



Submission to the Independent Pricing and Regulatory Tribunal's Issues Paper

Review of Gas Regulated Retail Tariffs

Regulatory period
commencing 1 July 2004

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EXECUTIVE SUMMARY

ActewAGL currently supplies about 11,600 gas customers in the Queanbeyan and Yarrowlumla (Queanbeyan) and Nowra and Shoalhaven areas in NSW. These customers make up about 11% of ActewAGL's total customer base in the NSW and ACT regions. ActewAGL took over the supply to AGL Retail Energy Limited's (AGLRE) gas customers in Queanbeyan in October 2000. ActewAGL purchased Integral Energy's gas business in the Nowra and Shoalhaven areas in July 2002.

ActewAGL is also in the process of becoming the standard gas supplier for approximately 12,000 customer in the 'Capital Region' which extends across the towns of Goulburn, Yass, Young and Boorowa and surrounding regions. It is anticipated that this process will be complete by 1 July 2004.

Voluntary pricing principles were agreed between ActewAGL and the Tribunal for Queanbeyan in July 2003 and for Nowra/Shoalhaven in October 2002. Both VPPs are due to expire on 30 June 2004.

It is ActewAGL's position that the most appropriate form of default price regulation for the coming regulatory period (2004-2007) needs to be assessed in the context of the NSW government's broader policy objectives in relation to energy market reform. A review of the legislative requirements for the energy market in NSW highlight three key objectives relevant to price regulation:

- promote competition in the energy market and ensure that the public receives the benefit of a competitive market;
- take proper account of and protect the interest of small retail customers (that is, ensure that small retail customers are not exposed to unacceptable price shocks); and
- take proper account of the business interests of persons supplying energy to small retail customers.

The NSW gas retail market has been open to competition since 1 January 2002. It is ActewAGL's view that a light-handed approach to setting default prices is now appropriate and would be most effective in meeting the Government's policy objectives whilst at the same time providing customers with a smooth transition from regulated prices. Such an approach would also provide ActewAGL with the flexibility to align prices in Queanbeyan with those in the ACT.

ActewAGL proposes that for the next regulatory period, the form of default price regulation should be based on a single average price cap (of CPI) on all tariff categories ("CPI approach"). If retailers propose average price variations that are less than or equal to the price cap then these should be allowed without further review. If retailers propose average price variations that exceed CPI (ie. a 'CPI plus' proposal), then this increase would need to be justified.

1. BACKGROUND

ActewAGL Retail (ActewAGL) is currently the standard gas supplier for customers in the ACT, Queanbeyan/Yarrowlumla (Queanbeyan) and Shoalhaven regions. ActewAGL took over the supply to AGL Retail Energy Limited's (AGLRE) gas customers in Queanbeyan in October 2000 and purchased Integral Energy's gas business in the Nowra and Shoalhaven areas in July 2002. As a result, ActewAGL now supplies about 11,600 gas customers in the Queanbeyan/Yarrowlumla (Queanbeyan) and Nowra/Shoalhaven areas in NSW. These customers make up about 11% of ActewAGL's total customer base in the NSW and ACT regions.

ActewAGL is also in the process of becoming the standard gas supplier for approximately 12,000 customer in the 'Capital Region' which extends across the towns of Goulburn, Yass, Young and Boorowa and surrounding regions. It is anticipated that this process will be complete by 1 July 2004.

Following the acquisition of AGLRE's Queanbeyan gas customers in October 2000 there was an absence of formal price regulation during which period ActewAGL managed prices in Queanbeyan in accordance with the Independent Competition and Regulatory Commission's (ICRC) May 2001 Price Determination for ACT gas retail prices. This resulted in a reduction in prices to small retail customers in Queanbeyan in July 2001. At the time of this price reduction, ActewAGL proposed to the Tribunal that since customers in Queanbeyan are supplied from the same network that supplies customers in the ACT, prices to small retail customers in Queanbeyan should be linked to those in the ACT. The Tribunal supported this proposal and the arrangements were formalised in Voluntary Pricing Principles (VPPs) in July 2003.

Following the acquisition of Integral Energy's gas business in Nowra and Shoalhaven, ActewAGL entered into discussions with the Tribunal and agreed to VPPs for small retail customers in October 2002.

Both the Queanbeyan/Yarrowlumla and Nowra/Shoalhaven VPPs are due to expire on 30 June 2004.

2. THE VOLUNTARY PRICING PRINCIPLES

Voluntary Pricing Principles (VPPs) for Queanbeyan were agreed in July 2003 and for the Shoalhaven region in October 2002 to protect customers who:

- were already connected to gas, by ensuring that they will not be stranded with gas appliances but no retailer;
- do not have a choice of retailer, or who do not consciously exercise a choice of retailer;
- face an elapsed retail contract due to default by a retailer; and
- otherwise may not benefit from a competitive market.

The VPPs have ensured price stability for customers whilst creating a business environment to foster competition. The market systems are now fully tested and operating effectively with low

barriers to entry to NSW and ACT gas markets. The Queanbeyan and Shoalhaven regions are serviced by two major gas transmission pipelines – the Eastern Gas Pipeline (EGP) and the East Australian Pipeline (EAPL) facilitating a high degree of access to gas supply sources and pipeline capacity. There are a number of retailers in the NSW energy market capable of supplying both gas and electricity. Incumbent electricity suppliers in ActewAGL's supply regions in NSW also supply gas.

By June 2004, the NSW gas retail market will have been open for two and a half years. It is ActewAGL's firm view that a market that is open to competition should not be regulated. Notwithstanding this, the NSW Government has determined that default tariffs for small retail customers remain regulated until 2007. Consequently, ActewAGL proposes that VPPs established for the period 2004 to 2007 reflect a light-handed form of regulation, as set out in this submission.

3. WHAT IS THE MOST APPROPRIATE FORM OF REGULATION?

It is widely accepted by regulators, policy makers, and industry that competition is preferred over price regulation. However during the early stages of competition when market systems had not been fully tested, there was a possibility that potential competitors may not be able to enter the market effectively and provide the discipline necessary for achieving competitive prices.

In the early stages of full retail contestability, regulators have therefore tended to adopt a cost plus approach to default price setting with the objectives of promoting competition whilst ensuring that customers are not subject to unacceptable price shocks. With competitive market systems now firmly in place in the NSW market, ActewAGL believes that during the next regulatory period, the Tribunal should consider a lighter-handed approach to price regulation.

In its Issues Paper, the Tribunal outlines a number of alternatives to the form of regulation currently used, and seeks comment on what form of regulation will meet the Tribunal's objectives of moving tariffs towards cost reflective levels without exposing customers on under-recovering tariffs to unacceptable price shocks. The options are as follows:

1. Target tariffs with price paths together with price constraints,
2. Remove price constraints but restrict movement of average price relative to a target level,
3. No average price constraint but restriction on per customer price movements,
4. Replace all existing constraints with a CPI – X constraint on all tariff categories,
5. Price constraints/limits for different volume bands,
6. Setting a single average price constraint on all tariff categories (ie. average price constraint),
7. Direct pass through of actual costs subject to price constraints.

ActewAGL believes that the Tribunal's option 6 best meets the objectives of promoting competition whilst protecting customers from unacceptable price shocks. ActewAGL proposes that the average price constraint (or cap) should be set at CPI. Where retailers propose average price variations of CPI or less then these should be allowed without further review. Should retailers' proposals result in average price increases of more than CPI then justification would be required.

The benefits of a CPI approach are that it would:

- ensure a smooth transition to market based default prices with no increases in real terms on average,
- allow year to year variations in costs to be managed more effectively and ahead of time,
- promote competition and customer churn by allowing a gradual but small increase in the difference between default and market prices, and
- reduce the costs of reviews as these would only be required for "CPI plus" proposals.

A CPI approach would also reduce the regulatory risk of creating distortions in the market and introducing artificial barriers to entry, thus providing new entrants with the certainty and business opportunities to enter the market. Moreover, it is likely that the threat of competition may result in average price variations of less than CPI.

It is ActewAGL's view that this 'CPI approach' would allow the default prices to transition to market based rates, whilst at the same time promoting competition and ensuring that customers do not see unacceptable price shocks.

ActewAGL also considers that the approach would provide it the flexibility to align prices in Queanbeyan and the ACT. Because customers in Queanbeyan are supplied from the same network that supplies customers in the ACT, it is ActewAGL's view that prices for small retail customers in Queanbeyan should be linked to those in the ACT. This would be consistent with the Tribunal's adoption of Allgas' prices in Queensland for the customers in Tweed Heads.

It is ActewAGL's view that by the end of the next regulatory period (2007) price controls should be removed altogether. This recently occurred in the United Kingdom (UK) gas and electricity markets following 4 years and 3 years of full retail contestability respectively.

To address any concerns the Tribunal might have about significant price increases to individual customers, ActewAGL considers that it may be appropriate to complement the CPI approach with a price constraint on tariffs. However, it is important to note that if the price constraints are set too low then there would be a risk that cost reflectivity for all tariffs may not be achieved by 2007. Price constraints should also recognise the potential for future segmentation of the market and the need to rebalance tariffs to ensure prices to different market segments are cost reflective.

Details on how ActewAGL's proposed CPI approach might be implemented by the Tribunal are set out in Appendix 1.

4. WHAT IS THE MOST APPROPRIATE LEVEL OF COST TO BE RECOVERED?

Establishing benchmarks for supply costs and margins requires a regulator to form a view on the 'benchmark' levels that will promote competition. The Tribunal in its Issues paper states:

"If default tariffs are set too low, they may hamper the development of competition because new retailers will find it difficult to offer a more attractive service to customers. If they are set too high, they may encourage customers to switch retailers. However, if default tariffs are set at cost reflective levels, they should operate in a 'neutral manner' and strengthen the incentives on retailers to operate efficiently."¹

ActewAGL believes that it is time to move away from regulatory approaches that attempt to "second guess" appropriate cost reflective (or benchmark) levels, which if set too low can create artificial barriers to market entry. Given the NSW market has been open to full retail competition since 1 January 2002 it is now appropriate to allow the market to establish these benchmarks, subject to ensuring customers are protected from unacceptable price increases. ActewAGL considers that the CPI approach proposed in this submission achieves this objective effectively.

It is possible that some retailers may seek approval of CPI plus proposals where business viability may be threatened due to under recovery of costs. For instance, proposals to seek changes to the level of pass-through costs may result from changes to compliance costs or network charges. Under these circumstances regulators would need to assess the merits of each proposed price variation.

In view of ActewAGL's proposal that the Tribunal only review proposals that represent a "CPI plus" variation, and the uncertainty surrounding future regulatory arrangements for gas retail prices in the ACT, ActewAGL proposes not to comment on the appropriate level of individual cost benchmarks in this submission. However, ActewAGL is prepared to comment on these matters pending the Tribunal's Draft Report.

5. WHAT IS THE MOST APPROPRIATE STRUCTURE FOR REGULATED TARIFFS?

The Tribunal is seeking comment on issues regarding the structure of regulated retail tariffs, including whether an inclining block structure is a proxy for cost reflectivity and the implications of allowing more complex price structures for the objective of rationalising the number of regulated tariffs.

¹ IPART, Review of Gas and Electricity Regulated Retail Tariffs, Issues paper, October 2003, p.9.

The majority of retail costs associated with supplying small retail customers are passed onto retailers by gas producers, transmission system operators, and network operators. Operating costs are generally incurred by retailers on a per customer basis. Retailers pass on these costs to customers through tariffs and charges on a cost reflective basis, that is, in the manner that the costs are incurred.

ActewAGL believes that it is not appropriate for the Tribunal to determine tariff structures as this may result in retailers not being able to appropriately recover costs. Regulating tariff structures may also compromise the objective of ensuring that tariffs are cost reflective.

6. ON WHAT BASIS SHOULD NON-TARIFF CHARGES BE REGULATED?

The Tribunal is seeking submissions relating to the regulation of non-tariff charges including where possible the incidence and cost of different types of charges.

Non-tariff charges should, consistent with the objectives of cost reflectivity, be determined on a cost reflective basis and be applied to customers who incur the costs. ActewAGL proposes that the Tribunal adopt a light-handed approach to the regulation of non-tariff charges based on a set of principles similar to those that have been adopted in South Australia:

- non-tariff charges are to be cost reflective, and
- passed onto customers on a fair and reasonable basis.

ActewAGL proposes that the Tribunal would be able to require retailers to justify non-tariff charges if they are seen to be not compliant with these principles.

There are three categories of non-tariff charges that may apply to customers:

- Pass through of costs incurred by retailers to third parties for services provided to customers, such as meter tests and special meter reads paid to the network operators. ActewAGL believes that retailers should be able to add an administration fee (on a cost reflective basis) associated with the procurement of services from third parties;
- Administration of service levels and incentive payments associated with services provided by third parties such as the network operators; and
- Retailers' own costs for specific services required by customers, such as high bill field visits (where no fault is found) and disconnection fee (for debt).

It should be noted that ActewAGL's non-tariff charges are for services that are required by customers, or costs incurred by ActewAGL if a customer fails to meet his/her obligations such as making payments on time.

Key aspects of ActewAGL's non-tariff charges are that they:

- are completely avoidable;
- are user/causer-pays based;
- act as an incentive for customers to meet their obligations;
- provide an incentive for those customers experiencing payment difficulties, for example, to make contact with ActewAGL and organise an appropriate payment arrangement; and
- allow for the recovery of costs incurred by ActewAGL for services.

The non-tariff charges are totally discretionary and customers can avoid these charges. With respect to customers facing hardship, ActewAGL has implemented a “*Staying Connected*” policy whereby gas customers can avoid all costs associated with late payment and disconnection and reconnection by contacting ActewAGL. This policy can be provided to the Tribunal on request.

PRINCIPLES FOR SETTING DEFAULT GAS PRICES IN NSW

ActewAGL proposes that the Tribunal adopt the following principles for retailers to set default prices over the next regulatory period:

1. Default tariffs will be available to all tariff customers whose consumption is below 1 TJ a year until 30 June [XXXX] in transition to a fully competitive market.
2. Customers using less than 1 TJ a year may return to default tariffs at any time.
3. Default tariffs should be broadly cost reflective.
4. Retailers will advise the Tribunal of proposed increases to default tariffs [X] days before the date of effect.
5. In the event that the Tribunal determines that a pricing proposal involves an average increase to default tariffs of greater than CPI (“CPI plus proposal”) the Tribunal may conduct a review into the proposed default tariffs to determine whether the proposal is justifiable.
6. Where the Tribunal determines that a proposal is not a CPI plus proposal the Tribunal will conduct no further review.
7. In the event that the Tribunal conducts a review in accordance with item 5 above, the Tribunal will publish a final report on Retailers’ proposals no later than [X] days before the day on which the proposal is to take effect.
8. Miscellaneous fees and charges for gas customers will be determined by Retailers’ on a cost reflective basis.