Review of Regulated Retail Tariffs and Charges for Gas 2013-2016

9 November 2012

ActewAGL

for you

Contents

1. Overview of ActewAGL’s proposal

On 27 September 2012 the New South Wales (NSW) Minister for Energy issued a Terms of Reference (ToR) to the Independent Pricing and Regulatory Tribunal (IPART) requesting that IPART continue regulating default tariffs for small retail gas customers in NSW for the period 1 July 2013 to 30 June 2016.

ActewAGL Retail (ActewAGL) submits this proposal in response to IPART’s invitation, received on 28 September 2012, to propose a revised Voluntary Transitional Pricing Arrangement (VTPA) for the 1 July 2013 to 30 June 2016 period. Given that regulation is to remain for a further three year period, ActewAGL agrees with the Tribunal that the VTPA’s “are a relatively “light-handed” form of regulation that can act as a stepping stone towards the removal of price regulation.”[1] Therefore, ActewAGL confirms that it is willing to enter into a new VTPA with IPART to apply from 1 July 2013 to 30 June 2016.

ActewAGL notes it has had limited time to submit its proposal for a revised VTPA and respond to the supplementary information request. IPART has indicated that it will “analyse…proposals to determine whether they are reasonable and reflect the efficient costs of supplying gas to small retail customers.”[2]

ActewAGL considers that it is important that pricing proposals are developed with consideration of all relevant information. ActewAGL’s preliminary internal modelling indicates that the R component of the 2013/14 default tariffs in NSW will be required to increase by around 1.5 per cent above CPI in order to maintain an appropriate margin consistent with IPART’s previous final decision. Further, ActewAGL proposes to incorporate a review of wholesale gas prices ahead of the second and third years review

ActewAGL proposes the continuation of the current VTPA which is based on a R+N+C structure for setting prices but with increased flexibility to account for additional uncertainties in this regulatory period. ActewAGL proposes maintaining the special circumstances clause for pass throughs in order to efficiently and transparently deal with issues outside ActewAGL’s control.

[1] IPART 2012d
[2] IPART 2012a

2. Introduction

ActewAGL currently supplies around 25,000 gas customers in the following areas in southeast NSW:

- Queanbeyan and Palerang;
- Capital Region (Boorowa, Goulburn-Mulwaree, Yass and Young); and
- Shoalhaven.

These customers currently account for about 19 per cent of ActewAGL's total gas customer base in NSW and the ACT.

Full retail contestability (FRC) was introduced to NSW retail gas markets in January 2002. However, IPART continues to regulate default tariffs for small retail customers who have not entered into negotiated contracts. Prices are regulated through a VTPA due to expire on 30 June 2013.

This new VTPA period will be the fourth 'three-year' period of price regulation for small customers who have not entered into a contract since the introduction of FRC to the NSW gas retail market. Throughout this period, ActewAGL has consistently highlighted the merits of removing price regulation. The context within which the current review is taking place illustrates the difficulty for a regulator to determine an appropriate price in a competitive market, particularly over a longer term three-year period. In particular, uncertainty over wholesale gas costs in the longer term as well as changes in the price on carbon mean that a flexible VTPA will be required for the 2013-2016 period.

3. Regulation of Retail Gas Prices 2013-2016

This submission responds to IPART's invitation of 28 September 2012 for ActewAGL to submit a revised VTPA proposal for the period 1 July 2013 to 30 June 2016. IPART has issued this invitation in response to a letter from the NSW Minister for Energy, which asks that IPART:

> ...continue to regulate the standard tariffs for small retail gas customers for the period 1 July 2013 to 30 June 2016, in accordance with section 27 of the *Gas Supply Act 1996* (the Act). I request that the tribunal ensure that either new VTPAs or gas pricing orders are in place for the period 1 July 2013 to 30 June 2016.[3]

ActewAGL supports IPART's approach to continue to use a VTPA rather than gas pricing orders.

ActewAGL notes that in 2006 the Council of Australian Governments (COAG) committed to remove retail price regulation where there is effective retail competition.[4] ActewAGL maintains that persisting with retail price regulation increases costs and risks for retailers and consumers and has the potential to distort the gas market, denying consumers the benefits that flow from a truly competitive market free of unnecessary regulatory constraints. Market based outcomes will enable customers to enjoy the full benefits of greater choice and competitive price offers. This view is consistent with the Standing Council on Energy and Resources (SCER) aim to promote "greater competition in the retail market to deliver greater choice to consumers."[5]

ActewAGL notes the current review by the Australian Energy Market Commission (AEMC) of the effectiveness of competition in the NSW retail energy market scheduled for completion by September 2013. The AEMC review will assess "the state of competition and the extent to which it is deemed effective for small electricity and natural gas customers…"[6] and "provide advice on the way in which the effectiveness of competition can be improved (where competition is found to be not effective) and possible implementation strategies for the removal of retail price regulation for small electricity and natural gas customers in NSW."[7]

The timing of the review means that the AEMC's advice on the effectiveness of competition and the possible implementation strategies for the removal of retail price regulation will not be available in time to influence this retail price review. It is noted that the regulatory period as provided in the Terms of Reference for the concurrent review into regulated electricity tariffs may be terminated earlier at the direction of the Minister. ActewAGL presumes that this could be invoked following an AEMC conclusion that electricity retail competition is effective, and similarly would also apply to the retail gas market if it is found to be effective. In anticipation of the upcoming AEMC review it is particularly important to maintain or reinforce the "light-handed" nature of IPART's VTPA approach.

A "light-handed" VTPA will also provide more flexibility to take account of a number of uncertainties apparent in this regulatory period. In particular, ActewAGL has been unable to

[3] IPART 2012c
[4] COAG 2006
[5] SCER 2012
[6] ibid, p. 4
[7] ibid

obtain firm forecasts of wholesale gas costs for years two and three of the regulatory period. The legislated changes to the price on carbon during the period as well as the potential abolition of the price on carbon will also require the VTPA to be flexible in the 2013-2016 period.

To this end, ActewAGL encourages IPART to set a price path for the first year of the regulatory period, with a single subsequent within period review of the wholesale cost of gas for the final 2 years. ActewAGL notes that this is similar to the current process for setting electricity retail prices each year in NSW where electricity purchase costs are reviewed prior to setting prices each year.

ActewAGL has accumulated the information requested by the Tribunal in its 28th September 2012 letter and, as discussed with the Tribunal's secretariat, has attached this information to this submission.

ActewAGL notes that it intends to review its tariffs for the 2013-2016 regulatory period in order to streamline the number of tariffs available in each region. A number of tariffs are currently either obsolete or have different names. For the purposes of simplicity for its customers, as well as reducing administrative costs, ActewAGL proposes to reduce the number of available tariffs to one residential and one commercial tariff in each of its three NSW regions.

4. ActewAGL’s proposal for 2013-2016

ActewAGL recommends the continuation of the current VTPA mechanism based on a R+N+C structure where IPART sets the price path for R as part of the VTPA, while the N and C components are effectively passed through.

Given the remaining uncertainties surrounding the price on the wholesale cost of gas, ActewAGL proposes that IPART set a price path for the first year of the regulatory period, with a single subsequent review of the wholesale cost of gas for the final two years of the period. ActewAGL would submit a proposal to the Tribunal in relation to the wholesale cost of gas and the impact on prices by 1 March for a 1 July pass through.

ActewAGL appreciates that the uncertainty in the wholesale cost of gas requires a shift in the current R + N + C methodology in that the R component for the final two years of the price period will be unknown at the final decision stage. However, ActewAGL intends to minimise the administrative burden by providing information on all other components of R and limiting the within period review to a one off review of wholesale gas costs prior to year 2 of the period.

ActewAGL envisages that the review will involve provision of wholesale gas cost information once it is received prior to year 2 of the review period. The review prior to year 2 will complete the cost information determined in this review currently undertaken by IPARTof the R component and enable the Tribunal to set a price path for years 2 and 3 accordingly.

ActewAGL’s preliminary internal modelling indicates that the R component of the 2013/14 default tariffs in NSW will be required to increase by around 1.5 per cent above CPI in order to maintain an appropriate margin consistent with IPART’s previous final decision, assuming network charges change in line with the AER’s current decisions. This calculation has been made based on consumption data for the 2011 calendar year. ActewAGL will be able to update the modelling early next year.

Since the VTPA is intended to span three years, the special circumstances provision (paragraph 4.8 in the 2010-13 VTPA) must still be retained in the 2013-16 VTPA to ensure that costs associated with events not included within the annual price review process and are outside ActewAGL’s control can be reflected in regulated retail prices during the period of the VTPA. ActewAGL will work with the Tribunal on the required amendments to the VTPA.

5. Cost components of the proposal

ActewAGL notes that IPART intends to undertake “analysis to ensure that the proposed regulated retail tariffs and charges reflect the efficient costs of gas supply to these customers over the regulatory period.”[8] IPART has sought certain information from each Standard Retailer in NSW to conduct this analysis and ActewAGL is in the process of completing the required information set for submission to IPART. In this section, ActewAGL provides a brief description of the issues for each cost component.

Wholesale gas costs

Wholesale gas costs represent a significant part of the total retail cost to the end-use customer. ActewAGL has outsourced the management of wholesale gas purchases to AGL to achieve an outcome that enables ActewAGL to manage risk and benefit from economies of scale.

ActewAGL is currently consulting with its wholesale gas provider, AGL, regarding the wholesale cost of gas. ActewAGL understand that its wholesale provider, AGL, is in price review proceedings with its wholesale providers and is therefore unable to commit beyond one year for the provision of wholesale gas costs. However, prior to year 2 of the period, a price for both year 2 and 3 of the period will be available.

ActewAGL notes that the Tribunal currently updates estimates of electricity purchase costs each year for the regulated electricity retail tariff and encourages the Tribunal to consider a single review of wholesale gas costs to take place for the final two years of the period as discussed in section 4.

Network charges

The Australian Energy Regulator (AER) is due to review the access arrangements which cover the New South Wales gas distribution networks for the 2015-2020 period. Network tariffs make up a significant proportion of final retail tariffs, and are not within the control of ActewAGL Retail. As the outcome of this access arrangement review process will not be known until well into the regulatory period but will impact on the final retail price ActewAGL can charge its customers, ActewAGL proposes that actual gas network tariffs approved each year by the AER be used to set the regulated gas retail tariff.

This will be a continuation of the current VTPA approach and avoids ActewAGL being forced to inappropriately face forecasting risk associated with network tariffs, which are largely determined through a regulated process. This approach is discussed further in section 7 below.

[8] IPART 2012d

Retail costs

ActewAGL proposes that the allowance for retail operating costs should be set at a level that includes all costs of acquiring, retaining and servicing customers. ActewAGL's retail operating costs are made up of a number of outsourced managed gas services including; billing and revenue collection, management of a customer contact centre, office space rental, debt collection and IT system costs. In addition to these outsourced expenditures, ActewAGL incurs marketing, including customer acquisition and retention, costs and general operating expenditure.

ActewAGL's costs have increased by more than the price path allowed by IPART in the 2010-2013 regulatory period, due to a number of factors. Primarily, the increase in competition following the sale of Government owned retail energy businesses has resulted in an increase in churn rates. This means customer acquisition and retention costs have increased beyond the allowance in the current period. In addition, the price increases from carbon and network charges have resulted in increases in bad debts.

ActewAGL has provided its forecast retail costs in the information attached to this submission.

Margin

The retail margin represents the return that a gas retailer requires in order to attract the capital to provide retail services. Retailers need to earn a sufficient return in order to compensate for the risks associated with providing an energy retail service. The size of the margin has important implications for market competition. A high margin incentivises retailers to maintain and acquire customers thereby promoting competitive tension and constraining prices to reflect the efficient cost of supply. Conversely, low margins create risks not only for the regulated supplier but for the whole market through the potential withdrawal of service offers, and in the worst case defaults.

In the previous review IPART accepted SFG Consulting's recommendation to use an EBITDA margin range of 7.3% to 8.3%. This reflected an EBIT margin of approximately 5.7%-6.7% with a mid-point of 6.25%, slightly lower than ActewAGL's proposal of 6.5%. ActewAGL maintains that it requires this margin to fully compensate retailers for the entire systematic risk incurred.

Consequently, to fully incorporate the systematic risk, and to avoid the regulated price potentially acting as a price ceiling, ActewAGL believes that an appropriate retailer margin should be at least 6.5%.

Consumer Price Index

ActewAGL is aware that there are many different methods of calculating the consumer price index (CPI). In the current VTPA, the CPI is equal to the CPI index number for the quarter ending in December of the preceding calendar year divided by the CPI index number for the corresponding quarter of the previous year to 2 decimal places. ActewAGL notes for the information of the Tribunal, that for all of its other regulatory calculations (AER and ICRC), the calculation for CPI is made using the average of four quarters in year i divided by the average of the four quarters in year i-1. ActewAGL believes that the current method of calculating CPI results in the CPI being more affected by ad hoc events than if it was based on the average of the four quarters. It would also be simpler for ActewAGL to use the same CPI calculation as that used for its other regulatory decisions.

6. Special circumstances events

The VTPA for the last two periods has allowed ActewAGL to change average default prices each year within a CPI +/- x limit. Importantly, the VTPA also contained a special circumstances provision, allowing some flexibility in prices if costs changed significantly. This provision has been used during the period in which a VTPA has been in place and has been effective at providing the necessary flexibility while maintaining prices at cost reflective levels.

As the VTPA is intended to span three years, it will need to include sufficient flexibility for ActewAGL to adjust prices in response to unexpected changes in retailer costs arising from market circumstances. ActewAGL proposes to maintain a similar VTPA arrangement to that which applied from 2010 to 2013.

The current VTPA includes, in paragraph 4.8, a mechanism to vary average default prices outside the limits set in the VTPA as a result of 'special circumstances'. These include, but are not limited to, events that result in changes to costs such as regulatory changes, taxation changes, unanticipated field price review or fundamental changes to gas market frameworks and arrangements.

ActewAGL proposes to maintain the 'special circumstances' provision in order to account for all possible types of events that could occur that may be appropriately considered under such a clause. ActewAGL believes that the current drafting of section 4.8 of the VTPA is sufficiently broad to allow IPART to consider the potential scope of pass through events and therefore proposes retention of this clause without change in the VTPA.

7. Adjustment mechanism of N and C

In addition to the 'special circumstance' provision, ActewAGL proposes the continuation of the current mechanism where network tariffs (N) and the price on carbon (C) are passed through.

ActewAGL considers this approach appropriate as these costs:

- are largely outside the control of ActewAGL;
- can be determined and verified by reference to external factors; and
- can have the potential to significantly impact the viability of the retail business where these costs are incorrectly forecast.

Changes in tariffs as a result of the operation of the adjustment mechanism will be in line with the underlying change in costs, consistent with the current 2010-13 period.

Network tariffs (N)

Network prices for 2013/14 are unlikely to be known prior to IPART's draft decision on the VTPA, and network prices in subsequent years are potentially subject to a number of tariff variations, including a revised regulatory decision from 1 July 2015 for NSW and ACT regions. ActewAGL also notes IPART's submission to the AEMC[9] proposing changes to the annual price setting arrangements to provide for network prices to be set earlier and with greater consultation and information provision to retailers and customers. ActewAGL agrees with the proposal for distribution charges to be set one month earlier than the current arrangements in the NER, meaning that they would be finalised two months prior to taking effect.

ActewAGL therefore proposes the VTPA continue to be structured so that the Network (N) component is a pass through and is reflected in retail tariffs. This approach ensures that ActewAGL does not face risks associated with changes in network tariffs that are outside its control, as well as ensuring that customers avoid the costs of forecasting error resulting from forecasting future network tariffs, which are themselves subject to pass through provisions for unexpected and unforeseen events. ActewAGL proposes that this mechanism be symmetrical, such that both increases and decreases in network tariffs are consistency reflected in the regulated retail tariff.

Price on carbon (C)

The *Clean Energy Act 2011* commenced on 2 April 2012. The legislative package sets out the carbon pricing mechanism that began on 1 July 2012 and sets out how the pricing mechanism will be run. For the first three years the price on carbon is a fixed charge after which a floating price period is scheduled to commence.

[9] IPART 2012d

A carbon component (C) was included in ActewAGL's 2010-2013 VTPA to provide for the costs of a carbon pollution reduction scheme implemented by the Federal Government to be passed through in accordance with the scheme. As part of the price approval process for ActewAGL's 2012/13 prices, ActewAGL provided the Tribunal with a submission regarding the pass through of carbon costs.

The methodology for calculating the carbon component was to estimate the upstream carbon cost, the downstream (or fuel combustion) carbon cost, an allowance for increases in bad debts and an uplift adjustment to the margin. The methodology was accepted as reasonable by the Tribunal and passed through in prices from 1 July 2012[10]. ActewAGL proposes to continue using the approved methodology as outlined above to calculate the carbon component for the N+R+C price adjustment.

As noted above, the final year of the regulatory period coincides with the first year in which the price on carbon is not fixed and is a floating price. ActewAGL also notes that the Coalition has included in its election platform that it will "abolish the carbon tax"[11] if it is elected at the next Federal election. The VTPA will need to be suitably flexible to allow for ActewAGL to propose a calculation method for determining the carbon component that takes account of possible alterations required to the calculation of the carbon price. The decision on the best way to estimate the cost of carbon would be best deferred until that time when more information is known. It is envisaged that the current situation that provides for a submission four months prior to the implementation of prices would be suitable for this purpose.

[10] IPART 2012b
[11] Abbot T, 2012

8. Miscellaneous fees and charges

In a submission to IPART's 2010 review of gas prices, ActewAGL advised IPART of its intention to adjust its miscellaneous fees and charges so that they directly reflect the network charges incurred. Both Jemena Gas Networks and ActewAGL Distribution network charges will increase each year as determined by their access arrangements, however, increases beyond that time period are not available.

ActewAGL proposes the same mechanism for treatment of miscellaneous fees and charges as applied for the 2010-2013 regulatory period. That is:

- to increase its miscellaneous fees and charges by no more than CPI on average in each year of the regulatory period;
- that standard retail miscellaneous charges be aligned with corresponding network miscellaneous fees and charges;
- to continue to add an administration fee, annually adjusted by CPI, to network miscellaneous charges;
- that the approved VTPA permit the pass through of future changes in network miscellaneous charges providing a more efficient process rather than conducting a regulatory review to approve such changes. One potential example, although currently unclear, is additional costs stemming from the implementation of the national energy customer framework.

ActewAGL believes that the arrangements for miscellaneous charges as outlined in paragraph 5 of the VTPA have worked well during the current period and should be retained for the 2013-2016 period.

9. Glossary

Abbreviation	Meaning
ActewAGL	Unless otherwise specified, refers to the ActewAGL retail partnership.
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
AEU	Australian Emission Unit
COAG	Council of Australian Governments
CPI	Consumer Price Index
ICRC	Independent Competition and Regulatory Commission
IPART	Independent Pricing and Regulatory Tribunal (of New South Wales)
SCER	Standing Council on Energy Resources
VTPA	Voluntary Transitional Pricing Arrangement

10. References

Abbott, T (Leader of the Opposition) 2012, *The Coalition's Plan to Abolish the Carbon Tax,* 29 June, viewed 17 October 2012, < http://www.liberal.org.au/Share/HRO_CT_doc.pdf >

Council of Australian Governments 2006, *Communiqué*, Attachment B, 10 February

Independent Pricing and Regulatory Tribunal 2012a, *Fact Sheet: Review of regulated retail tariffs and charges for gas: 1 July 2013 to 30 June 2016*, September.

Independent Pricing and Regulatory Tribunal 2012b, *IPART's proposed changes to the National Electricity Rules,* 12 September

Independent Pricing and Regulatory Tribunal 2012c, 'Letter from Chris Hartcher MP, Minister for Resources and Energy to Dr Peter Boxall, Chairman IPART, 27 September'.

Independent Pricing and Regulatory Tribunal 2012d, 'Letter from Fiona Towers, Acting Chief Executive Officer IPART to Michael Costello, Chief Executive Officer, ActewAGL, 28 September'.

Standing Council on Energy and Resources 2012, Meeting of Energy Ministers, Communiqué*,* 5 October