14 November, 2001

Mr Gary Drysdale
Review of Country Energy's Voluntary Pricing Principles
Independent Pricing and Regulatory Tribunal
PO Box Q290, QVB Post Office,
Sydney NSW 1230

Dear Mr Drysdale

Review of the Delivered Price of Natural Gas to Low-Usage Customers Served by Country Energy – Draft Report

AGL Energy Sales and Marketing Limited (AGL ES&M) welcomes the opportunity to provide comments on the Draft Report on the "Review of the Delivered Price of Natural Gas to Low-Usage Customers Served by Country Energy (the Report).

AGL ES&M believes that the advent of full retail contestability in gas from January 2002 warrants a reassessment of principles for the determination of safety net prices. AGL ES&M is of the view that the following overarching principles outlined in the Terms of Reference issued by the Victorian Minister for Energy to the Office of the Regulator General (ORG)[1] for review of electricity prices in Victoria provide a framework for safety net price setting:

(i) that effective competition is preferred over regulation;
(ii) that where regulation (in place of effective competition) is needed to achieve what would otherwise be the outcome or outcomes of effective competition (that is, where there are constraints on, or on the development of, effective competition), the form of regulation (or the outcomes, or projected outcomes from applying that regulation);
    A. should not hinder the development of effective competition;
    B. should seek to provide outcomes that are consistent with the outcomes that could be expected under effective competition (if effective competition existed);
    C. should be consistent with the principle of "light handed regulation"
    D. should seek to avoid unnecessary duplication, reduce compliance costs and the administrative and regulatory burden on retailers, to the greatest extent possible; and
    E. should be consistent with other relevant regulatory regimes, in particular the current regime for excluded service charges.

These principles are not inconsistent with the aim of the NSW Gas Supply Act (Retail Competition) Act 2001 the aim of which is to ensure that retail customers are sufficiently protected in the new, competitive environment.

[1] Options for the Review of Retail Electricity Tariffs, Final Report, Office of the Regulator General, September 2001 (refer Attachment)

AGL ES&M suggests that consideration to be given to defining the parameters for effective competition and ensuring that there are enabling regulatory arrangements in place. We are concerned that regulatory arrangements with a focus primarily on the management of price impacts on customers and/or based on inappropriate benchmarks have the potential to delay or impede the development of effective competition in the NSW gas market.

AGL ES&M supports in principle the Independent Pricing and Regulatory Tribunal's (the Tribunal's) light handed approach, in the form of Voluntary Pricing Principles, for setting safety net prices in NSW as a transitional phase in moving towards a fully competitive market.

If you have any questions regarding this submission please contact Kam Khelawan, Manager Regulatory Development on (02) 9922 8611 or khelawan@agl.com.au.

Yours sincerely,

Phil James
General Manager Business Strategy

Attach:

Review of the Delivered Price of Natural Gas to Low-Usage Customers Served by Country Energy – Draft Report

Competition and Price Regulation

AGL ES&M strongly believes that it is not appropriate to regulate retail prices in markets where competition is effective. Regulation, if not carefully designed, has the potential to distort markets with the result of disproportionate allocation of risk to the incumbents, barriers to entry for new entrants, and arbitrary allocation of benefits to some customers and costs to others. AGL ES&M believes that under full retail contestability the market will be the best determinant of benefit, cost and risk allocation between participants.

AGL ES&M notes that the Tribunal supports the view that once effective competition is established, market forces should ensure that suppliers provide services of the quality demanded by customers, and that they do not earn excessive profit. AGL ES&M supports the Tribunal's stated intention to play less of an active role once effective competition is established.

The Tribunal also notes that the policy view is that effective competition is likely to take some time to develop. As a result the Tribunal sees a need, for an interim period, for the regulator to ensure that incumbent suppliers do not use their dominant position in particular markets to:

- raise prices or reduce service levels, particularly to vulnerable customer groups, or
- prevent development of effective competition.

AGL ES&M believes that increase in prices or reduction in services by incumbent retailers will in fact increase the level of competition by encouraging other retailers to enter the market unless there are barriers to entry.

It is not clear how an absence of price regulation will prevent development of effective competition given that the Trade Practices Act already ensures that prices are not designed to prevent or lessen competition.

The objectives for price regulation outlined above are based on the view that competition is not likely to be effective during the interim period. Contributing factors to the absence of effective competition include:

- structural barriers to competition,
- lack of effective customer communication, or
- the level of current prices acting as a disincentive for new entrants to enter the market.

Regulation of prices is not likely to address these issues and deliver effective competition.

Structural barriers to entry need to be removed by establishing equitable business rules. Communication programs need to be undertaken to ensure customers are informed of the choices they can make with respect to sourcing energy. The Ministry of Energy and Utilities' (MEU's) gas reform process has delivered business rules that will ensure equitable access to a competitive gas market for both retailers and customers. The MEU will also be undertaking a customer communication program in time for the market start in January 2002.

If the current levels of prices are not sufficient for effective competition, then the imperative should be to allow the prices to move to a level that encourages competitors to enter the market. Given that 99% of Country Energy's residential customers and 70% of the commercial customers currently do not meet the cost of supply, in all probability transitional price regulation based on tariff side constraints will delay development of effective competition until cost recovery is achieved.

It also apparent from the Report that Country's Energy's industrial customers are subsidising the residential and the commercial customer market. As a result it is likely that initially only the industrial customer segment of the market will see effective competition, putting Country Energy's profitability at risk. There is an urgent need to manage out any cross subsidies between the customer groups. AGL ES&M notes that the Tribunal has proposed wider side constraints on existing prices to address this issue.

AGL ES&M is also concerned with the regulation of retail prices where prices upstream, for example the wholesale price of energy is not regulated. There is a risk of a "cost-price" squeeze under these circumstances, increasing risk to retailers in the market. AGL ES&M notes that the Tribunal has allowed for a review of the Voluntary Pricing Principles (VPPs) under such circumstances.

AGL ES&M supports in principle transitional price regulation in the form of VPPs that fosters competition while alleviating community concerns about price movements, and that allows retailers to manage risk effectively in an evolving market where costs are not as predictable and where prices based on historical customer segmentations are no longer appropriate.

Transitional Arrangements Based on Benchmarks

For the transition to a competitive market to be effective the default prices must provide sufficient incentive or headroom for competitors to enter the market. The ORG in its Draft Report on options for the review of retail electricity prices acknowledged that in order to allow competition to develop, a degree of headroom may be required to provide scope for new entrants to come into the market and offer competitive market tariffs which are more attractive than standing offer tariffs (safety net prices). At the same time the ORG indicated that an allowance for such headroom could be made by adopting "conservative" approach to benchmarking the energy and retail cost components of retail tariffs and selecting the benchmarks towards the top end of the feasible range, rather than providing an artificial incentive for competition through allowing an additional headroom element.

The Independent Competition and Regulatory Commission of ACT[2] also acknowledged that a sufficient headroom on the retail margin is important if potential competitors are to be encouraged to enter the gas market.

AGL ES&M is concerned that the "cost plus" regulation proposed based on an operating cost recovery of $45 plus 2.5% margin will not be sufficient to ensure effective competition across that market.

- 2-3% margins not sufficient for effective competition

The ORG in its Final Report on Options for the Review of Retail Electricity Tariffs notes that "there is no straightforward approach for determining an appropriate level of profit margin". There are, however, some useful points of reference as to what may constitute a reasonable range. We note also a reference in the ORG's report to "the convention for electricity

[2] Final Determination, Review of Natural Gas Prices, Independent Competition and Regulatory Commission, May 2001.

retailing profit margins to be expressed as a percentage of sales". Typically this means the expression of earnings before interest, tax and depreciation/amortisation as a percentage of sales revenue. AGL ES&M agrees that this is an appropriate way to measure retail margins, but points out that it should not be used without reference to the net profitability of the business, that is after interest, tax and capital charges.

To find more relevant indicators for retail margins for retailers operating in competitive markets, and facing the ongoing exposure to the demands of the capital markets, it is necessary to look to other industries. AGL ES&M suggests that petrol retailing and food retailing offer broadly similar circumstances to gas and electricity retailing with lesser exposure to customer default and bad debts. Our research suggests that net margins in these industries fall generally within the range 2 to 6%.

In considering an appropriate benchmark for retail margin for retailers heading into a competitive market environment, AGL ES&M wishes to raise the concept of 'economic profit' for inclusion in the discussions. Economic profit is not often included in debate about returns in regulated businesses. Economic profit is widely recognised in economic texts as an appropriate reward for entrepreneurship, and a necessary and legitimate item to be recovered through sales revenues.

Traditionally regulated energy businesses have essentially been viewed by regulators as a "natural-monopoly low-risk bond" and consequently have only been allowed a normal profit (ie a return on capital, based upon the capital asset pricing model along with return of capital – depreciation – and recovery of efficient costs).

However as the Australian energy market is restructured the "natural-monopoly low-risk bond" component of the regulated energy business is being separated away from the riskier energy wholesaling and retailing business. It is no longer appropriate for regulators to view energy retailers as a "natural-monopoly low-risk bond", they should be viewed as a wholesale/retail operation, and to the extent that they are regulated at all, the regulation should acknowledge the need for entrepreneurship to be rewarded via economic profit.

AGL ES&M is of the view that net margin should be compared with a benchmark range of 4 to 6%.

AGL ES&M also believes that net margin should be determined as a percentage of sales revenue (turnover) when setting safety net prices. This is consistent with a light handed approach to safety net price setting and offers incumbent retailers the opportunity to offer prices to all customers which reflect the cost of supply, thereby ensuring price outcomes that would occur in a competitive market.

- **Operating costs of $45 per customer does not reflect costs under competition**

The $45 benchmark for operating costs is derived from the $35 to $55 range assessed as reasonable for the incumbent electricity businesses in NSW operating in an environment where competition did not exist and where the level of accounting separation between the retail and distribution businesses may not have been sufficient.

With the advent of competition businesses are going to operate differently with some costs that are a direct result of full retail contestability (recoverable under the VPPs) and some costs as a result of a different approach to business (not recoverable under the VPPs). At present all customers are supplied under standard form contracts with automatic "contract" rollovers and limited retailer intervention. Under full retail contestability costs associated with marketing, churn enquiries, churn related intervention, contract/offer/product management, and the supporting IT will increase, increasing the operating costs per customer. Operating costs per customer should also take into account the size of the retailer because average costs per customer are generally higher for smaller retailers.

Recovery of Contestability Costs

AGL ES&M supports the Tribunal's decision to allow a pass through of costs associated with implementing full retail contestability.

Whilst we note that the method of cost recovery (ie, who should pay, how and when) is subject to the Tribunal approval, AGL ES&M would reasonably expect that cost recovery will take into account the:

- manner in which the costs are incurred,
- consistency of approach with the objectives of achieving full cost recovery on safety net prices, and
- timing to ensure costs are recovered as incurred to avoid risk of under recovery or allocation of costs to customers who do not contribute to it.