Proposed VTPA for NSW regulated gas prices from 1 July 2013 to 30 June 2016 – public version

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Executive Summary

Introduction

This is a proposal by AGL for a revised Voluntary Transitional Pricing Arrangement (***VTPA***) from 1 July 2013 to 30 June 2016. AGL welcomes IPART's preference to continue with this "light handed" form of regulation which, as noted by IPART, can be a stepping stone towards removal of price regulation.

In short, AGL is proposing a three year price path whereby the retail component is increased by CPI only each year but for:

- an increase in the wholesale costs in 2013/14 to reflect real changes in gas commodity, transportation and market costs,
- real changes in gas commodity costs for 2014/15 and 2015/16, and
- an increase in 2013/14 to reflect IPART's previous assessment of the level of margin necessary to facilitate effective competition.

AGL is seeking to work with IPART to achieve a price path with as much certainty as possible over the period of the VTPA given the constraints imposed by current circumstances, as detailed below.

Wholesale and retail developments

The current VTPA has covered a period of significant change in energy markets including the privatisation of government owned energy retailers in NSW and the introduction of the *Clean Energy Act 2011*. As expected, there has been an improvement in competition in the retail gas market following the electricity privatisation as activity in the dual fuel market has increased. The continuation of a light handed form of regulation, as a precursor to deregulation, and a shift to a reasonable retail margin, as determined by IPART in the 2010 review, will ensure this trend continues.

The period of the next VTPA will also be a period of significant change in respect of matters more specifically relevant to AGL. A number of AGL's long term gas supply agreements are subject to price reviews over this period (GSA price reviews). As IPART is aware, these GSA price reviews are lengthy, legal processes in which evidence is led and document discovery processes are the norm. This has material consequences for both the manner in which AGL has constructed and explained the proposed VTPA in this document, and the terms on which it is ultimately determined.

Not only is AGL uncertain what its costs of supply will be over the period of the proposed VTPA, AGL is not able to include in public or confidential submissions any indications as to the expected outcomes of these GSA price reviews. Any statement to IPART regarding the likely price or even the direction of the movement of the price would likely become evidence in the GSA price review process. While AGL understands that this makes it extremely difficult for IPART to fulfil its duties in respect of establishing a three year regulated price path, any 'front running' of the outcome of the GSA price reviews in the VTPA process could be disadvantageous to AGL and its customers.

Proposed VTPA

As the current VTPA is considered to be effective, the structure and substance of AGL's proposed VTPA is intended to be as close as possible to the 2010-13 VTPA – namely a CPI increase on the Retail Component but for real increases in wholesale costs in 2013-16, and an increase to accord with the retail margin assessed by IPART in the 2010 review as being consistent with the margin which would prevail in a competitive market.

AGL is proposing an approach whereby the Retail Component is 'locked in' but for these real increases, which will be identified in early 2014 with respect to the price path for 2014/15 and 2015/16. AGL acknowledges that this approach does not provide the immediate certainty of the Retail Component for the entire three years of the price path. However, AGL is not proposing a complete re-assessment of the Retail Component each year but merely the finalisation of one component (i.e. gas commodity cost) of an otherwise pre-determined WEC. For the reasons articulated above, AGL is of the view that the proposed approach is necessary in the interests of both consumers and AGL.

It is envisaged that AGL and IPART will work together to:

- establish the Retail Component 2013/14,
- finalise the real increases in gas commodity costs for 2014/15 and 2015/16 once the relevant GSA price reviews are completed, and
- outline all other terms and conditions with as much certainty as possible at this time, while providing the necessary flexibility to accommodate special circumstances.

As in the current VTPA, the default tariffs are comprised of:

- A Retail Component (R) being the wholesale costs, the retail operating costs and retail margin,
- A Network Component (N) being charges levied by the distribution network business, and
- A Carbon Component (C) being the costs relating to the *Clean Energy Act 2011*.

The proposed VTPA will allow for real increases due to wholesale costs and adjustment to the retail margin allowance. The proposed price path for 2013-16 is summarised below:

	2013/14	2014/15	2015/16
Retail Component (R)	CPI + 7.7%	TBA	TBA
Carbon Component (C)	CPI + 2.4%	CPI+2.4%	TBA

Miscellaneous fees

Current fees will be maintained in real terms. AGL will introduce a merchant service fee for NSW gas customers on the basis that the National Energy Customer Framework (NECF) is adopted by the NSW Government from 1 July 2013.

Introduction

Background

AGL Retail Energy Limited (AGL) is the standard retailer with the largest supply area in NSW which covers Sydney, Wollongong, Newcastle, Dubbo, Orange, Parkes and parts of the Riverina. AGL Sales (Queensland) Pty Ltd also supplies to the border regions of NSW and Queensland under arrangements which are not regulated by IPART and therefore not included in this proposal.

Full retail contestability (FRC) in the retail gas market in NSW commenced over 10 years ago in January 2002. A light handed approach to setting retail gas prices was adopted by IPART to coincide with FRC and established under the Voluntary Pricing Principles in 2001 as a means of protecting customers' interests while minimising regulatory costs. This was followed by a series of three year price paths (VTPAs) from 2004.

The 2010-13 VTPA has been effective in allowing a restructuring of default gas tariffs to align with network tariffs as well as the incorporation of a carbon component following the introduction of the *Clean Energy Act 2011*. The current VTPA expires on 30 June 2013.

On 28 September 2012, IPART invited AGL to propose a revised VTPA for the period from 1 July 2013 to 30 June 2016.

Constraints relevant to proposed VTPA

AGL acknowledges that in the usual course, AGL and IPART would seek to agree a three year price path, where the increase in the Retail Component was identified at the commencement of the price path. This provides consumers and retailers with a degree of certainty across the period of the VTPA. Under the proposed VTPA, the Retail Component will be stable but for the real increases identified. As it is not possible to identify the real increases at this time, it is not possible to finalise the Retail Component for 2014/15 and 2015/16.

The certainty available in the past has been possible as prices are underpinned by relatively stable pricing arrangements entered into by AGL. These pricing arrangements have provided the basis for IPART to determine the reasonableness of AGL's proposal. However, over the next VTPA, there is significant uncertainty in these arrangements.

A number of AGL's long term gas supply agreements are subject to GSA price reviews and are expected to conclude at different times in mid and late 2013. As IPART is aware, these GSA price reviews are lengthy, legal processes in which evidence is led and document discovery processes are the norm. This means that anything AGL were to include in a submission to IPART, whether as part of a public or confidential submission, could be tendered as evidence in the GSA price review proceedings. At this time, AGL cannot offer IPART a view, either in respect of likely actual costs or 'appropriate benchmarks', without potentially prejudicing its arguments under the GSA price reviews. Anything submitted to IPART may be fed back into the GSA price review process as evidence and therefore risk becoming a 'self fulfilling statement'. AGL would have great difficulty in preventing such a price becoming the baseline for negotiation in the GSA price reviews.

Accordingly, due to the risk in setting a 'benchmark' prior to these reviews being completed, AGL proposes a specific price path for 2013/14 with the price path for 2014/15 and 2015/16 to be finalised at a later date.

While AGL understands that this makes it difficult for IPART to establish a three year price path as in previous reviews, any 'front running' of the outcome of the GSA price reviews in the VTPA process would be disadvantageous to AGL and to all its customers, regulated and unregulated. AGL is of the view that if required to prepare a specific three year proposal at this time, it is unlikely that it will result in a price path which reflects an "efficient cost of supply to small retail customers", as it will risk foregoing the benefit to consumers of AGL being in the best position to fully contest the GSA price reviews.

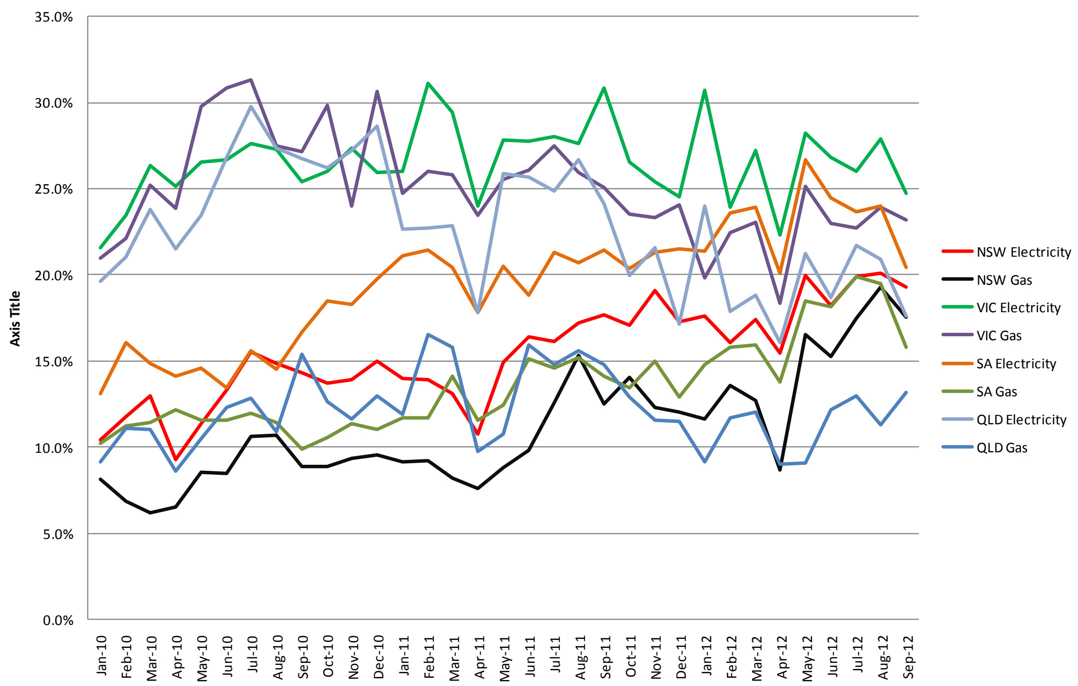
This situation has material consequences for both the manner in which AGL has proposed and explained the proposed VTPA in this document, and the terms on which it is ultimately determined.

Retail market competition

The number of customers in NSW remaining on default tariffs has been decreasing every year since FRC. Currently, less than 30% of customers in NSW remain on default tariffs.

Over the current pricing arrangements from 2010 to 2012, the rate of customers switching retailers in NSW has ranged from an annualised rate of 8% to 15%, and up to 19% in August 2012. The privatisation of the government owned NSW electricity retailers in December 2011 has led to increased churn in retail energy markets more generally. More recently, heightened activity in customer switching is a result of large increases in electricity prices and promotions by aggregators.

Figure 1 Churn rate from January 2010 to September 2012



With a continuation of light handed regulation, as a precursor to deregulation, and the improvement of retail margin to the levels IPART had determined to be reasonable in the 2010 review, this churn will continue to improve.

AGL notes the Minister for Resources and Energy's letter to IPART refers to the goal of standard retail tariffs reflecting the "efficient cost of supplying natural gas to small retail customers," as well as the requirement to consider the objects under Section 3 of the Gas Supply Act 1996 which, amongst others, are to "encourage the development of a competitive market in gas..." and to "protect the interests of customers and to promote customer choice in relation to gas supply."

Proposed VTPA 2013-16

Scope of the VTPA

Default tariff prices for residential and small business consuming up to 1 TJ of gas per annum were initially established under the VTPA agreed between IPART and AGL in 2004. The proposed VTPA will continue to apply to these customers.

The proposed VTPA pertains to the period from 1 July 2013 to 30 June 2016 (price path period) unless there is a removal of price regulation during this period.

Specific Terms and Conditions of the VTPA

While AGL intends to propose a VTPA that is as close as possible to the terms and conditions of the current VTPA, due to the uncertainties about the price path of the VTPA beyond 2013/14, the specific content of the VTPA will need to be carefully considered. To this end, AGL has not yet proposed the content of the VTPA, but will work with IPART to develop the details of the VTPA.

'R + N + C' approach

In the current VTPA, AGL's retail gas prices have been restructured to align with network charges to allow for network pricing signals to be passed through to customers.

The proposed VTPA continues with the current 'R + N + C' approach where

R = Retail Component,

N = Network Component, and

C = Carbon Component.

As in the current VTPA, AGL proposes a continuation of the weighted average price cap for the Retail and Carbon Components.

The Retail Component comprises:

- wholesale costs, including commodity costs, transportation charges, peak demand costs, market charges and arbitration costs.
- retail operating costs, and
- retail margin.

The Network Component, comprising the reference tariffs published by Jemena Gas Networks (NSW) Limited, will be directly passed through to the default tariffs which have been restructured from 1 July 2010 to allow network pricing signals to be reflected.

The Carbon Component which was agreed with IPART for 2012/13 included an allowance for incremental operating costs related to the introduction of the *Clean Energy Act 2011*. From 1 July 2013, this portion of the Carbon Component will be combined with the general operating cost allowance and removed from the Carbon Component. The Carbon Component from 2013/14 and 2014/15, during the period of fixed carbon prices, will comprise:

- upstream carbon costs,
- downstream carbon costs, and
- retail margin on the upstream and downstream carbon costs.

Price path

AGL proposes a three year price path from 1 July 2013 to 30 June 2016 as follows:

	2013/14	2014/15	2015/16
Retail Component (R)	CPI	CPI	CPI
Plus adjustment for: **Wholesale costs** **Retail margin**	 +1.5% +6.2%	 TBA 0%	 TBA 0%
Retail Component (R) - total	CPI + 7.7%	TBA	TBA
Carbon Component (C)	CPI + 2.4%	CPI+2.4%	TBA

2013/14

The Retail Component for 2013/14, aside from CPI escalation, will reflect:

- a risk allowance in gas commodity costs,
- arbitration costs for GSA price reviews,
- a real increase in AEMO charges,
- a real increase in gas transportation costs, and
- an adjustment to align the retail margin within a reasonable range.

The Carbon Component for 2013/14 will be adjusted for the 2013/14 fixed carbon price of $24.15 per unit without the carbon related operating costs as explained above.

Annexure C provides details of the various components of the proposed price path for 2013/14.

2014/15 & 2015/16

In early 2014, AGL will finalise the price path for the Retail Component for 2014/15 and 2015/16 following the expected conclusion of the GSA price reviews. This update will be limited to the real change in gas commodity costs only.

This price path for 2014/15 and 2015/16 will also include expected real increases in gas transportation costs.

Under the *Clean Energy Act 2011*, the fixed carbon price period will end in June 2015 and transition to flexible carbon pricing from 1 July 2015. Due to the uncertainty of the carbon price in 2015/16, AGL suggests that a review of the Carbon Component closer to the relevant time will also be more appropriate.

Annexure D provides further details how the price paths for 2014/15 and 2015/16 will be set.

Miscellaneous Fees and Charges

Miscellaneous Fees and Charges are intended to reimburse the retailer for costs incidental to the supply of gas that occur from time to time.

From 1 July 2013, AGL proposes to introduce a merchant service fee of 0.6% for credit and debit transactions. This proposal will proceed only if the NSW Government passes legislation to ensure that NSW joins the National Energy Customer Framework (NECF) from 1 July 2013.

AGL's proposed schedule of fees and charges is set out in Annexure E.

With the exception of the merchant service fee, AGL intends to increase the fees and charges set out in the schedule by no more than CPI each year.

Special Circumstances

AGL seeks to retain this general provision for unforeseen events, which are unknown or cannot be quantified at the time of the pricing proposal and its finalised form.

The special circumstances which may give rise to changes in costs include, but are not limited to:

- regulatory changes,
- taxation changes,
- unanticipated changes in gas commodity and transportation costs, and
- fundamental changes to gas market frameworks and arrangements.

AGL is of the view that the terms of the VTPA should make specific allowance for the setting of the price path beyond 2013/14 separately from the special circumstances clause.

The current VTPA specifies 'unanticipated field price review' as a special circumstance, which would not capture the GSA price reviews. The special circumstances clause would remain for the purpose of dealing with unanticipated changes, rather than those arising out of the GSA price reviews.

Customer Impact

In the proposed VTPA, network tariff increases will account for over half of the total increase in default gas prices. Default prices are expected to increase by 7.7% in real terms in 2013/14:

	Contribution to real increase
Retail component (R)	**3.6%**
Network component (N)	**4.0%**
Carbon component (C)	**0.1%**
Total = R + N + C	**7.7%**

In nominal terms, based on a CPI of 2.5%, the overall change in default prices for 2013/14 will be about 10.4%. Subject to the actual network charges and any rebalancing, the impact on a customer's bill of the proposed VTPA for 2013/14 will be as follows:

	2012/13 Annual bill (incl GST)	2013/14 Bill increases (incl GST)
Residential		
5 GJ/year	$341	$36
23 GJ/year	$822	$84
40 GJ/year	$1,149	$116
Business		
184 GJ/year	$4,187	$415

Annexure A – Confidential

Annexure B – Confidential

Annexure C – R + N + C for 2013/14

a) Retail Component (R)

The Retail Component comprises wholesale costs, retail operating costs and retail margin. The wholesale costs do not include carbon costs which are treated as part of the Carbon Component.

Wholesale costs

In the 2010 review, AGL provided IPART with a detailed methodology to estimate the wholesale gas and transportation costs delivered at Wilton based on a prudent retailer sourcing gas from multiple regions. AGL does not propose any change to this methodology and has maintained the settings applied in the 2010 review with the exception of gas commodity and transportation costs which are updated for 2013/14.

The original intent of moving to a light handed approach was to offer customer protection and at the same time to minimise regulatory costs. By using the methodology and settings (where appropriate) assessed in the 2010 review, this review can be undertaken more efficiently.

Except for certain costs to be updated and an adjustment for retail margin, AGL considers that the methodology and settings used in the 2010 review continue to be reasonable. The level of churn shown in the main section strongly suggests that the default gas prices are not excessive if the churn level in NSW gas is compared with the levels reached in the electricity and gas markets in the NEM.

The wholesale costs proposed for 2013/14 comprise of the following:

- the average wholesale costs, including gas commodity, transportation and additional deliverability for peak demand of $7.26/GJ (2009/10$) over 2010-13 considered by IPART[1] to be reasonable. In 2012/13$, this is equivalent to $7.85/GJ using the CPI escalation specified in the 2010-13 VTPA;
- CPI escalation for 2013/14 (assuming CPI of 2.5%);
- risk allowance for gas commodity costs;
- estimated arbitration costs averaged over three years;
- real increase in gas transportation costs, and
- real increase in AEMO charges.

The changes in wholesale costs for 2013/14 are outlined below:

[1] Review of regulated retail tariffs and charges for gas 2010-13, Gas – Final Report, June 2010, IPART, p 25

Nominal $	$/GJ
Wholesale costs – IPART benchmark - 2012/13	7.85
+ CPI escalation (2.5%)	0.20
+Other changes in wholesale costs	0.21
Wholesale costs – 2013/14	**8.26**

Retail operating costs

Retail operating costs are based on a benchmark cost of $102/customer in 2009/10$. This was the mid-point of the range of benchmarks which IPART considered in the 2010 review. Using the average consumption per customer applied in the 2012/13 gas compliance template, they amount to $4.17/GJ. These costs are increased by $0.05/GJ for the incremental carbon related operating costs which were approved by IPART as part of the Carbon Component for 2012/13. In total, the retail operating costs for 2012/13 amount to $112 per customer.

AGL considers this to be representative of AGL's operating costs in the NSW gas retail market. AGL notes that this is well below the benchmark for electricity customers of $123 per customer in 2012/13$[2].

Retail margin

In the 2010 review, IPART found that a "reasonable range of 7.3% to 8.3% of EBITDA... is consistent with the margin that would prevail in a competitive market"[3]. Although AGL anticipates business risks to increase over the next pricing period, AGL considers that it is appropriate to use this range for the purpose of the 2013-16 VTPA.

The current (2012/13) retail margin is 5.7% based on benchmarks.

The proposed VTPA will deliver a retail margin of 8% for 2013/14 (see Summary - page 19 below). Given the uncertain outcome of the price reviews, it is important that default prices are set to a neutral level, with respect to the benchmarks, to minimise any price shocks customers in the future. AGL notes that customers remaining on default prices can reduce this price impact by taking advantage of market offers.

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[2] The benchmark for retail operating costs for electricity customers was determined to be $113.70 per customer in 2009/10$ in Review of regulated retail tariffs and charge for electricity 2010-13, Electricity – Final Report, March 2010, IPART, p 111

[3] Review of regulated retail tariffs and charges for gas 2010-13, Gas – Final Report, June 2010, IPART, p 32

Retail Component

The retail operating costs and Retail Component for 2012/13 have been re-stated to include the incremental operating costs related to the introduction of the *Clean Energy Act 2011*.

It is proposed that the Retail Component for 2013/14 be increased by CPI + 7.7%.

Nominal $ (CPI = 2.5%)	2012/13 $/GJ	2013/14 $/GJ	X factor (real increase)
Wholesale costs	7.85	8.26	1.5%
Retail operating costs	4.22	4.32	0.0%
Retail margin	1.52	2.42	6.2%
Retail Component	**13.59**	**15.00**	**7.7%**

b) Network Component (N)

The Access Arrangement for Jemena's NSW gas distribution networks for 1 July 2010 to 30 June 2015 was amended by order of the Australian Competition Tribunal in June and September 2011.

Under clause 3.5 (A), the CPI-X annual tariff variation mechanism, the X factor for 2012/13, 2013/14 and 2014/15 was determined to be -8.39%.

The Network Component is a pass-through of Jemena's charges and is calculated below for the purpose of calculating the Revenue (= R + N + C) and retail margin for 2013/14. The Network Component is not part of this proposed VTPA.

Nominal $ (CPI=2.5%)	2012/13 $/GJ	2013/14 $/GJ	X factor (real increase)
Network Component	13.56	15.07	8.39%

c) Carbon Component (C)

For 2013/14, the Carbon Component will not include a component for incremental operating costs due to the introduction of the *Clean Energy Act 2011*. This operating cost element is now combined with retail operating costs. The Carbon Component will comprise of the costs associated with the upstream and downstream emissions and an allowance for a retail margin of 8%.

Nominal $ (CPI = 2.5%)	Emission Factor* kg/GJ	2012/13	2013/14	X factor (real increase)
Fixed carbon price		$23/tonne	$24.15/tonne	2.4%
		$/GJ	**$/GJ**	
Carbon – upstream	14.60	0.34	0.35	
Carbon - downstream	51.33	1.18	1.24	
Carbon related opex		-	-	
Retail margin		0.13	0.13	
Carbon Component		**1.65**	**1.72**	**2.4%****

* *The emission factors are based on the Department of Climate Change and Energy Efficiency, Natural Greenhouse Accounts Factors, July 2012 and is consistent with the approach used to derive the Carbon Component for 2012/13.*

** rounding ignored

d) Summary

Based on the settings above, the Revenue (= R + N + C) for 2013/14 will be 10.4% higher than 2012/13 in nominal dollars or a 7.7% increase in real terms.

Nominal $ (CPI=2.5%)	2012/13 $/GJ	2013/14 $/GJ	X factor (real increase)
Retail component (R)	13.59	15.00	7.7%
Network component (N)	13.56	15.07	8.4%
Carbon component (C)	1.65	1.72	2.4%
Revenue = R+ N + C	**28.80**	**31.78**	**7.7%**
less			
Network charges	13.56	15.07	
Wholesale costs (excl carbon)	7.85	8.26	
Carbon costs - upstream	0.34	0.35	
Carbon costs - downstream	1.18	1.24	
Retail operating costs	4.22	4.32	
Total cost	**27.15**	**29.24**	
Retail margin	**1.65**	**2.54**	
Retail margin % Revenue	**5.7%**	**8.0%**	

Aside from network charges, the key contributor to the real increase in default prices is the adjustment for retail margin.

Wholesale costs will contribute less than 1% of the real increase in 2013/14.

Nominal $ (CPI=2.5%)	Change $/GJ	Contribution to real increase
Wholesale costs	0.41	0.7%
Retail operating costs	0.10	0.0%
Retail margin	0.90	2.9%
Retail component (R)	**1.41**	**3.6%**
Network component (N)	**1.51**	**4.0%**
Carbon component (C)	**0.07**	**0.1%**
Revenue = R + N + C	**2.98**	**7.7%**

Annexure D – Finalisation of price path for 2014/15 and 2015/16

This Annexure outlines AGL's proposal for finalising the Retail and Carbon Components for 2014/15 and 2015/16.

Retail Component (R) for 2014/15 and 2015/16

The GSA price reviews with AGL's wholesale gas suppliers are expected to be completed by December 2013. AGL proposes that the finalisation of the Retail Components for 2014/15 and 2015/16 be limited to gas commodity costs (and related margin allowance).

In this way, the scope of the review in 2014 can be minimised. With the price reviews expected to be settled by this time, there will be no need to include any risk allowance for uncertain outcomes.

The changes to the Retail Component for 2014/15 and 2015/16 can be summarised as:

	2014/15	2015/16
Retail Component (R)	CPI	CPI
Plus adjustment for:		
Gas commodity costs	TBA	TBA
Other costs	$0.065/GJ	$0.065/GJ
Retail Component (R) - total	TBA	TBA

The price path for the 2014/15 and 2015/16 is also subject to any review arising from special circumstances.

Carbon Component (C) for 2014/15 and 2015/16

Assuming that the *Clean Energy Act 2011* is not repealed, the Carbon Component for 2014/15 will reflect the fixed price of $25.40/unit. This means the Carbon Component for 2014/15 will increase by 5% in nominal terms on the basis that the NGA Factors remain unchanged.

From 1 July 2015, the price of carbon units will be set by the market. In AGL's view, it is unreasonable to propose a carbon price at this time and proposes that a review of the Carbon Component for 2015/16 be deferred to early 2015. The proposed price path for the Carbon Component is summarised below:

Nominal $	NGA Factor	2013/14	2014/15	2015/16
Carbon prices $/unit		$24.15	$25.40	TBA
Upstream **Downstream**	14.60 51.33	0.35 1.24	0.37 1.30	TBA TBA
Retail margin		0.13	0.13	TBA
Carbon Component		1.72	1.80	TBA

Annexure E – Fees and Charges

	Current charge 2012/13 (GST exclusive)
AGL Charges	
Account establishment fee	$25.28
Late payment fee	$11.64
Collector call fee	$38.24
Dishonoured payment	$26.90
Other charges	
Retailer administration fee Charges for network operator services will be no more than the quoted network operator charge plus a retailer administration fee (above) (including where the service is provided by a third party). Network operator services include (but are not limited to) special meter reads, disconnections, reconnections, high bill field visits and meter testing charges. Currently, AGL does not charge the account establishment fee above but reserves the right to apply this charge in the future. The current charge for account establishment fee is the special meter reading fee and will be listed on the customer's bill as a special meter reading fee.	$2.64

New charge	
Merchant service fee (GST inclusive)	0.6%

Annexure F – Proposed VTPA

AGL Retail Energy Limited

Voluntary Transitional Pricing Arrangements for AGL Retail Energy Limited for supply of natural gas to small gas customers (consuming 0-1TJ a year)

1 July 2013 to 30 June 2016

[AGL will work to IPART to develop the 2013-16 VTPA]