IPART
New South Wales

Independent Pricing and Regulatory Tribunal

Regulated gas retail tariffs

Decision and statement of reasons – AGL's 2008 application for a special circumstances price increase

Gas — Final Decision and statement of reasons
March 2008

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Gas08/01

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Mr James Cox, Chief Executive Officer and Full Time Member

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1 Decision

IPART has decided that it is appropriate for AGL to increase the average prices for regulated gas customers by $0.75[1]/GJ from 1 April 2008. For a typical residential customer in NSW, with annual consumption of 23 GJ, this translates into a 5.24 per cent increase in the customer's annual bill. This increase replaces the CPI increase that would have otherwise occurred on 1 July 2008.

2 Background

On 30 June 2006 the then Minister for Energy wrote to IPART requesting that it continue to regulate default tariffs for small retail customers by ensuring that either new voluntary pricing principles or a gas pricing order under section 27 of the *Gas Supply Act 1996* operate until 30 June 2010.

In June 2007 IPART finalised voluntary transitional pricing arrangements (VTPA) with the standard gas suppliers in NSW for the regulated retail prices.[2] IPART developed a specific agreement with each of the standard suppliers, including AGL. The agreements provide for annual price increases of the consumer price index (CPI) or less. In special circumstances a supplier may apply to IPART to vary prices outside of this limit.

2.1 AGL's application for a price increase resulting from special circumstances

On 17 January 2008 AGL submitted a proposal for average price increases to regulated tariffs of $1.13 per GJ or by 7.3 per cent (for customers using less than 1 TJ each year) to apply from 1 April 2008, which is different to the standard arrangements of a CPI price increase on 1 July of each year that is provided for in the VTPA. AGL submitted that the special circumstances under which it sought approval to increase gas prices by more than CPI arose from two specific events:

1. AGL was unsuccessful in securing sufficient transmission on the Eastern Gas Pipeline for gas required for peak winter usage - as a result, AGL is seeking to replace the 34.8 TJ/day lost capacity by entering into a supply agreement with producers in the Cooper Basin (South Australia) and transporting the gas on the Moomba to Sydney pipeline.
2. A significant change in the contractual arrangements for transport on the Moomba to Sydney Pipeline (MSP), specifically relating to the introduction of park charges and imbalance charges.

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1 $0.75/GJ is before the impact of inflation, however the 5.24 per cent includes inflation.

2 IPART, *Promoting retail competition and investment in the NSW gas industry, Regulated gas retail tariffs and charges for small customers 2007 to 2010, Gas – Final Report and Voluntary Transitional Pricing Arrangements*, June 2007.

AGL submitted that these two events lead to a substantial increase in costs over 2008/09 and that these additional costs should be recovered from tariff customers.

2.2 Process for this review

The VTPA requires the supplier to give IPART four months notice of price increases resulting from special circumstances. However, in the report that accompanied the VTPA, IPART said:

> The notice period for suppliers to inform the Tribunal of special circumstances can be varied with the agreement of the Tribunal and the supplier. This provides flexibility where the change in circumstances is relatively straightforward (and so can be assessed in less than 4 months), or where it requires more complex analysis (entailing a longer lead time before prices changes are approved).[3]

In response to AGL's request, IPART agreed to undertake an expedited review of whether the incremental costs that AGL identified are reasonable and should be passed onto tariff market customers. Due to the commercially sensitive nature of the cost information and the condensed timeframe, IPART did not undertake formal public consultation of this incremental review, but engaged Frontier Economics to provide expert advice to assist its decision making. The advice focussed on the following issues:

1. verifying the claim that AGL would not be able to meet its forecast maximum demand over winter in the absence of the gas from the SACB
2. assessment of the costs of the SACB winter gas, including:
   a) examining whether as a prudent and efficient retailer, AGL should have anticipated the heightened demand for capacity on the EGP and sought alternative arrangements prior to the auction in the event that it did not secure the required capacity at the auction
   b) the appropriate deduction of the value of the gas that AGL now has available in the Victorian market as a result of not securing capacity to transport it to the Sydney/ACT market on the EGP
   c) The appropriate deduction for the EGP transportation costs that were implicitly included in the CPI price path established under the VTPA
3. assessment of the increased transportation charges on the MSP
4. the allocation of the increased costs for winter 2008 between the tariff and contract markets

[3] IPART, *Promoting retail competition and investment in the NSW gas industry, Regulated gas retail tariffs and charges for small customers 2007 to 2010, Gas Final Report and Voluntary Transitional Pricing Arrangements*, June 2007, p 3.

Deloitte was engaged by AGL and IPART to perform procedures on the information provided by AGL in respect of AGL's Moomba and Longford Gas supply arrangements.[4]

3 The price increase and statement of reasons

Decision

1 IPART has decided that it is appropriate for AGL to increase the average prices for regulated gas customers by $0.75/GJ from 1 April 2008. For a typical residential customer in NSW, with annual consumption of 23 GJ, this translates into a 5.24 per cent increase in the customer's annual bill. This increase replaces the CPI increase that would have otherwise occurred on 1 July 2008. IPART's reasons for this decision are set out in this chapter.

In assessing this price application, the Tribunal reviewed the costs from an incremental approach. It did not assess all costs from a first-principles basis, but looked at the additional costs that resulted from the special circumstances presented by AGL.

To calculate the incremental cost, IPART established the incremental cost of the SACB gas and added the incremental cost of transporting it down the MSP. From this additional cost, IPART deducted the value of the gas that AGL now has available in Victoria plus the expected costs of transporting that gas on the EGP. These costs are discussed in sections below.

3.1 The supply of gas to the Sydney and ACT market for winter 2008

AGL submitted that as a result of not securing the capacity on the EGP and without additional gas from the SACB producers, it will not be able to meet its forecast maximum demand for the Sydney market over winter 2008. IPART considers that, after considering AGL's gas supplies from Victoria (delivered through the EGP), SACB (delivered through the MSP) and the Sydney Basin, AGL does require the additional gas from the SACB.

The additional gas required from the SACB producers represents roughly 10 per cent of AGL's forecast maximum demand for winter 2008.

3.2 Winter gas (commodity) costs for 2008

To assess the incremental winter gas costs IPART examined:

4 Deloitte performed an agreed upon procedures engagement in accordance with Australian Auditing Standard 904 Engagements to Perform Agreed-Upon Procedures, which consisted of the performance of certain agreed upon procedures on selected volumetric and pricing data provided by AGL.

- what costs would an efficient and prudent retailer incur to secure supply for the Sydney market over the 2008 winter (the cost of the winter gas from SACB producers); and deducted
- the value of the gas the AGL now has available in Victoria over winter 2008 due to not securing the capacity on the EGP to transfer it to the Sydney market.

3.2.1 The cost of the winter gas from the SACB producers

AGL provided evidence of the offer from the SACB producers for the additional gas over the 2008 winter period.[5] The details of this offer are commercial in confidence. The Tribunal allowed the value of that gas.

3.2.2 The value of the winter gas now available in Victoria

After considering a range of information, including information provided by AGL, Victorian spot prices and forward prices for electricity prices for winter 2008 and advice from Frontier Economics, IPART deducted $4/GJ as the value of the Victorian gas now available to AGL. This cost is deducted from the cost of SACB gas to determine the incremental cost.

3.3 Transportation charges for 2008

To assess the additional transportation charges IPART examined:

- the incremental charges on the MSP; and deducted:
- the expected savings that AGL will make as a result of not transporting this additional gas on the EGP.

3.3.1 Incremental charges on the MSP

AGL submitted that it now faces two additional charges for services for the MSP – charges for park services and imbalance charges. AGL provided details of the haulage contracts to establish this is the case.

Park charges are charges for linepack on the MSP. Linepack is gas storage within the pipeline. In the short term, gas in the pipeline can be used to meet peak demand where demand exceeds injected gas on a particular day, however, if demand significantly exceeds supply over a number of days, the gas available from linepack diminishes. Further, imbalance charges apply if a cumulative imbalance is not reduced to within agreed limits within an agreed timeframe.

However, AGL has applied to recover costs incurred since July 2007 in addition to the costs for 2008/09. IPART considers that the VTPA represents a prospective

5 This data was verified by Frontier Economics.

incentive-based form of regulation rather than a retrospective cost build-up approach and, therefore, AGL should not recover the retrospective park and imbalance charges incurred since July 2007. Further, AGL should have known at the time of negotiating the VTPA that at least some of these charges could apply. IPART has therefore allowed the forecast park and imbalance charges from 1 April 2008.

3.3.2 Expected cost savings on EGP

From the additional MSP costs IPART deducted the expected cost of transporting Victorian gas via the EGP. The relevant cost is an estimate of what AGL would have expected to incur when it signed the VTPA. IPART, of course, has no exact knowledge of what allowance AGL made for the cost of gas transportation at the time that it signed the VTPA, but IPART notes that the market for gas was tightening at the time, and a prudent and efficient retailer would have factored in an allowance for this tightening when agreeing to its future retail prices. After considering the market information available at that time IPART has decided that a reasonable cost reduction for the cost of transporting the Victorian gas by the EGP would be $2.55 per GJ.

3.4 Allocation of costs across tariff and contract customers

The gas retail market consists of two types of customers:

- Tariff customers – customers that consume less than 10 TJ each year. These customers are not metered on a daily basis.
- Contract customers – consuming more than 10 TJ each year.

Competition has been progressively introduced in the NSW market. Since 2002, all NSW gas customers have been able to choose their retailer, with around 17 licensed retailers supplying the market.[6] Tariff customers consuming less than 1 TJ each year can either:

- enter into a market contract with a licensed supplier or
- remain on a regulated tariff, established under the VTPA.

AGL initially submitted that the appropriate allocation of the costs of securing gas to meet winter demand in NSW and the ACT is to recover all the incremental costs from tariff customers. AGL argued that tariff customers cause the winter peak and that the contract customers (those consuming more than 10 TJ each year) have a relatively flat load over the year. AGL's proposed cost allocation would mean that contract customers should not see any of the higher costs of supplying gas over winter.

6 Not all licensed retailers offer supply contracts across all customers or all geographic areas within NSW.

IPART indicated that it did not agree with AGL's proposed cost allocation. Those contract customers whose contracts expire over winter 2008 are no different to tariff customers as they are consuming the same scarce gas and should expect to pay the market price for that gas as their contracts expire.

In subsequent discussions, AGL proposed a cost allocation to reflect the difference between the average and peak load for each customer class.

IPART considered a number of cost allocations and decided to allocate 80 per cent of the efficient incremental costs to the tariff market and 20 per cent to the contract market. This split offers a balance between the price increase faced by tariff customers and those likely to be faced by contract customers and recognises the proportion of contract customers that will face contract negotiations over winter 2008.

3.5 Price change date for 2008

The VTPA established price changes for 1 July each year. IPART has agreed to AGL's request for a 1 April 2008 price change instead of the 1 July price change. Bringing the price change forward by three months lessened the increase in the tariff necessary for AGL to recover the appropriate costs. Further, the cost of securing supply for winter 2008 will be incurred prior to 1 July 2008.

There will not be a further price change on 1 July 2008 – the 1 April 2008 price change includes the CPI adjustment (amended to reflect its early implementation).

4 The costs of supplying gas in winter 2009

This price increase arose from special circumstances relating to the supply of gas to the Sydney and ACT market for winter of 2008. IPART does not expect these circumstances to be replicated in 2009.

However, it does consider that the cost of supplying gas to the Sydney and ACT market could be more expensive than it has been over the earlier part of this decade, due to increased demand for gas and its transportation. This increased demand stems in part from more demand from gas-fired power stations.

Anecdotally IPART has been informed (and seen evidence) of a reduction in active competition in the retail gas market for both contract and tariff customers.

IPART has decided to conduct a review of costs prior to the 1 July 2009 price change. Since receiving this AGL application for a special circumstances price increase, IPART has received special circumstances applications from ActewAGL and Country Energy. IPART considers that it is appropriate to review costs to ensure that prices remain at cost reflective levels.

5 Social impacts of IPART's decision

IPART is concerned that, due to the scarcity of gas transportation capacity in NSW, the retail market for both contract and tariff customers may become less competitive over the short to medium term, particularly over winter 2008.

The NSW Government is currently working with other jurisdictions to develop the arrangements for the national gas market. IPART recommends this process specifically consider the current market structure in NSW to ensure that the market arrangements allow the security of supply at a reasonable price for NSW customers.

Further, IPART is concerned that customers are experiencing real price increases across water, electricity and gas and that prices are likely to continue to rise over the medium term.

There is currently a pensioner rebate for energy (electricity and gas) in NSW, set at $112 per annum. Since this level was set in 2002, typical combined electricity and gas bills have increased by around $80 per quarter, or over 30 per cent, yet the rebate has remained unchanged. However, the Commonwealth Government has committed to increasing its Utility Allowance.

While recognising the important contribution of the current hardship programs run by energy retailers, IPART considers that both the level and eligibility of the energy rebate should be further examined.[7]

7 The Premier of NSW established the Consultative Reference Committee to test the impacts of changes to the State's electricity industry which the NSW Government announced in 2007. The Tribunal notes that the Committee, in its March 2008 report, has recommended an increase in the current pensioner rebate from $112 to $130 and that it should be indexed to the CPI.