INFORMATION

Advice on a Best Practice Retail Price Regulation Methodology

Publication of final report

The AEMC has provided its final advice on a recommended method for setting regulated retail electricity prices for small customers. The approach to retail price regulation outlined in this advice is principles based, to allow regulators to take their particular jurisdictional circumstances into account.

Purpose of the advice

The AEMC was asked by the Standing Council on Energy and Resources (SCER) to develop a recommended method for setting regulated retail electricity prices for small customers.

Most small electricity customers can choose to be supplied under a standard electricity contract or under a competitive market offer. In all states and territories, except for Victoria and South Australia, the price of standard contracts ("regulated retail price") is set by a jurisdictional regulator or government. The price of market offers is set by retailers.

Approaches to setting regulated retail prices for small customers currently differ across jurisdictions.

Decisions about retention of a regulated retail price in contestable markets and the overarching form of regulation are made by jurisdictional governments.

There have been significant developments in retail energy markets since the Council of Australian Governments (COAG) initiated this work in December 2012. These include the South Australian Government's decision to remove regulated retail prices as of February 2013 and the Queensland Government's announcement of its intention to remove regulation of retail prices in South-East Queensland by 1 July 2015.

Recommendations

The Commission's recommended method builds on a number of the current approaches taken by jurisdictional regulators. The impact on the level of regulated retail prices would depend on how regulators implemented the recommended method.

Where a regulated retail price is maintained the Commission considers that a stable regulatory framework and method is important for the effective operation of the competitive wholesale and retail sectors. A consistent approach reduces regulatory risk for retailers and promotes competition, which both deliver long-term benefits for customers.

Objective of price regulation

A stable and clear objective is key, since it can assist regulators in making subsequent decisions about how retail prices should be regulated.

The AEMC has articulated an objective for retail price regulation that can accommodate the differing retail market characteristics across the jurisdictions:

> *In promoting the long-term interests of customers, retail price regulation should determine electricity prices for small customers, which:*
>
> - *reflect the efficient costs of providing retail electricity services; and*
> - *facilitate the development of competition in retail electricity markets, where competition may be feasible.*

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A consistent approach to setting regulated retail prices reduces regulatory risk for retailers and promotes competition, which both deliver long-term benefits for customers.

Recommendations (continued)

Key cost components

Retailers face a range of different costs in providing electricity services to customers. Jurisdictional regulators set the regulated retail price by estimating each of the cost components that are likely to be faced by the retailer. Together these cost components comprise the retail cost stack, which is used to set the regulated retail price. An indicative residential retail cost stack comprises components for:

- wholesale energy costs;
- transmission and distribution network costs;
- retail operating costs and retail margin;
- headroom to facilitate competition; and
- environmental and jurisdictional schemes.

Jurisdictional regulators do not have a formal role in setting all of the cost components. For example, transmission and distribution network costs are set under a separate process by an independent regulator, eg the Australian Energy Regulator. Jurisdictional regulators include network costs as part of the retail cost stack in setting the regulated retail price.

For the setting of the remaining cost components, the jurisdictional regulator does have a formal role. This report makes a number of recommendations relating to the setting of these cost components, including for the key cost components of wholesale energy costs and headroom for facilitating competition, as discussed below.

Wholesale energy costs

Retailers buy energy directly from the wholesale spot market, where prices can be volatile. Retailers manage this volatility (and associated risk) through a variety of strategies, including entering into financial contracts with generators. These contracts aim to lock in future wholesale prices. Prices for future contracts will generally produce the best estimates of future energy purchase costs.

The Commission recommends that these future prices should be used to estimate energy purchase costs. If a regulator considers that this method would not produce reliable results then a method approximating the long-term costs of generation should be used (commonly known as long-run marginal cost).

Headroom for facilitating competition

Where jurisdictions consider competition to be feasible, transparently calculated “headroom” should be included in the regulated retail price. For competition to develop, regulated retail prices must be set at a level to allow retailers to efficiently enter the market and compete for customers. The Commission considers that effective competitive markets are generally the best means of promoting customers’ long-term interests.

Other cost components

The report also makes a number of recommendations relating to the other cost components, including network costs, retail operating costs and margin, and environmental and jurisdictional schemes.

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