

**Draft Decision**

**Review of the Delivered Price of  
Natural Gas in Wagga Wagga and Albury**

**INDEPENDENT PRICING AND REGULATORY TRIBUNAL  
OF NEW SOUTH WALES**

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### **Submissions**

Public involvement is an important element of the Tribunal's processes. The Tribunal therefore invites submissions from interested parties to all of its investigations.

Submissions should have regard to the specific issues that have been raised. There is no standard format for preparation of submissions but reference should be made to relevant issues papers and interim reports. Submissions should be made in writing and, if they exceed 15 pages in length, should also be provided on computer disk in word processor, PDF or spreadsheet format.

### **Confidentiality**

Special reference must be made to any issues in submissions for which confidential treatment is sought and all confidential parts of submissions must be clearly marked. *However, it is important to note that confidentiality cannot be guaranteed as the Freedom of Information Act and section 22A of the Independent Pricing and Regulatory Tribunal Act provide measures for possible public access to certain documents.*

### **Public access to submissions**

All submissions that are not subject to confidentiality will be made available for public inspection at the Tribunal's offices immediately after registration by the Tribunal and also via the Tribunal's website. Transcriptions of public hearings will also be available.

### **Public information about the Tribunal's activities**

A range of information about the role and current activities of the Tribunal, including copies of latest reports and submissions can be found on the Tribunal's website at [www.ipart.nsw.gov.au](http://www.ipart.nsw.gov.au).

***Submissions on the recommendations and options proposed in this draft decision should be received no later than 29 October 1999. Comments or inquiries regarding this review should be directed to:  
Tom Hird ☎02-9290 8450 or Gary Drysdale ☎02-9290 8477***

## **Independent Pricing and Regulatory Tribunal of New South Wales**

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# 1 INTRODUCTION

## 1.1 Background

In keeping with the commitments made in 1994 by the Council of Australian Governments, the NSW Government is introducing competition in the supply of natural gas. This involves a series of stages including:

- development of third party access regimes for transport systems, setting out terms and conditions for the use of distribution pipes
- the progressive introduction of contestability to customer groups
- regulation and monitoring of prices by the Tribunal until effective competition is established

This report primarily addresses the Tribunal's approach to the last of these three stages. However, as the establishment of effective competition requires implementation of the first two stages, it is useful to first outline the current state of play with respect to these reforms.

### 1.1.1 Purpose of the review

Currently, delivered prices to the tariff market in Wagga Wagga, Albury, Moama and NSW Murray Towns are not regulated.

In this review the Tribunal proposes to consider the following:

- should the tariff market be regulated?
- if so, how should prices be regulated?
- are suppliers receiving an appropriate return?
- is regulation required once the retail market is contestable?

### 1.1.2 Review process to date

The Tribunal began its review of the delivered price in Wagga Wagga, Albury, Moama and NSW Murray Towns in August 1997. In accordance with the processes set out in section 32(2) of the *NSW Gas Supply Act 1996* and Part 4 of the *Independent Pricing and Regulatory Tribunal Act 1992*, the Tribunal released an issues paper on tariff regulation, held a public hearing, and called for submissions from interested parties.

Submissions were received from Great Southern Energy and the Albury Gas Company in September 1997. These submissions were made available to interested parties and subsequently the Tribunal received submissions from stakeholders. The submissions are outlined in Appendix 2. A public hearing was held on 6 November 1997 in Wagga Wagga.

In March 1998 the Tribunal released a further paper on the review of the delivered price of natural gas in Albury and Moama. The purpose of this consultation paper was to inform interested parties of the progress of the review and to provide additional material provided by AGC in support of its proposals. Submissions received in response to this consultation paper are also outlined in Appendix 2.

The Tribunal duly considered the submissions in response to the issues and consultation papers and resolved:

- not to regulate the delivered price in the Murray Valley towns. This decision was taken in light of the fact that gas supply to those towns was being introduced for the first time, and this was occurring through a competitive tender process. (In July 1995 the Central Murray Regional Development Corporation chose the Albury Gas Company to supply the region with natural gas.)
- to postpone its determination of the delivered price of gas to the tariff market in Wagga Wagga and Albury to allow the tariff and access reviews to run concurrently. Transportation prices are a significant component of the delivered price of gas. It was therefore practical for a deferral of this type to take place. This decision was widely supported by submissions to the Tribunal. In addition, the incumbent retailers agreed to a price freeze until the review process advanced.

The Tribunal is now nearing completion of its access reviews for gas distribution networks operated by Great Southern Network's (GSN) and the Albury Gas Company (AGC). In the case of Wagga Wagga, GSN did not submit a complying access arrangement following the Tribunal's final decision on their proposed access arrangement. The Tribunal drafted its own access arrangement which it approved in September 1999. In respect of AGC, the Tribunal issued its draft decision on the access arrangement in July 1999 and a final decision is expected in October 1999.

In light of the status of the access reviews for GSN and AGC, the Tribunal is now in a position to finalise its review of delivered tariffs in Wagga Wagga and Albury. This draft decision sets out the Tribunal's preferred approach to tariff regulation in these regions as NSW moves towards full retail contestability.

The Tribunal invites submissions on this draft decision from interested stakeholders.

## **1.2 The contestability timetable**

Customers above 10 TJ are already contestable. The timetable for the introduction of retail contestability for other customers in New South Wales is presented in the table below

**Table 1 Timetable for the introduction of retail competition in NSW**

<b>Date</b>	<b>Load Category</b>
1 October 1999	New and existing loads > 1 TJ pa (large users in the tariff market)
1 July 2000	All remaining customers

Contestability is being introduced in NSW earlier than in other states. Victorian residential customers will be contestable from 1 September 2001.

## 1.3 Regulation and oversight of prices by the Tribunal

### 1.3.1 The Tribunal's regulatory powers in the tariff market

The Tribunal may regulate the price of gas supply to the tariff market by making a gas pricing order under section 27 of the *Gas Supply Act 1996*. A gas pricing order can be issued at any time and is the Tribunal's principle power in regulating gas tariff market prices. Essentially, a gas pricing order can:

- establish a methodology within which tariff prices for delivered gas must be set
- establish maximum tariffs or maximum average tariffs
- prohibit the imposition of certain charges.

There is currently no gas pricing order in effect for the Wagga Wagga and Albury tariff markets. However, the knowledge that a gas pricing order could be introduced at any time along with the Tribunal's ongoing price monitoring may have a role in constraining tariff market prices. The Tribunal's power to issue a gas pricing order can also influence the nature of negotiations with retailers over the voluntary acceptance of pricing principles. The Tribunal will maintain the power to issue a gas pricing order following the introduction of contestability for tariff market customers.

### 1.3.2 The Tribunal's role under the *Gas Supply Act 1996*

Under s32(1) of the *Gas Supply Act 1996*, the Tribunal may conduct investigations for the purpose enabling it to exercise its functions under the Act. An investigation must be consistent with the Act's statutory objectives. The objectives of the Act are listed in s3(1). They are:

- to encourage the development of a competitive market in gas so as to promote the thermally efficient use of gas and deliver a safe and reliable supply of gas
- to regulate gas reticulators and gas supply, so as to facilitate open access to gas reticulation systems and promote customer choice
- to provide for the adoption of an access code.

To ensure that these objectives are met, the Tribunal (and others) have the duties in s3(3)-(6) of the Act as set out below.

- 3(3) In relation to persons involved in the reticulation of gas (authorised reticulators and licensed distributors), the duties are as follows:
- (a) to ensure that such persons satisfy, so far as it is economical for them to do so, all reasonable demands for the conveyance of gas
  - (b) to take proper account of the business interests of such persons and the ability of such persons to finance the provision of gas reticulation services
  - (c) to consider the development of efficient and safe gas distribution systems
  - (d) to promote the efficient and safe operation of gas distribution systems
  - (e) to take proper account of the interests of gas users in respect of transportation tariffs and other terms of service.
- 3(4) In relation to persons involved in the supply of gas (authorised suppliers and licensed distributors), the duties are as follows:
- (f) to ensure that the public receives the benefit of a competitive gas market

- (g) to take proper account of the interests of tariff customers in respect of gas pricing and other terms of gas supply
  - (h) to take proper account of the business interests of persons supplying gas to the tariff market
  - (i) to encourage the development of competitive gas supply in the non-tariff market, with a focus on free and fair trade.
- 3(5) In relation to gas users the duties are to promote the efficient and safe use of gas.
- 3(6) In relation to both persons involved in the reticulation of natural gas (authorised reticultors) and persons seeking third party access rights to gas distribution systems (system users), the duties are to ensure that those rights are given effect to in accordance with the access code adopted by this Act.

### **1.3.3 Development of third party access regimes for distribution systems**

Under the National Third Party Access Code for Natural Gas Pipeline Systems ('the Code') the owner of a covered pipeline submits an access arrangement for approval by the relevant regulator. Access arrangements set out the terms and conditions (including reference prices) for the transport of gas through the transmission and distribution pipes. Access arrangements are intended to ensure capacity to finance reticulation of gas and seek to ensure sufficient funds are available for a prudent service provider to maintain the safety and integrity of the network system. The technical regulation of safety requirements is a responsibility for the Ministry of Energy and Utilities.

While the Australian Competition and Consumer Commission (ACCC) reviews most of the large scale transmission pipes<sup>1</sup> which transport gas from the source to the city gate (haulage costs), the state regulator, in this case the Tribunal, reviews the access arrangements for distribution systems from the city gate to the customer (transport costs). Transport costs generally form upwards of a half of the total cost of tariff market gas supply costs.

## **1.4 Existing tariff market in Wagga Wagga and Albury**

### **1.4.1 Wagga Wagga**

Situated halfway between Sydney and Melbourne, Wagga Wagga is a significant regional centre with a population of approximately 57,000. The largest inland city in NSW, it is the commercial centre of the Riverina district. It is strategically located on the route of the recently commissioned Wodonga to Wagga Wagga pipeline connection between the Victorian and New South Wales gas networks.

Gas has been available in Wagga Wagga since the late 1880s. Manufactured gas was used until natural gas from the Cooper Basin became available in 1981. The supply and reticulation of gas was a business of the Wagga Wagga City Council from the introduction of gas until 27 June 1997 when Great Southern Energy acquired the utility. To meet ring fencing requirements under the code, Great Southern Energy has established a wholly owned subsidiary to operate the gas network, Great Southern Energy Gas Networks Pty Limited. Operating and maintenance and support services are currently provided by Great Southern Energy, which charges GSN for these services. Great Southern Energy is also the gas retailer on the GSN system.

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<sup>1</sup> As listed in the code.

The Wagga Wagga system currently serves about 14,000 customers purchasing a total of approximately 1.5 petajoules of gas each year, which is transported through 525 km of pipes/mains.

Most of the gas consumers in Wagga Wagga are tariff customers.<sup>2</sup> They consume about 45 per cent of total gas sold. The tariff market can be separated into residential, commercial and industrial sub-classes. Residential customers account for 96 per cent of all natural gas customers in Wagga Wagga and consume about 34 per cent of the total Wagga Wagga load. Of all the households in Wagga Wagga with access to gas mains, 85 per cent are connected to gas. By comparison, about 60 per cent of households with access to the gas mains are connected in Sydney, while 80 per cent are connected in South Australia.

The other tariff customer sub-class is industrial and commercial customers. There are over 400 industrial and commercial customers in Wagga Wagga consuming 11 per cent of total gas sold.

There are also 14 contract customers.<sup>3</sup> These customers account for the remaining 55 per cent of gas consumed. Commercial uses range from board processing, wool combing and hospital services, to plywood manufacture and asphalt production. Gas is also used by large army and airforce establishments and by Charles Sturt University.

#### **1.4.2 Albury**

The Albury Gas Company (AGC) supplies gas to Albury, Moama, Jindera (in the Hume Shire) and the NSW Murray Valley towns. Since 1 December 1997, AGC has been a wholly owned subsidiary of Stratus Networks. More recently, Stratus Networks and its 'stapled' retail arm, Energy 21 were purchased by a consortium of Boral Energy and Envestra. Stratus Networks owns and operates distribution networks in north and south-eastern Victoria as well as the Mornington Peninsula. Although it is owned by Stratus Networks, AGC operates a discrete network which serves customers in NSW. AGC also has its own audited financial accounts. Energy 21 is the principal retailer supplying gas to Albury, Moama and Jindera.

AGC's distribution network in Albury, Jindera and Moama is about 325 kilometres in length and serves approximately 16,000 customers which consume a total of about 3 petajoules of gas per year. Natural gas was officially turned on at the Albury city gate on 2 June 1977. Reticulation of natural gas to the town of Jindera commenced on 29 August 1995 and to Moama two days later.

Most of the gas consumers served by AGC network are tariff customers. They consume about 32 per cent of total gas sold. Tariff customers can be separated into residential, commercial and industrial sub-classes. About 95 per cent of all natural gas customers using AGC network are residential customers. Of all the households that have access to the Albury network, 84 per cent are connected to gas. By comparison, about 60 per cent of households with access to the gas mains are connected in Sydney, while 80 per cent are connected in South Australia.

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<sup>2</sup> Tariff customers are end use customers consuming less than 10 TJ per annum.

<sup>3</sup> Contract customers are end use customers consuming more than 10 TJ per annum.

The other tariff customer sub-class is industrial and commercial customers. AGC network has about 100 industrial and commercial customers which consume about 9 per cent of total gas sold.

There are also eight contract customers who account for the remaining 68 per cent of gas consumed. These customers generally use gas for commercial uses ranging from a variety of processing and manufacturing plants to hospital services.

Although Moama is located in NSW, its distribution network is an extension of the network serving Echuca in Victoria and is not connected to the distribution network serving Albury and Jindera. There are towns with similar characteristics to Moama in the Central Murray region.

### **1.5 Report outline**

Chapter 2 of this report provides an overview of submissions received in the review process.

Chapters 3 and 4 examine the reasonableness of current prices and assess whether competition will be effective in ensuring their reasonableness in the future. Chapter 3 presents a micro comparison of existing prices and existing costs. Chapter 4 examines the potential barriers to effective competition in the NSW retail tariff market as well as overseas experience with the introduction of contestability.

Chapter 5 takes account of the preceding analysis and outlines the Tribunal's preferred regulatory approach to tariff market pricing. The Tribunal's regulatory objectives and constraints are also discussed in this context.

## 2 OVERVIEW OF SUBMISSIONS

The submissions by Great Southern Energy and the Albury Gas Company both predate the current proposed Access Arrangements. The lapse since these submissions were written may mean some issues are no longer relevant or stakeholders' views have changed. The Tribunal will give stakeholders the opportunity to submit revised submissions prior to the release of the final determination.

### 2.1 Proposal by Great Southern Energy

In its 1997 submissions Great Southern Energy (GSE) states:

- Little public benefit is derived from regulating the gas tariff market.
- The cost of supply for serving both the tariff and contract markets is considerably more than the revenue derived from that market.
- Price increases in Wagga Wagga in previous years were less than increases in the consumer price index (CPI).
- GSE should be allowed to pass through the price of gas to customers.
- Prices should reflect the fixed costs involved in running a gas business. In this regard, the price structure should change from a minimum and three stepped tariff, to a fixed charge and a flat energy charge. Charges in Wagga Wagga are more heavily usage based than for AGL or the Victorian gas businesses.
- GSE expects unit retail cost reductions from running a combined gas and electricity retail business. GSE proposes charging gas retail customers the incremental retail costs incurred when adding these customers to their existing electricity customer base. The incremental cost for gas is estimated at \$15, while retail costs per electricity customer are estimated at \$60 per customer.

### 2.2 Submission by the Albury Gas Company

A submission by Albury Gas Company (AGC) was received by the Tribunal on 18 September 1997. The submission argued that there was no need for regulation in the lead up to retail contestability. Like the GSE submissions, AGC suggests that if the Tribunal does introduce regulation, that regulation should cease with the introduction of contestability.

AGC proposed an initial real increase in prices of 1.3 per cent in 1997/98 and then no real increases in the period up to the introduction of contestability. AGC note that these initial price rises would align prices in the NSW towns of Albury and Moama with the nearby Victorian towns of Wodonga and Echuca, which are also served by AGC.

However, shortly after these submissions were received, AGC agreed to a price freeze until the review process had advanced and the nature of network charges under the relevant access arrangement would be clearer.

## **2.3 Other submissions**

The Tribunal initially received six submissions from interested parties, and a further four submissions following the release of the consultation paper for Albury and Moama. Many issues raised relate to the determination of transport prices, and are dealt with in the access review. Regarding the setting of the delivered price, the main points are:

- Four of the submissions argue that prices to tariff customers should be regulated until they are contestable<sup>4</sup>.
- NSW Treasury warns that there is a danger GSE and AGC may act strategically to recover excessive costs in the unregulated part of the market.
- BHPP states that regulation of the natural gas industry in NSW should be fair to consumers and conducive to on-going investment and growth in the industry.
- BHPP comments that the assertion that cross subsidies exist in GSE pricing is not supported by sufficient facts.
- BTR argues that as Wagga Wagga and Albury are closer to the Cooper Basin than Sydney is, the cost of gas in these towns should be less than in Sydney.
- Boral and BHP state that operating costs for GSE and AGC appear reasonable. AGL argues that operating costs for Great Southern Energy appear low, and warns that GSE may be using revenues from electricity sales to cross subsidise its gas customers.

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<sup>4</sup> AGL, NSW Treasury, BHPP, Boral.

### 3 REASONABLENESS OF CURRENT TARIFF MARKET PRICES

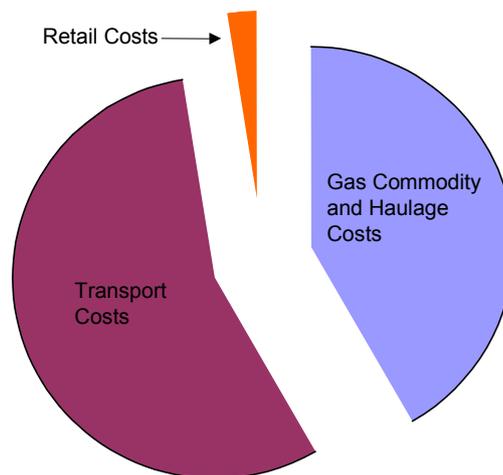
The Tribunal has examined the reasonableness of tariff prices in Wagga Wagga at macro and micro levels. The macro analysis involves a comparison of total revenue raised with total costs incurred. The micro analysis focuses on whether individual tariff prices accurately reflect the costs of servicing particular customers. The Tribunal's findings in this regard are outlined below.

Owing to a lack of up-to-date data, the Tribunal has not performed the same detailed analysis of tariffs in Albury as in Wagga Wagga. The Tribunal has decided not to delay the release of this draft decision until this information is available. Energy 21 has undertaken to provide the Tribunal with the relevant data as soon as possible after the release of this draft determination. In making this decision the Tribunal has taken into account the fact that Energy 21 currently offers the lowest tariff market prices in NSW and that the recent purchase of Energy 21 by Boral has placed significant demands on Energy 21's management resources.

Several cost components make up the delivered price of gas. The supplier incurs the cost of:

- *gas commodity and haulage costs* - purchasing the gas from the field and transporting the gas from the field to the city gate through a transmission pipeline
- *transport costs* - transporting the gas through the reticulation system within the town
- *retail costs* - running the supply business.

**Figure 3.1 GSE's Supply Costs**



The relative importance of these costs for GSE is shown graphically above.

A more detailed description of each of each of the cost components is provided in Appendix 1.

### 3.1 Comparison of aggregate revenues and costs in the Wagga Wagga tariff market

The Tribunal has estimated the cost of servicing the Wagga Wagga tariff market in the first and second full years of the GSN access arrangement assuming that gas sales are stable at their 1998/99 levels. These results are outlined in the following table. Also included in this table is GSE's estimate of full year revenue under currently proposed tariff prices.

**Table 3.1 Tariff Market Costs and Revenues<sup>5</sup>**

	Year 1 of Access Arrangement 1999/00 (Notional Estimates <sup>6</sup> ) (\$m)	Year 2 of Access Arrangement 2000 (\$m)
<b>Cost Components</b>		
Transport	4.322	4.292
Gas and Haulage	3.231	3.252
Retail	0.183	0.183
Total Costs	7.736	7.726
Revenue	7.656 (1 full yr. of current tariffs)	7.773 (1 yr. of tariffs proposed for 1 Jan 2000)
Net Retail Margin	- 0.080	0.046

This analysis suggests that GSE is close to 'break even' in its gas retailing operations. However, the Tribunal notes that the estimated net retail margin is quite sensitive to sales projections. Should the figures in the above table be based on 1997/98 sales data rather than 1998/99 sales data then the net retail margin would be around \$0.050m higher than indicated.

*On the basis of this evidence, and the fact that GSE does not have control over gas field price, haulage and transportation costs in the immediate future, the Tribunal considers that GSE's aggregate tariff market revenue is not unreasonably high.*

### 3.2 Comparison of price and cost structures in Wagga Wagga

A large portion of the cost of supplying gas customers is 'fixed'. That is, many costs do not vary with the level of gas consumed. Marketing, billing, contract and customer management, haulage, and transport costs all have elements of fixed costs. Therefore, it can be argued that in order for prices to better reflect costs it is necessary for gas retailers to pass on fixed costs in the form of fixed charges.

<sup>5</sup> The Tribunal notes that the numbers in this table are partly based on information supplied by GSE that has not been formally audited.

<sup>6</sup> Delays in putting the Year 1 transport charges in place mean that these charges will in actuality apply for a period of less than 1 year. The figures in the 'Year 1' column are therefore indicative of what would be incurred if these charges were in place for a full 12 month period from 1 July 1999. Similarly, the revenue estimate in this column is indicative on the continuation of the price structure introduced in July 1999 for a twelve month period.

GSE has recently introduced a fixed charge for all tariff market customers and significantly reduced usage rates. GSE's recent price history and proposed future prices are outlined in the following table.

**Table 3.2 GSE's tariff prices**

	Hot Water	General	Commercial	Industrial
<b>Prices from July 1996</b>				
Fixed (\$/qtr)	-	-	-	-
First 0.866 GJ/qtr (\$/GJ)	19.1	19.1	19.8	8.7
Next 2.250 GJ/qtr (\$/GJ)	14.6	14.6	14.3	8.7
Remainder	8.3	10.0	10.8	8.7
Minimum	16.5	16.5	16.5	16.5
<b>Prices from 19 July 1999</b>				
(Year 1 of Access Arrangement.)				
Fixed (\$/qtr)	12.75	12.75	12.75	53.5
< 15.0 GJ/qtr (\$/GJ)	9.4	10.7	10.7	8.6
> 15.0 GJ/qtr (\$/GJ)	8.3	10.0	10.0	8.6
Minimum	19.50	19.50	19.50	-
<b>Proposed Prices Jan 2000</b>				
(Year 2 of Access Arrangement.)				
Fixed (\$/qtr)	17.50	17.50	17.50	107.0
< 15.0 GJ/qtr (\$/GJ)	9.0	10.3	10.3	8.5
> 15.0 GJ/qtr (\$/GJ)	9.0	10.3	10.3	8.5
Minimum	22.50	22.50	22.50	-

The Tribunal's analysis suggests that GSE's fixed charges outlined in Table 3.2 do not fully cover their fixed costs of supply as shown in table 3.3. Table 3.3 below compares GSE's fixed charges with the Tribunal's conservative estimate of the actual fixed cost of servicing tariff market customers. These estimates of actual fixed costs are considered conservative because they assume that usage volumes determine all haulage costs. In reality, a portion of GSE's haulage costs is determined by the maximum daily amount of gas reserved for haulage during the period, whether hauled or not. The Tribunal notes that fixed transport costs per residential customer in Wagga Wagga will increase by \$19 per annum in real terms in each of the five years of the GSN Access Arrangement.

**Table 3.3 Comparison of fixed charges and estimated fixed costs of supply**

<b>Year of Access Arrangement</b>	<b>Residential<sup>1</sup> (\$/qtr)</b>	<b>Commercial (\$/qtr)</b>	<b>Industrial (\$/qtr)</b>	<b>Large Industrial (\$/qtr)</b>
<b>Year 1</b>				
Estimated Fixed Costs	17	23.2	57.9	98.8
Actual Fixed Charges	12.75	12.75	53.5	53.5
<b>Year 2</b>				
Estimated Fixed Costs	22	42	111	193
Proposed Fixed Charges	17.5	17.5	107.5	107.5

Notes:

1. Residential, commercial, industrial and large industrial customers are defined here in terms of their maximum metre flow rate that in turn determines the level of fixed network costs charged by GSN. Maximum metre flow rates are, respectively, 10, 30, 85 and 150 metres cubed per hour.

This table suggests that GSE is not recovering all its fixed costs through fixed charges. As a result, GSE can recover its full costs of supply only by charging above the marginal cost per unit of gas consumed. This pricing structure disadvantages high volume customers and creates a distortion against high consumption patterns in favour of low consumption patterns. However, the Tribunal is concerned about the impact of fixed charges on consumers, especially as consumers have made significant investment decisions based on past prices. For this reason, the Tribunal wishes to avoid the sudden introduction of large fixed charges. Under the network pricing arrangement put forward by the Tribunal, the fixed transport charge for tariff customers will be phased in over five years.

GSE's recent introduction of a fixed charge into the tariff market accompanied by lower usage rates has reduced this disincentive to high consumption patterns. This may suggest GSE is restructuring prices in an attempt to protect its high volume customer base from competition post contestability. Continued movement in this direction is to be expected post contestability as competition increases the pressure to move to more cost reflective retail pricing.

GSE applies a minimum bill of \$19.50 per quarter to its residential customers. This charge affects only very small users of gas (less than 700 MJ/qtr) and ensures that GSE recovers from these customers some of its fixed costs that are not covered in its fixed charge.

### **3.3 Comparison of tariffs charged by GSE, Energy 21 and AGL**

The following table and related graphs suggest Energy 21 offers the lowest tariff prices in NSW followed by GSE and then AGL.

Table 3.4 Representative tariffs

	GSE	Energy 21	AGL
<b>Residential</b>	“Hot Water”	“General”	“Economy Plus”
Fixed (\$/qtr)	12.75	12.82	35.00
First Block (\$/GJ)	9.40	6.87	7.99
Second Block (\$/GJ)	8.30	8.76	10.30
Minimum (\$)	19.50	-	-
<b>Commercial</b>	“Commercial”	“Commercial”	“I&C Rate 1”
Fixed (\$/qtr)	12.75	19.02	35
First Block (\$/GJ)	10.70	9.16	1.1192
Second Block (\$/GJ)	10.00	7.54	9.007
Remainder (\$/GJ)	10.00	4.39	9.007
Minimum (\$)	19.5	-	-

The following three charts provide a graphical representation of the tariffs described above. The first two charts depict the tariffs outlined in the above table. The last chart compares the average tariff price of gas sold by the three NSW incumbent gas retailers in 1997/98. The average tariff price is derived by dividing tariff sales revenues by tariff sales volumes.

Figure 3.2 Commercial tariffs

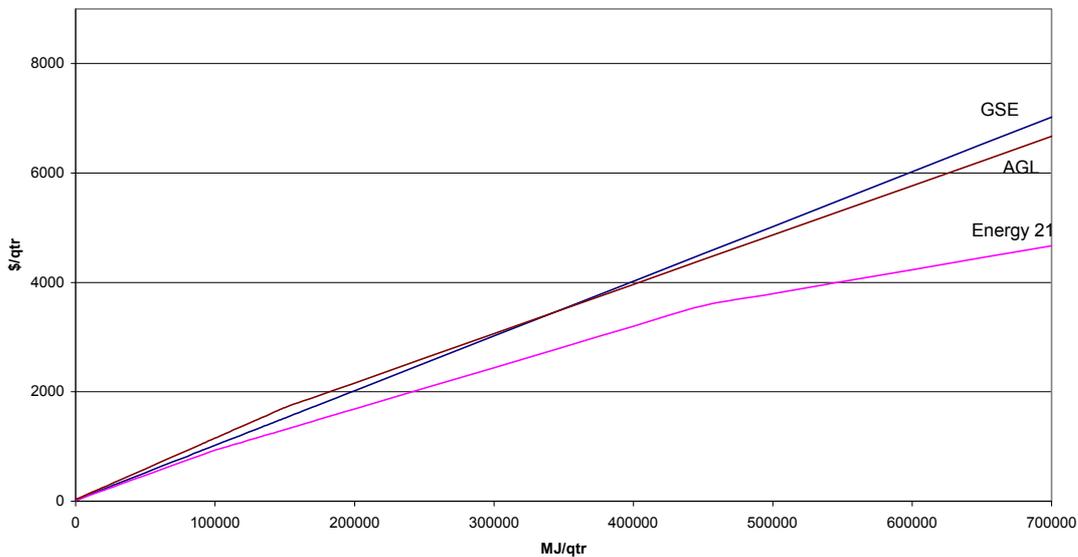


Figure 3.3 Residential tariffs

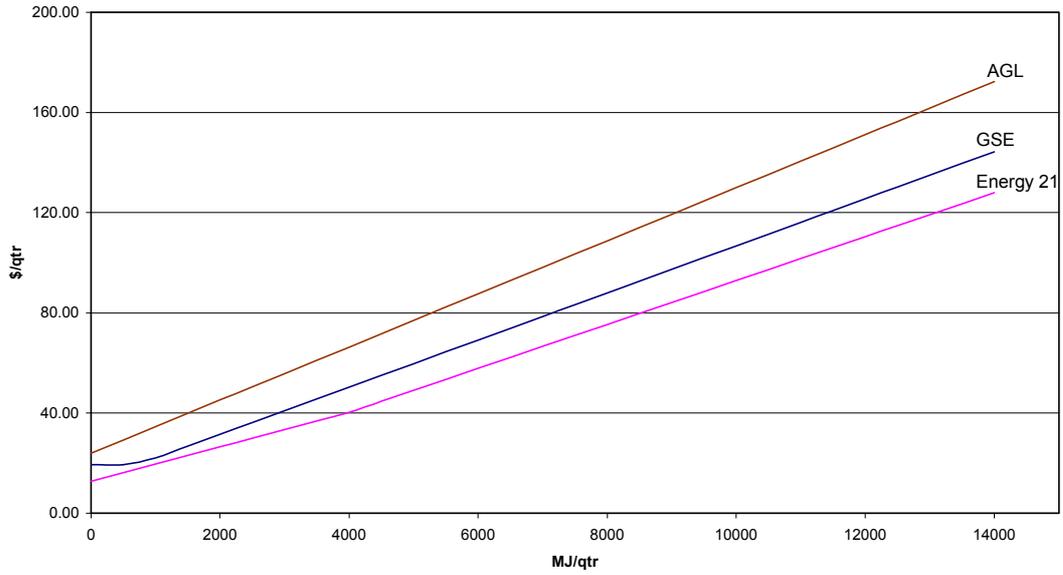
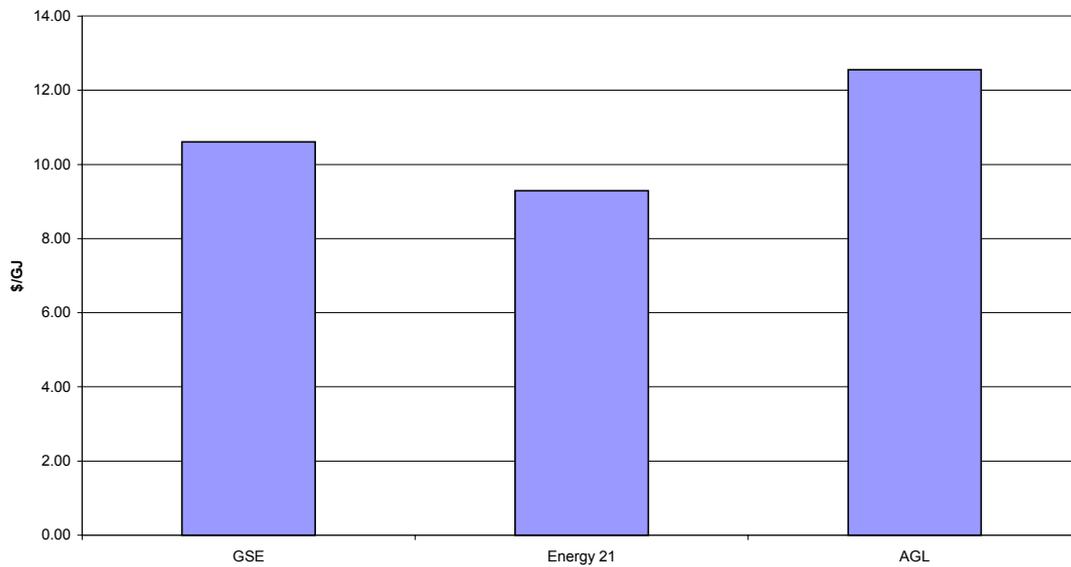


Figure 3.4 1997/98 Average Tariff Prices



### **3.4 Costs and quality of service**

The above analysis implicitly includes in retail costs those expenses necessary for retailers to meet their quality of service obligations. Quality of service for gas retailers includes such dimensions as the provision of customer advisory services, billing inquiries and complaint handling procedures. Quality of service requirements are regulated by the Ministry of Energy and Utilities and there is no evidence that Energy 21 or GSE are not meeting these requirements. The current level of prices should be sufficient to maintain existing service quality all other things equal.

### **3.5 Conclusions**

The preceding analysis suggests that, on average, tariff market customers in both Albury and Wagga Wagga are currently not being overcharged for gas. However, where competition places pressure on retailers to structure their prices to reflect costs, there may be upward pressure on fixed charges and downward pressure on usage rates in the post contestability period.



## **4 ASSESSMENT OF THE LIKELY EFFECTIVENESS OF COMPETITION**

The introduction of contestability for the tariff market poses significant challenges for the regulator. The Tribunal understands that some customers and stakeholders may be concerned about the effectiveness of competition and its impacts. There may be concerns that the incumbent will have significant market power and that new entrants may not be able to compete effectively. If so, customers may face rising prices as the incumbent increases its margins. On the other hand, there may be a concern that competition will be fierce and that, in the battle for market share, retailers may use unethical practices which 'take advantage' of customers.

The primary concern for this report is whether contestability will place sufficient competitive pressures on prices to contain margins for the incumbent retailer. While the Tribunal recognises the concerns of stakeholders, considerable care is required in the design of any regulation in a competitive environment. Design of regulation to protect customers during the transition to competition needs to carefully balance its benefits against the potential impact on the development of competition.

In the case of Wagga Wagga and Albury, retail tariffs have not been regulated previously and the analysis in the previous chapter suggests that current prices are reasonable. However, it is also important to consider whether those prices are likely to remain reasonable following the introduction of contestability. In this regard it is important to analyse the likely level of competition post contestability – especially if incumbent retailers regard the possibility of the Tribunal's issuing a gas pricing order as less likely in this period.

The Tribunal's analysis suggests that there is no strong reason to presume that competition will not be effective in the Wagga Wagga and Albury tariff markets following the introduction of contestability. In reaching this conclusion the Tribunal has had regard to various market structure and conduct issues, as outlined below.

### **4.1.1 Economies of scale in gas retailing**

The Tribunal considers that NSW (and later Victoria) will form a unified marketplace of sufficient size to support effective competition.

In order to be competitive and achieve economies of scale, new participants in the tariff market retailing sector will have to achieve a critical number of customers. In NSW and Victoria there are over two million gas consumers, 700,000 in NSW and 1,300,000 in Victoria. Furthermore, new gas retailers may also be able to 'leverage' off an existing customer base in order to achieve economies of scale. It is likely that several entrants to the NSW tariff market will already have established customer bases in energy retailing both in NSW and in the rest of Australia. The inclusion of electricity tariff market customers dramatically increases the potential customer base available to new entrants. For example, as a gas retailer, GSE has only 14,000 customers, but as a combined gas/electricity retailer GSE has 240,000 customers.

While gas retailers will face some region specific fixed costs, such as region specific advertising, it is reasonable to assume that these costs will be small in relation to non-region specific fixed costs, such as gas supply management, computer/billing technologies and staff/management resources and accommodation. The UK experience suggests that new retailers do not face significant area specific fixed costs. The vast majority of new entrants into gas retailing in the UK operate on a nationwide basis<sup>7</sup>.

The three existing Victorian retailers may supply customers in both NSW and Victoria from the dates of NSW contestability, other potential NSW gas retailers may access Victorian residential customers only after 1 September 2001, according to the current timetable for contestability in Victoria.

### 4.1.2 Sunk costs in gas retailing

The Tribunal does not consider that sunk costs will pose a significant barrier to effective competition in the retail gas market. A firm's sunk costs of entering a market are those costs that can not be fully recouped should the firm exit from that market. Sunk costs therefore represent the costs of unsuccessful entry. All other things constant, the higher the sunk costs, the higher must be the probability of successful entry to entice new entrants.

In gas retailing sunk costs are likely to be considerably smaller than in many other competitive industries. Much of the capital equipment of new entrants (eg computer equipment and office space) is not sector specific, and should therefore have reasonable resale value or it can be leased. Even sector specific intangible capital (such as marketing capital) may be able to be sold to other potential entrants.

### 4.1.3 Effective competition from electricity

The Tribunal does not consider competition with electricity alone to be sufficient to constrain gas prices to reasonable levels. However, electricity can provide a degree of competitive pressure in certain circumstances.

If electricity is not a good substitute for gas (in terms of price and non-price characteristics), then competition with electricity can not be relied on to constrain gas prices. For example, electricity and gas may provide relatively weak competition for each other in the space heating market but, depending on cost and customer perceptions, they may compete more strongly in the hot water market. Furthermore the decisions may be interrelated. The economics of gas space heating are better if the customer already has gas hot water. The use of appliance based tariffs (such as 'hot water' tariffs) has occurred where competition is strongest between gas and electricity.

In Wagga Wagga, GSE is the incumbent electricity and gas retailer. Given that contestability for electricity tariff customers is only scheduled for introduction in January 2000, it is questionable whether competition with electricity can be relied on to constrain gas prices in Wagga Wagga.

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<sup>7</sup> UK Office of Gas Supply, *A Review of the Development of Competition in the Domestic Gas Market*, October 1998.

#### **4.1.4 Upstream access to gas**

In order for competition to be effective, it is important that new entrants to the NSW gas retail market have access to sufficient supplies of gas. Currently, potential new gas retailers in NSW must, in the main, source their gas from the Cooper Basin. This is because there is only limited capacity on the pipe between Albury and Wagga Wagga which connects the main NSW gas network to Bass Strait gas. However, in September 2000 two months after contestability for residential customers begins, the Eastern Gas Pipeline (EGP) is expected to be able to supply gas from Bass Strait into the AGL Gas Network (AGLGN). Its initial capacity of approximately 60 PJ pa compares with the current capacity on the Eastern Australian Gas Pipeline (EAPL) from Cooper Basin of 110 PJ pa.

The Tribunal is aware that some potential entrants have been unable to reach agreement on terms for supply of gas from the Cooper Basin. If no successful agreements are reached, this may create a barrier to competition throughout NSW prior to the connection of the EGP.

However, in Wagga Wagga and Albury there will be at least four other potential competitors with a significant existing customer base in other regions and access to gas. These are namely the other incumbent gas retailers in NSW and Victoria, including GSE as a combined gas and electricity retailer.

Although natural gas retailed in NSW must currently be sourced from either the Cooper Basin or Bass Strait, new entrants to the retail market need not purchase all gas directly from the respective producers controlling those fields. Instead, new entrants may have the capacity buy gas from other retailers who have an oversupply of gas for their purposes. The Tribunal considers it likely that a significant secondary market in gas supply will develop if experience in the UK is reflected in Australia. However, such a market is likely to be in its infancy in the early stages of contestability.

The Tribunal has noted the apparent difficulties in new retailers obtaining access to gas since contract customers became contestable in NSW. However, the Tribunal considers that:

1. as noted above, there are already retailers well placed to enter the Albury and Wagga Wagga markets who have access to gas
2. the completion of the EGP will substantially change the gas market and improve the prospect for independent retailers to have effective access to gas.

Nonetheless, the Tribunal proposes to monitor the gas supply market and the effective availability of gas to competing retailers.

#### **4.1.5 Implied perceptions of market players in Wagga Wagga and Albury**

The pricing policy of incumbent retailers can give an indication of the degree of competition they are expecting to face post contestability. If strong competition is expected then incumbents are likely to price such that the both the aggregate level of prices and the structure of prices (the mix between fixed and usage charges) reflect the actual costs of supply. If incumbents fail to price in this manner then new entrants may be able to offer lower prices to the whole market or to select segments of the market, such as high usage customers.

The analysis presented in sections 3.1 and 3.3 above suggest that GSE and Energy 21's aggregate level of prices reflect their aggregate costs. However, it is problematic to attribute this to impending competition given the existence of a voluntary price freeze agreement between the utilities and the Tribunal. However, GSE's July 1999 price restructure has, by increasing fixed charges and reducing usage rates, effectively reduced tariff prices to the more profitable high volume customers. Such action is consistent with an expectation by GSE that there will be effective competition for this segment of their customer base post contestability.

In addition, 21 organisations have currently taken out gas or electricity retail licences in NSW. This suggests there is considerable interest in entering the NSW energy retail market post contestability.

### 4.1.6 UK experience with gas contestability

Whilst there may be aspects of the British experience with contestability which will not translate directly to Australia, it is instructive to examine developments in that market.

In its October 1998 review of competition in the gas market,<sup>8</sup> the UK gas regulator, Ofgas, found that customers from all social and economic groups and customers from all tariff groups were benefiting from competition. Some new retailers were offering up to 21 per cent lower tariffs than the incumbent retailer was. Ofgas found that competition had resulted in an increase in customer service levels for customers who switched to new retailers, as well as for customers who remained with the incumbent retailer.

All UK customers became contestable in May 1998. By August that year there were 24 gas retailers, 18 of them operating nation wide, which had secured 15 per cent of customers between them, or an average of 125,000 customers each. However, in the regions that were first opened up to competition in April 1996 and February 1997 around 25 per cent of customers had switched to new retailers.

Ofgas reports that customers consuming 650 therms (approximately 0.7 GJ) of gas a year on the incumbent retailer's Standard Credit terms have seen a reduction in gas costs of approximately 25 per cent in real terms from December 1987 to December 1998<sup>9</sup>. Furthermore, had such customers chosen to switch to a competitor on Direct Debit terms in April 1996 they could have received an immediate reduction of up to 20 per cent.

Ofgas also reports that competition is even more firmly entrenched in the industrial and commercial market. The largest customers in this class became contestable in 1986 and the smallest customers became contestable in 1992. In this sector, the incumbent's market share is down to around 24 per cent, excluding power generation and 28 per cent when power generation is included. Over 50 retailers currently compete in this market and, since 1992, gas prices in this market have fallen by around 30 per cent.

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<sup>8</sup> UK Office of Gas Supply, *A Review of the Development of Competition in the Domestic Gas Market*, October 1998.

<sup>9</sup> UK Office of Gas Supply, *Annual Report*, 1998-99.

#### 4.1.7 Contestability costs and protocols

The success of competition in the post contestability environment in NSW will depend on the costs (both price and non-price) incurred by new retailers and customers when customers switch from the incumbent gas retailer to new retailers. (Switching is also referred to as customer churn.) Should these costs be too high, they may act as a barrier to competition.

To support competition, systems and procedures will need to be developed. These will include the development of:

- daily metering facilities and/or a load profiling/reconciliation system for tariff customers
- information protocols between the network operator and retailers
- changes to existing customer IT systems.

These costs could be significant. How these costs will be allocated between customers, the existing retailer, and the new retailer will have a direct bearing on how the market will operate. For example, the spreading of contestability costs into general network charges would, from both retailer and customer perspectives reduce the barriers to customer churn.

The NSW Ministry for Energy and Utilities (MoEU) has established several working groups with wide representation from all interested stakeholders to examine and develop systems and procedures for retail contestability in gas in NSW (the Retail Gas Project). The working groups are also reviewing barriers to competition and suggesting options for resolution where possible.

Based on the recommendations from the MoEU's project, the Tribunal will be in a better position to assess contestability costs for the NSW gas market.



## **5 DRAFT DECISION**

### **5.1 Regulatory objectives**

The Tribunal's regulatory objective is to achieve the best feasible pricing outcomes that balance the competing claims within the community. In order to achieve this, the Tribunal will have regard to, amongst other things, the issues of efficiency, equity, environmental impact and the regulatory costs of its actions.

#### **5.1.1 Promote efficiency**

Regulation of retail gas supply has a range of potential benefits. If regulation makes prices better reflect costs then gas consumers receive more appropriate signals by which to determine their consumption patterns. Similarly, other consumers and producers can make more efficient decisions concerning whether or not to use gas rather than electricity for various applications.

However, competition can also be used to constrain prices to reflect costs. Competition also gives retailers an added incentive to reduce overall cost levels in order to gain a market advantage. In this way effective competition can force market players to price according to the minimum 'true costs' of supply and is, where effective, superior to direct regulation of prices. The Tribunal must strike a balance between the use of regulation and competition in order to promote efficiency.

#### **5.1.2 Promote equity**

In addition to these efficiency benefits, equity gains may result from regulation. A regulated reduction in gas retail prices can transfer economic value from businesses in the gas supply chain to consumers of gas. Such a transfer may be considered to be more equitable as well as more efficient.

Regulation may also protect socially disadvantaged consumers from large unexpected increases in their bills in any given period. This can be done by limiting the magnitude of price changes faced by individual consumers (rather than simply the average level of prices). Price change regulation is often referred to as placing 'side constraints' on price movements. Side constraints have a role in ensuring affordable access to services is maintained.

#### **5.1.3 Environmental considerations**

Gas is generally considered to be a 'cleaner' source of energy than its strongest competitor, coal powered generation of electricity. By ensuring that gas prices are not significantly above the cost of supply, the Tribunal ensures that energy consumers do not have an artificial disincentive to consume this relatively 'clean' energy source. Similarly, by not forcing prices to be artificially low, the Tribunal ensures that consumers have a disincentive to over consume gas or to consume it in a thermally inefficient manner.

### 5.1.4 Minimise regulatory costs

Whilst regulation can provide efficiency and equity benefits, it is a blunt tool that can be difficult to apply with precision. The principles behind the introduction of National Competition Policy acknowledge this fact and favour the introduction of competition or contestability where appropriate, using regulation only where the introduction of competition is not appropriate or in the interim period when competition is ineffective.

The possibility that gas retailers may charge prices above costs does not necessarily imply a need for regulation. The costs of potential regulatory failure need to be weighed against the costs of any market failure. The Tribunal aims to ensure there is a net public benefit from its activities. This is always a difficult task, which is made even more difficult in the early stages of introducing competition.

Whilst competition may take some time to develop, the regulator must be careful not to hinder this development through its interactions with regulated firms. These issues need to be kept in mind when considering whether regulation should be introduced in the retail gas markets of Wagga Wagga and Albury. For example, price regulation could act to suppress competition in the following ways:

- Entry may be deterred to the extent that regulation reduces potential entrants' perceptions of the security of any expected 'excess' profits associated with entry. That is, entrants may believe that the risk of entry is not justified because of concern that any above normal profits will be regulated away.
- Innovation by retailers (existing and potential) may be reduced to the extent that they fear any 'excess' returns resulting from innovation will be regulated away.
- Entry may be deterred to the extent that regulation lowers incumbents' prices below entry inducing levels by regulation. In such cases regulation may be superfluous, as competition would constrain prices anyway. Alternatively, regulation may impose a net cost on consumers, due to the administrative and compliance costs associated with regulation or any resultant reduction in product innovation by retailers.

## 5.2 The Tribunal's preferred approach

Two of the critical issues addressed in this review have been the reasonableness of current prices, and the likelihood of competition constraining these prices into the future. The Tribunal's analysis suggests that current average tariff prices are reasonable, and that competition will constrain these prices into the future. Competition can also bring additional benefits in the form of product innovation that may not otherwise occur in a regulated market.

This suggests that heavy-handed regulation of prices via a gas pricing order can be avoided by relying primarily on competition and ongoing monitoring to constrain prices. The Tribunal considers that a gas pricing order may not be necessary provided that the Tribunal continues to be satisfied that:

- gas prices remain reasonable
- customers, or classes of customers are not being overcharged
- customers are not under 'pressure' to enter into contracts, particularly contracts for long terms, without adequate exit provisions.

### 5.2.1 Maintaining existing ('default') tariffs

The Tribunal considers that allowing customers to continue on existing tariffs into the post contestability period for a 'grace period' will help smooth the transition to contestability for tariff market customers. In effect, this will make existing tariffs 'default tariffs' which customers will have to choose to leave. Of course, incumbent retailers may still offer existing customers new tariffs/contracts which are more favourable than existing tariffs.

Such a grace period will help to ensure that existing tariff customers have sufficient time to adapt to the new market conditions and obtain information on which retailers are offering the best services for their needs. Without such a grace period, it is possible that some customers could feel pressured to sign contracts before they have had time to properly adjust to the new marketplace. This is particularly the case where there is some doubt about the likely availability of gas to new retailers until the Eastern Gas Pipeline is completed (EGP is expected to connect to AGLGN networks in September 2000). The Tribunal considers that continuing existing tariffs for a grace period will alleviate this potential problem. This approach is consistent with the approach taken following the introduction of contestability in electricity to date.

The Tribunal considers a grace period of 15 months for customers in the 1-10TJ pa class and 12 months for customers in the 0-1TJ pa class to be appropriate. A longer grace period for the 1-10 TJ pa class is considered appropriate due to the fact that this customer class became contestable on 1 October 1999. This earlier contestability date means that a longer grace period is required if default tariffs are to apply for a reasonable period after the connection of the EGP, which is expected to be September 2000. The Tribunal considers the connection of the EGP to be a significant factor in promoting competition in the NSW retail gas tariff market.

The Tribunal notes that the arguments for maintaining existing tariffs in the post contestability period apply equally to AGL tariff market customers as to GSE and Energy 21 customers.

*The Tribunal considers it appropriate to provide all tariff customers with the option to stay on existing tariffs for a period following the introduction of contestability, and to apply side constraints to any change in the tariff prices of residential customers.*

### 5.2.2 Side constraints on residential tariffs

As discussed previously, side constraints can protect socially disadvantaged households from large unexpected increases in their bills in any given period. The Tribunal considers this to be appropriate, given its objective of achieving outcomes which are efficient and equitable. As such, the Tribunal will consider the introduction of a gas pricing order should price increases to default tariffs exceed certain side constraints.

However, in setting side constraints the Tribunal must also have regard to the need for regulated firms to change their price structures to reflect changes in cost structures. For example, the fixed component of GSE's transport costs for residential customers will increase on 1 January 1999 by \$19 per annum per customer in real terms. At the same time the usage rate per gigajoule will fall by 38 cents. If side constraints prevent GSE from reflecting changes in its fixed costs in its prices, this may result in unfair cross subsidies between consumers.

The Tribunal does not intend that side constraints be applied to industrial and commercial tariffs, as these tariffs do not impact directly on socially disadvantaged households. In addition, commercial customers are likely to be better-informed purchasers of energy than residential consumers. This decision is consistent with the Tribunal's recent proposal to apply a side constraint to residential electricity customers' tariffs only. However, the Tribunal does propose that commercial customers should, like residential customers, be able to remain on existing tariffs for a grace period post contestability.

### 5.2.3 Information requirements

In order to facilitate its monitoring the Tribunal has asked incumbent retailers to provide the following information 1 month prior to any changes to default tariffs:

- a) an estimate (and associated methodology) of the expected impact on revenue of the proposed price changes. If the estimated revenue impact is positive, evidence should be supplied showing that either costs have increased for supplying that particular tariff class, or that existing prices were not covering costs in that particular tariff class
- b) a breakdown of the costs of supply into fixed costs per customer and costs that vary with the absolute magnitude of gas consumption per customer (in \$ per GJ)
- c) a customer impact analysis detailing in tabular form:
  - the number of customers in particular consumption ranges
  - the current cost of gas per quarter associated with consumption at the midpoint of the relevant range
  - the proposed cost per quarter associated with consumption at the midpoint of the relevant range
  - the absolute and proportional change in the cost per quarter associated with consumption at the midpoint of the relevant range).
- d) plus other supporting information (where applicable).

### 5.3 Draft decision

The Tribunal does not currently consider a gas pricing order is necessary. This view is based on the fact that current prices are reasonable and the expectation that competition will be effective in constraining prices in the future. However, the dynamics of the retail market post contestability can not be predicted with certainty.

*Due to this uncertainty, the Tribunal will continue to monitor developments in the tariff market to ensure prices remain reasonable. The Tribunal will, however, consider the introduction of a gas pricing order if, amongst other things, existing tariffs are not maintained for a specified grace period following contestability or if side constraints on residential tariffs are exceeded. For this purpose, the specified grace period and residential side constraints presently considered appropriate by the Tribunal are set out in schedule 1.*

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## **SCHEDULE 1: GRACE PERIOD AND RESIDENTIAL SIDE CONSTRAINTS PRESENTLY CONSIDERED APPROPRIATE**

1. Customers on existing tariffs at the commencement of contestability be given the option of remaining on their current 'default' tariff for the specified 'grace period' following the introduction of contestability. For 1-10TJ pa customers the specified grace period extends to 31 December 2000. For 0-1TJ pa customers the specified grace period extends to 30 June 2001.
2. Changes to residential default tariff prices be subject to the following constraints.
  - a) Until 30 June 2001, increases in a customer's bill for the same pattern and volume of gas consumption do not exceed the bill for the corresponding period of the previous year by more than \$20 or 5 per cent real (exclusive of the audited impact of indirect tax reform), whichever is the greater. Calculation of real changes in prices to be measured with reference to the Australian Bureau of Statistics All Capital CPI series.
  - b) Where the full pass through of a change in transport charges would, given existing tariff prices on 1 October 1999, result in the constraint in 2a) being exceeded, that constraint will be widened automatically to allow the full pass through of the change in network charges.



## **APPENDIX 1 COMPONENTS OF THE COSTS OF RETAIL SUPPLY OF GAS**

This appendix details the Tribunal's analysis of the reasonable costs of retail gas supply to the Albury and Wagga Wagga tariff markets.

### **A1 Components of the price of gas**

In the newly contestable retail market, competitive constraints will tend to force retailers to minimise the pass through of costs to customers and to allocate those costs according to the customer class for which they are incurred. If incumbent retailers do not apply cost reflective prices, competitors are likely to attract their profitable customers with lower prices, and leave them with their least profitable customers.

The field price of gas, haulage and transportation costs for GSE and Energy 21 are set by contracts already in place, or by reference to the relevant access arrangement. As such, the retailer's main opportunity to influence costs in the short term is in retail costs and margin.

#### **A1.1.1 Field price of gas**

The cost of gas is currently beyond the control of GSE and Energy 21. However, in the future both retailers may have alternative supply options, and may be able to negotiate cheaper purchase costs.

Given that retailers do not have control over current field prices, the Tribunal regards this contractual cost as reasonable.

A potential complication to this analysis is the treatment of GSE's take-or-pay contract. A take-or-pay contract requires the buyer of gas to pay for a minimum quantity, regardless of whether that buyer takes the gas. Potentially, where GSE cannot sell the gas to its customers, it must still pay the gas supplier for the minimum amount. The question which arises is whether GSE or its customers should pay for this unused gas in the eventuality that the take-or-pay clause becomes effective.

A competitive market would not, in general, allow individual firms to transfer such contractual risks to their consumers. Take-or-pay contracts were considered in the recent AGL access review. Various parties argued in their submissions that the take-or-pay problem could be resolved commercially, and should not require regulatory intervention. Options available to the supplier include: renegotiating; diverting gas interstate; or increasing the market.

The Tribunal considers that these options are sufficient and that the take-or-pay aspect of negotiated contracts should not influence the determination of the reasonable cost of retail gas supply.

### **A1.1.2 Cost of haulage and transport**

Transport prices for the networks in Albury and Wagga Wagga have been, or soon will be, set by the finalisation of the relevant access arrangements for the distribution systems. GSE's cost of haulage is set in its contract with AGL. Energy 21's cost of haulage is set in the access arrangements for the Victorian transmission assets.

There is limited opportunity for the gas supplier to negotiate haulage or transport costs. However, as the price of haulage and transport is based on the demand placed on the transmission and distribution systems, there may be scope for the supplier to reduce costs by managing demand. The gas supplier could do this by providing customers with an incentive to reduce their consumption at peak times. Where managing demand is cost effective, it will be in retailers' best interests to do so and competition is likely force cost reductions to be passed on to customers through lower prices.

The Tribunal considers that existing contractual haulage costs and reticulation costs (as per the relevant access arrangement) are reasonable and will be passed directly to customers. Of course, where competitors achieve lower haulage costs, competition should force this to be reflected in lower prices to customers.

Haulage and transport costs have both fixed and variable components. The Tribunal considers it appropriate for tariff price structures to reflect these cost structures.

### **A1.1.3 Unaccounted for gas**

Unaccounted for gas (UAG) is gas lost during its transportation through the pipeline network. In its final decision on Great Southern Networks' Access Arrangement, and the draft decision for AGC, the Tribunal agreed that UAG is a retailing cost rather than a cost of the network. The Tribunal also agreed that GSE's UAG costs should be allocated primarily to tariff market customers. This decision reflects the fact that low pressure pipes serving the tariff market are responsible for the majority of UAG.

Great Southern Networks and the Tribunal have agreed to an average allowance for UAG of 3.8 per cent reducing to 2.5 per cent by the end of the access arrangement. This has been allocated to the tariff market at 7.4 per cent in the first year of the access arrangement reducing to 4 per cent in the fifth year of the access arrangement.

The Albury Gas Company has proposed a lower average UAG of 1.8 per cent. In its draft decision on the Albury Gas Company's access proposal, the Tribunal considers this proposal reasonable. This proposal is currently being considered as part of AGC access arrangement review.

### **A1.1.4. Retail costs and margin**

As noted earlier, retail costs are expenses incurred to run the retail component of the gas business. These may include: expenses such as billing, marketing, customer advisory services, advertising, promotions, time spent handling customer inquiries and negotiating gas contracts, haulage and reticulation. Where retailers are responsible for maintaining customer service standards, these costs must be covered in their retail margin.

The net retail margin is the margin on gas sales before interest and tax, but after all other costs (including retail costs) have been accounted for. The net retail margin therefore represents a return on the capital employed in the business and the risks associated with the business. Incumbents and potential entrants alike must be able to expect to earn a net retail margin in order to make their investment in the business worthwhile. It follows that the appropriate net retail margin will depend on the specific circumstances of the industry and market a firm is operating in. For example, if the reasonable ratio of capital to sales is high for a particular firm, a higher net retail margin is also reasonable.

Another measure of the retail margin is the gross retail margin. This is the margin on gas sales before interest, tax and retail costs, but after all other costs. Benchmarking the gross retail margin gives the regulated firm an incentive to increase sales and reduce retail costs.

London Economics completed a consultancy on retail margins for the Tribunal as part of a review of the electricity industry. Results suggested that the net retail margin on all electricity sales was somewhere between two to three per cent of sales revenue. The Tribunal has proposed a 6.6 per cent gross retail margin for electricity franchise customers<sup>10</sup>.

In AGL Gas Networks' 1997 access review, the Tribunal decided a retail margin component should be deducted from AGL Networks' allowable revenue. For the business as a whole, the net retail margin was determined as 2 per cent of gas sales revenue. The Tribunal then allocated 70 per cent of the retail margin to tariff market customers and 30 per cent to contract market customers. This resulted in a net retail margin of 3 per cent for tariff customers and 1 per cent for contract customers.

### Great Southern Energy

GSE has stated that its gas retail costs are \$250,000 and that a further \$250,000 would represent a reasonable return on the capital and risk associated with retail operations. GSE considers that this represents something close to the incremental retail costs incurred when its gas retailing operations are added to its existing electricity retailing operations. GSE has proposed allocating these costs to the gas contract and tariff markets on the basis of 50 per cent by customer numbers and 50 per cent by gas usage. Applying these assumptions gives a net retail margin of around 2.3 per cent and a gross retail margin of around 4.6 per cent.

Retail costs of \$250,000 represent an average cost of around \$17 pa per tariff market customer. The Tribunal considers this to be a conservative estimate of retail costs.

The Tribunal considers GSE's indicative level and allocation of gross retail margin is reasonable.

### Energy 21

In October 1997, Energy 21 proposed a net retail margin of 4 per cent of residential sales and 2 per cent of industrial and commercial sales. Energy 21 may revise this estimate in its forthcoming submission to the Tribunal.

The Tribunal will consider Energy 21's submission in its final decision.

<sup>10</sup> *Pricing for Electricity Networks and Retail Supply*, IPART, June 1999, p 176.

## APPENDIX 2 LIST OF SUBMISSIONS

Submissions to the Issues and Consultations Papers on the Delivered Price of Natural Gas in Wagga Wagga, Albury, Moama and the NSW Murray Valley Towns.

Organisation	Name
AGC/Energy 21	T. Wallish
AGC/Energy 21	T. Wallish
AGL	B. Connery
AMCOR	D. Headberry
AGL	B. Connery
Albury Wodonga Limited	O. Graham
Albury Gas Users Group	A. Reichel
BHP Petroleum	D. Briggs
BHP Petroleum	D. Briggs
Boral Energy	J. Hayward
BTR	P. Dobney
GSE	B. Burton
GSE	P. Hoogland
GSE	M. Smith
Member for Wagga Wagga Legislative Assembly Parliament of New South Wales	J. Schipp
NSW Treasury	J. Pierce

