



Retailer of last resort cost recovery scheme

Issues paper

November 2010

© Commonwealth of Australia 2010

This work is copyright. Apart from any use permitted by the Copyright Act 1968, no part may be reproduced without permission of the Australian Competition and Consumer Commission. Requests and inquiries concerning reproduction and rights should be addressed to the Director Publishing, Australian Competition and Consumer Commission, GPO Box 3131, Canberra ACT 2601.

Inquiries about the currency of this document should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: (03) 9290 1444
Fax: (03) 9290 1457
Email: AERInquiry@aer.gov.au

Contents

Shortened forms	iv
1 Introduction	1
2 Consultation process	3
2.1 How to make submissions to this paper.....	3
2.2 Next steps.....	3
2.3 Stakeholder forums	4
3 Background	5
3.1 Development of a national RoLR regime	5
3.2 Transition to the NECF.....	5
3.3 Overview of the national RoLR arrangements	5
3.4 Existing approaches to cost recovery.....	7
4 Framework for assessing cost recovery schemes.....	8
4.1 Regulatory arrangements	8
4.2 Principles for assessing RoLR cost recovery schemes	9
5 Process for making RoLR cost recovery scheme determinations.....	11
5.1 Different approaches for different categories of RoLRs.....	11
5.2 Time limits for RoLR cost recovery scheme applications.....	12
5.3 Information to be included in an application for a RoLR cost recovery scheme.....	12
6 Issues the AER will consider when making RoLR cost recovery scheme determinations.....	14
6.1 Classes of costs and benefits.....	14
6.2 Estimating costs and benefits.....	21
6.3 Mechanisms for recovering costs.....	24
A. Summary of existing approaches to RoLR cost recovery.....	28

Shortened forms

AAR	Allens Arthur Robinson
ACCC	Australian Competition and Consumer Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ESC (Victoria)	Essential Services Commission (Victoria)
ESCOSA	Essential Services Commission of South Australia
ICRC	Independent Competition and Regulatory Commission
IPART	Independent Pricing and Regulatory Tribunal
MCE	Ministerial Council on Energy
NECF	National Energy Customer Framework
NEM	National Electricity Market
NERA	NERA Economic Consulting
OTTER	Office of the Tasmanian Economic Regulator
Retail Law	National Energy Retail Law
Retail Rules	National Energy Retail Rules
RoLR	Retailer of last resort
RPWG	Retail Policy Working Group

1 Introduction

The Australian Energy Regulator (AER) is an independent statutory authority that is part of the Australian Competition and Consumer Commission (ACCC). It monitors wholesale and retail electricity and gas markets and is responsible for compliance with, and enforcement of, the National Electricity Law, the National Electricity Rules, the National Gas Law and the National Gas Rules. It is also responsible for the economic regulation of the electricity networks in the National Electricity Market (NEM) and gas pipelines in jurisdictions other than Western Australia.

A National Energy Customer Framework (NECF) for the regulation of electricity and gas retail markets (other than retail pricing) was developed by the Ministerial Council on Energy (MCE). The framework comprises the National Energy Retail Law (Retail Law), the National Energy Retail Rules (Retail Rules) and the National Energy Retail Regulations.

The legislation for the NECF was introduced into the South Australian Parliament in October 2010. Jurisdictions are expected to apply the NECF progressively between July 2011 and July 2013.

The NECF includes new national arrangements which seek to ensure that customers maintain continuity of supply in the event their electricity or gas retailer fails, by automatically transferring the customers to another retailer (the retailer of last resort (RoLR)). A 'RoLR event' triggers the transfer of customers to the RoLR(s). A RoLR event can be triggered in a number of ways including market suspension by the Australian Energy Market Operator (AEMO) or revocation of the retailer's authorisation by the AER.

The AER will be responsible for administering several aspects of the national RoLR scheme, including making determinations on proposed RoLR cost recovery schemes. RoLR cost recovery schemes allow RoLRs to recover reasonable costs incurred in preparing for and following a RoLR event. RoLRs are likely to incur a range of administrative and supply costs that are above normal business expenditure. It is necessary that a RoLR be provided with an opportunity to recover these costs in a timely manner to avoid the risk of this additional financial burden setting off a cascade of retail business failures.

The AER is also required to develop, make and maintain RoLR guidelines. The RoLR guidelines may (without limitation):

- specify the form of and information to be included in a RoLR register expression of interest
- specify the form of and information to be included in an application for a RoLR cost recovery scheme, and
- provide for any other matter the AER considers necessary with respect to the RoLR scheme.

Depending on the responses to this paper, the AER may also develop a RoLR cost recovery principles and process paper. This paper would provide information on the

legal requirements regarding RoLR cost recovery schemes and some of the principles the AER may consider when making RoLR cost recovery scheme determinations.

This paper is the first step in the AER's consultation on its obligations under the Retail Law regarding RoLR cost recovery. It summarises the relevant provisions of the Retail Law and outlines some of the matters that the AER may be required to consider when making RoLR cost recovery scheme determinations.

The purpose of this paper is to:

- inform stakeholders of the AER's obligations
- seek stakeholders' views on various RoLR cost recovery issues, and
- seek feedback on the matters the AER should consider when developing the RoLR cost recovery provisions of the RoLR guidelines.

The paper is not intended to be binding on the AER or retailers. In accordance with its obligations under the Retail Law, the AER will consider each application for a RoLR cost recovery scheme on its individual merits.

This paper does not address the recovery of any unpaid network charges from a failed retailer to a distributor. These charges are not recovered through a RoLR costs recovery scheme approved by the AER under the Retail Law. The NECF proposes separate pass through arrangements for the recovery of unpaid network charges under the National Electricity Rules and National Gas Rules.

This paper is one of three papers on the RoLR scheme that the AER is releasing for consultation. The other two relate to the development of a RoLR plan and the registration and appointment of RoLRs.

2 Consultation process

2.1 How to make submissions to this paper

The AER invites interested parties to review the matters raised in this paper and provide written submissions. Interested parties are also welcome to provide submissions on relevant issues not discussed in the paper.

Submissions can be sent electronically to: AERInquiry@aer.gov.au or by mail to:

General Manager
Markets Branch
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

The closing date for submissions is **22 December 2010**.

The AER prefers that all submissions be publicly available to facilitate an informed and transparent process. Submissions will be treated as public documents unless otherwise requested and will be placed on the AER's website (www.aer.gov.au). Parties wishing to submit confidential information are requested to:

- clearly identify the information that is subject of the confidentiality claim and
- provide a non-confidential version of the submission, in addition to the confidential one.

The AER does not generally accept blanket claims for confidentiality over the entirety of the information provided and such claims should not be made unless all information is truly regarded as confidential. The identified information should genuinely be of a confidential nature and not be otherwise publicly available.

In addition, parties must identify the specific documents or relevant parts of those documents which contain confidential information. The AER does not accept documents or parts of documents which are redacted or 'blacked out'.

For further information regarding the use and disclosure of information provided to us, please refer to the *ACCC–AER information policy: the collection, use and disclosure of information* on our website under 'Publications'.

2.2 Next steps

This paper is the first step in the AER's consultation on the principles that it will consider when making determinations on RoLR cost recovery schemes. The AER has also released issues papers on the registration and appointment of RoLRs and the development of RoLR plans. The AER is also planning a stakeholder forum to discuss issues arising from these papers.

Responses to these papers will inform the AER's development of its approach to its various obligations under the national RoLR scheme and the RoLR guidelines. The

AER will release a draft RoLR guideline for consultation and is aiming to publish the final RoLR guideline within the first quarter of 2011.

2.3 Stakeholder forums

The AER will host a stakeholder forum on **Wednesday 1 December 2010** from 2pm to 5pm (AEDST) to discuss the development of a national RoLR scheme. AER staff will be located in Melbourne for this forum, but there will be video conference links to all capital cities in participating jurisdictions.

Registration for this forum is essential. Attendance will be limited so we ask that each stakeholder nominates no more than one participant to attend. To register your attendance at the forum, please email AERInquiry@er.gov.au by 26 November 2010. The subject of the email should state “Registration for RoLR scheme forum: attention Dominique Chivers” and should specify the city in which you will attend.

3 Background

3.1 Development of a national RoLR regime

The NECF was developed by the MCE's Retail Policy Working Group (RPWG) and approved by each of the Commonwealth, State and Territory energy ministers.

When developing the NECF, the RPWG engaged NERA Economic Consulting (NERA) and Allens Arthur Robinson (AAR) to:

- review the existing jurisdictional RoLR frameworks
- advise the MCE on the development of an appropriate policy framework for a national RoLR scheme
- develop a base set of proposals for a national RoLR scheme.

Following consultation with interested parties, NERA and AAR released their final report on 29 January 2009.¹ The NERA and AAR report informed the development of the RoLR arrangements in the customer framework. Their findings and recommendations are referred to throughout this paper.

3.2 Transition to the NECF

Energy Ministers have agreed to allow jurisdictions to transition to the new energy retail framework over time to enable them to meet their particular market circumstances and regulatory needs. Jurisdictions will also be able to apply parts of the NECF at different times. At the time of writing, no firm implementation decisions had been made. Although the new RoLR arrangements will apply nationally, the AER will implement them progressively as and when jurisdictions apply the RoLR scheme. The AER will focus initially on those jurisdictions with the most immediate needs.

3.3 Overview of the national RoLR arrangements

The national RoLR arrangements in the NECF are set out in Part 6 of the Retail Law. In brief, a RoLR event may occur due to a range of reasons including, the revocation of a retailer's authorisation, the suspension of the retailer's right to trade in the wholesale market, the appointment of an insolvency official in respect of a retailer or an order is made to wind up a retailer.

Under s. 136 of the Retail Law, the AER must issue a RoLR notice following a RoLR event. This notice must (among other things):

- identify the RoLR event
- specify the failed retailer and the designated RoLRs

¹ NERA Economic Consulting and Allens Arthur Robinson, *Retailer of Last Resort – Review of Current Jurisdictional Arrangements and Development of a National Policy Framework*, Final Report prepared for the MCE Retail Policy Working Group, 2009

- specify which customers will be transferred to each RoLR (if applicable), and
- fix a date for transferring the customers of the failed retailer to the RoLR.

RoLR registration and appointment

Part 6, division 2 of the Retail Law establishes a process for registering RoLRs. When (and if) a jurisdiction commences operation under the RoLR provisions of the Retail Law, the AER must shortly thereafter call for an initial expression of interest from retailers to become registered RoLRs.² The AER will assess the retailer's suitability to act as a RoLR based on the RoLR criteria set out in s. 123 of the Retail Law and publish a list of registered RoLRs on its website.³ The AER must register a default RoLR per connection point (for electricity) and distribution zone (for gas).⁴

Division 4 of the Retail Law establishes a process for the appointment of designated RoLRs. A designated RoLR is a registered RoLR who is appointed by the AER for the RoLR event. It is the retailer that receives the failed retailer's customers. If a RoLR event occurs, the default RoLR is the designated RoLR for that event (even if the retailer has indicated to the AER that they do not wish to act as the RoLR) unless the AER has appointed one of the other registered RoLRs before the event occurred.⁵

When appointing a registered RoLR the AER can consider a range of matters set out in the Retail Law including whether the retailer has a RoLR cost recovery scheme and what costs can be recovered under that scheme.⁶ The AER may also agree with an additional RoLR to limit or waive the costs that it will recover under this scheme.⁷

The AER has released a RoLR registrations and appointments issues paper.⁸ In this paper the AER has sought feed back on a proposal to establish two 'categories' of additional registered RoLRs, which for convenience, are referred to as 'additional RoLRs with firm offer' and 'additional RoLRs with non-firm offers'.⁹ Under the additional RoLRs with a firm offer category, a retailer would commit to assuming the responsibilities of a RoLR in certain circumstances provided that it meets certain conditions. For example, the retailer may commit to being an additional RoLR for up to 10 000 small customers in Victoria if average prices in the market over a particular period are below a pre-defined level and on the basis that it will not recover any costs if appointed.

The additional RoLR with a non-firm offer category is for retailers that have not committed to accepting transferred customers, but have indicated an interest in being a designated RoLR. Where circumstances permit and directly before the declaration

² Section 124(1) of the Retail Law.

³ Sections 124(7) and 125(6) of the Retail Law.

⁴ Section 125(2) of the Retail Law.

⁵ Sections 132 and 134 of the Retail Law.

⁶ Section 133(1)(b) of the Retail Law.

⁷ Section 133(2) of the Retail Law.

⁸ AER, *Issues paper—RoLR registrations and appointments*, November 2010.

⁹ The AER has the power in s. 126(8) of the Retail Law to impose conditions, as the same time it registers a retailer as an additional RoLR. This is contingent on the retailer consenting to the relevant condition.

of a RoLR event, the AER would consult with a retailer with a non-firm offer to confirm its willingness and terms before appointing it as a designated RoLR.

Terms and conditions of supply by RoLRs

Designated RoLRs are obliged to supply transferred small customers¹⁰ under a ‘RoLR deemed small customer retail arrangement.’ This arrangement includes the terms and conditions of the designated RoLR’s standard retail contract and the RoLR’s standing offer price (subject to any variation under the RoLR cost recovery arrangements).¹¹ There is no minimum period for the small customer to remain with the RoLR on this arrangement, however small customers are automatically transferred to a standard retail contract after three months.¹² The RoLR and the small customer may negotiate a market retail contract at any time after three months (or before if the RoLR agrees).¹³

The designated RoLR must supply transferred large customers according to a ‘RoLR deemed large customer retail arrangement.’ The terms and conditions of this arrangement must be published on the RoLR’s website and be fair and reasonable.¹⁴ There is no minimum period that the large customer must remain with the RoLR, however the RoLR can only terminate the arrangement a minimum of six months after the transfer date.¹⁵

Cost recovery

A registered RoLR can only recover costs associated with fulfilling its RoLR obligations in accordance with a RoLR cost recovery scheme approved by the AER.¹⁶ RoLR cost recovery schemes allow RoLRs to recover reasonable costs incurred following a RoLR event and, in the case of a default RoLR, in preparing for a RoLR event.¹⁷

3.4 Existing approaches to cost recovery

States and Territories currently have cost recovery arrangements in place. A summary of different jurisdictional approaches to retail cost recovery is set out in appendix A.

¹⁰ Section 7 of the National Energy Retail Regulations sets out the upper thresholds to qualify as a small customer. For electricity this is 100 MWh per annum and for gas this is 1 TJ per annum.

¹¹ Section 145 of the Retail Law.

¹² Section 147 of the Retail Law.

¹³ Section 147 of the Retail Law.

¹⁴ Section 146 of the Retail Law.

¹⁵ Section 148 of the Retail Law.

¹⁶ Section 165 of the Retail Law.

¹⁷ Section 166 of the Retail Law.

4 Framework for assessing cost recovery schemes

This chapter summarises the regulatory arrangements that apply to the AER's determinations on RoLR cost recovery schemes and proposes several guiding principles that the AER could consider when fulfilling its obligations in approving the schemes.

4.1 Regulatory arrangements

The provisions regarding RoLR cost recovery are set out in Part 6 Division 9 of the National Energy Retail Law (Retail Law).

RoLR cost recovery schemes

Under s. 165 of the Retail Law a registered RoLR is only permitted to recover costs incurred under the RoLR scheme in accordance with the RoLR cost recovery scheme determined by the AER.

Section 166 of the Retail Law provides that a RoLR cost recovery scheme is designed to allow a RoLR to recover:

- in the case of a default RoLR only—costs incurred in preparing for RoLR events, and
- in the case of a designated RoLR (default and additional) —costs incurred on and after a RoLR event, including:
 - costs paid to an insolvency official of a failed retailer in respect of anything done under the RoLR scheme provisions of the Retail Law, and
 - costs paid to a distributor by the RoLR for service orders and not recoverable from the customers concerned or from the failed retailer.

The AER must, on application by a registered RoLR, determine a RoLR cost recovery scheme for the RoLR.¹⁸ The AER must be guided by the following principles when making a determination on a RoLR cost recovery scheme:¹⁹

- the registered RoLR should be provided with a reasonable opportunity to recover the reasonable costs that it incurs with respect to the RoLR scheme
- the recovery of costs should allow for a return commensurate with the regulatory and commercial risks with respect to the RoLR scheme
- the registered RoLR will itself bear some of the costs in proportion to its customer base.

¹⁸ Section 166(1) of the Retail Law.

¹⁹ Section 166(7) of the Retail Law

The AER must also have regard to the national energy retail objective. This objective is to:²⁰

promote efficient investment in, and efficient operation and use of, energy services for the long term interests of consumers of energy with respect to price, quality, safety, reliability and security of supply of energy.

In making this determination the AER may limit the costs that can be recovered (either generally or in particular cases or classes of costs).²¹ The AER's determination on a RoLR cost recovery scheme may also, so far as it relates to or affects tariffs payable by customers, differ between customers and classes of customers.²²

Where a designated RoLR (other than a default RoLR) agrees with the AER that it will not seek to recover costs (or only a particular percentage or component of its costs), the designated RoLR may not seek to recover any more than as agreed.²³

RoLR cost recovery scheme distributor payment determination

As part of its determination on the RoLR cost recovery scheme the AER must include a determination that one or more distributors make payments to the RoLR towards the costs of the scheme (the distributor payment determination).²⁴

The distributor's distribution determination or access arrangement (as applicable) are then taken to be amended so that any payments the distributor makes to the RoLR are taken to be:

- in the case of electricity—positive pass through amounts approved under clause 6.6 of the National Electricity Rules, or
- in the case of gas—approved cost pass throughs allowing variation of the distributor's reference tariffs.

These arrangements allow the distributor to recover its payments to the RoLR from all retailers through its network charges.

4.2 Principles for assessing RoLR cost recovery schemes

The purpose of this section is to explore how the AER will be guided by the three principles set out in the Retail Law and the national energy retail objective, and the factors it may have regard to.

In their report to the MCE, NERA and AAR proposed principles to guide the development of the national RoLR scheme. These principles were intended to apply to the RoLR regime more broadly, but may also be useful when assessing alternative approaches to RoLR cost recovery.

²⁰ Section 13 of the Retail Law.

²¹ Section 166(8) of the Retail Law.

²² Section 166(9) of the Retail Law.

²³ Section 167(5) of the Retail Law.

²⁴ Section 167 of the Retail Law.

In addition to the principles proposed by NERA and AAR, several jurisdictional regulators have developed principles for their RoLR schemes. For example in its development of an electricity RoLR scheme in South Australia, ESCOSA considered the scheme should include such objectives as achieving stable prices for RoLR customers and ensuring that the scheme does not compromise the financial position of the RoLR.²⁵ Similarly, the ESC (Victoria) established a set of criteria to assess various options for RoLR customer charges.²⁶

The AER must be guided by the three principles in the Retail Law and have regard to the national energy retail objective. In doing so, the AER considers that the following factors are likely to be important when assessing a RoLR's application for a cost recovery scheme:

- The approach should be as simple as possible and practical to implement. The approach should minimise administrative costs and ideally be able to be implemented using existing systems.
- Ideally the approach should be consistent across jurisdictions and between electricity and gas, however it should also be sufficiently flexible to respond to the wide range of circumstances that may apply at the time of a retailer failure.
- The approach should not compromise the financial position of the RoLR and should aim to minimise the risks of the RoLR itself defaulting.
- Ideally the approach should provide relatively stable and fair prices for RoLR customers and should insulate small customers from volatility in wholesale prices.
- Ideally the approach should provide an incentive for the RoLR to minimise its costs.
- The approach should provide regulatory certainty by facilitating transparent and robust decision making.

The AER has outlined these factors to provide guidance on the matters that may inform the AER's consideration of the principles in the Retail Law, and in particular, the national energy retail objective, when it makes its decisions on a RoLR's application for a cost recovery scheme. Depending on the application, the AER may give greater weight to certain factors over other factors.

Issues for consideration

Q1. Are the factors listed above appropriate?

Q2. Are there any additional factors that the AER should consider?

²⁵ ESCOSA, *Electricity retailer of last resort discussion paper*, March 2005, p. 3.

²⁶ ESC (Vic), *Issues paper—Energy Retailer of Last Resort*, October 2004, p. 22.

5 Process for making RoLR cost recovery scheme determinations

The Retail Law sets out the process that must be followed by the RoLR and the AER when setting a RoLR cost recovery scheme. Under s. 166 of the Retail Law the AER must, on application from a registered RoLR determine a RoLR cost recovery scheme for the RoLR. The RoLR's cost recovery scheme application must be in the form and contain the information specified in the AER RoLR guidelines. The AER may also require further information from the RoLR that is reasonably necessary to determine the application.

The AER is required to publish details of the applications for RoLR cost recovery schemes on its website and allow at least 20 business days for submissions from interested parties. The AER must decide whether to grant or refuse the application and publish a copy of its decision on its website.

Under s. 168 of the Retail Law, both the RoLR cost recovery scheme and RoLR cost recovery scheme distributor payment determination may be amended by the AER. This will be done either on application by a registered RoLR or affected distributor or after consultation with the registered RoLR or affected distributor.

5.1 Different approaches for different categories of RoLRs

As noted in section 3.3 above, under the Retail Law a RoLR can be registered as a default RoLRs or an additional RoLR. In its issues paper on RoLR registration and appointment, the AER sought feedback on a proposal to establish two 'categories' of additional registered RoLRs—additional RoLRs with a firm offer and additional RoLRs with a non-firm offer. A short description of each of these categories is set out in section 3.3 above.

The AER recognises that different approaches to RoLR cost recovery may be warranted for each class of registered RoLR and in some circumstances a RoLR may not apply for a RoLR cost recovery scheme at all. For example, unlike additional RoLRs, default RoLRs may recover costs incurred preparing for RoLR events as well as costs incurred on or after a RoLR event.²⁷

Regarding additional RoLRs the AER notes that in the lead up to a RoLR event or at the time of appointment as a designated RoLR, the retailer and the AER may agree to limit the costs that can be recovered.²⁸ This could include an agreement that the designated RoLR will not seek to recover any costs or only a capped amount or percentage of its costs. Where a designated RoLR agrees to limit its costs, it must not seek to recover any more than what was agreed. Therefore, any agreements made with the designated RoLR at the time of appointment will clearly affect the RoLR cost recovery scheme.

²⁷ Section 166(3) of the Retail Law.

²⁸ Section 133(2) of the Retail Law.

5.2 Time limits for RoLR cost recovery scheme applications

The Retail Law does not specify the time within which a RoLR should apply to the AER for a determination on its RoLR cost recovery scheme. The AER considers that this could be addressed in the RoLR guidelines. For example, the RoLR guidelines could require a RoLR to submit any application for post event costs no longer than nine months after the RoLR event. Similarly, for preparation costs claimed by a default RoLR, the guidelines could require that the RoLR make an application to the AER within a certain period of being registered as the default RoLR.

There are several reasons why these types of restrictions may be considered necessary. For instance, a time limit would avoid a situation where a retailer claims costs long after the costs are incurred. A lengthy delay between the RoLR event and the application would make the substantiation of the actual costs more difficult. A limit on the time within which a default RoLR can make an application for RoLR preparation costs may also contribute towards greater certainty in the market place. Timely consideration of RoLR cost recovery schemes would provide market participants with greater awareness of their obligations and potential liabilities under the Retail Law.

Issues for consideration

- Q3. Should the AER place restrictions in the RoLR guidelines on the time within which a RoLR may apply for a RoLR cost recovery scheme?
- Q4. If so, what is an appropriate time limit for an application for post event costs following a RoLR event?
- Q5. What is an appropriate time limit for an application from a default RoLR for preparation costs?

5.3 Information to be included in an application for a RoLR cost recovery scheme

A RoLR cost recovery scheme application must contain information and be in the form specified in the RoLR guidelines.²⁹ The AER is interested in what information regarding costs is readily available to a registered RoLR and could be provided to the AER to support an application for a RoLR cost recovery scheme. For example, a default RoLR might consider including market-based quotes for the scope of works to justify its proposed preparation costs as reasonable. Alternatively, if the work is proposed to be undertaken by a related party, the RoLR might consider providing historical unit-rate analysis that shows the costs are reasonable and/or cost reflective of industry standards.

The AER is also interested in stakeholders' views on what form information in a RoLR cost recovery application should be presented. For example, a cover sheet

²⁹ Section 166 of the Retail Law.

outlining essential summary information may assist interested parties to quickly identify the nature and content of the application. The application may attach more detailed analysis of the costs to support the application and outline any other relevant matters.

Issues for consideration

- Q6. What information should be included in an application for a RoLR cost recovery scheme?
- Q7. What form should the information in a RoLR cost recovery be presented in?

6 Issues the AER will consider when making RoLR cost recovery scheme determinations

This chapter explores some of the issues the AER may need to consider when making RoLR cost recovery scheme determinations. As noted earlier, this paper is not intended to be binding on the AER or retailers. In accordance with its obligations under the Retail Law, the AER will consider each application for a RoLR cost recovery scheme on its individual merits.

Considering these issues may also assist in informing the development of the cost recovery provisions in the RoLR guidelines. For example, understanding some of the likely approaches the AER will need to consider when making determinations on cost recovery schemes will assist the AER to develop meaningful information requirements in the RoLR guidelines.

6.1 Classes of costs and benefits

Under the Retail Law a RoLR cost recovery scheme is designed to allow a RoLR to recover:

- in the case of a default RoLR—costs incurred in preparing for RoLR events, and
- in the case of a designated RoLR (default and additional)—costs incurred on and after a RoLR event.³⁰

The AER considers that costs incurred by a RoLR are likely to be (at least partially) offset by the benefits accruing to the RoLR from gaining new customers without having to incur sales or marketing costs.

Without limiting the range of costs that a retailer may apply for in a RoLR cost recovery scheme application, this section explores some of the likely sources of costs and benefits that will be incurred by a designated RoLR on or after a RoLR event and, in the case of a default RoLR, costs incurred in preparing for a RoLR event. The classes of costs considered are summarised in table 6.1. The AER notes that other classes of costs may need to be considered when making RoLR cost recovery scheme determinations and invites submissions on the issues raised.

³⁰ Section 166(3) of the Retail Law.

Table 6.1 **Likely sources of RoLR costs**

Preparation costs	Costs associated with introducing greater automation of systems to process a large transfer of new customer information.
	Costs associated with having a database system that can store details for a large number of additional customers

Costs incurred on or after event	Energy purchasing and hedging costs.
	Retail operating costs including costs associated with establishing new supply arrangements, communicating with transferred customers, additional prudential requirements and the additional risk of customer defaults.
	Payments to insolvency officials.
	Payments to distributors for service orders.

Possible costs incurred preparing for a RoLR event

A default RoLR may incur costs associated with its legal obligation to act as a RoLR (even if a RoLR event does not occur). These costs could include one-off costs associated with establishing the RoLR scheme. Examples might include, implementing processes to accommodate the potential transfer of a large number of customers and adapting IT capability to accommodate additional customer information.

The AER understands that many of the existing state based RoLR cost recovery schemes have not provided a mechanism for RoLRs to recover upfront preparation costs.³¹ In their advice to the MCE, NERA and AAR noted that the majority of stakeholders considered that the up-front costs associated with being appointed a RoLR would be minimal, as the retailers' billing systems would be capable of handling the additional customers that would be transferred to them following a retailer failure.³²

However, NERA and AAR also noted that in the case of a large retailer failure, current systems that rely on manual processing for many functions are unlikely to be adequate to process a large number of customers. Given this, a default RoLR may need to incur costs to introduce greater automation of its systems to ensure that it is able to discharge its obligations following a large retailer failure.³³

³¹ The exception is South Australia. In its 2005 to 2010 price determination ETSA Utilities price determination, ESCOSA approved an allowance of \$1 million per year to establish the necessary RoLR processes. This allowance is not provided for in the AER's most recent revenue determination for ETSA Utilities.

³² NERA Economic Consulting and Allens Arthur Robinson, *Retailer of last resort—Review of current jurisdictional arrangements and development of a national policy framework* (Final report prepared for the MCE Retail Policy Working Group, January 2009, p. 29).

³³ NERA Economic Consulting and Allens Arthur Robinson, *Retailer of last resort—Review of current jurisdictional arrangements and development of a national policy framework* (Final report prepared for the MCE Retail Policy Working Group, January 2009, p. 83).

The AER notes that while it may be appropriate to allow a RoLR to recover these types of preparation costs, the actual amount that can be recovered would be limited to those costs which are directly related to the retailer's obligation to act as a default RoLR and would not be incurred by the RoLR under business as usual operations.

Issues for consideration

- Q8. What are likely sources of preparation costs for a default RoLR?
- Q9. What factors do you consider will affect the magnitude of preparation costs incurred by a default RoLR?
- Q10. What principles should be considered when separating costs incurred in preparing for a RoLR event from costs associated with the retailer's business as usual operations?

Possible costs incurred on or after a RoLR event

A registered RoLR may incur a range of costs at the time of a RoLR event, or following the transfer of the failed retailer's customer base. This may include incremental costs associated with procuring energy on the wholesale market and costs associated with the RoLR performing its retail functions. The Retail Law also provides that cost recovery schemes allow the RoLR to recover any costs that it must pay to an insolvency official under the RoLR provisions in the Retail Law and any costs paid to a distributor for uncompleted service orders.³⁴

The RoLR must supply small transferred customers at the RoLR's standing offer prices (subject to any variations under a RoLR cost recovery scheme).³⁵ In the absence of a RoLR event it could generally be expected that a retailer's standing offer price should allow it to recover the incremental wholesale purchasing and retail operating costs associated with supplying a new retail customer as well as a retail margin. However depending on the circumstances surrounding the RoLR event, a RoLR may incur additional hedging costs and retail operating costs that cannot be recovered from the RoLR's standing offer prices. Given this, arguably RoLR cost recovery schemes should only permit a RoLR to recover the additional **incremental** costs incurred by the RoLR following the retailer failure that were not factored into the RoLR's standing offer prices.

The RoLR cost recovery scheme should also only permit a RoLR to recover those costs that are associated with the retailer fulfilling its obligations under the RoLR scheme and would not otherwise be incurred under business as usual operations.

Energy purchase costs

The cost of purchasing energy is a significant component of a retailer's overall costs. For example in its 2009 Draft Decision on benchmark retail cost index for electricity,

³⁴ Section 166(3)(b) of the Retail Law.

³⁵ Section 145 of the Retail Law.

the Queensland regulator (QCA) estimated that the wholesale electricity costs for an electricity retailer are 44 per cent of the overall cost of providing electricity.³⁶

For electricity purchase costs, retailers purchase electricity from the wholesale market at a spot price that is determined by supply and demand conditions. To manage the risk that spot prices may fluctuate, retailers enter into financial contracts (known as hedging contracts or derivatives) that lock in firm prices for the energy they intend to buy in the future. These hedge contracts allow the retailer to manage risk and provide retail contracts to customers at relatively stable prices. A retailer's hedging strategy will depend on its expectations of future spot price outcomes and the load profile of its customers as well as the retailer's willingness to take risks regarding the under or over contracting of its load.

If a retailer failure occurs at a time of high electricity spot prices, this may increase the cost of hedging the load of the transferred customers beyond the amount that can be recovered from the RoLR's standing offer prices. Where a RoLR faces difficulty in obtaining hedging arrangements at reasonable prices, the RoLR is exposed to wholesale market purchasing risks for its unhedged load.

Many of the jurisdictional-based cost recovery schemes recognise that this may be a significant source of cost for a RoLR. ESCOSA's RoLR pricing guidelines allow the RoLR to recover electricity wholesale market purchasing and hedging costs.³⁷ In the ACT, the regulator (ICRC) permitted the RoLR to charge transferred customers the greater of the RoLR's default tariff or the wholesale spot price plus a margin of 10 per cent (capped at \$20/MWh in 1998 and adjusted for CPI).³⁸ The ESC (Vic) also considered that a RoLR will face risk associated with uncertainty over the size and shape of the load of the transferred customers. It considered that the significance of this risk will depend on the size of the RoLR relative to the number of customers transferred to the RoLR.³⁹

In contrast, in its draft determination on RoLR supply fees for small retail customers, IPART proposed that electricity wholesale costs should not be recovered by the RoLR as these costs would be fully recovered by the Electricity Tariff Equalisation Fund (ETEF) for up to three months. However the New South Wales Government intends to completely phase out ETEF by 1 July 2011.⁴⁰

However a RoLR event may not occur during a period of high wholesale prices. If a RoLR event occurs during a period of relatively benign wholesale prices, the RoLR may be able to obtain hedging arrangements for the additional load at a similar cost to that which underlies the RoLR's standing offer price.

For gas purchase costs of customers served by the Victorian Gas Market, the Sydney hub or Adelaide hub of the Short Term Trading Markets, gas can be immediately

³⁶ QCA, *Draft Decision—Benchmark Retail Cost Index for Electricity: 2010-11*, December 2009, p. 2.

³⁷ ESCOSA, *Electricity industry guideline number 8—Retailer of last resort pricing guideline*, July 2007, p. 8.

³⁸ ICRC (ACT), *Retailer of last resort guidelines*, December 2002, p. 2.

³⁹ ESC (Vic), *Issues paper—Energy retailer of last resort*, October 2004, p. 28.

⁴⁰ NSW Treasury, *Crown 2008-09 Annual report*, volume 3, p. 8.

bought off daily markets. In most circumstances, the price for gas in these daily markets will be capped for a period of time following a RoLR event under Part 19 and Part 20 of the National Gas Rules. For example following a RoLR event in Victoria, the market price is capped at \$40/GJ, otherwise the market ceiling is \$800/GJ. This mechanism mitigates the price risks for retailers purchasing gas in the daily markets.

Whether it be for customers in these daily markets or outside these markets, retailers will need to enter into long term contracts to support increased gas supply requirements to new customers (daily markets are only used on a short term basis for imbalances between gas supplies and customer needs). Following a RoLR event, the RoLR will need to enter into these contracts relatively quickly and may find it difficult to secure gas at low prices from producers and similarly to negotiate extra capacity arrangements on pipelines.

It is important to note however that the Retail Law provides some cost protection for retailers in these contractual negotiations. Section 137 of the Retail Law allows in some circumstances retailers to take over existing gas contractual arrangements of the failed retailer in the short term on a deemed price basis and also provides for capacity and production to be commercially negotiated. Such negotiations are subject to an access dispute process.

Retail operating costs

Following a RoLR event, a RoLR may incur a range of additional retail operating costs which may not be factored into the RoLR's standing offer price. For example, jurisdictional regulators have considered that there may be additional incremental retail operating costs associated with:

- establishing new supply arrangements with the transferred customers
- additional AEMO prudential requirements, and
- communicating with the customers of the failed retailer.

Each of these potential sources of cost are discussed below.

Establishing new supply arrangements

In its draft report on the RoLR supply fee for small customers, IPART noted that the RoLR may incur costs associated with establishing new supply arrangements with the customers of the failed retailer.⁴¹

The customer transfer process can be separated into two stages. The first stage involves the transfer of market settlement data (relating to customers from the failed retailer) to the RoLR. This is likely to occur immediately after a RoLR event is declared. In the case of electricity, the transfer of customers from the failed retailer to the RoLR will be conducted by AEMO automatically through a market settlement and transfer process. However this transfer process will not include key customer details. The retailer is not likely to incur costs relating to this stage of the transfer process.

⁴¹ IPART, *Retailer of last resort supply fee for small retail customers, Electricity Draft Report*, November 2007, pp. 17–18.

The second stage involves the transfer of key customer details. This information includes names and addresses and other important information such as whether the customer is on payment plans or hardship programs. To the extent that the RoLR's IT systems do not facilitate automatic transfer of customer information or there is inconsistency in the information provided, transferring customers to the RoLR may require manual information handling. Given this, the RoLR may incur additional costs associated with this part of the customer transfer process.

The AER is considering whether there should be provision for the regular transfer of customer data from retailers to a data custodian as part of its consultation on the RoLR plan.⁴² The outcome of this consultation may affect the costs a RoLR may incur associated with transferring customer information.

Additional prudential requirements

Additional prudential requirements may be a potential source of cost for a RoLR. AEMO calculates retailers' prudential requirements according to the retailers' load and price exposure. Following a retailer failure, AEMO is likely to require additional prudential support from the RoLR in proportion to the increase in its load and any increase in wholesale electricity prices. Given this, a RoLR may experience a step change in costs following a retailer failure associated with obtaining access to additional funds to meet its increased prudential requirements.

Communicating with transferred customers

IPART noted that a RoLR may incur costs associated with communicating with affected customers following a RoLR event. It considered that this will involve direct costs to the RoLR due to increased call centre activity, corresponding with customers and placing advertisements in newspapers.⁴³ The RoLR may also incur costs in providing a one-off information pack to transferred customers to explain the new arrangements for supply, billing and metering.

Payments to insolvency officials

An insolvency official has a range of obligations set out in Part 6 in the Retail Law. These include dealing with ongoing small customer complaints or disputes with the failed retailer, cancelling direct debit authorisations, refunding any outstanding prepayments and refunding security deposits.

Under s. 171 of the Retail Law an insolvency official of a failed retailer is entitled to be indemnified by the designated RoLR for any reasonable costs associated with complying with the requirements of the national RoLR scheme, a RoLR notice or a RoLR regulatory information notice. Under s. 166 of the Retail Law, the RoLR is entitled to recover any payments made to an insolvency official under a RoLR cost recovery scheme.

⁴² AER, *Issues paper—RoLR plan development*, November 2010.

⁴³ IPART, *Retailer of last resort supply fee for small retail customers, Electricity Draft Report*, November 2007, p. 14.

Payments to distributors for service orders

The Retail Law includes provisions to address circumstances where a customer has paid the failed retailer for a service order and this order was not completed at the time the customer was transferred to the RoLR. The RoLR may place the order with the relevant distributor and take steps to ensure its completion. The customer is not liable to pay for the order (except to the extent that it has not already paid for it). Under s. 166 of the Retail Law the RoLR may recover costs paid to a distributor for service orders (where these costs cannot be recovered from the customers concerned or from the failed retailer).

Issues for consideration

- Q11. What are the likely sources of incremental costs for a RoLR at the time of or following a RoLR event?
- Q12. What factors do you consider will affect the magnitude of the incremental costs incurred by a RoLR at the time of or following a RoLR event?
- Q13. In what circumstances are the incremental costs incurred after a RoLR event likely to be significant?

Possible benefits of a RoLR event

In addition to incurring costs, the RoLR may receive benefits following the RoLR event. In particular the RoLR will increase its customer base as customers are transferred to the RoLR from the failed retailer without incurring the usual marketing costs.

The ESC (Victoria) considered that benefits to a RoLR are likely to be material and that the acquisition of customers following a RoLR event may also be a more cost effective option to increase the customer base than a trade sale of an energy retailer.⁴⁴ It considered that a RoLR will extract ongoing value from the larger customer base by having the opportunity to establish a long-term commercial relationship with customers. The larger customer base may also improve economies of scale and profit margins per customer.⁴⁵

Similarly IPART considered that a RoLR is likely to benefit from acquiring new customers following a retailer failure. However, it considered this benefit would be a function of the length of time the transferred customer stays with the RoLR and that the benefits are likely to be smaller than retaining an existing regulated customer.⁴⁶

Despite noting these benefits, both the ESC (Victoria) and IPART did not explicitly factor them into the RoLR supply charge as they were considered too difficult to

⁴⁴ AGL reportedly paid approximately \$820 for each customer of Pulse Energy in July 2002 which was considered to be consistent with previous industry acquisitions. Source: ESC (Vic), *Final Decision—Energy Retailer of Last Resort*, February 2006, p. 36.

⁴⁵ ESC (Vic), *Draft decision—Energy retailer of last resort*, July 2005, pp. 40–41

⁴⁶ IPART, *Retailer of last resort supply fee for small retail customers*, *Electricity Draft Report*, November 2007, pp. 18–19.

accurately quantify.⁴⁷ IPART noted that the likely period of time a transferred customer would stay with the RoLR was unknown and that it was not yet possible to quantify any benefit based on actual experience.

Issues for consideration

Q14. Should the AER consider the benefits that may accrue to a RoLR following a retailer failure? If so, what methods can the RoLR and the AER adopt to quantify these benefits?

6.2 Estimating costs and benefits

This section explores some of the issues the AER may need to consider when making assessments on proposed approaches to estimating a RoLR's reasonable costs. This includes the most appropriate timing to assess costs and whether the AER should place limits on the costs that can be recovered.

Timing of assessment of costs and benefits

Costs and benefits may be assessed either before (an ex ante assessment) or after (ex post assessment) the RoLR has incurred any costs. There are advantages and disadvantages for each option.

The benefit of an ex ante approach is that it strengthens the retailer's incentive to minimise its costs. This is because the RoLR knows in advance the amount that it will be permitted to recover and will have an incentive to minimise costs to take advantage of efficiency gains. This approach also provides greater certainty on the likely charges that customers will be exposed to in the event that a retailer fails.

However an upfront assessment of costs has a number of disadvantages. A RoLR event is unpredictable and it may be difficult to accurately estimate the RoLR's post event costs upfront. The size of the failed retailer and the wholesale market conditions are largely unknown in advance of the event and will influence the magnitude of the costs incurred by the RoLR. While these costs may be estimated using scenario analysis, cost estimates made ex ante may not adequately consider the full range of potential price outcomes that may be experienced during a RoLR event. To the extent that the RoLR's costs are underestimated, the RoLR is exposed to considerable financial risk. In contrast, if RoLR costs are overestimated then customers bear that cost.

In addition an upfront assessment of costs may need to be undertaken periodically to ensure that the estimate is as accurate as possible (even if an actual RoLR event has not occurred). This regular review process may place a regulatory burden and cost on stakeholders.

An alternative approach is to assess the RoLR's post-event costs after the RoLR event has occurred. The key advantage of this approach is that the actual costs can be observed and the AER and the RoLR will have access to information that can inform

⁴⁷ ESC (Vic), *Final Decision—Energy Retailer of Last Resort*, February 2006, p. 36.

the assessment. However under this approach there is uncertainty for customers regarding the level of costs that will be recovered.

There is arguably also very little incentive for the RoLR to minimise its costs up to and during the RoLR period, particularly where it is expected that the RoLR's actual costs will be recovered through the RoLR cost recovery scheme. However the AER notes that under the Retail Law a RoLR is only entitled to recover its 'reasonable costs', rather than its actual costs. The risk that the AER will determine that particular costs are not reasonable may provide sufficient discipline on a RoLR to ensure that it minimises its costs.

In their approaches to RoLR cost recovery both the ESC (Victoria) and IPART have adopted an ex ante assessment process for post event costs. The ESC (Victoria) provided upfront estimates of both the retail operating costs and the additional wholesale energy costs that a RoLR is likely to incur following a RoLR event. The retail operating costs were calculated using the retailer's operating cost allowance in the standing offer tariff. The wholesale energy costs were calculated by probability weighting the expected costs in five separate wholesale market scenarios.⁴⁸ IPART estimated the additional retail operating costs by considering incremental cost estimates provided by the RoLRs for the Energy One event and another hypothetical event.⁴⁹

In its advice to the MCE, NERA and AAR proposed a combined approach.⁵⁰ Under this approach the AER would periodically determine an upfront fee which allows the RoLR to recover its administrative costs. To determine this fee the AER would estimate a RoLR's likely costs before the event. The RoLR could also apply to the AER after a RoLR event to recover any difference between the wholesale energy costs incurred and the amounts recovered from customers under the RoLR's standing offer price.

The AER notes that whether a RoLR's costs are assessed ex ante, ex post or a combination of these options may to some extent depend on the timeframes within which the RoLR lodges its application for a RoLR cost recovery scheme.

Limits on costs that can be recovered

Under the Retail Law the AER is explicitly permitted to limit the costs that can be recovered (either generally or in particular cases or classes of costs).⁵¹ A RoLR may also agree with the AER to limit the costs it will recover under a RoLR cost recovery scheme.⁵² Limits could be placed on the particular classes or types of costs that can be recovered or the period over which additional costs can be incurred by the RoLR.

⁴⁸ ESC (Vic), *Final decision—Retailer of last resort customer charges*, May 2008, p. 40.

⁴⁹ IPART, *Retailer of last resort supply fee for small retail customers, Electricity Draft Report*, November 2007, p. 19.

⁵⁰ NERA Economic Consulting and Allens Arthur Robinson, *Retailer of last resort—Review of current jurisdictional arrangements and development of a national policy framework* (Final report prepared for the MCE Retail Policy Working Group), January 2009, p. 88.

⁵¹ Section 166(8) of the Retail Law.

⁵² Section 167(5) of the Retail Law.

This section explores the types of limits the AER might consider placing on the costs that can be recovered when making RoLR cost recovery determinations.

Classes of costs

A RoLR cost recovery scheme should only permit a RoLR to recover costs incurred with respect to its obligations under the RoLR scheme.⁵³ For example, it may not be appropriate for a RoLR to recover costs associated with senior management time or general overheads as these costs may not be directly associated with the RoLR event. ESCOSA's RoLR pricing guideline specifically excludes existing fixed costs, such as office space already rented to the RoLR, from qualifying as a RoLR charge.⁵⁴

The Retail Law excludes additional RoLRs from recovering costs incurred in preparing for a RoLR event.⁵⁵ Limiting the preparation costs for a default RoLR may also be justified where these costs are relatively small compared to the overall costs incurred by a RoLR. However, limiting costs in this manner would need to be weighed against the risk that default RoLRs will have an inadequate incentive to prepare for a RoLR event.

Limits on magnitude of costs

A limit could be placed on the magnitude of costs that a RoLR can recover. For example, a RoLR may only recover its costs up to a pre-defined limit. This could limit the risk to customers of high RoLR costs.

However, this type of limit may not be necessary, given the Retail Law effectively limits the costs that a RoLR can recover to those that are reasonable. Any further limit imposed by the AER may also expose a RoLR to increased risk following a RoLR event.

Time based limits

Limits may also be applied to constrain the period over which reasonable RoLR costs can be incurred. For example, NERA and AAR proposed that the RoLR cost recovery arrangements only permit a retailer to recover its additional wholesale energy costs for a maximum period of three months.⁵⁶ It considered that this period should provide the RoLR with sufficient opportunity to obtain satisfactory hedging arrangements.

After three months, the small customer and the RoLR are deemed to have entered the RoLR's standard retail contract.⁵⁷ Given this, there may be no need for a special RoLR cost recovery arrangements beyond three months.

⁵³ Section 166(7) of the Retail Law.

⁵⁴ ESCOSA, *Electricity industry guideline number 8—Retailer of last resort pricing guideline*, July 2007, p. 8.

⁵⁵ Section 166(3) of the Retail Law.

⁵⁶ NERA Economic Consulting and Allens Arthur Robinson, *Retailer of last resort—Review of current jurisdictional arrangements and development of a national policy framework* (Final report prepared for the MCE Retail Policy Working Group), January 2009, p. 48.

⁵⁷ Section 147(3) of the Retail Law.

Agreed limits

In the lead up to a RoLR event or at the time of appointment as a designated RoLR, the AER may agree with additional RoLRs to limit the costs that can be recovered. This is discussed further in section 5.1 above.

Issues for consideration

- Q15. What limits should the AER consider placing on the RoLR costs that can be recovered?
- Q16. Should the AER consider placing a limit on the magnitude of the costs that a RoLR may recover (beyond the limit in the Retail Law that the costs must be ‘reasonable’)? If yes, what methods should the AER employ to set this limit?
- Q17. Should the period over which a RoLR can incur retail operating or wholesale costs be limited? If so, what is an appropriate limit?

6.3 Mechanisms for recovering costs

The AER has identified the following three possible cost recovery mechanisms:

- an upfront fee
- a retail tariff variation, and
- distribution network tariff variation.

Table 6.2 outlines features of each of these options.

This section of the paper outlines some of the advantages and disadvantages of each cost recovery mechanism. The AER welcomes stakeholders’ views on which mechanisms may be appropriate for each category of cost.

Table 6.2: Comparison of cost recovery mechanism

Mechanism	Ex ante or ex post assessment framework	Burden of cost recovery	Estimated time to recover costs	Relative administrative cost of recovery mechanism
Up front fee	Ex ante	Customers of the failed retailer	<6 months	Low
Retail tariff variation	Ex post or ex ante	Customers of the failed retailer	6-12 months	Medium – high
Distribution network tariff variation	Ex post or ex ante	Customers connected to the relevant distribution network	About one year	Medium – high

Up-front fee

An upfront fee is determined before a RoLR event and is a one off fee charged by the RoLR to the customers of the failed retailer. This approach generally implies an up-front assessment of costs and may be used to recover costs incurred on or after a RoLR event. This approach is not suitable for recovering a RoLR’s preparation costs (as it is unclear who this fee should be charged to and the need for cost recovery may be immediate). Victoria and New South Wales adopted this approach in their RoLR cost recovery regimes.

An advantage of this approach is that it provides certainty to customers and the RoLR on the amount that will be charged following a RoLR event. The upfront fee mechanism is also reasonably straight forward and allows the RoLR to recover its costs relatively quickly.

However this approach also has a number of disadvantages. In particular it may unfairly penalise customers of the failed retailer. It may also stifle retail competition in the long term as customers may be unwilling to sign-up to a new market entrant because of the risk of being charged a RoLR fee in the future. Finally, for customers of the failed retailer that are experiencing hardship, an upfront fee could exacerbate their financial difficulties.

Retail tariff variation

A retail tariff variation is similar to an upfront fee in that it allows a retailer to recover costs incurred on or after a RoLR event from the customers of the failed retailer. Under this approach the RoLR charges customers of the failed retailer the standing offer price plus an additional margin for a set period of time. This additional margin can be determined ex ante or ex post and is designed to allow the RoLR to recover its additional incremental costs.

As with an upfront fee, this approach may unfairly penalise customers of the failed retailer and stifle competition in the long-term. The approach may also place the

RoLR at a competitive disadvantage as transferred customers may consider that the RoLR's prices are comparatively higher. The higher retail prices may also encourage customers to transfer away from the RoLR to another retailer reasonably quickly. In these circumstances the RoLR may not be able to fully recover its costs.

Distribution network tariff variation

The final cost recovery mechanism identified by the AER is a distribution network tariff variation. This mechanism may be used to recover both the RoLR's preparation costs and the costs incurred on or after a RoLR event.

Under this approach the distributor makes payments to the RoLR to allow it to recover its costs. The distributor then recovers these payments from all customers by varying its distribution network tariffs. The distribution network tariffs are varied under clause 6.6 of the National Electricity Rules or approved pass throughs under the gas access arrangements.

A distribution network tariff variation allows the costs of the RoLR event to be recovered from a much broader customer base, so the burden of cost recovery experienced by individual customers is much smaller. The distribution network tariff variation may also provide the RoLR with an improved ability to recover all of its costs as it does not only recover costs from customers of the failed retailer.

However there are a number of challenges associated with this approach. The recovery of costs through this mechanism is likely to take the longest time compared to the other cost recovery mechanisms and may not be as administratively simple as an upfront fee.

Further, retail operations typically extend across the boundaries of different distribution networks and jurisdictions. Therefore it is not immediately clear which or how many distributors will be expected to pay RoLR related costs. In the simplest scenario, a RoLR event is confined to one jurisdiction, to one retailer and to one distributor. In this case it is arguable that identifying the distributor that must make payments towards the cost recovery scheme is straight-forward. However, as demonstrated by the Energy One and Jackgreen events, a RoLR event may affect customers that extend across boundaries of distribution systems and across jurisdictions.

To minimise administrative costs, ideally only one distributor should make payments towards the cost recovery scheme. However for a large RoLR event, this could present an unacceptable financial burden for customers within that distribution network. Cost recovery from customers of only one distribution network may also not be fair and equitable if the customers of the failed retailer are spread across numerous networks.

The AER is interested in stakeholders' views on the most appropriate mechanism for determining which distributor should make payments towards the costs of the scheme. Where more than one distributor should make these payments, the AER is also interested in how these costs should be divided.

Issues for consideration

- Q18. Are there any particular problems or difficulties with the cost recovery mechanisms discussed above?
- Q19. Are there any other appropriate cost recovery mechanisms?
- Q20. What is the most appropriate cost recovery mechanism for each class of cost that a RoLR may recover?
- Q21. For a distribution network tariff variation, what are the relevant considerations when determining which distributor should make payments to the retailer?
- Q22. If more than one distributor is required to make payments towards the costs of the scheme, how should the costs be divided between each of the distributors?

A. Summary of existing approaches to RoLR cost recovery

Queensland

Queensland operates a RoLR cost recovery scheme for electricity but not for gas. Under the scheme, RoLRs:

- are required to supply transferred customers under a standing offer contract and
- can charge transferred customers an additional one-off fee that must be approved by the QCA.

In approving the fee the QCA will consider the RoLR's incremental administrative costs and other energy costs to the extent that they are not included in the notified prices.

New South Wales

New South Wales has separate RoLR cost recovery schemes for electricity and gas. Under the electricity RoLR cost recovery scheme, RoLRs:

- are required to supply transferred customers at the standing offer tariff for a period of three months (though the RoLR period may be up to three years), and
- can charge transferred customers an additional one-off fee.

The upfront fee is set by IPART and can be used to recover incremental retail costs not recovered under the retail tariff. The fee cannot be used to recover the cost of supplying customers or the risk of significant changes to wholesale market price volatility, as these are already recovered under the retail tariff.

Under the gas RoLR cost recovery scheme, RoLRs are required to supply transferred customers with a standard form contract and can charge transferred customers an additional one-off fee. The one-off fee must be approved by the minister (in consultation with the tribunal).

Victoria

Victoria has RoLR cost recovery schemes for both electricity and gas. Under each scheme, RoLRs are required to supply transferred customers with a standing offer tariff for a period of three months and can charge transferred customers an additional one-off fee.

The one-off fee can be used to recover incremental energy costs and retail operating costs above those incorporated in the standing offer tariff (including wholesale market risk and costs involved in the provision of RoLR services). The fee cannot be used to recover costs already accounted for by other cost determinations, including:

- network charges, market fees and retail operating costs (apart from identified RoLR costs) which are accounted for in the standing offer tariff, and

- distributor costs, commercial risks and commercial processing costs, which are already accounted for in the review of Gas Access Arrangements and Electricity Distribution Price Review.

South Australia

South Australia operates a RoLR scheme for electricity. Under the scheme the local distributor (ETSA Utilities) is the RoLR. ETSA Utilities subcontracts the RoLR retail functions to AGL Energy.

The RoLR is required to supply transferred customers under a standing offer contract for a period of three months. The RoLR can recover its costs through a revenue allowance, an electricity charge and a pass-through. In its 2005 to 2010 price determination ETSA Utilities price determination, ESCOSA approved an allowance of \$1 million per year to establish the necessary RoLR processes. This allowance is not provided for in the AER's most recent revenue determination for ETSA Utilities.

The electricity charge is paid by customers and used to recoup energy costs and retail operating costs. For small customers it consists of a fixed element (the supply charge) and a variable element (the usage charge). The variable element must be consistent with pricing requirements under the Electricity Supply Act, which suggests that it should be similar or identical to the annual Retail Tariff Adjustments made by ESCOSA. The fixed element must not exceed one dollar per day per connection point. Large customers must be charged a fair and reasonable charge comprising wholesale energy costs, regulated charges, other retail operating costs and administrative costs. Further, ETSA Utilities must reimburse large customers if the charges result in an over-recovery of costs. If there is a shortfall then the RoLR can apply to the AER for a pass-through to allow the recovery of any extra costs.

Tasmania

The Tasmanian electricity RoLR cost recovery scheme applies only to very large customers where full retail competition exists. The RoLR may only recover its costs through the electricity charge, which must be approved by OTTER. The electricity charge must not result in the customer paying more than the cost incurred by the RoLR in supplying the retail service, taking into account the wholesale pool price, distribution and transmission charges, reasonable margin (approved by OTTER) and any other costs which are, in the opinion of OTTER, incurred in providing RoLR services.

ACT

The Australian Capital Territory electricity RoLR arrangements require a RoLR to supply transferred customers for a period of three months or until the customer terminates the contract. Transferred customers are charged the greater of the RoLR's default tariff or the AEMO pool price plus a 10 per cent margin (capped at \$20/MWh and adjusted for change in CPI relative to fourth quarter 1998). This cost recovery is limited to the electricity charge.