

Regulated electricity retail tariffs and charges for small customers 2007 to 2010

Review of 2009 market based electricity purchase cost allowances

On 14 June 2007, IPART released its determination on regulated electricity retail tariffs and charges for small customers 2007 to 2010 (the 2007 determination). IPART included an annual review of the market-based electricity purchase cost allowances (the review), to factor into the determination material step-changes in this allowance, if required.

In early 2009 IPART will commence the second and final review of market based electricity purchase cost allowances to facilitate price changes on 1 July 2009. This will be a mechanical review that will not involve any policy decisions and will apply the pre-determined methodology that is set out in the 2007 determination.

This Fact Sheet provides background information from IPART's 2007 determination and the process for this annual review.

Background information from the 2007 determination

In June 2007 IPART released its determination of regulated retail tariffs and charges to apply for small customers from 2007 to 2010.¹ In undertaking its review and making its determination, the IPART was guided by the terms of reference provided by the Minister for Energy. These terms of reference required IPART to, among other things:

- ▼ Assess the costs of a hypothetical retailer, including the electricity purchase costs for the regulated load in each Standard Retailer's supply district, and the retail costs and retail margin for a mass market new entrant.
- ▼ Recognise retailers' hedging, risk management and transaction costs, particularly given that the ETEF will be phased out during determination period.

For 2010, IPART set R values (in \$2006/07) that reflect the following factors:

- ▼ The market-based electricity purchase costs, based on the Frontier Economics' conservative point estimate for each business.

¹ IPART, *Promoting retail competition and investment in the NSW electricity industry, Regulated electricity retail tariffs and charges for small customers 2007 to 2010, Electricity – Final Report and Final Determination*, June 2007.

- ▼ The volatility allowance.
- ▼ Costs associated with greenhouse reduction and renewable energy requirements.
- ▼ Retail operating costs and margin.
- ▼ NEM fees.
- ▼ Energy losses.

IPART decided to set the R values for 2007/08 and 2008/09 to reflect a transition to the calculated hypothetical retailer costs in 2009/10.

Electricity purchase cost allowance

IPART engaged Frontier Economics to provide expert advice on the electricity purchase cost allowances included in its determination by specifically addressing the relevant matters set out in the terms of reference. Frontier Economics provided advice to IPART on:

- ▼ The long-run marginal cost of electricity
- ▼ Market based electricity purchase costs, based on analysis of the efficient mix of electricity purchase instruments, derived using its proprietary portfolio optimisation models (STRIKE). The results of this analysis formed an efficient frontier and Frontier identified two points on each frontier – a conservative point, representing the lowest risk, highest cost point on the frontier, and an elbow point, representing a lower cost but higher risk portfolio.

In its determination IPART adopted Frontier Economics' conservative point estimate of the market based prices for calculating the R values.

Around the time that IPART released its draft report in April 2007 there were substantial increases in reported spot and contract wholesale electricity prices. These increases highlighted the relationship between critical inputs (such as water), plant availability and the market price of electricity.

Frontier Economics provided supplementary advice to IPART addressing the increased wholesale prices in the period between the release of the draft determination and the deliberation on the final determination. It recommended that IPART address the risk of a step-change in future wholesale energy prices by reviewing the cost allowance prior to the roll-off of ETEF.

The annual review of market-based electricity purchase cost allowance and R values

After considering submissions to the draft determination and the supplementary advice provided by Frontier, IPART decided to include annual price reviews of the market-based electricity purchase cost component. IPART's intention was to provide for updated information on electricity purchase cost allowances to be incorporated into the prices as if it was known at the time of making the determination. Therefore, IPART limited the extent of these reviews, stating in its report:

- ▼ The review will examine the market based electricity purchase cost allowance only – it will NOT consider LRMC, the volatility allowance, green energy costs, NEM fees, retail operating costs, customer acquisition costs or the retail margin.
- ▼ IPART will engage an expert to advise it on the appropriate future market-based electricity purchase cost allowance.
- ▼ IPART will adopt a conservative approach to estimating the market-based electricity purchase cost and focus on changes to the spot and contract prices for electricity.
- ▼ IPART will use the same load profiles as it used in the 2007 determination – it will not update the load profiles.
- ▼ These reviews will commence by 1 March 2008 and 1 March 2009. IPART will release a draft report and consult with stakeholders prior to issuing its final decision by 20 May in each year.

If, in any year, the market-based electricity purchase cost allowance is at least 10 per cent higher or lower than IPART's determined market-based electricity purchase cost allowance, then IPART will reconsider the transition path (to 2010 prices) and recalculate the R values.² In doing so, it will consider:

- ▼ The revised market-based electricity purchase cost allowance and
- ▼ The transitioning of the tariffs to full cost reflectivity by 2009/10.

The approach recommended by Frontier and adopted by IPART in the determination was based on forecasts of spot and contracted prices. IPART did not seek to examine the actual hedging books of the businesses. IPART intends to repeat the approach that it took in the 2007 determination, specifically, it does not intend to examine actual hedging books in this review.

The relevant provisions of the determination are set out in Attachment A.

² The R values are set out in sections 7.3 and 7.4 of the determination.

Process for 2009 review of market based electricity purchase costs

IPART has engaged Frontier Economics to prepare a report, which will be released with a draft report in early March 2009. IPART will hold a stakeholder information session on its draft report, including the consultant's draft report.

<i>Date</i>	<i>Event</i>
6 March	Consultants reports and Tribunal draft decision released
2 pm, 19 March	Stakeholder information session on consultant's draft report
3 April	Submissions due
20 May	Release final decision

Appendix A – Extract from the 2007 electricity retail determination relating to the review of market based electricity purchase cost allowance

16 Review of market based electricity purchase cost allowance³

16.1 Market based electricity purchase cost allowance

For the purpose of this clause 16 the *market based electricity purchase cost allowance* (for each *standard retail supplier* for each *year*) as at the time a review of that allowance by the Tribunal is due under clause 16.2, will be taken to be:

- (a) the amount for that *standard retail supplier* for that *year* set out in the table below; or
- (b) any *revised amount* taken to be the *market based electricity purchase cost allowance* for that *standard retail supplier* for that *year* under clause 16.2(b)(i).

Market based electricity purchase cost allowance (\$2007/08 per MWh)

Retailer	2007/08	2008/09	2009/10
Country Energy	50.2	49.1	45.1
EnergyAustralia	57.3	56.0	51.3
Integral Energy	59.6	58.5	53.9

16.2 Review mechanism

- (a) From 1 March of each of 2008 and 2009, the Tribunal will:
 - (i) conduct a review of the market based electricity purchase cost allowance (**review**) for each standard retail supplier for each remaining year; and
 - (ii) determine any revised amount which the Tribunal considers reflects the market based electricity purchase cost allowance for each standard retail supplier for each remaining year (each a **revised amount**) as a result of that review.
- (b) If, for any standard retail supplier for any remaining year, that revised amount is more than 10 per cent higher or lower than the market based electricity purchase cost allowance for that standard retail supplier for that year for the purposes of clause 16.1(b), then:

³ IPART, Determination No 1, 2007, Part 2, Clause 16, NSW Electricity Regulated Retail Tariffs and Charges, Reference No. 06/40, June 2007.


- (iii) that *revised amount* (determined under clause 16.2(a)(ii)) will be taken as the *market based electricity purchase cost allowance* for that *standard retail supplier* for that *year*; and
- (iv) the *Tribunal* will determine a revised $FixedR_c^t$ and $VariableR_{ij}^t$ (in \$2007/08) to apply for that *standard retail supplier* for that *year* for the purposes of clauses 7.3 and 7.4, taking into account:
 - (A) that *revised amount*; and
 - (B) the transitioning of *regulated retail tariffs* to full cost reflectivity by the 2009/10 *year*.
- (c) If, for any *standard retail supplier* for any remaining *year*, that revised amount (determined under clause 16.2(a)(ii)) is not more than 10 per cent higher or lower than the *market based electricity purchase cost allowance* for that *standard retail supplier* for that *year*, then:
 - (i) the relevant amount for $FixedR_c^t$ and $VariableR_{ij}^t$ for that *standard retail supplier* for that *year* as set out in clauses 7.3 and 7.4 (or as previously determined for the purposes of those clauses) will continue to apply; and
 - (ii) the relevant *market based electricity purchase cost allowance* for that *standard retail supplier* for that *year* as set out in clause 16.1(b) (or as previously determined for the purposes of that clause) will continue to apply.

16.3 Consultation

- (a) Prior to making a determination under clauses 16.2(a)(ii) and 16.2(b)(ii), the *Tribunal* will:
 - (i) issue a draft report of its findings; and
 - (ii) consult on such matters (if any) arising out of its review as the *Tribunal* considers appropriate with the *standard retail suppliers* and such other persons (if any) as the *Tribunal* considers appropriate.
- (b) By the date specified in item 4 of the timetable in clause 14, the *Tribunal* will publish a final report of its review and of its determination under clauses 16.2(a)(ii) and 16.2(b)(ii), including the reasons for such determination.

Definitions

market based electricity purchase cost allowance for a *standard retail supplier* for a *year*, means an allowance made by the *Tribunal* for that *standard retail supplier's* costs of purchasing electricity under wholesale supply arrangements in order to supply electricity under its regulated load but not including any volatility allowance, green energy costs, NEMMCO fees, any costs related to energy losses or any other



costs relating to the standard retail supplier's retail supply business or the recovery of any retail margin relating to that business.

regulated load, for a standard retail supplier means the load for all customers in that standard retail supplier's supply district, as used by the Tribunal in making this determination (as at its commencement)

wholesale supply arrangement has the meaning given to that term in the ESA and includes any derivatives relating to electricity supplied under such an arrangement