be ‘fair and reasonable’ and comprise the wholesale market energy price, regulated charges, other retail operating costs, an administration fee to cover the costs of providing the RoLR service, and an appropriate profit margin for the RoLR. This assessment will be made by the Commission on receipt of the proposed RoLR tariffs from prospective RoLRs.

Discussion

The Commission acknowledged in the draft decision paper that the acquisition of large customers on the occurrence of a RoLR event may result in a financial exposure for a RoLR. It concluded that, in order to ensure that certainty is provided to all parties and financial flows are protected within the energy industry for the period immediately following a RoLR event, the RoLR tariffs submitted for Commission approval should be ‘fair and reasonable’ and comprise the wholesale market energy price, regulated charges, other retail operating costs, an administration fee to cover the costs of providing the RoLR service, and an appropriate profit margin for the RoLR.

AGL submitted that large RoLR customers should negotiate prices with the competing retailers in the market. It stated that where there are transitional supply arrangements during an interim period when large customers are negotiating alternative supply arrangements (1) the customers should be deemed to be contracted to a RoLR and (2) the RoLR prices should be fair and reasonable. AGL also reiterated its comment in relation to RoLR terms and conditions that RoLR prices for large customers are likely to be unique and hence a review by the Commission of RoLR prices for all large customers is not practical. It suggested that these prices should be subject to a fair and reasonable test.

For the reasons discussed in section 3.2 in relation to RoLR terms and conditions for large customers, the Commission now considers that it should not approve or specify a RoLR tariff for large customers. As stated in the draft decision paper, retail tariffs for large customers under FRC are determined by commercial negotiation between the parties and there is no role for the Commission. The Commission therefore considers that it may lack the necessary expertise to approve or specify RoLR tariffs for large customers. It also agrees with AGL that there may be practical difficulties associated with the role of the Commission envisaged by the RoLR legislation because tariffs for large customers often vary according to consumption patterns and business needs. The Commission considers that the existence of fallback arrangements for large customers under the RoLR scheme is likely to reduce the incentive on the RoLR and/or each large customer to negotiate a contract. Since there will be no moratorium on transfers by large RoLR customers, there will be an incentive for the RoLR to make competitive offers so that the customers do not transfer to other retailers.

To overcome the limitations of the RoLR legislative provisions which envisage that the Commission will approve or specify RoLR tariffs for all classes of customers, the Commission has obtained ‘in principle’ agreement from DoI that it will propose to Government that the current RoLR legislative provisions should be amended to provide the Commission with

discretion to require prospective RoLRs to submit for the Commission's approval proposed RoLR tariffs for different classes of RoLR customers. Following this legislative amendment, the Commission does not intend to approve or specify RoLR tariffs for large customers – though the Commission will retain its current role in relation to relevant customers. The Commission considers that on the occurrence of a RoLR event, fair and reasonable tariffs for the provision of RoLR services will need to be agreed between the RoLR and each large customer.

Final decision

Subject to legislative amendments to provide the Commission with discretion to require prospective RoLRs to submit for its approval proposed RoLR tariffs for different classes of RoLR customers, the Commission will not approve or specify RoLR tariffs for large customers. The Commission considers that on the occurrence of a RoLR event, fair and reasonable tariffs for the provision of RoLR services will need to be agreed between the RoLR and each large customer. The Commission will not mandate a moratorium on transfers by large customers of the RoLR (who have been transferred from the failed retailer) during the RoLR supply period.

5 Implementation

This section contains the Commission's final decisions regarding the RoLR implementation issues that were discussed in the draft decision paper, including the interaction of the RoLR legislative provisions with the Corporations Act 2001 (Cwlth) and the ongoing status of a failed retailer's customer contracts on the occurrence of a RoLR event in respect of that retailer. In response to comments by local retailers about their IT system capabilities, the section outlines an approach discussed with the Department of Infrastructure that will enable a RoLR to access the failed retailer's IT systems for the purposes of invoicing RoLR customers. It also considers distributor, market operator, generator and communication issues relating to RoLR implementation.

5.1 RoLR scheme and the Corporations Act

5.1.1 Potential inconsistencies

The potential for inconsistencies between the RoLR provisions in the Electricity Industry Act and the Gas Industry Act – including any RoLR scheme implemented under those provisions – and the external administration provisions in chapter 5 of the Corporations Act was discussed in both the issues paper and draft decision paper. The Commission noted that if the RoLR scheme purported to effect a transfer of property from the failed retailer to a RoLR – such as to transfer the failed retailer's rights in relation to its customers – this could potentially conflict with the Corporations Act if at the relevant time an insolvency practitioner had been appointed to the failed retailer. The Commission's legal advice indicated, however, that the RoLR provisions do not envisage a transfer of any property of the failed retailer to a RoLR. In particular, there is nothing in the proposed RoLR scheme that purports to transfer the failed retailer's customer contracts in a legal – as opposed to a commercial – sense to a RoLR. The RoLR provisions instead envisage the creation of new contracts between a RoLR and the failed retailer's customers. The Commission thus considers that there is no uncertainty about its ability to allocate the failed retailer's customers to a RoLR on the occurrence of a RoLR event.

The Commission also notes the 'last resort' nature of the proposed RoLR scheme and that the conditions under which the scheme may need to be activated are exceptional. The statutory trigger events are likely to be activated only at the point where a retailer becomes legally or commercially incapable of continuing to supply its customers.

5.1.2 Termination of customer contracts

Draft Decision

The Commission will clarify the ongoing status of a failed retailer's customer contracts by amending the retail licences to require retailers to:

- in the case of single fuel customer contracts, include a term that the contracts will automatically terminate on the occurrence of a RoLR event in respect of that retailer, without any penalty or exit fee payable by the customers

- in the case of dual fuel customer contracts, include a term that:
 - if RoLR events in respect of that retailer occur simultaneously in relation to both fuels, the contracts will automatically terminate, without any penalty or exit fee payable by the customers
 - if a RoLR event in respect of that retailer occurs in relation to only one of the fuels (1) the contracts will automatically terminate in respect of the fuel that can no longer be supplied but continue in respect of the unaffected fuel and (2) the customers have an option to terminate the contract in its entirety on a relatively short period of notice to the retailer (for example, seven days), without any penalty or exit fee payable.

Discussion

AGL submitted that a RoLR's financial responsibility for RoLR customers should only commence from the date that a RoLR event is declared. It stated that a RoLR should not have any retrospective financial responsibility for periods prior to the acquisition of RoLR customers. As the Commission stated in both the issues paper and draft decision paper, the RoLR statutory provisions have the effect of creating a new deemed contract between the RoLR and the failed retailer's customers on the occurrence of a RoLR event.²⁸ The deemed contract comes into existence immediately on the occurrence of a trigger event, without the need for any active step to be taken by the RoLR, the failed retailer or the affected customers. The Commission has not suggested in any previous RoLR consultation paper that a RoLR should have financial responsibility for the failed retailer's customers prior to the acquisition of those customers under the energy RoLR scheme.

EWOV commented that the automatic termination of contracts with the failed retailer may involve the loss of loyalty rebates or other discounts. The Commission notes that some customer benefits deriving from the failed retailer's customer contracts may be lost on the occurrence of a RoLR event, though it considers this to be an unavoidable consequence of such an exceptional circumstance.

Origin Energy argued that the Commission had not considered the contractual basis upon which the dual fuel contract may be structured and its implications for the continued sale of the surviving fuel. It commented that the Energy Retail Code provides that a 'dual fuel contract' may mean either (1) a single contract for the sale of gas and the sale of electricity or (2) two contracts, one for the sale of gas and another for the sale of electricity, under which billing cycles are synchronised. Origin also stated that in the case of a RoLR event for one fuel but not the other, the contractual implications will vary depending on the type of dual fuel contract.

Origin claimed that the Commission's proposal that 'the contracts will automatically terminate in respect of the fuel that can no longer be supplied but continue in respect of the unaffected fuel' does not make sense where the dual fuel contract is a single contract. It argued that if the contract is terminated and the retailer continues to sell the surviving fuel, then s.46 of the Gas Industry Act and s.39 of the Electricity Industry Act provide that the retailer will be doing so under a deemed contract. The Commission notes that the draft decision stated that the Commission would amend the retail licences to require retailers to include a term in their dual fuel customer

²⁸ See Electricity Industry Act s.27(9); Gas Industry Act s.34(10).

contracts providing that the contracts would terminate in respect of the fuel that can no longer be supplied but continue in respect of the unaffected fuel. That is, the contract would need to provide expressly for this scenario. The unaffected fuel would therefore continue to be provided under the contract and not on the basis of a deemed contract; a deemed contract would only be relevant if the dual fuel contract was terminated in its entirety. The Commission also notes that the deemed contract provisions of the Gas Industry Act and the Electricity Industry Act do not apply to non-local retailers. Therefore, if a dual fuel customer contract with a non-local retailer was terminated in its entirety but the non-local retailer continued to supply the unaffected fuel to the customer, it would not be doing so under a deemed contract.

Origin further claimed that in the case of two separate contracts constituting a dual fuel contract, the surviving fuel will continue to be sold in accordance with the terms and conditions of the surviving contract. Origin stated that it is not clear why the terms of the surviving contract should be altered – or in fact the legality of doing so – to provide for a shorter period of cancellation or the prohibition of any applicable exit fee. The Commission acknowledges that the draft decision regarding termination of dual fuel customer contracts was aimed at single dual fuel contracts rather than two separate contracts with a synchronised billing cycle. It considered that in the case of single dual fuel contracts, customers should (1) be provided with an option to terminate the contract in its entirety on a relatively short period of notice to the retailer (for example, seven days) as they may have only entered into the contract because of the benefits of having a dual fuel contract and (2) not be required to pay a penalty or exit fee because the termination of contracts on the occurrence of a RoLR event is not due to any fault that can be attributed to customers.

The Commission agrees with Origin that if a RoLR event occurs in relation to only one of the fuels supplied by a dual fuel retailer, and the dual fuel contract comprises two separate contracts with a synchronised billing cycle, only the contract in respect of the affected fuel should terminate. Given the stand alone nature of the separate electricity and gas contracts in this case, the Commission considers that the contract for the unaffected fuel should continue in accordance with its existing terms and conditions.

The Commission notes that the draft decision provided that the Commission will clarify the ongoing status of a failed retailer's customer contracts by amending the retail licences. Following further consideration, the Commission now believes that in the case of relevant customers, it may be preferable to impose the contract termination requirements via the Energy Retail Code. This issue will be discussed further during the consultation process for the development of a RoLR regulatory instrument.

Final decision

The Commission will clarify the ongoing status of a failed retailer's customer contracts by amending the retail licences and/or the Energy Retail Code to require retailers to:

- in the case of single fuel customer contracts, include a term that the contracts will automatically terminate on the occurrence of a RoLR event in respect of that retailer, without any penalty or exit fee payable by the customers
- in the case of single dual fuel customer contracts, include a term that:
 - if RoLR events in respect of that retailer occur simultaneously in relation to both fuels, the

contracts will automatically terminate, without any penalty or exit fee payable by the customers

- if a RoLR event in respect of that retailer occurs in relation to only one of the fuels (1) the contracts will automatically terminate in respect of the fuel that can no longer be supplied but continue in respect of the unaffected fuel and (2) the customers have an option to terminate the contract in its entirety by providing the retailer with seven days of notice, without any penalty or exit fee payable
- in the case of dual fuel customer contracts that comprise two separate contracts with a synchronised billing cycle, include a term that:
 - if RoLR events in respect of that retailer occur simultaneously in relation to both fuels, the contracts will automatically terminate, without any penalty or exit fee payable by the customers
 - if a RoLR event in respect of that retailer occurs in relation to only one of the fuels, the contracts in respect of the fuel that can no longer be supplied will automatically terminate, without any penalty or exit fee payable by the customers; the contracts in respect of the unaffected fuel will continue in accordance with their existing terms and conditions.

5.2 Workability of the RoLR scheme

In the issues paper, the Commission invited comments from the local electricity and gas retailers about the ability of their systems and processes to accommodate the physical transfer of a large number of customers from a failed retailer, particularly in the event of a local retailer failure. It also sought comments about the workability of the proposed energy RoLR scheme, including whether there are likely to be any practical implementation difficulties that had not been identified by the Commission.

The Commission's views regarding the stakeholder comments in relation to these matters were discussed in the draft decision paper and are considered further below.

5.2.1 Retailer issues

System capabilities

As stated in the issues paper and the draft decision paper, a RoLR is likely to require access to various categories of information regarding the RoLR customers – including customer names and addresses, metering information, details of customer consumption and any special requirements for particular customers – in order to enable it to fulfil its RoLR obligations. The Commission noted that one option to ensure that a RoLR has access to the necessary information would involve the transfer of customer information – for example, by copying the physical or electronic records – from the failed retailer to the RoLR. If the electricity and gas retailers do not use standardised customer information and billing systems, however, it may be difficult for the information to be provided in a format that is compatible with the RoLR's systems and/or may require significant time to be input into those systems.

In response to the Commission's request for comments in the issues paper, some local retailers indicated that the integration of a large number of customers into a RoLR's customer information and billing systems would not be possible within the proposed RoLR period. The Commission understands that the electricity and gas retailers do not use standardised IT systems and that it would therefore be difficult to transfer the necessary customer information from the failed retailer to a RoLR in a short period of time on the occurrence of a RoLR event. The standardisation of IT systems across the energy industry is likely to be a particularly costly approach, especially considering the low probability of a RoLR event occurring. The Commission thus considered that the most cost effective and practical option to overcome the difficulties referred to above and improve the workability of the RoLR scheme was to amend the current RoLR legislative provisions to provide a RoLR with access to the failed retailer's customer information and other IT systems for the purposes of enabling the RoLR to invoice customers.

The Commission noted that this option would most likely involve the enactment of detailed provisions that:

- prescribe the types of information and support systems to which authorised representatives of a RoLR could have access and thereby limit the ability of the authorised representatives to access commercially sensitive material that is not required by a RoLR in performing its obligations

- provide a RoLR's authorised representatives with the right to access premises and facilities for the purposes of accessing such information and support systems
- require the failed retailer and its officers (including insolvency officials of the failed retailer) not to hinder a RoLR's access and to provide reasonable assistance to a RoLR's authorised representatives
- require a RoLR to pay compensation for any damage to the property of the failed retailer.

The Commission's legal advice indicated that such legislative provisions may, however, be inconsistent with the Corporations Act because they may involve the transfer of a failed retailer's property in the context of insolvency or interfere with the power of insolvency officials to take control of the property of a failed retailer and carry on its business. It may therefore be possible for insolvency officials appointed to a failed retailer to frustrate the effective operation of the RoLR scheme by seeking court orders that they are not required to comply with such provisions of the scheme and/or prevent the transfer of the failed retailer's property to a RoLR.

To overcome this potential problem, the Commission proposed that the RoLR provisions in the Electricity Industry Act and the Gas Industry Act – as amended by the customer information and system access requirements – should be declared to be 'Corporations legislation displacement provisions' for the purposes of s.5G of the Corporations Act. The application of s.5G limits the operation of the Corporations Act and ensures that the relevant State legislation prevails to the extent of any direct inconsistency. The Commission noted that before utilising s.5G, the Victorian Government would be required to comply with the Ministerial Council for Corporations' approval process set out in clause 514 of the Corporations Agreement.

Following discussions with the Department of Infrastructure, the Commission obtained 'in principle' agreement from the Department that it will pursue within Government that (1) the current RoLR legislative provisions should be amended to provide a RoLR with access to the failed retailer's customer information and other IT systems for the purposes of enabling the RoLR to invoice customers and (2) the amended RoLR provisions should be declared to be 'Corporations legislation displacement provisions' for the purposes of s.5G of the Corporations Act.

AGL welcomed the Commission's attempts to ensure that a RoLR will have access to customer information so as to enable it to fulfil its RoLR obligations. It claimed, however, that the RoLR legislative provisions may not in themselves achieve the Commission's desired objective. AGL submitted that from an operational perspective, the RoLR may require access to information that is controlled by a third party – such as an insolvency official or administrator. It argued that in many cases the insolvency official or administrator will, in law, be an agent of the company and would therefore remain subject to any pre-existing licence conditions. AGL stated that it is unclear whether the licence condition would be binding on a third party such as a secured creditor. It suggested that it would be preferable if the requirements were imposed through an Act of the Victorian Parliament which took effect and operated on all relevant persons dealing with the assets.

As indicated in the draft decision paper, the Commission has obtained 'in principle' agreement from the Department of Infrastructure that it will pursue within Government that the current RoLR legislative provisions should be amended to provide a RoLR with access to the failed

retailer's customer information and other IT systems for the purposes of enabling the RoLR to invoice customers. The Commission therefore envisages that these customer information and system access requirements will be introduced by way of legislation – rather than by licence condition – and will apply to insolvency officials of the failed retailer.

EWOV submitted that the automatic transfer of customer information from the failed retailer to the RoLR will raise some privacy concerns, particularly if the information is used for marketing purposes. The Commission considers that (1) the exercise by a RoLR of a statutory right of access to a failed retailer's customer information and (2) the performance by a failed retailer of a statutory obligation to assist in the exercise of such a right would not contravene any applicable privacy legislation as the conduct would be required or authorised by or under law.

5.2.2 Distributor issues

System capabilities

Draft decision

The Commission will insert a provision in each of the gas distribution licences to require a gas distributor, on request by a RoLR, to disclose such customer or other information to the RoLR as is necessary for the RoLR to act in that capacity.

Discussion

The Commission noted in the draft decision paper that each electricity distribution licence requires a distributor, on request by a RoLR, to disclose such customer or other information to the RoLR as is necessary for the RoLR to act in that capacity. It considered that the systems and processes of each electricity and gas distributor should be capable of handling the information transfers that would be required in the event of a retailer failure, whether non-local or local. The Commission decided to replicate the electricity distribution licence requirement referred to above in relation to gas; that is, to require a gas distributor, on request by a RoLR, to disclose such customer or other information to the RoLR as is necessary for the RoLR to act in that capacity.

The Commission also noted that in gas, the 2003-2007 gas access arrangements provide for distributors to recover costs associated with any additional RoLR obligations imposed on them during the access arrangement period via a change in tax pass-through mechanism. The cost pass through relates both to the cost of any up front activities required (such as installing systems) and to the cost of responding to a RoLR event (should such an event arise). In electricity, the Electricity Distribution Price Review 2006-2010 final decision allows distributors to apply for a pass through for the incremental costs that arise from a 'declared' RoLR event where these are material and cannot be recovered through another mechanism.

AGL supported the Commission's draft decision, though it submitted that the customer information held by the distributor may not be detailed enough to allow the RoLR to fulfil its obligations. It stated that while a distributor may hold site address details in its systems, it may not hold the customer mailing addresses or contact details that will be required by a RoLR. The Commission has previously noted that the information held by distributors regarding the RoLR customers is unlikely to be sufficient on its own to enable a RoLR to fulfil its RoLR supply

obligations. The Commission has therefore sought to facilitate the introduction of the RoLR customer information and system access requirements discussed in section 5.2.1.

Final decision

The Commission will insert a provision in each of the gas distribution licences to require a gas distributor, on request by a RoLR, to disclose such customer or other information to the RoLR as is necessary for the RoLR to act in that capacity.

Metering

Draft decision

The Commission will permit RoLR customer transfers on the basis of estimated meter readings.

Discussion

In the draft decision paper, the Commission agreed with stakeholders that there is unlikely to be sufficient time to conduct actual meter readings for the customers of a failed retailer, and that RoLR customer transfers should therefore occur on the basis of estimated meter readings. The Commission noted that the Electricity Customer Transfer Code and the Gas Retail Rules currently only permit customer transfers on the basis of actual reads. It considered, however, that the 'transfer' of customers from a failed retailer to a RoLR on the occurrence of a RoLR event differs from conventional retailer initiated transfers with customer consent. The Commission proposed to make the necessary amendments via a RoLR regulatory instrument rather than in the existing customer transfer regulatory instruments, and considered that the *National Measurement Act 1960* (Cwlth) does not present any obstacles to this approach. Due to the time pressures associated with a RoLR event, the Commission also considered that RoLR customers should be billed by a RoLR on the basis of estimated meter readings.

AGL supported the Commission's draft decision to permit the transfer of RoLR customers on the basis of estimated meter readings, and stated that a consistent methodology will need to be employed for the estimation of such reads. VENCORP commented that it is important that the mechanisms and responsibilities for the implementation of the Commission's draft decision are fully understood. It argued that this is fundamental in establishing the financial responsibilities of the failed retailer and the starting positions of the RoLRs in wholesale market settlement. VENCORP also stated that in order to avoid problems associated with settlement revisions and disputes over billing between customers and retailers, the responsibility and methodology to be used for generating the estimates needs to be determined and understood before a RoLR event occurs. EWOV stated that there will be adverse impacts on RoLR customers if estimated meter readings are inaccurate.

The Commission considers that estimated meter readings for RoLR customer transfers should be generated by distributors in the same way as conventional estimated meter readings. It notes, however, that it may be necessary for the estimated meter readings to be deemed as actual meter readings to provide all affected parties with greater certainty about their respective financial responsibilities on the occurrence of a RoLR event. These issues will be discussed further during the consultation process for the development of a RoLR regulatory instrument.

Final decision

The Commission will permit RoLR customer transfers on the basis of estimated meter readings.

5.2.3 Market operator issues*NEMMCO*

In the draft decision paper, the Commission discussed the inability of the automated RoLR process of NEMMCO's Market Settlement and Transfer Solution (MSATS) to handle:

- the failure of a local retailer, including the transfer of the Responsible Person (RP) role
- the failure of a retailer in one jurisdiction only (for example, where a single jurisdiction revokes a retailer's licence)
- the failure of a metering service provider (each NMI has three nominated metering service providers in MSATS; its MDP – metering data provider, MPB – metering installation and maintenance, MPC – metering data collection and transfer).²⁹

The Commission also noted that NEMMCO released a discussion paper during May 2005 setting out draft proposals for RoLR functionality and bulk participant change in MSATS.³⁰ The paper contained draft proposals for:

- developing a new tool in MSATS that can handle local and non-local retailer RoLR events through bulk changes to role relationships, based on user specified selection and update parameters
- developing scenario trials with jurisdictional, regulator and participant involvement that cover the failure of local and non-local retailers and that use production level data volumes
- developing and implementing end-to-end scenario testing on the processing of a RoLR event once capability to handle local retailer failures is developed.

As stated in the draft decision paper, the Commission will continue to work with NEMMCO on the capability of NEMMCO's systems to accommodate the RoLR scheme that is being developed by the Commission.

VENCorp

The Commission noted in the draft decision paper that VENCorp's systems can handle the transfer of customers in the event of a non-local or local gas retailer failure. VENCorp had indicated that a mass transfer of MIRNs from a failed retailer to a RoLR is possible in VENCorp's systems via the manual replacement of the failed retailer's details with the RoLR's details in both the retail and wholesale meter registers. It stated that the transfer would probably take two days to implement.

²⁹ National Electricity Market Management Company Limited 2003, *MSATS RoLR Business Processes: Issues Paper*.

³⁰ National Electricity Market Management Company Limited 2005, *RoLR Functionality and Bulk Participant Change in MSATS: Discussion Paper*.

In response to the draft decision paper, VENCORP argued that it may not have the resources available to manually intervene effectively in the customer transfer processes throughout a three month RoLR supply period. VENCORP submitted that changes to its gas retail market systems would be required to provide the capability to manage a moratorium on RoLR customer transfers. The Commission will continue to work with VENCORP and other relevant stakeholders to address the gas RoLR implementation issues that are currently unresolved.

5.2.4 Generator issues

As stated in both the issues paper and the draft decision paper, one of the Commission's objectives in implementing an energy RoLR scheme is to maintain the integrity of payments for energy in the relevant wholesale markets and thereby protect the interests of participants in those markets. The Commission noted that the financial integrity of the wholesale market may be compromised if the assignment of financial responsibility for the supply taken by the failed retailer's customers is uncertain. It is thus important for the Commission to develop a RoLR scheme that provides for a smooth transition for both customers and industry on the occurrence of a RoLR event. The Commission also considers that market participants affected by a RoLR event should take all necessary action to manage their risk exposure.

5.2.5 Communication issues

A number of stakeholders submitted in their responses to the issues paper that further work is necessary to develop an effective RoLR communications strategy. In the draft decision paper, the Commission highlighted the importance of developing clear documented procedures setting out the actions required to be taken by all parties potentially involved in a RoLR event. It noted that each electricity and gas retail licence requires a RoLR to provide specified information to a RoLR customer in writing as soon as practicable after being notified by the Commission or otherwise becoming aware of its RoLR obligations. The Commission also noted that it was working with NEMMCO to establish a protocol for dealing with market prudential events that may lead to a RoLR event. It considered that such a protocol would enable the Commission and NEMMCO to better inform market participants of developments at the time of an electricity RoLR event.

VENCORP stated that some processes – such as those for public notices and customer communication – need to be developed for both the gas and electricity industry. It supported the Commission's position of further developing the necessary protocols and processes with the relevant industry participants, in much the same way that emergency plans are developed across the industry. VENCORP suggested that, to minimise the impact on gas system security and the wholesale and retail markets, an industry working group should be formed to develop the detailed set of processes required to implement the RoLR decisions for gas and develop the most economical and efficient method of implementation.

EWOV submitted that the substantial adverse impacts of a RoLR event on customers of the failed retailer – particularly the combination of the RoLR supply fee and the prohibition on switching retailer – may result in a strong negative reaction from at least some of the customers of the failed retailer. It stated that (1) some customers may take it for granted that their energy supply will continue notwithstanding the failure of their retailer and therefore will not be persuaded that the RoLR rules and the RoLR supply fee provide a fair return for the continuity of

supply and (2) the perception of unfairness will be heightened by the RoLR supply fee only applying to the customers of the failed retailer. It commented that, in this context, clear and consistent communication is particularly important.

EWOV further submitted that in the period after the failure of telecommunications provider One.Tel, the major lesson learnt by the telecommunications regulators and the Telecommunications Industry Ombudsman was the need to coordinate and provide timely and authoritative information to consumers. It expressed concerns that the Commission had proposed that communications will be the responsibility of the RoLR, noting the Commission's statement in the draft decision paper that '[the Commission] considers that implementation of an effective communications strategy by the RoLR should assist to alleviate the concerns of RoLR customers and provide the RoLR with an opportunity to establish a long-term commercial relationship with them'. The Commission notes that the above statement was made in response to a stakeholder's comment that RoLR customers may be discontent with having to pay a RoLR supply fee; it was not intended to suggest that development of a RoLR communications strategy would be the sole responsibility of a RoLR.

EWOV suggested that in the early stages of a RoLR event – before a RoLR has had an opportunity to send information to affected customers or to fully brief its contact centre staff – it will be particularly important for the Government and the Commission (not just a RoLR) to be providing clear and consistent information to the Victorian community. It argued that the Government and the Commission will be best placed to provide authoritative information about the basis and nature of the RoLR rules and the RoLR supply fee, and to explain that they have set these rules and fees. EWOV also argued that there will be a need for the Government and the Commission (not just the RoLR) to proactively communicate information so that it is widely reported in the media. It claimed that otherwise there is a risk that the first communication that customers of the failed retailer will receive from the RoLR will include a bill for the RoLR supply fee and it will be very difficult for a RoLR to build a positive relationship after that.

EWOV concluded by stating that the RoLR scheme has great potential to cause adverse customer reactions and a substantial increase in enquiries and complaints to the failed retailer, the RoLR and EWOV. It strongly supported any initiative that would provide clear and consistent information and reassurance to customers affected by a RoLR event – including further development of the RoLR communications plan, with a greater role for Government and the Commission.

The Commission notes the above comments suggesting that further work is necessary to develop effective RoLR communications processes. It also agrees with EWOV that clear and consistent information must be provided to all parties affected by a RoLR event, and particularly to customers of the failed retailer. The Commission has established a protocol with NEMMCO for dealing with market prudential events that may lead to an electricity RoLR event, and it is currently working with VENCORP to establish a similar protocol in relation to gas. It will also convene a working group of relevant stakeholders to discuss RoLR communications issues that are currently unresolved, including the development of an effective RoLR communications strategy that outlines the responsibilities of market participants on the occurrence of a RoLR event.

APPENDIX 1 Analysis of electricity RoLR scenarios

This appendix describes six scenarios proposed by The Allen Consulting Group (ACG) in which a RoLR may be required to supply the customers of a failed electricity retailer, the wholesale electricity costs per MWh for the scenarios, and the reasonable probability of each scenario.

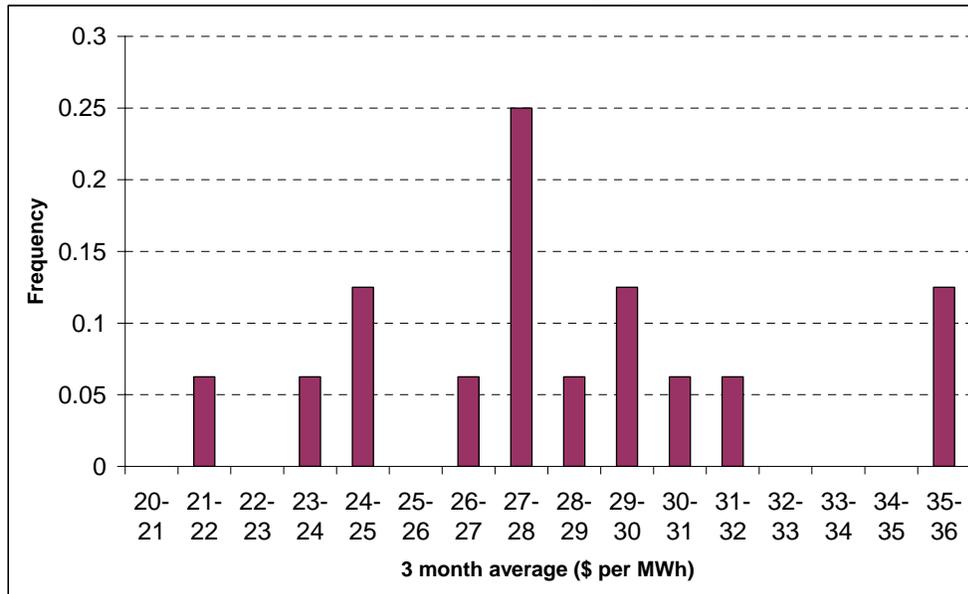
A1.1 Scenarios 1 to 3: Pool prices

ACG proposed three pool price scenarios, namely (1) low pool prices, (2) average pool prices and (3) high pool prices. Under each of these scenarios, the RoLR event does not result in any change to the wholesale electricity market, and the RoLR can therefore purchase from the pool at prevailing pool prices for three months following the RoLR event.

Some may argue that these scenarios are unlikely because RoLR events are more likely to occur during very high price periods rather than under normal market conditions. It should be noted, however, that a RoLR event may occur even if wholesale prices are low; for example, a retailer may suffer financial losses as a result of being over contracted. It is also important to note that most of the financial failures involving energy retailers that have occurred in the United Kingdom following implementation of the New Electricity Trading Arrangements (NETA) – such as the failures of Maverick Energy Limited and TXU Europe – have been due to low rather than high pool prices. In both cases, administrators were appointed and customers transferred to new retailers without any effect on market prices.

ACG used pool price data from January 2004 to May 2005 to estimate pool prices following a RoLR event because (1) January 2004 to May 2005 is the most recent pool price data and should represent the most up to date conditions in the market and (2) 2004-2005 has a high average price compared to the years that followed the increase in the wholesale price cap from \$5,000 to \$10,000 per MWh.

ACG analysed Victorian pool prices from January 2004 to May 2005. Figure A1.1 shows the density of three month rolling average pool prices, which is broadly symmetric at about \$28 per MWh. The inclusion of additional months will make the density function smoother, but will not change the overall shape or average. It will also make the tails of the density function more clear, but will not significantly change the 10th percentile low price, or the 90th percentile high price. ACG has selected the actual historical time series corresponding to the low, average and high prices in order to calculate load weighted prices. However, it is the level of the pool price rather than the actual timing that is important.

Figure A1.1 Density of three month average prices

Source: The Allen Consulting Group analysis

Probabilities

The lowest three month average of \$21.12 occurs from January 2005 to March 2005. The probability of low pool prices is 6.25 per cent. The average pool price scenario has been chosen as three months – namely July to September 2004 – whose average pool price is closest to the time weighted average pool price during 2004 and 2005 of \$27.96 per MWh. The probability of average pool prices (between low and high) is 81.25 per cent. The highest three month average of \$35.97 per MWh occurs from October to December 2004. The probability of high pool prices is 12.5 per cent.

Scenarios one, two and three together have been reweighted at fifty per cent of overall probability, in the above proportions.

Load weighted costs

A RoLR is required to purchase sufficient energy to supply the load profiles of its RoLR customers. Hence, it is necessary to calculate the load weighted price rather than time weighted price. In order to calculate the load weighted price, ACG used the net system load profiles (NSLPs) for small customers as a proxy for customer load. This data was obtained from the NEMMCO website; weekly data is available only until 19 February 2005, so 2004 data was used for the months of February and March 2005.³¹

³¹ NEMMCO 2005, *Net System Load Profiles in the NEM*, available at: <http://www.nemmco.com.au/meteringandretail/700-0158.htm>

NSLPs are published for all of the Victorian distributors – CitiPower, Powercor Australia, SP AusNet (formerly TXU), United Energy Distribution and AGL Electricity. The various distributor load profiles do not vary substantially in overall shape (except perhaps Citipower which has an atypical Melbourne CBD only distribution area); ACG therefore chose to use a representative profile rather than attempt to calculate a numerical average of distributor loads. AGL (series name VICAGL) was used for this purpose, although any of the distributors would have been acceptable.

A1.2 Scenario 4: Contract prices

The fourth scenario takes account of the likelihood that a RoLR will seek to purchase contracts to hedge the risks of purchasing electricity for its RoLR customers. There is likely to be sufficient liquidity in the contract market at a price equal to the average pool price plus a premium of \$40 per MWh, namely \$69.75. An amount of \$40 per MWh is a generous premium, and would permit the purchase of either (1) swap contracts at twice the typical forward price or (2) cap contracts for the whole year at a premium of \$10 per MWh,³² even though the maximum RoLR supply period is only three months. ACG assumed a probability of ten per cent to thirty per cent for the contract prices scenario.

A1.3 Scenario 5: Administered prices

This scenario assumes that the RoLR event follows extreme market conditions that trigger administered prices, that is, prices reaching the cumulative price threshold (CPT) of \$150,000. ACG assumed the worst case, namely that administered prices last for three months. In practice, 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. In addition, studies of the NEM have shown that price spikes generally last for less than one per cent of the hours in the year. Otherwise, scenario four is based on the high pool price scenario. The load weighted cost is \$86.82 per MWh.

There have not been administered prices in the NEM since its inception, so it is not possible to make an empirical estimate of the probability. However, the mean time between administered prices is likely to be greater than eight years (of NEM history), so the probability is likely to be less than one in eight, or 0.125. ACG assumed a probability of between ten and twenty per cent for this scenario, which is likely to over state the risk.

A1.4 Scenario 6: Market power

The sixth scenario assumes that the RoLR event leads to significant changes in the underlying wholesale market. For example, up to 30 per cent of the market could be subject to RoLR conditions in the case of a local retailer failure. In addition, if a RoLR event occurs because of suspension or termination of a retailer's right to acquire electricity from the wholesale electricity market and the retailer's underlying hedge contracts are cancelled, the wholesale market could be left significantly under hedged. The response of generators would be crucial in analysing the impact on prices. Generators may (1) seek to replace hedge contracts quickly, which is modelled

³² The Allen Consulting Group 2004, *Energy Wholesale Price Study – Final Report*; report to the Essential Services Commission of South Australia, available at: <http://www.escosa.sa.gov.au/webdata/resources/files/040913-R-WholesaleEnergyPriceStudy.pdf>

as scenario four, or (2) not replace hedges, but instead use their market power to increase pool prices.

The sixth scenario assumes that pool prices are set at \$300 per MWh for every peak period during the maximum RoLR supply period of three months, and remain at the same level as in scenario three during off peak periods.³³ Under this scenario, the conditions for administered prices are not met. The load weighted cost under these conditions is \$227 per MWh.

There have not been conditions leading to sustained market power bidding and prices sustained at \$300 per MWh for all peak periods over three months in the NEM since its inception, so it is not possible to make an empirical estimate of the probability. However, the mean time between market power prices is likely to be greater than eight years (of NEM history), so the probability is likely to be less than one in eight, or 0.125. ACG assumed a probability of between ten and twenty per cent for this scenario, which is likely to over state the risk.

A1.5 Summary

Table A1.1 summarises the above analysis.

Table A1.1 Base case scenarios: Costs and probabilities

	Scenario	Load weighted cost (\$ per MWh)	Base case probability
1	Low pool prices	\$22.19	3%
2	Average pool prices	\$29.75	41%
3	High pool prices	\$38.63	6%
4	Contracted prices	\$69.75	30%
5	Administered prices	\$86.82	10%
6	Market power prices	\$227.24	10%

Source: The Allen Consulting Group analysis

³³ The typical strike price for caps is \$300 per MWh, so generators have an incentive to keep prices below \$300 per MWh to avoid paying out on caps.

APPENDIX 2 Analysis of gas RoLR scenarios

This appendix describes six price scenarios and two load scenarios proposed by The Allen Consulting Group (ACG) in which a RoLR may be required to supply the customers of a failed gas retailer, the wholesale gas costs per GJ for the scenarios and the reasonable probability of each scenario. It also discusses the steps used by ACG to calculate the wholesale gas cost per customer for inclusion in the RoLR tariff, and the related sensitivity assessment.

A2.1 Price scenarios

Retailers in Victoria can purchase gas either under contracts or through the wholesale gas spot market.³⁴ Following a RoLR event, a RoLR is unlikely to have sufficient contracts to meet customer demand. Conversely, gas suppliers who had contracts with the failed retailer may have surplus gas which they may either sell through the spot market or offer under new contracts to a RoLR.

The six price scenarios represent a plausible range of scenarios that might apply to RoLR wholesale gas purchases, as shown in table A2.1. Four of the scenarios represent situations in which a RoLR purchases gas through the spot market at market prices. The other two scenarios are contracting strategies where the retailer arranges gas supply contracts to reduce exposure to spot market prices.

Table A2.1 Price scenarios

	Strategy	Price Scenario
1	Purchase from spot market	Low spot market price
2		Average spot market price
3		High spot market price
4		Extreme spot market price
5	Enter into supply contracts	Contract - competitive suppliers
6		Contract - tight supply market

Source: The Allen Consulting Group analysis

Scenarios 1 to 3: Spot prices

Under scenarios one to three, a RoLR elects to purchase from the spot market for three months following a RoLR event. The prices are based on historical spot market prices under the following three possible cases:

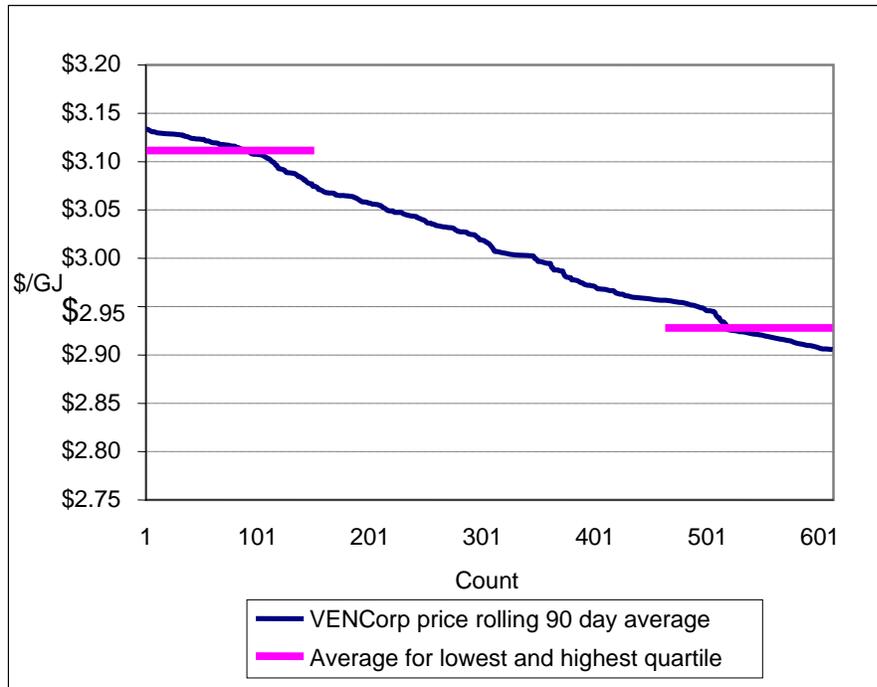
- low spot prices
- average spot prices
- high spot prices.

³⁴ The spot market is operated by VENCORP. VENCORP receives nominations and competitive offers from market participants to inject or withdraw gas, and schedules gas flows in accordance with these nominations. VENCORP calculates market prices and quantities so that system requirements are met in the most cost effective way. Finally, VENCORP determines the implied market clearing prices and manages the settlement of spot market trades.

ACG used spot market price data from January 2004 to November 2005 to calculate historical spot prices. It ranked the 90 day rolling average spot prices and chose the lowest quartile to represent the low price scenario, the highest quartile for the high price scenario, and the middle 50 per cent for the average price scenario. ACG used time weighted averages, as load weighted averages make little difference in a market with low volatility.

Figure A2.1 shows the three month rolling average spot prices, which have a low price of \$2.93 per GJ and high price of \$3.11 per GJ, and are symmetric about the average price of \$3.01 per GJ.

Figure A2.1 90 day rolling average spot prices



Source: VENCORP prices from www.vencorp.com.au, January 2004 to November 2005

Scenarios one to three assume that a RoLR purchases gas from the spot market without using any supply contracts and that the RoLR event does not affect the market significantly. However, a one per cent risk allowance has been added to the spot price.³⁵

Scenario 4: Extreme spot prices

Scenario four assumes that a RoLR buys from the spot market, but allows for the possibility of an extreme spot price event. Such an event could arise from (1) the cause or outcomes of a RoLR event, (2) changed behaviours in the market or (3) an unrelated event.

The price in this scenario has been structured as a price shock added to the high spot price, given that an extreme price event has not been observed in the Victorian gas spot market to date. As

³⁵ No adjustment is needed for unaccounted for gas (UAFG) because the spot market already includes an allowance for UAFG.

there is no history as a guide, ACG assumed an event in which the spot price goes to VoLL (\$800 per GJ) for one day, and is then set by VENCORP to the administered price (\$80 per GJ) for a further five days.

Scenarios 5 and 6: Contract prices

Scenarios five and six consider the situation in which a RoLR seeks to purchase gas supply contracts.

The price of gas contracts depends on the degree of competition and the attitude of suppliers. Scenario five assumes that suitable contracts are made available at similar prices to historical market prices on which standing offer prices are based. Scenario six allows for the possibility that suppliers exert some market power in negotiating contract terms.

Scenario five 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 that for standing offers. Commodity contracts or groups of contracts would need to include sufficient flexibility to cover the expected load shape to a significant extent, as is the case for standing offers. Local retailers currently have the benefit of significant flexibility under the GASCOR contracts. Newer contracts are unlikely to have the same amount of flexibility, and contract portfolios held by retailers will seek to cover the load sufficiently to meet their risk management targets. The scenario assumes that there is sufficient supply competition to enable adequate contract cover at the benchmark rate plus a one per cent transaction cost.³⁶

Scenario six assumes much less competition because supply contract volumes for commodity and capacity are tightly held. This would not normally be an issue during low load periods, so this scenario is limited 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 peak capacity as well as the flexible commodity assumed in scenario five.

Additional capacity contract cover may be available from gas suppliers, LNG contract holders, the underground storage facility, or other market participants. Public prices for capacity contracts are not generally available, with one exception. The underground storage facility owned by TRUenergy publishes a standard price on its website, with the one year price being \$190 per GJ of contracted capacity per year.³⁷ Given that this is a published price, it may be viewed as an opening offer by the seller and a lower price may be negotiable. However, a risk averse RoLR will have little time to finalise such a contract, and this scenario assumes that a RoLR pays the full price of \$190 per GJ. The scenario assumes that a RoLR purchases sufficient capacity to meet the peak load implied by the highest 90 day load factor for residential customers, which is not less than 0.45.³⁸

³⁶ The benchmark rate used by ACG is \$3.64 per GJ; see wholesale gas costs discussion in section 4.3.2.

³⁷ VENCORP supports this figure, by suggesting an opportunity value for LNG of \$185/GJ. See VENCORP, *Gas Annual Planning Report 2005*, www.vencorp.com.au/docs/Gas_Transmission/Transmission_Planning/GAPR_2005_-_Final.PDF

³⁸ Maximum ratio of 90 day average small customer demand to 90 day peak small customer demand; calculated from VENCORP's one in 20 year load duration curve, excluding generation and large customers.

Gas purchase costs for each scenario have been calculated on the basis of the above scenario descriptions, and are shown in table A2.2.

Table A2.2 Gas purchase costs

	Price scenario	Gas purchase cost (\$ per GJ)
1	Low spot market price plus 1% risk premium	\$2.96
2	Average spot market price plus 1% risk premium	\$3.04
3	High spot market price plus 1% risk premium	\$3.14
4	Extreme spot market price	\$16.12
5	Contract - competitive suppliers	\$3.67
6	Contract - tight supply market	\$5.73

Source: The Allen Consulting Group analysis

A2.2 Load scenarios

The mass market gas customer segment is very seasonal in Victoria, given the high usage for space heating and hot water. The annual average gas consumption is 61 GJ per customer.³⁹ The RoLR supply period could conceivably occur during a period of light demand, heavy demand or during seasonal crossover. ACG considered two separate load scenarios, namely low and high load. The low load period was determined using consumption during the January-March quarter (12.4 GJ) and the high load period used consumption during the July-September quarter (24.8 GJ). The percentage seasonal split was calculated from the total VENCORP load, rather than from consumption directly attributable to mass market customers.⁴⁰ ACG acknowledged that this may tend to underestimate the seasonal effect, however the impact was considered in the sensitivity analysis contained in table 4.4 of section 4.3.2. Table A2.3 shows the load data used.

Table A2.3 Load data

	Proportion of annual consumption	GJ
Average annual customer usage		61
High load period (July-Sep quarter)	41%	24.8
Low load period (Jan-Mar quarter)	20%	12.4

Source for proportions: VENCORP withdrawals 2005

³⁹ An average gas consumption of 61 GJ per customer per annum is broadly consistent with the findings of the Victorian Utility Consumption Survey 2001 (for non-cardholder households) to which reference is made in Essential Services Commission 2004, *Final Report to Minister – Special Investigation: Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas And Electricity, Background Report*, page 62.

⁴⁰ See http://www.vencorp.com.au/docs/mibb/Price_and-Withdrawals_2004.xls and http://www.vencorp.com.au/docs/mibb/Price_and-Withdrawals_2005.XLS?NO_CACHE

A2.3 Weightings for the scenarios

The probability that a RoLR will purchase gas from the spot market is indicated by the percentage of gas that is purchased from the spot market. Currently 10 per cent of total gas is purchased from the spot market, but failure of a local retailer could lead to an additional 30 per cent of total gas being purchased from the spot market.⁴¹ Therefore the combined weighting of scenarios one, two, three and four should lie between 10 per cent and 40 per cent. The midpoint of 25 per cent has been used as the combined weighting for spot market purchases, and sensitivities have been calculated at 10 per cent and 40 per cent. The relative weightings of the first three spot price scenarios were based on the historical frequency of low, average and high spot prices respectively, namely 25 per cent, 50 per cent and 25 per cent. Scenario four assumes an extremely high price event. Such an event has not occurred in the market to date, but the scenario was allocated a probability of one per cent.

The previous four scenarios have a combined weighting of 25 per cent, therefore scenarios five and six have a combined weighting of 75 per cent. The relative weightings of scenarios five and six will depend on the market situation at the time of a RoLR event, which will be affected by participants' market power and the use of any such power. ACG attributed an equal weighting to competitive supply and tight supply during high load periods. Scenario six has a zero weighting during low load periods because competition for supply is much more likely.

The high load period occurs in the winter peak period – June 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 complete set of weightings is shown in table A2.4.

⁴¹ Local retailers have approximately 30 per cent market share each.

Table A2.4 Scenario weightings

Group	Scenario	Weighting within group		Group weighting	Final weighting		
		Low load	High load		Low load	High load	
A	Spot market	Low spot market price	25%	25%		4.00%	2.00%
		Average spot market price	50%	50%	24%	8.00%	4.00%
		High spot market price	25%	25%		4.00%	2.00%
B	Extreme price event	Extreme spot market price	100%	100%	1%	0.67%	0.33%
C	Contract	Contract - competitive suppliers	100%	50%	75%	50.00%	12.50%
		Contract - tight supply market	0%	50%		0.00%	12.50%
						66.7%	33.3%

Source: The Allen Consulting Group analysis

A2.4 Weighted additional RoLR wholesale gas costs

Further to the development of price and load scenarios, costs and weightings, ACG used four steps to calculate the wholesale gas cost per customer for inclusion in the RoLR tariff:

1. A benchmark rate of \$3.64 per GJ was determined by using the Consumer Price Index (1.039) to convert the wholesale gas cost used in the Commission's FRC effectiveness review margin analysis (\$3.50 per GJ) from June 2004 to December 2005 dollars.
2. The benchmark rate was subtracted from the wholesale gas cost for each price scenario to calculate the cost per GJ in addition to the benchmark rate.
3. The resulting cost per GJ for each price scenario was multiplied by the average customer usage during low and high load periods to determine the cost per customer. The outcomes of steps two and three are shown in table A2.5.
4. The cost per customer during low and high load periods was multiplied by the low and high load weightings respectively for each price scenario to determine their contribution to the final weighted additional cost per gas RoLR customer. The outcome of step four is shown in table A2.6.

Table A2.5 shows that the range of RoLR outcomes covered by the chosen price scenarios is very wide, representing loads at different times of the year, the spot/contract strategies chosen by

a RoLR and the market conditions that occur after a RoLR event. The price scenarios have additional RoLR costs varying between negative \$17 per customer (if a spot market strategy is chosen and the spot market price is low) and \$312 per customer (if full spot exposure is taken and there is an extreme price event).

Table A2.5 Costs per customer

	Price scenario	Wholesale cost \$/GJ	Costs in addition to benchmark		
			\$/GJ	low load (12.4 GJ) \$/customer	high load (24.8 GJ) \$/customer
1	Low spot market price	\$2.96	-\$0.68	-\$8.31	-\$17.03
2	Average spot market price	\$3.04	-\$0.60	-\$7.31	-\$14.99
3	High spot market price	\$3.14	-\$0.50	-\$6.05	-\$12.40
4	Extreme spot market price	\$16.12	\$12.48	\$152.30	\$312.22
5	Contract - competitive suppliers	\$3.67	\$0.04	\$0.44	\$0.91
6	Contract - tight supply market	\$5.73	\$2.09	na	\$52.24

Source: The Allen Consulting Group analysis

Table A2.6 shows the contribution of each price scenario to the final weighted additional cost of \$6.57 per gas RoLR customer. For example, extreme spot market prices contribute 0.67 per cent multiplied by \$152.30 (low load) plus 0.33 per cent multiplied by \$312.22 (high load) – or \$2.06 per customer – to the total cost.

Table A2.6 Scenario weightings and costings

	Price scenario	Low load weighting	High load weighting	Low load \$/customer	High load \$/customer	Contribution
1	Low spot market price	4.00%	2.00%	-\$8.31	-\$17.03	-\$0.67
2	Average spot market price	8.00%	4.00%	-\$7.31	-\$14.99	-\$1.18
3	High spot market price	4.00%	2.00%	-\$6.05	-\$12.40	-\$0.49
4	Extreme spot market price	0.67%	0.33%	\$152.30	\$312.22	\$2.06
5	Contract - competitive suppliers	50.00%	12.50%	\$0.44	\$0.91	\$0.34
6	Contract - tight supply market	0.00%	12.50%	na	\$52.24	\$6.53
Weighted cost						\$6.57

Source: The Allen Consulting Group analysis

The ACG analysis suggests that a RoLR should be willing to accept compensation of \$6.57 per customer for the wholesale gas cost of serving an average customer acquired on the occurrence of a RoLR event (in addition to the gas standing offer tariff).

A2.5 Sensitivities

ACG calculated sensitivities by varying a number of parameters individually. In most cases the effect is symmetric when parameters are altered up or down from the base assumptions. The results are shown in table A2.7 below. The chosen sensitivities alter the required compensation amount by a maximum of approximately \$3 per customer.

Table A2.7 Sensitivities

	Sensitivity	Change	Impact on cost per customer (\$)
A	Load seasonality	Increase the proportion of consumption during the high load period by 10% (41% to 44%)	+ \$0.66
B	Spot exposure	Change spot / extreme spot / contract weighting split from 24/1/75 to 9/1/90	+ \$2.84
		Change spot / extreme spot / contract weighting split from 24/1/75 to 39/1/60	- \$2.84
C	Extreme spot price	Double the occurrence weighting to 2%	+ \$1.96
		Halve its occurrence to 0.5%	- \$0.98
D	Contract market conditions	Change competitive / tight weighting split in high load periods from 50/50 to 25/75	+ \$3.21
		Change competitive / tight weighting split in high load periods from 50/50 to 75/25	- \$3.21

Source: The Allen Consulting Group analysis

A2.6 Estimated meter readings

The analysis assumes that a RoLR will be able to invoice the new customers for the energy they consume. As estimated meter readings will be used, the algorithm for estimation is important. If a RoLR event was to occur at the start of winter, the algorithm has to adequately account for the non-uniform daily usage of customers as the seasons change. ACG assumed that there will be no significant bias in either direction.

A2.7 Precedents

There are few precedents to indicate the causes or outcomes of RoLR events. Electricity RoLR events in the United Kingdom after implementation of the New Electricity Trading Arrangements (NETA) – such as the failures of Maverick Energy Limited and TXU Europe – were due to low rather than high pool prices. In both cases, administrators were appointed and

there was a smooth process of transferring customers to new retailers with no effect on market prices.

A RoLR event did not occur during the shortages of gas that followed the explosion at the Moomba gas processing plant on 1 January 2004. Although there were shortages of supply, government intervention and cooperation between gas suppliers, large users and retailers resulted in prices not rising significantly. This experience suggests that competitive contracting at historical prices (scenario five) – is the most likely scenario following a RoLR event.