Proposed retail and carbon components for 2014/15 gas prices in NSW

ActewAGL Retail proposal to the Independent Pricing and Regulatory Tribunal

ActewAGL for you

Contents

1. Introduction

On 17 June 2013, ActewAGL Retail (ActewAGL) finalised a Voluntary Pricing Arrangement (VPA) with the Independent Pricing and Regulatory Tribunal (the Tribunal) for the period from 1 July 2013 to 30 June 2016.

Clause 6.1 of the VPA specifies:

> *By no later than 11 February 2014 or any later date agreed with IPART, ActewAGL must submit to IPART a proposal specifying such percentage increase or decrease in the Retail component as it proposes to apply for:*
>
> *(a) the 2014/15 Financial Year; and*
> *(b) the 2015/16 Financial Year,*
>
> *to reflect any increase or decrease in ActewAGL's Retail Component for the 2014/15 Financial Year and the 2015/16 Financial Year, as the case may be. The proposal must also include the consequential proposed changes to Regulated Offer Prices.*

Clause 10.1 of the VPA specifies:

> *By no later than 11 February 2014 or any later date agreed with IPART, ActewAGL is to notify IPART of its likely costs for the 2014/15 Financial Year arising as a result of the operation of the Carbon Pricing Scheme and submit to IPART a proposal specifying, as applicable:*
>
> *(a) such increase in the Carbon Component as it proposes to apply for the 2014/15 Financial Year to reflect those likely costs; or*
> *(b) such decrease in the Carbon Component for the 2014/15 Financial Year as is necessary to reflect those likely costs.*
>
> *Any such proposal must also include the consequential proposed changes to Regulated Offer Prices.*

ActewAGL has prepared this submission in order to comply with these sections of the VPA.

2. Deregulation of the NSW gas market

ActewAGL remains committed to its long held position[1] that retail price control regulation should be removed. Further, ActewAGL remains concerned about the asymmetric risks inherent in continued price regulation.

Price regulation for gas retail was successfully removed in the ACT from 2004. Price regulation has also already been removed in Victoria and South Australia for both electricity and gas and in Queensland for gas with the intention to deregulate electricity in south-east Queensland from 1 July 2015. The completion of the Australian Energy Market Commission's (AEMC's) review into the effectiveness of competition[2] raises the prospect that the NSW Government may deregulate before the end of the 2013-16 gas retail agreement with the Tribunal. 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.

ActewAGL notes that in its review into the effectiveness of competition, the AEMC found that "competition in NSW is now sufficiently robust to promote choice for consumers and we expect removing retail price regulation for all consumers will lead to more innovation, increased product choice, and competitive pricing."[3] In its review, the AEMC notes "as competition develops, price regulation can become unnecessary and counteractive as competition works to protect consumers from the misuse or exploitation of market power."[4]

ActewAGL recognises that IPART has endorsed[5] the AEMC's findings but notes that the NSW Government is yet to respond to the AEMC's findings, that was due to respond within six months of receiving the advice, 31 March 2014 (the AEMA has subsequently been amended following the move to annual competition reviews).

In the current environment of changing wholesale gas prices, ActewAGL is aware of the difficulty regulators face in attempting to determine a regulated retail price in a competitive market. ActewAGL is therefore pleased at the light handed approach put in place by IPART that, in the meantime, allows retailers to submit an appropriate price for assessment based on current market conditions.

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[1] ActewAGL 2012, *Pricing Proposal - Review of regulated gas retail tariffs and charges from 2013 to 2016*, November, p. 5
[2] AEMC 2013, *Final Report Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales*, 3 October.
[3] AEMC 2013, *Final Report Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales*, 3 October, p. i
[4] AEMC 2013, *Final Report Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales*, 3 October, p. 59
[5] IPART 2013, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wale: Response to draft submission,* June.

3. Retail component

In order to address the risk related to wholesale gas costs over the regulatory period, the Tribunal introduced a periodic review of the retail costs component in 2014/15 and 2015/16. The retail costs of gas supply include wholesale gas costs, retail operating costs and a retail margin. ActewAGL's proposal on these costs is included below.

3.1 Wholesale gas costs

ActewAGL sources its wholesale gas via a commercial arrangement with AGL. Gas to the tariff market is supplied on a delivered basis, inclusive of commodity, deliverability and transmission charges. ActewAGL does not enter into any supply or transportation agreements with any producer or pipeline operator in its own right. This arrangement provides economies of scale that it would not otherwise be able to achieve, thereby reducing the risk to ActewAGL of being a marginal gas procurer in the wholesale gas market.

ActewAGL serves customers in locations with more severe winter peaks than in most other parts of NSW and Australia. This adds unique risks to ActewAGL's operations, including to its gas procurements and load factor, which ActewAGL would bear if it were to procure the gas by itself.

AGL has provided ActewAGL with a market based cost for wholesale gas costs for NSW for 2014/15 and 2015/16. ActewAGL has reviewed the total wholesale gas cost against other reports. The cost is below ACIL Allen's (formerly ACIL Tasman's) forecast of wholesale gas costs of $13.28 ($14/15) and $13.17 ($14/15) for 2014/15 and 2015/16 respectively, prepared in 2013 for IPART as part of the 2013/14 price reset.[6]

AGL will be providing further details to the Tribunal on the wholesale gas costs and purchasing arrangements.

3.2 Retail operating costs

The Tribunal, in its review of regulated gas retail prices 2013 to 2016, found a reasonable range for retail operating costs of between $96 and $116 per customer during 2013/14 - 2014/15 ($2014/15).[7] This range does not include customer acquisition and retention (CARC) costs.

[6] ACIL Tasman, *Cost of gas for the 2013 to 2016 regulatory period, A report on the wholesale cost of gas for the review for Standard Retailers in New South Wales*, 13 June 2013, pp. 40-41
[7] IPART 2013, *Review of regulated retail prices and charges for gas – Final Report*, June, p. 80

As part of its concurrent review of electricity retail prices the Tribunal undertook a detailed review of the electricity retail operating cost and determined a legitimate and separate allowance for CARC.[8]

The Australian Energy Market Commission (AEMC) reviewed competition in the retail electricity and natural gas markets in NSW in October 2013. In its Final Report, the AEMC concluded that "there is a separate retail market for the supply of gas"[9] as "it appears retailers are not presently offering a dual fuel product that provides additional discounts or any other differences to their separate electricity and gas products."[10] This finding confirms that commercial and efficient gas retailers incur costs for attaining and retaining customers.

The need to reflect all efficient and commercial cost in the VPA is accepted by the Tribunal, which is confirmed in its statement in its November 2012 Issues Paper to "ensure that regulated retail gas prices reflect the efficient costs of supplying gas to small retail customers on regulated prices."[11] As a result, a CARC allowance is required in the VPA.

The AEMC's September 2013 advice on best practice retail price methodology for electricity has noted the asymmetric risk that standard retailers are exposed to. It stated:

> "The risks of setting a regulated price too high, or too low are asymmetrical. If a regulated retail price is set too high, then there may be higher costs for the customer in the short-term. The Commission considers that it is likely that over time prices would be reduced through competition, with competitors entering the market and eroding the higher prices down to efficient cost levels." [12]

In its submission to the AEMC's competition review, the Energy Supply Association of Australia similarly noted "the risks with price regulation in a contestable market are asymmetric. While prices set too low will stifle the development of competition (this occurred in NSW during the 2007-10 Retail Price Determination), excess returns from regulated prices set too high would be eroded away by competition."[13]

In view of the above, ActewAGL considers that an explicit CARC allowance needs to be properly included in regulated gas prices. Therefore, ActewAGL has estimated an appropriate CARC allowance using a method consistent with the Tribunal's decision for the NSW regulated electricity price. This approach is consistent with the light-handed form of regulation applied by IPART.

[8] IPART 2013, *Review of Regulated Retail Prices for Electricity – Final Report*, June 2013, p. 110
[9] AEMC 2013, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales – Final Report*, 3 October 2013, p. 10
[10] AEMC 2013, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales – Final Report,* 3 October 2013, p. 9
[11] IPART 2013, *Review of regulated retail prices and charges for gas, 2013 to 2016 – Gas Issues Paper,* November, p. 2
[12] AEMC 2013, *Advice on best practice retail price methodology – Final Report*, p.72
[13] esaa 2013, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales – Response to AEMC Issues paper*, 15 February.

3.3 Retail margin

ActewAGL continues to consider that an EBIT-margin[14] of at least 6.5% is appropriate. This is consistent with an EBITDA-margin in the range of 7.3%-8.3% that previously has been accepted and applied by the Tribunal[15].

[14] See for example ActewAGL's response to IPART's Issues Paper for regulated retail tariffs and charges for gas 2013-2016, page 12 and ActewAGL's response to the Tribunal's draft decision on 20 May 2013.
[15] This was accepted and applied by the Tribunal in its 2010 decision.

4. Carbon component

There is considerable uncertainty regarding the carbon price for 2014/15. At the time of submission, the Clean Energy Legislation (Carbon Tax Repeal) Bill 2013 has been introduced into the parliament but has not been passed by both houses. Therefore, ActewAGL has prepared proposed changes to prices under two carbon scenarios: one including a price on carbon and one excluding a price on carbon. Should the carbon price be repealed after 1 July 2014, ActewAGL notes that clause 13 of the VPA will be used.

4.1 Carbon Component calculation

Clause 10.3 of the VPA states:

> *A proposal submitted under clause 10.1 or 10.2 must provide IPART with sufficient information:*
>
> *(a) to demonstrate how ActewAGL has calculated the proposed increase or decrease in the Carbon Component (including the carbon price and emissions factors used to calculate ActewAGL's likely costs arising as a result of the operation of the Carbon Pricing Scheme; and*
>
> *(b) to enable IPART to verify that the proposed increase or decrease in the Carbon Component is reasonable.*

Assuming no repeal to the carbon pricing mechanism, ActewAGL has calculated that a carbon component of $1.75 is required for 2014/15 as shown in Table 1. In calculating the carbon component, ActewAGL has used the methodology accepted as reasonable by the Tribunal and passed through in prices from 1 July 2012[16] and again from 1 July 2013.[17] The methodology for calculating the carbon component is to estimate the upstream carbon cost, the downstream (or fuel combustion) carbon cost, adjustment to bad debts and an uplift adjustment to the margin.

Table 1 Calculation of the carbon component

Nominal $/GJ	NGA Factor kgCO2e/GJ	2014/15
Carbon price $/unit		25.40
Upstream[1]	13.15	0.33
Downstream[2]	51.33	1.30
Retail margin		0.12
Carbon Component ($2014/15)		1.75

1 Based on the average of the metro and non-metro natural gas emission factors for scope 3, NGA Factors, July 2013, Table 37, p 71;
2 NGA Factors, July 2013, Table 2, p 14

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16 IPART 2012, *Information Paper – Regulated retail tariffs and changes from 1 July 2012,* June, p. 4
17 IPART 2013, *Review of regulated retail prices and charges for gas – Final Report*, June, p. 43

4.2 National Energy Customer Framework impact

ActewAGL considers it important for the Tribunal to be aware of a requirement under NECF that standing offer tariffs cannot be varied more often than once every 6 months.[18] While ActewAGL did not support this approach,[19] this provision now limits flexibility in making price changes. ActewAGL is cognisant of public interest and expectations as well as the position of the Australian Competition and Consumer Commission in its proposed role of price monitoring and price exploitation prosecutor that prices should decrease "fairly immediately".[20] The ability to adjust standing offer tariffs "fairly immediately" after repeal of the carbon price, as may occur for mass market offers, would be impacted if changes are to come into effect after 1 July 2014.[21] If this is the case, ActewAGL will work with IPART to ensure a smooth transition to carbon-exclusive gas prices to ensure no parties are disadvantaged through this process.

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[18] National Energy Retail Law clause 23 (5) (a) and ActewAGL Standard retail contract terms for small customers in the ACT and NSW Effective from 1 July 2013, clause 8.2 (b)

[19] ActewAGL 2010, *ActewAGL response to National Energy Customer Framework: Second exposure draft*, 26 February, p. 27

[20] Sydney Morning Herald, 8 November 2013, *Power bills must fall as soon as tax goes, ACCC warns business*, p. 10

[21] ESAA, ERAA, ENA, APIA, NGF 2013, *Submission to Department of the Environment Carbon tax repeal exposure draft legislation and consultation paper*, November, p. 5

5. Proposed changes to the standing offer for 2014/15

Consistent with the VPA, ActewAGL has calculated the regulated offer prices to apply from 1 July 2014. Due to the uncertainty in relation to the carbon price, ActewAGL has calculated two scenarios: continuation of the carbon price mechanism and repeal of the carbon price mechanism. Primarily due to the increase in the wholesale gas cost, the R component will increase by 30.4 per cent plus CPI in 2014/15 and by 13.2 per cent in 2015-16.

The estimated impact of the total standing tariff in 2014/15 is 15.9 per cent. The drivers of this increase are shown in Table 2.

Table 2 Estimated drivers of the standing tariff, 2014/15

Cost component	Impact on standing tariff, real
Wholesale gas	12.7%
CARC	2.4%
Network	0.9%
Retail operating cost (ex. CARC)	0.0%
Carbon	-0.1%
Total standing tariff	**15.9%**