

IPART engages Frontier Economics and SFG to provide expert advice to 2010-2013 review on electricity retail tariffs

On 19 June 2009, IPART received terms of reference for an investigation and report on regulated retail charges to apply between 1 July 2010 and 30 June 2013. The determination will follow the previous 2007-2010 determination on regulated electricity retail tariffs and charges for small customers.

The terms of reference specify that a draft report is to be released by December 2009 and a final report by March 2010. The accompanying letter from the Minister for Energy expressly requested that if at all possible the Government would appreciate the review being completed in a quicker timeframe. Given the nature of the review – which involves complex analysis of the national electricity market, the timeframe is tight

Given this context and timetable, IPART will draw and expand on the methodology that it used in its 2007 determination. This methodology was a package that included:

- ▼ adopting a market-based electricity purchase cost, based on a conservative risk management position, and an annual review to provide for any step change to this allowance
- ▼ allowing the businesses to cover residual volatility with a working capital allowance
- ▼ allowing for retail operating costs and other specified costs
- ▼ allowing a margin that reflected the risks involved in retailing electricity
- ▼ allowing the retailers to set their own cost reflective tariffs
- ▼ providing a cost pass through mechanism to provide for the change in costs arising from unanticipated regulatory or taxation change events.

In the 2007 review IPART engaged Frontier Economics and SFG to provide expert advice on the electricity purchase cost allowance and the retail operating costs and margin. IPART consulted extensively on that methodology during the 2007 review and it was generally accepted by stakeholders. IPART then drew upon that methodology in the 2008 and 2009 annual reviews of the market-based electricity purchase cost allowances.

IPART considers that building on the methodology it used for the 2007 review is consistent with its terms of reference. It also considers that this is prudent, given that:

- ▼ there is a reasonable degree of knowledge and acceptance among stakeholders about the 2007 methodology
- ▼ building on the current methodology should increase the regulatory certainty of the 2010 review
- ▼ developing and consulting on a completely new methodology would be very difficult given the short timeframe for the review.

Given this background, the terms of reference for the review and the timetable for the review IPART has decided to appoint Frontier Economics and SFG, its consultants for the 2007 retail review, to provide advice on wholesale cost allowances and retail margins. The scope of work for which Frontier and SFG have been engaged is attached.

IPART has undertaken sufficient investigation to assure itself that Frontier Economics and SFG's quotes represent good value for money and that there are no conflicts of interest.

Services required by consultant

1. Services

The Minister has asked the Tribunal to determine regulated retail tariffs for the three standard retailers for the period 1 July 2010 to 30 June 2013. The terms of reference defines the objectives for the review, identifies the cost allowances to be included and specifies a range of matters which must be considered.

While the external environment has changed, in general the review will build on the principles and methodologies developed in the 2007-2010 electricity retail price review, albeit the timetable calls for a compressed analysis and decision-making process.

Given the short timeframe, importance of regulatory certainty and the level of industry understanding of the Tribunal's approach and methodologies used in the 2007 determination, the Tribunal will, as far as it reasonably can, use the same methodologies and approaches as it used in the 2007 determination. Consistent with the 2007 determination, the Tribunal intends that the wholesale electricity cost allowance will be subject to periodic review during the determination period.

Therefore, the Tribunal wishes to obtain a quote from the consultant to provide advice on cost allowances and regulatory mechanisms for:

- ▼ Wholesale energy costs.
- ▼ Retail margin.

The Tribunal intends to conduct its own analysis on retail operating costs and energy losses.

In addition, in response to feedback on past reviews and recognising the known pressures on electricity retail prices, the Tribunal is taking steps to facilitate effective consultation and help stakeholders further understand the methodology and assumptions applied in this review and to understand the sensitivity of the assumptions. The methodologies that the consultant develops should be as transparent and predictable as reasonably possible.

Detailed scope and deliverables

The consultant is required to determine a cost range for each standard retailer for each of the following elements, which are to be allowed for in the regulated retail tariffs:

- ▼ A total allowance for electricity purchase costs and associated volatility, which, to the extent possible, should refer to publicly available market information (such as d-cypha). This allowance should:
 - Provide for the likely efficient impact of the CPRS on electricity prices.
 - Provide an efficient allowance which takes in to account price and volume for retailer compliance with expanded Commonwealth mandatory renewable energy target (MRET) requirements and the licence requirements relating to the NSW Greenhouse Gas Benchmark Scheme and the energy savings scheme.
 - Provide for fees (including charges for ancillary services) as imposed by AEMO under the National Electricity Rules.

- Be based on the latest reasonable assumptions reflecting the operation of the national electricity market.
- ▼ An estimate of the long run marginal cost of electricity generation, including any plant that would be required to meet any regulatory obligation.
- ▼ An appropriate retail margin, based on benchmarking, bottom up analysis and expected returns.

The analysis and recommendations on cost range parameters should be expressed in a form that facilitates consultation and transparent decision-making by the Tribunal. The report needs to specify the risks that are being compensated for in each of the margin and the energy cost allowances.

The approach to the analysis should be explained clearly and any differences from the approaches used by the Tribunal in the 2007 review should be explained and justified. Where relevant, the analysis should explain how the results compare to benchmarks in other jurisdictions, other industries and internationally. Assumptions should be clearly stated, and any third party support should be referenced.

Additional advice

The consultant should also provide advice on:

- ▼ The key assumptions affecting the advice and the sensitivity of the recommended cost ranges to changes in these assumptions. The consultant should particularly focus on recent changes to capital costs.
- ▼ The appropriateness of a point-in-time analysis of energy costs instead of constructing a portfolio over time (the approach adopted by the ICRC).
- ▼ The extent to which it is possible to use publicly available information, including d-cypha, for the purposes of setting and updating regulated retail prices.
- ▼ The scope and process for the periodic review of electricity purchase costs.
- ▼ Whether and on what basis the retail margin should be recalculated if the forecast cost estimates are updated in the annual review.
- ▼ The relationship between changes in electricity volumes and GDP growth for residential customers as a basis for setting the retail margin.
- ▼ The consultant should provide recommended ranges for beta and gearing for both retail and generation businesses. The Tribunal will then calculate the WACC for the consultant to use in its analysis
- ▼ The consultant should explain any difference between the LRMC estimates and the market based cost estimates and what is driving any difference.

The consultant's analysis is to consider each year in the determination period.

Modelling results

The recommended cost range parameters should be expressed in a form suitable for direct use by the Tribunal in its modelling.

As such, cost ranges for each standard retailer area should be broken down into appropriate tariff component categories. As an indication¹, the following components will be required:

- ▼ The energy cost for consumption by all customers on regulated retail tariffs.
- ▼ The energy cost for consumption by customers during the peak period (covering the daily time period covered by the TOU peak tariff).
- ▼ The energy cost for consumption by customers during the off-peak period (covering the daily time period covered by the TOU off-peak tariff).
- ▼ The energy cost for consumption by customers during the shoulder period (covering the daily time period covered by the TOU shoulder tariff).
- ▼ These cost ranges are to be developed in accordance with the Minister's Terms of Reference.
- ▼ For the retail margin, the consultant should also express the recommendation as a % of retail costs or a c/kWh or \$ value.

Written reports, presentations and participation in meetings and consultation forums

The consultant will be required to provide the following reports:

1. A draft methodology and assumptions document – this document should explain the methodology adopted in estimating both the energy cost allowances and the retail margin, and the inter-relationship between these allowances. The assumptions used in modelling need to be clearly specified. Additionally, the documents should highlight key assumptions. It should explain the differences between the methodology used in the 2007 determination and the proposed methodology for the 2010 review.
2. A draft report that provides cost ranges for the energy purchase costs and retail margin. This draft report needs to consider issues raised in consultation in relation to the draft methodology and assumptions. For illustrative and transparency purposes (and recognising that the expert recommendations will be based on confidential load profile data), the consultant will provide data on the publicly available net system load profile, the consultant's forecast spot prices and the resulting contract positions for each net system load profile.
3. A final report that provides updated cost ranges for energy purchase costs and retail margin and any updated advice to the Tribunal. This report needs to address issues raised in the public consultation on the draft report.

¹ Note that IPART intends to discuss and refine these breakdowns during the first stage of the consultancy. It is possible that a split between business and residential may also be required.