



Independent Pricing and Regulatory Tribunal

Review of regulated retail prices and charges for gas

From 1 July 2013 to 30 June 2016

Gas — Final Report
June 2013



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Contents

1	Executive summary	1
1.1	Regulated gas prices will rise on 1 July 2013	2
1.2	Why are gas prices increasing again?	3
1.3	Average annual gas bills for households and small business customers will rise on 1 July 2013	5
1.4	Gas retail price regulation may no longer be necessary	6
1.5	Regulation should continue to be light-handed to promote competition and the long term interest of customers	6
1.6	Regulation also needs to be more flexible if it is to be maintained	8
1.7	Standard Retailers' proposed increases in the 'Retail Component' and 'Carbon Component' of regulated gas prices in 2013/14	8
1.8	Further action to promote the long term interests of customers	11
1.9	What does the rest of this report cover?	14
2	Terms of reference and context for the review	15
2.1	Terms of reference	15
2.2	Review of costs of supply	16
2.3	Policy and regulatory developments	16
2.4	Market developments	19
3	Our process and analytical approach for this review	22
3.1	Overview of our analytical approach for 2013 review	23
3.2	How we applied our approach	24
4	Assessing the Standard Retailers' proposed form of regulation	27
4.1	Overview of final decision on form of regulation	28
4.2	Form of price control	28
4.3	Additional regulatory mechanisms to address risk	29
5	Assessing the proposed increase in the retail component	33
5.1	Overview of final decisions on proposed increase in the R component	34
5.2	Analysing the retail costs of supply	34
5.3	Assessing Standard Retailers' proposed R components with our view of the reasonable range for 2013/14	37
6	Assessing the proposed increase in the carbon component	43
6.1	Overview of final decisions on proposed C component	43
6.2	Our assessment of the proposed C component	44

7	Non-tariff fees and charges	46
7.1	Overview of final decisions on miscellaneous charges	47
7.2	National Energy Customer Framework (NECF)	48
7.3	Late payment fees	48
7.4	Security deposits	49
7.5	Administration charge on network non-tariff fees and charges	50
7.6	Other miscellaneous charges	50
8	Impact of price increases on customers	51
8.1	Overview of key findings on the impact of the price increases on customers	51
8.2	Who uses gas and what for?	52
8.3	Impact of final decision on typical customer bills in each supply area	53
8.4	Gas and energy bills as a proportion of disposable income	55
8.5	Household types most likely to be having difficulty paying their energy bills	60
	Appendices	63
A	Terms of Reference	65
B	Overview of Standard Retailers' proposed pricing agreements	67
C	Assessment of competition in the retail market	69
D	Wholesale gas costs	72
E	Analysis of retail operating costs	80
F	Analysis on retail margin	84

1 Executive summary

The Independent Pricing and Regulatory Tribunal (IPART) is responsible for regulating retail gas prices for around 28% of residential and small business customers¹ in NSW. These are the prices the Standard Retailers in this state – AGL, ActewAGL and Origin Energy² – charge customers who have not signed a market contract with them or another retailer.³

For the past 10 years, we have regulated these prices using a relatively light-handed approach that involves making multi-year pricing agreements with each Standard Retailer (known as Voluntary Pricing Agreements). The Standard Retailers then set their own regulated prices to comply with these agreements, and we monitor their compliance.

As the current agreements will expire on 30 June 2013, the Minister for Energy and Resources has asked IPART to put in new regulatory arrangements for the period 1 July 2013 to 30 June 2016. We have invited the Standard Retailers to propose new pricing agreements for this period, and considered those agreements.

In April 2013, we made a draft decision to broadly agree to each of these proposals, although we have requested some specific changes. This report sets out our final decisions on these agreements and our reasons for making them. It also provides an estimate of the average price increase for 2013/14, and sets out how we will agree on prices for the second and third year closer to that time.

¹ All customers that consume less than 1 terajoule (TJ) per year are eligible for supply under a standard form customer supply contract.

² On 1 March 2011, the state-owned Standard Retailer - Country Energy - was sold to Origin Energy. Country Energy supplied gas to the South Western regions of NSW including Wagga Wagga and Gundagai and inland cities such as Tamworth. We have referred to these customers as Origin Energy (Wagga Wagga).

³ We set regulated retail prices paid by customers who have not signed a contract with an energy retailer or who have chosen to return to the regulated price. Customers who are currently on a contract with retailers pay unregulated prices. However, these market-based prices are influenced by changes in the regulated price, so often these prices change at the same time as the regulated price.

1.1 Regulated gas prices will rise on 1 July 2013

Under our final decision average retail gas prices will increase by 8.5% across NSW on 1 July 2013 – or by between 5.2% and 9.2% in the Standard Retailers' individual supply areas.

In reaching these final decisions, we have assessed the Standard Retailers' proposed increases in regulated retail prices, and considered stakeholder comments on our draft decisions and report. We have also taken into account the Australian Energy Regulator's (AER) recent final decisions on network charges for most small retail customers⁴, and forecast inflation⁵. As a result, we consider the following total average increases to be reasonable:

- ▼ **9.2% for AGL**, which supplies gas to over 80% of small regulated retail customers in NSW, covering Sydney, Wollongong, Newcastle, Dubbo, Orange, Parkes, and parts of the Riverina region.
- ▼ **5.5% for ActewAGL**, which supplies the regions around the NSW/ACT border (including Young, Goulburn, and Yass) and South East NSW (including Shoalhaven).
- ▼ **5.8% for Origin Energy (Wagga Wagga)**, which supplies the South Western regions of NSW including Wagga Wagga and Gundagai and inland cities such as Tamworth.
- ▼ **5.2% for Origin Energy**, which supplies customers on the NSW - Victorian border, including the Albury and the Murray Valley Towns.

We have made a final decision to agree to AGL's revised proposal to increase regulated retail prices by 9.2% for 2013/14.⁶ In our view, this increase in regulated retail prices is consistent with balancing the longer and shorter term objectives for this price review.

⁴ The maximum prices and charges that distribution network operators can charge retailers are typically set out in an Access Arrangement which is regulated by the AER. However, ActewAGL has a small distribution network in the Shoalhaven area which is not regulated by the AER.

⁵ Forecast inflation is 2.5%

⁶ AGL initially proposed an increase in the R component of AGL's regulated retail prices of CPI + 7.7%, leading to an overall price increase of 10.7%. In May 2013, AGL provided a revised proposal to increase the R component by CPI + 5.1%, consistent with our draft decision, leading to an overall price increase of 9.2%.

We have made a final decision to agree to ActewAGL's proposal to increase regulated retail prices by 5.5%⁷ for 2013/14, and Origin Energy's proposal to increase regulated retail prices by 5.2% to 5.8%⁸ for 2013/14. In our view, these increases in regulated retail prices are consistent with balancing the longer and shorter term objectives for this price review.

1.2 Why are gas prices increasing again?

These increases in regulated retail gas prices follow large increases in regulated gas prices in 2012/13.⁹ The sustained increases in network costs (N Component) have been the largest contributor to increases in gas prices over the last 2 years, particularly for AGL customers supplied by the Jemena gas distribution network.

Network costs reflect the charges that retailers must pay to deliver gas through the low pressure distribution network to homes and businesses. These charges are regulated by the AER and we take these regulated costs and include them in the retail prices. These costs typically make up around 50% of overall regulated retail gas prices.

As Figure 1.1 shows, the increase in network costs is responsible for around 60% of the price increase from 1 July 2013 for AGL customers, adding 5.5% to prices. These network cost increases primarily result from Jemena's successful appeal to the Australian Competition Tribunal (ACT) of the maximum prices and charges they can levy on retailers for use of the distribution network.¹⁰ We consider that action is required to address policy settings that are leading to higher than necessary gas network prices. (Refer Section 1.8)

⁷ ActewAGL proposed an increase in the R component of ActewAGL's regulated retail prices of CPI + 1.5%, leading to an overall price increase of 5.5%.

⁸ Origin Energy proposed an increase in the R component of Origin's regulated retail prices of CPI + 4.9% and CPI + 5.7% for its customers in the Wagga Wagga and Albury/Murray Valley supply area. This leads to an overall price increase of 5.8% and 5.2%. This is lower than the estimated increases in our draft report due to lower than forecast network prices and lower forecast inflation.

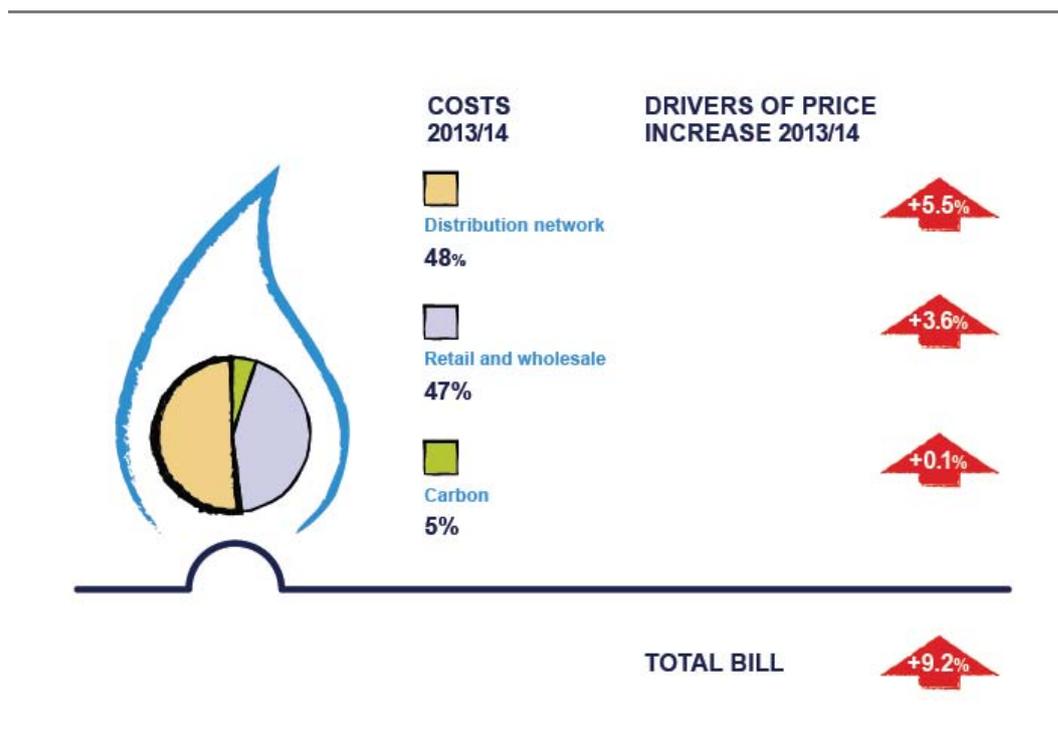
⁹ These price increases were primarily the result of significant increases in network costs and the introduction of the carbon price. For further detail on the price changes that occurred on 1 July 2012, click [here](#).

¹⁰ The maximum prices and charges that distribution network operators can charge retailers are set out in an Access Arrangement which is regulated by the AER. Jemena successfully appealed the AER's final decision to the Australian Competition Tribunal (ACT). Further information on the Jemena Access Arrangement can be found [here](#).

The increase in the R component is responsible for around 39% of the price increase from 1 July 2013 for AGL customers.¹¹ In our view, the increase in the R component of regulated retail prices is consistent with balancing the longer and shorter term objectives for this price review.

We have established a process for updating the prices from 1 July 2014 and 2015 given that there are too many uncertainties to reach agreements on these price changes now. However, we consider it likely that regulated retail prices will rise further over the following 2 years, partly driven by sustained increases in gas network costs under distribution pricing determinations already in place,¹² and the structural changes that are likely to emerge in the wholesale gas market. These structural changes, which mean that Australia’s domestic gas markets will be increasingly influenced by the international market, are likely to put upward pressure on wholesale gas costs, which currently make up around 30% of regulated retail gas prices.

Figure 1.1 Drivers of increase in average regulated retail gas prices for AGL on 1 July 2013 (nominal, %)



¹¹ The Retail Component of regulated retail prices reflects the controllable costs retailers incur in supplying gas to customers, including wholesale and gas transmission costs, retail operating costs and a retail margin.

¹² AER, *Access Arrangement for JGN’s NSW gas distribution networks 1 July 2010 – 30 June 2015*, Amended by order of the Australian Competition Tribunal, 30 June 2011, Further amended with regard to mine subsidence expenditure, 26 September 2011, June 2010, p 18.

1.3 Average annual gas bills for households and small business customers will rise on 1 July 2013

We cannot calculate how our final decisions will affect individual customers' annual gas bills. This impact will depend on how much gas they use, which of their Standard Retailers' regulated prices they are on, and how the Standard Retailer changes these individual prices. However to estimate the potential impact, we have calculated an indicative annual gas bill for residential and business customers with average usage in each gas supply area (Table 1.1 and 1.2).

Table 1.1 Indicative annual bill for typical residential customers of each Standard Retailer (nominal \$, inc GST)

	Current bill (2012/13)	Estimated bill (2013/14)	\$ increase
AGL	822	898	76
ActewAGL	1,217	1,283	66
Origin Energy (Wagga Wagga)	965	1,021	56
Origin Energy (Albury/Murray valley)	886	933	46

Note: This assumes a typical customer uses 23GJ, 45GJ, 37GJ, and 45GJ of gas per annum in the AGL, ActewAGL, Origin Energy (Wagga Wagga) and Origin Energy (Murray Valley) areas. Impact on bills includes GST.

Table 1.2 Indicative annual bill for typical business customers of each Standard Retailer (nominal \$, excl GST)

	Current bill (2012/13)	Estimated bill (2013/14)	\$ increase
AGL	3,864	4,220	356
ActewAGL	4,423	4,665	242
Origin Energy (Wagga Wagga)	3,262	3,452	190
Origin Energy (Albury/Murray valley)	3,133	3,296	163

Note: This assumes a typical customer uses 184GJ, 229GJ, 231GJ and 209GJ of gas per annum in the AGL, ActewAGL, Origin Energy (Wagga Wagga) and Origin Energy (Murray Valley) areas.

1.4 Gas retail price regulation may no longer be necessary

Since our last review in 2010, there have been significant changes in the gas market. These include the continued development of competition in the gas retail market, as well as structural changes that are emerging in the wholesale gas market.

Based on our analysis for this report, we consider it likely that competition in the market is now effective enough to provide sufficient protection to customers, as well as offering more choices and better price and service outcomes. Only 28% of small gas customers now remain on regulated prices in NSW, below the proportion of small electricity customers remaining on regulated prices (around 40%). We also consider that a competitive market is best placed to manage the uncertainties that are emerging in the wholesale gas market and note that other States have removed formal price regulation of retail gas.

We note that the Australian Energy Market Commission (AEMC) is currently reviewing the competitiveness of the NSW energy market, for the purpose of determining whether regulation can be removed. The AEMC's draft advice is that competition is sufficient to enable all customers to benefit from the removal of price caps.¹³ The AEMC will provide its final advice to the NSW Government in September this year, and the Government will decide on the future of price regulation after considering that advice.

The NSW Government has requested us to continue regulating gas prices for customers who have not entered the competitive market, in line with the objective of the *Gas Supply Act 1996* (the Act). These include protecting the interests of customers and encouraging the development of the competitive market.

1.5 Regulation should continue to be light-handed to promote competition and the long term interest of customers

We have made final decisions to agree to the Standard Retailers' proposals to largely continue the current light-handed form of regulation. This involves:

- ▼ Using a weighted average price cap (WAPC) form of price control¹⁴ for the retail component of prices (including wholesale and gas transmission costs, retail operating costs and a retail margin).
- ▼ Passing through of the network component of prices determined by the Australian Energy Regulator, and the carbon component of prices estimated by the retailers and approved by IPART.

¹³ AEMC, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales – Draft Report*, May 2013, p ii.

¹⁴ Under the WAPC Standard Retailers are able change their individual retail regulated prices or components of these tariffs (such as fixed service or variable charges) as long as the overall increase in average regulated tariffs does not exceed the WAPC.

- ▼ Providing a mechanism for adjusting these components to address ‘special circumstances’.

In our view, this light-handed approach has been successful in meeting the objectives of the Act in the past. It has protected the interests of customers by limiting price increases to movements in efficient costs, and encouraged the development of retail competition by minimising unnecessary regulatory intervention. As our assessment of the gas market in NSW indicates that the effectiveness of competition has improved since our last review of gas prices, we are confident this form of regulation will continue to meet those objectives in the 2013 period.

We consider it important this approach continues to promote a competitive market where strong rivalry between retailers delivers products that customer’s value. We consider that a competitive market offers customers the best protection from higher than efficient prices in the short term and better ‘value for money’ service through reduced costs and/or innovation in the longer term. Both of these are in the interest of customers.

Without a competitive market, there would be little discipline on retailers to offer cost reflective prices or improve their performance. As is the case with natural monopolies, such as gas distribution networks, customers would in effect rely on the regulator to counter the inevitable market power and to drive these efficiency improvements. It is important to recognise that regulation is likely to be an inferior way of driving these improvements compared to competition.

As with any price regulation there is also the risk that given the imperfect information available, attempting to discover the ‘efficient costs and prices’ that would emerge in a competitive market may not be feasible. The dynamic nature of retail energy markets only makes this more difficult, creating the potential for price regulation to distort the competitive market. Given that the NSW Government has requested us to continue regulating gas prices for customers who have not entered the competitive market; we will continue our light handed approach to minimise this risk.

In implementing this approach and making our final decision we have sought to strike a balance between efficient prices in the short term and facilitating competition and the longer term customer interests. Balancing these risks means that the regulated prices under our final decision are unlikely to be the lowest price in the market. Rather, it is a price for customers who have not taken up a competitive, unregulated market offer. IPART operates an independent, free comparator website, [myenergyoffers](http://myenergyoffers.com.au),¹⁵ to help customers identify and compare the offers available in their supply area.

¹⁵ From 1 July 2013, the independent, free price comparator website will be operated by the AER, www.energymadeeasy.gov.au

1.6 Regulation also needs to be more flexible if it is to be maintained

We have also made final decisions to agree to the Standard Retailers' proposals to make the form of regulation more flexible by providing for periodic reviews of the retail and carbon cost components in the second and third years of the regulatory period. We consider these periodic reviews are necessary and appropriate to manage the risk and uncertainty associated with forecasting these cost components more than one year in advance.

The emerging changes in the wholesale gas market mean there is an unprecedented level of risk in forecasting gas commodity costs over the 2013 regulatory period. These costs are likely to be influenced by the development of liquefied natural gas facilities on the eastern coast of Australia, which mean that Australia's domestic gas markets will be increasingly influenced by the international market. However, there is significant uncertainty in relation to the medium-term supply and demand dynamics in the Australian market.

There is also uncertainty in forecasting carbon costs over this period, as the carbon price will move from a fixed to a market-based price in 2015.

It is important that the agreements are capable of managing this uncertainty. We consider that periodic reviews are an appropriate and efficient way to do this. This will mean regulated prices are more likely to reflect movements in costs driven by regulatory, policy and market factors, and are less likely to distort the competitive market. We recognise that periodic reviews will reduce price certainty for customers, and potentially increase the administrative costs of updating regulated prices in 2014 and 2015. However, on balance, we consider that periodic reviews will support the long-term interests of customers.

1.7 Standard Retailers' proposed increases in the 'Retail Component' and 'Carbon Component' of regulated gas prices in 2013/14

The Retail Component of regulated retail prices reflects the controllable costs retailers incur in supplying gas to customers, including wholesale and gas transmission costs, retail operating costs and a retail margin.

The Standard Retailers' proposed increases in the Retail Component of average regulated prices for 2013/14. This component accounts for around 50% of a typical customer bill.

We consider that regulated retail prices over the regulatory period need to balance 2 potentially conflicting objectives:

- ▼ To encourage efficiency and protect customers from prices that are higher than efficient levels in the short term by setting regulated prices that reflect the efficient cost of supply.
- ▼ To support the interests of customers in the long term by setting regulated retail prices that create sufficient incentives for retailers to compete and customers to participate in the market.

We have made an assessment of the Standard Retailers' proposals, and exercised our own judgement to decide whether they are reasonable and balance the longer and shorter term objectives for this price review.

We have made a final decision to agree to:

- ▼ AGL's revised proposal to increase the Retail Component of regulated retail prices for 2013/14 by CPI + 5.1%.¹⁶
- ▼ ActewAGL's proposal to increase the Retail Component of regulated retail prices for 2013/14 by CPI + 1.5%.
- ▼ Origin Energy's proposal to increase the Retail Component of regulated retail prices for 2013/14 by CPI + 4.9% and CPI + 5.7% for its Wagga Wagga and Albury/Murray Valley customers.

In our view, this increase in regulated retail prices is consistent with balancing the longer and shorter term objectives for this price review

We have also made final decisions to agree to the Standard Retailers' proposal to increase the Carbon Component of average regulated prices for 2013/14 in line with the legislated increase in the carbon price. This component accounts for a small proportion of a typical customer bill.

A summary of our final decisions on the regulatory arrangements that will apply to the regulated retail prices and charges levied by the 4 gas Standard Retailers in NSW is provided in Table 1.3.

¹⁶ AGL initially proposed an increase in the R component of AGL's regulated retail prices of CPI + 7.7%, leading to an overall price increase of 10.7%. In May 2013, AGL provided a revised proposal to increase the R component by CPI + 5.1%, consistent with our draft decision, leading to an overall price increase of 9.2%.

Table 1.3 Summary of IPART's final decision in relation to the Standard Retailers' proposals for regulated retail gas prices for 2013/14 to 2015/16

	AGL	ActewAGL	Origin Energy (Wagga Wagga)	Origin Energy (Albury/Murray Valley)
Form of price control	Continue using WAPC based on a R+C+N structure	Continue using WAPC based on a R+C+N structure	Continue using WAPC based on a R+C+N structure	Continue using WAPC based on a R+C+N structure
Change in R component of prices for 2013/14	CPI + 5.1%	CPI + 1.5%	CPI + 4.9%	CPI + 5.7%
Change in R component for 2014/15 and 2015/16	To be updated in 2014 with flexibility to update in 2015 if necessary	To be updated in 2014 with flexibility to update in 2015 if necessary	To be updated in 2014 and 2015	To be updated in 2014 and 2015
C component of prices for 2013/14 (\$ nominal)	\$1.72/GJ	\$1.72/GJ	\$1.63/GJ	\$1.56/GJ
Change in C component for 2014/15 and 2015/16	To be updated in 2014 and 2015	To be updated in 2014 and 2015	To be updated in 2014 and 2015	To be updated in 2014 and 2015
N component	Automatically pass through of regulated distribution network costs	Automatically pass through of regulated distribution network costs and unregulated network costs	Automatically pass through of regulated distribution network costs	Automatically pass through of regulated distribution network costs
Unforeseen cost changes	Address through special circumstances clause	Address through special circumstances clause	Address through special circumstances clause	Address through special circumstances clause
Change in carbon related costs resulting from policy and/or regulatory change	Address through additional clause that provides for costs increases and decreases	Address through additional clause that provides for costs increases and decreases	Address through additional clause that provides for costs increases and decreases	Address through additional clause that provides for costs increases and decreases
Tariff restructuring	-	Reduce number of regulated tariffs available in each region	-	-
Miscellaneous charges	Increase by no more than CPI in each year	Increase by no more than CPI in each year	Align with charges that apply in the Albury/Murray Valley regions	Increase by no more than CPI in each year

1.8 Further action to promote the long term interests of customers

There are many regulatory and policy settings that affect the price customers pay for gas, many of which are outside the scope of our pricing decisions. Price regulation cannot protect customers from price increases driven by regulatory, policy and market factors.

We are pleased that some significant reforms to energy policy have been made over the past year. However, many actions can still be taken to improve outcomes for customers, including actions to increase the competitiveness of the NSW gas market and facilitate the removal of price regulation.

In our view, there are adjustments to energy policy that need to be made to better serve gas customers. It will take a co-ordinated effort to deliver these reforms, relying on governments, regulators, the gas industry and customers. Getting these settings 'right' is likely to be in the long term interests of customers.

1.8.1 Energy reforms should be implemented to reduce pressure on network costs

Over the past 2 years there has been considerable focus on energy policy, and the need for reform to ameliorate future price increases. While progress has been made in many areas, more action is required to implement some of the proposed reforms.

Improvements have been made to the National Gas Rules, which will allow network prices to more closely reflect efficient costs.¹⁷ These new Rules will apply for the next network determinations from 1 July 2014, including the new network determination for Jemena from 1 July 2015 which will affect the prices paid by AGL and some ActewAGL customers.

¹⁷ <http://www.aemc.gov.au/Media/docs/Information-sheet--final-rule-determination-0234dda9-acbc-4cdb-b6de-a4f3297d2d6a-0.pdf>

However, further reforms in other areas are not yet complete. Commonwealth and State Governments through the Standing Council on Energy and Resources (SCER) commissioned an expert panel to review the merits review framework under the National Electricity Law and National Gas Law. The merits review framework provides parties affected by the AER's decisions with recourse to a review mechanism. In September 2012, an expert panel recommended significant changes to the framework in ways that better serve the long term interests of customers. This included broadening the scope of the review mechanism, moving away from an adversarial review to an investigative review and to have appeals heard by an independent administrative body with increased customer participation. However, these changes are yet to be made with consultation currently being undertaken by SCER. We strongly support changing the merits review framework, as outlined in our submissions to the expert panel and SCER.¹⁸

Changing the merits review framework is an important measure that Governments can implement to address policy settings that are leading to higher than necessary gas network prices.

1.8.2 Encouraging customers to actively engage in the competitive market

In our view, effective retail competition – where retailers strive to offer customers products and services they value – is the best way to ensure that gas prices are driven towards the efficient cost of supply. We consider that a well-functioning competitive market is in the long-term interests of customers.

While almost three-quarters of gas customers in NSW are now supplied under a market offer, further action can be taken to improve the functioning of the market, and better enable small customers to extract benefits from competition. This includes action to:

- ▼ Improve retailers' engagement with customers, so they make their offers more accessible and easier to understand and compare. Further, retailers need to take action to ensure that customers understand how their prices might change during the term of a contract to improve customer confidence in the market.
- ▼ Encourage customers to actively engage in the competitive market through education campaigns.
- ▼ Assist those specific customers that may need additional support to engage in the market.¹⁹

¹⁸ http://www.ipart.nsw.gov.au/Home/Quicklinks/IPART_Submissions_to_External_Reviews

¹⁹ The vast majority of customers can access the market, albeit with assistance in some circumstances (for example, IPART's price comparator website is accompanied by a multilingual telephone line, assisting customers without access to the internet or with reading or language barriers). However there may be specific groups of customers that require additional assistance, for example, from consumer groups and/or community welfare organisations.

1.8.3 Assisting customers facing financial hardship through targeted and well-designed assistance measures

We recognise that these indicative increases in regulated gas prices are relatively high compared to previous years, and are likely to be significant for many customers. It is likely that regulated retail prices will continue to rise over the following 2 years.

Price regulation cannot protect customers from price increases driven by regulatory, policy and market factors, nor can it protect vulnerable households that may be experiencing affordability problems. Rather it is important to ensure that any specific groups of customers that might be affected are specifically considered and targeted responses are developed.

Our customer impact analysis for NSW illustrates that the most vulnerable customers are those households that have low incomes and high levels of energy consumption (see Chapter 8 for the analysis of impacts of the final decision on small customers).

Governments have a limited budget for customer assistance given the numerous demands across the range of government expenditure priorities. Commonwealth and State governments provide financial assistance to households for their energy bills. This has primarily been through income support, energy rebates, energy efficiency and emergency assistance.

The segmented nature of the available information and delivery of customer assistance make it difficult to both identify a vulnerable household that is experiencing affordability problems and to deliver the most effective and cost efficient assistance measures – that is, the appropriate mixture of emergency assistance, ongoing income support and energy efficiency measures for individual households. This ultimately affects the ‘value for money’ provided from government assistance funding.

We therefore recommend a review of affordability measures to ensure that the existing budgets target the most vulnerable customers in a comprehensive, complementary and cost effective manner.

1.9 What does the rest of this report cover?

The rest of this paper is structured as follows:

- ▼ Chapter 2 outlines the terms of reference and context for this review, and how it influences the objectives for the review
- ▼ Chapter 3 sets out our process for the review and the approach we used to make our final decisions
- ▼ Chapter 4 sets out our final decision on the form of regulation
- ▼ Chapter 5 sets out our final decisions and our assessment of the Standard Retailers' proposed change to the Retail Component for 2013/14
- ▼ Chapter 6 sets out our final decisions on the Carbon Component for 2013/14
- ▼ Chapter 7 sets out our final decisions on miscellaneous charges
- ▼ Chapter 8 analyses the impacts of the final decision on small customers.
- ▼ Appendices A - G provide additional information.

2 Terms of reference and context for the review

The Minister for Resources and Energy has requested that we continue to regulate retail gas prices in accordance with section 27 of the *Gas Supply Act 1996* (the Act), and the terms of reference he has provided. We also need to consider the context for this review. In the coming years, there are likely to be a range of market, policy and regulatory developments that have significant potential to affect the gas industry.

2.1 Terms of reference

The terms of reference for this review (provided in **Appendix A**) indicate that we must ensure the objects under section 3 of the Act are taken into account. They also ask us to consider whether a review of the costs involved in supplying natural gas to small retail customers is necessary to ensure that regulated retail gas prices reflect an efficient level of these costs.

2.1.1 Objectives of section 3 of the Act

Section 3(1) of the Act lists 4 objects:

1. To encourage the development of a competitive market in gas, so as to promote the thermally efficient use of gas and to deliver a safe and reliable supply of gas in compliance with the principles of ecologically sustainable development
2. To regulate gas reticulation and gas supply, so as to protect the interests of customers and to promote customer choice in relation to gas supply
3. To facilitate the continuity of supply of natural gas to customers, and
4. To promote the safe use of gas.

There can be a tension between these objectives, particularly as customers have both short and longer term interests in relation to price, quality and security of supply. This creates a challenge for IPART, as it means we need to exercise our discretion in balancing the shorter and longer term objectives for this review. (See Chapter 3 for more information.)

2.2 Review of costs of supply

The terms of reference also ask us to consider whether a review of the costs involved in supplying natural gas to small retail customers is necessary to ensure that regulated retail gas prices reflect an efficient level of these costs. We consider that such a cost review is necessary, and have incorporated this into our analytical approach for this review (discussed in Chapter 3).

2.3 Policy and regulatory developments

In the period between now and the end of the 2013 regulatory period, a range of policy and regulatory developments are likely to affect the gas industry. In particular, these developments may affect the cost and risk associated with forecasting the costs of supplying gas to small retail customers in NSW. They may also affect the level of price certainty we can provide customers on regulated prices over the regulatory period.

2.3.1 Changes to climate change mitigation programs

A number of climate change mitigation programs affect the cost of supplying gas to customers. These include the Commonwealth Government's carbon pricing mechanism and Renewable Energy Target (RET) scheme.

The carbon pricing mechanism places direct costs on around 375 entities by requiring them to pay for their greenhouse gas emissions.²⁰ Many of these entities are part of the gas supply chain that delivers gas to households and businesses in NSW. They are liable for the costs of carbon emissions associated with extracting gas and transporting via the transmission and distribution networks, and with its consumption by retail customers.

While the price of carbon is fixed for the first 2 years of the regulatory period,²¹ the carbon pricing mechanism will transition to a flexible pricing mechanism on 1 July 2015. From then, the price of carbon will be determined by the market, and to some extent will reflect the international price of carbon. This will make it difficult to forecast the likely impact on the cost of supplying gas to small customers in the final year of the regulatory period. We took this into account in deciding on the form of regulation and other elements of the regulatory package included in the pricing agreements. We have also taken account of future changes to national climate change policies.

²⁰ <http://www.cleanenergyregulator.gov.au/Carbon-Pricing-Mechanism/Liable-Entities-Public-Information-Database/LEPID-for-2012-13-Financial-year/Pages/default.aspx>.

²¹ The carbon price started at a fixed price \$23 per tonne of CO₂e in 2012 and will rise at 2.5% (plus inflation) for the next 2 years. See <http://www.cleanenergyfuture.gov.au/clean-energy-future/an-overview-of-the-clean-energy-legislative-package/>.

In addition, both the carbon pricing mechanism and the RET scheme also have indirect effects on the cost of supplying gas to customers. This is because they create incentives for investment in lower carbon emission electricity generation, which influences the demand for wholesale gas and gas transmission services. The potential for changes in the policy and regulating settings makes it difficult to forecast their likely impact on the gas industry over the 2013 regulatory period.

2.3.2 Changes to gas distribution network prices

Gas distribution network costs (which account for around half of a typical customer bill) are currently passed through to small retail customers in their gas bills. The Standard Retailers have no control over these costs, as they typically depend on the network prices set out in the gas distribution access arrangements determined by Australian Energy Regulator (AER).

In the final 2 years of the **current** regulatory period (2011/12 and 2012/13), the average network costs passed through to the majority of gas customers in NSW (those in the Jemena distribution network supply area) increased materially. This led to a considerable increase in regulated retail gas prices in those years²², and will continue for the next 2 years.

As Table 2.1 shows, these customers face further material increases in average network costs in the first 2 years of the 2013 period (2013/14 and 2014/15).

²² http://www.ipart.nsw.gov.au/Home/Industries/Gas/Reviews/Retail_Pricing/Changes_in_regulated_gas_retail_prices_from_1_July_2012/13_June_2012_-_Information_Paper_-_Changes_in_regulated_retail_gas_prices_1_July_2012/Information_paper_-_Regulated_retail_gas_tariffs_and_changes_from_1_July_2012.

Table 2.1 Regulated gas distribution access arrangements

Gas retail supplier	Gas distribution network supplier	Period of access arrangement	Estimate of average real price change in remaining years ^a
AGL	Jemena	1 July 2010 –30 June 2015	8.39% pa in 2013/14 and 2014/15
ActewAGL	ActewAGL (Australian Capital Territory)	1 July 2010 –30 June 2015	0% pa in 2013/14 and 2014/15 ^b
	Jemena (Capital region)	1 July 2010 –30 June 2015	8.39% pa in 2013/14 and 2014/15
Origin Energy	Envestra (Wagga Wagga)	1 July 2010 –30 June 2015	2.5% pa in 2013/14 and 2014/15
	Central Ranges Pipeline (Tamworth)	1 July 2004 – 1 July 2019	0% pa from 2013 to 2019
	Envestra (Albury)	1 January 2013 - 31 December 2017	-3.5% in 2013, 0% pa from 2014 to 2017

^a Estimated price increases exclude inflation.

^b Based on capacity and throughput charges.

Note: Average price increases will depend on a number of external factors including pass through amounts for unaccounted gas and carbon costs.

Source: AER, *Access Arrangement for JGN's NSW gas distribution networks 1 July 2010 – 30 June 2015, Amended by order of the Australian Competition Tribunal, 30 June 2011, Further amended with regard to mine subsidence expenditure, 26 September 2011, June 2010, p 18.* AER, *Access arrangement variation for the Wagga Wagga gas distribution network 1 July 2010-30 June 2015, September 2010, p 5.* AER, *Access Arrangement Information for the ACT, Queanbeyan and Palerang gas distribution network 1 July 2010-30 June 2015, Amended by order of the Australian Competition Tribunal, 23 September 2010, April 2010, pp 66 & 85.* IPART, *Access Arrangement for the Central Ranges Pipeline Gas Network, November 2005, p 15.* AER, *Access Arrangement Final Decision Envestra Ltd Albury & Victoria Gas Distribution System 2013 – 2017, March 2013, p 14.*

In the final year of the 2013 period (2015/16) the change in network costs for most customers is uncertain, as the access agreements for the Jemena, ActewAGL and Envestra (Wagga Wagga) network supply areas are due to expire on 30 June 2015. Several policy and regulatory developments may influence these costs, including the AER's new determinations which will apply under amended National Gas Rules (NGR)²³ and potential changes to the Limited Merits Review Regime for gas businesses.²⁴

²³ In November 2012, the AEMC released a final determination and amendments to the economic regulation provisions in the NGR.

²⁴ The National Gas Law (NGL) includes a Limited Merits Review Regime to provide parties affected by the AER's decisions with recourse to a review mechanism. In September 2012, an expert panel recommended significant changes to the regime, including broadening of the scope of the review mechanism, increasing customer participation, and establishing a new administrative body to hear appeals under the regime.

2.3.3 Development of the NSW coal seam gas industry

Following the discovery of significant reserves of coal seam gas (CSG) in NSW²⁵ and technological advances that allow CSG to be extracted, the NSW Government is considering the role of this gas in meeting the state's future energy demand. The Government currently plays a significant role in the development of the CSG industry through a regulatory framework that includes legislation, regulation, environmental planning instruments and other guidance material. It has recently announced the policy and regulatory settings that will influence the development of the CSG industry in NSW.²⁶

Depending on how the industry develops, this may increase the domestic gas supply sufficiently to put downward pressure on wholesale gas costs over the 2013 regulatory period. However, the likely extent and rate of this development is still uncertain.

Several CSG production projects are at various stages of the planning approval process in NSW. For instance, AGL's Gloucester Gas Project, which could meet the gas demand of more than one million homes, has received approval for Stage 1 of the Project.²⁷ Meanwhile, AGL has requested that the assessment of its application to expand production at its Camden Gas Project to supply up to 15% of the NSW market be suspended.²⁸

2.4 Market developments

Since our last review of regulated retail gas prices, a range of market developments have occurred or been initiated. These developments may impact on the costs of supplying gas to small retail customers in NSW, or the level and development of competition in the retail gas market. Together with the policy and regulatory developments discussed above, they make it particularly difficult to forecast the efficient costs of supplying gas over the 2013 regulatory period.

2.4.1 Increased uncertainty in the wholesale gas market

Currently there is significant investment in liquefied natural gas (LNG) facilities on the eastern coast of Australia. These facilities convert natural gas into liquid form, making it easier to store and transport over long distances.

²⁵ Proven and probable reserves of coal seam gas in NSW have increased significantly over the past few years. These reserves were estimated to reach 2910 PJ in August 2011 compared to 743 PJ in June 2008. See AER, *State of the Energy Market 2011*, p 79.

²⁶ Barry O'Farrell MP NSW Premier - *Tough new rules for coal seam gas activity* - Media Release, Tuesday, 19 February 2013.

²⁷ <http://www.agl.com.au/about/ASXandMedia/Pages/AGLreceivesCommonwealthapprovalfortheGloucesterGasProject.aspx>

²⁸ <http://www.agl.com.au/about/ASXandMedia/Pages/AGLannouncessuspensionofapplicationforCamdenNorthProject.aspx>

If these LNG projects proceed as planned, large volumes of domestic gas production could be diverted to international markets. Increasingly, Australia's domestic gas markets will be influenced by the international market. This market – particularly the international demand for gas – is changing the incentives faced by domestic producers and consumers of gas.

As a result, Australia's domestic gas users may need to compete with international users, and domestic gas prices may rise towards international levels. However, the effect of LNG developments on domestic gas prices over the 2013 regulatory period is uncertain.

Many factors will influence international LNG prices in the coming years. These include the price of oil, the timing and capacity of new LNG facilities, country-specific policies, competing sources of gas supply such as gas pipelines, and the speed of global economic recovery.

In addition, there is significant uncertainty in relation to the medium-term supply and demand dynamics in the Australian market. Higher international prices for gas have altered the expectations of some gas producers. But the precise timing of many of LNG projects in Australia is not known, and the limited LNG export capacity may mean that there is limited scope for producers to access these international prices over the coming years. In addition, expectations of higher international prices for gas may in turn provide incentives for further development of gas supplies. However, the availability, cost and timing of CSG developments are uncertain.

In the longer term, we expect gas prices to rise towards international levels, increasing the costs of supplying gas to retail customers. However, this process of price transition is unlikely to be smooth with the changing market dynamics having the potential to lead to increasing levels of price uncertainty in the gas market in the medium term.

2.4.2 Improving competition in the retail market

Since we undertook our last review in 2009, the competitiveness of the retail gas market in NSW has increased. Currently, only around 28% of small customers remain on regulated retail prices, although this trend is not uniform across the supply areas. (See **Appendix D** for further detail.)

This improvement in competition is likely to be partially driven by conditions in the retail electricity market. Because small customers have gas bundled with electricity it is likely that more active retailer marketing, and increasing electricity prices and customer awareness have contributed to more customers seeking a better deal on their combined energy bills via a market contract.

We have formed our own view that competition is sufficiently effective to protect customers from prices being set above efficient levels, such that gas retail price regulation may no longer be necessary. However, it is a matter for the NSW Government to decide whether or not to remove regulation, and if so the timeframe for its removal.

We note that the Standing Council on Energy and Resources (SCER) has asked the AEMC to review the retail gas market in NSW, and provide advice on the effectiveness of competition in the market, and whether or not price regulation should be removed. As part of this review, the AEMC made a draft finding that competition in the NSW retail energy markets is delivering benefits to customers and that competition is sufficient to enable all customers to benefit from the removal of price caps.²⁹ The AEMC will provide its final advice to the NSW Government in September this year, and the Government will decide on the future of price regulation after considering that advice.

2.4.3 Price reviews under AGL's gas supply agreements

AGL's pricing proposal indicates that there are also important contextual market factors specifically relevant to this Standard Retailer. A number of AGL's long-term gas supply agreements will be subject to price reviews over the next 3 years. AGL has submitted that this creates uncertainty about costs it will face in purchasing wholesale gas over the 2013 regulatory period. It also submitted that this uncertainty limits its ability to propose prices beyond 2013/14.

²⁹ AEMC, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales – Draft Report*, May 2013, p ii.

3 Our process and analytical approach for this review

We have regulated retail gas prices over the past decade by reaching an agreement with each Standard Retailer on a regulated price path over the regulatory period. This is a relatively light-handed approach, and has historically been seen as a stepping stone towards the removal of price regulation.

We consider this regulatory approach has been successful in promoting the objectives of the Act to date. In our view, it has protected the interests of customers by limiting price increases to movements in efficient costs, encouraging retail competition, minimising unnecessary regulatory intervention, and facilitating a transition towards the removal of retail price regulation.

There is no evidence to suggest this regulatory approach will not continue to promote the objectives of the Act over the next regulatory period. Therefore, as the first step in our process for this review, we invited each Standard Retailer to submit a proposal for a revised agreement to apply over the period 1 July 2013 to 30 June 2016. We then conducted public consultation and detailed analysis, as outlined in Box 3.1.

To assess the Standard Retailers' proposals and reach our pricing agreements with them, we used a similar analytical approach to the one we used for our 2010 review. However, we made some important changes to this approach to reflect the context for this 2013 review – especially the particular challenges and difficulties noted in Chapter 2. In particular, we have modified our previous approach to:

- ▼ Holistically assess the extent to which the proposals will result in prices that meet the objectives to promote efficiency, the interests of customers and the development of competition.
- ▼ Ensure that Standard Retailers proposed prices reflect a 'reasonable range' that balances these objectives.

The sections below provide an overview of our analytical approach, and then discuss how our approach addresses the challenges for this review in more detail.

3.1 Overview of our analytical approach for 2013 review

In broad terms, the approach we used to assess and respond to the Standard Retailers' proposals includes the following 5 steps:

1. Analysing each Standard Retailer's proposed pricing agreement, together with stakeholder comments and expert advice, to determine whether its proposed regulated retail prices and charges are reasonable and in the long-term interests of customers. In particular, we considered:
 - a) whether the proposed form of regulation – including the form of price control and additional regulatory mechanisms – is appropriate, taking into account the level of competition in the NSW retail gas market, and the risks and uncertainties associated with forecasting the costs of supplying gas over the next 3 years
 - b) a reasonable change in the forecast Retail and Carbon Costs a retailer is likely to incur in supplying small retail customers on regulated prices over this period
 - c) the likely impact of the proposed form of regulation and prices on competition and customer choice in relation to gas supply.
2. Based on the above analysis, exercising our discretion to determine the reasonable change in the Retail and Carbon components of regulated prices that we consider balance the objectives for the review.
3. Assessing each Standard Retailer's proposal to determine whether or not it is consistent with our view of the reasonable change in prices established in Step 2, and:
 - a) if it is consistent, reaching a voluntary pricing agreement (VPA) with the Standard Retailer in line with its proposal
 - b) if it is not consistent, conveying our reasons for not agreeing to the proposal to the Standard Retailer so it can submit a revised proposal that better balances the objectives for this review, and that we can agree to
 - c) if we cannot reach an agreement, making a pricing order that sets a price path for the Standard Retailer over the regulatory period.
4. Estimating the average change in each Standard Retailer's overall regulated retail prices under its VPA (Network + Retail + Carbon components) or pricing order.
5. Assisting the Standard Retailers to communicate with customers by providing information on the impact of the new VPAs on customers.

Box 3.1 Process for this review

The process we followed in conducting this review included public consultation and detailed analysis. As part of this process, we:

- ▼ Invited Standard Retailers' to propose a new pricing agreement for the 2013-16 regulatory period.
 - ▼ Released an issues paper in November 2012. This paper explained the terms of reference for the review, outlined our proposed approach for assessing the Standard Retailers' proposals, and discussed the key issues we would consider. It also invited all interested parties to make a submission in response to this paper.
 - ▼ Sought information from the Standard Retailers, and other retailers in relation to the forecast cost of supplying gas over the period.
 - ▼ Engaged consultants, ACIL Tasman, to provide expert advice on wholesale gas costs, and SFG to provide expert advice on the retail margin.
 - ▼ Held a public forum to provide stakeholders with a further opportunity to comment on our issues paper and proposed approach.
 - ▼ Conducted our own analysis in line with the approach outlined in section 3.1, and considered all stakeholder submissions and comments.
 - ▼ Made a draft decision, considering all relevant material available.
 - ▼ Held a public hearing on the draft report to provide stakeholders with the opportunity to comment on our draft decision.
 - ▼ Considered all submissions and stakeholder comments in making our final decision.
-

3.2 How we applied our approach

As Chapter 2 indicated, the terms of reference and developments in the gas market create some specific uncertainties. The first relates to balancing the shorter and longer term objectives for this review. The second relates to assessing the Standard Retailers' proposals to determine whether their proposed price changes are 'reasonable'.

3.2.1 Balancing shorter and longer term objectives

In agreeing to pricing arrangements for the 2013 regulatory period, we ensured that regulated retail gas prices reflect the efficient costs of supplying gas to small retail customers on regulated prices. We also took account of the objectives of the Act, particularly protecting the interests of customers, promoting customer choice, and encouraging the development of a competitive gas market. There can be a tension between these objectives, particularly as customers have both shorter and longer term interests in relation to price, quality and security of supply.

In our view, the best way to support the interests of customers is by facilitating increased competition in the market and enabling the removal of price regulation. We consider an effectively functioning competitive market offers customers the best protection from higher than efficient prices in the short term and better 'value for money' service through reduced costs and/or innovation in the longer term. Both of these are in the interest of customers.

Without a competitive market, there would be little discipline on retailers to offer cost reflective prices or improve their performance. As is the case with natural monopolies, such as gas distribution networks, customers would in effect rely on the regulator to counter the inevitable market power and to drive these efficiency improvements. It is important to recognise that regulation is likely to be an inferior way of driving these improvements compared to competition. In our view, the focus for regulators, consumer groups and Governments in this context should be on promoting competitive market conditions rather than determining market outcomes.³⁰

However, for such a market to develop while regulation exists, regulated prices must be high enough to create incentives for retailers to enter the market and compete for customers, and for customers to seek out better offers in the competitive market. If regulated prices are set too low – for example, to recover the forecast efficient costs of supply only – the incentives may not be sufficient.

The regulatory approach must also recognise the limited ability of regulators to discover 'efficient costs'.³¹ As with any price regulation there is the risk that given the imperfect information available, setting prices to reflect the outcomes that may emerge in a competitive market may not be feasible. The dynamic nature of retail energy markets only makes this more difficult, creating the potential for price regulation to distort the competitive market.

Given the above, we consider that regulated retail prices over the regulatory period need to balance 2 potentially conflicting objectives:

- ▼ To encourage efficiency and protect customers from prices that are higher than efficient levels in the short term by setting regulated prices that reflect the efficient cost of supply.
- ▼ To support the interests of customers in the long term by setting regulated retail prices that create sufficient incentives for retailers to compete and customers to participate in the market.

³⁰ For example, by removing barriers to retail entry, and assisting customers engage in the competitive market.

³¹ The challenge facing regulators in trying to discover 'efficient costs' is well documented. For example, see Yarrow, G., Report on the impact of maintaining price regulation, Regulatory Policy Institute Oxford, UK, 2008, p 21. Yarrow notes that the determination of a competitive price is something that is discovered by a competitive process, and implicitly makes use of huge amounts of information. The ability of a regulator to forecast the outcomes of this process is highly limited.

3.2.2 Assessing whether proposed price changes are reasonable

In past reviews, our approach for assessing whether the Standard Retailers' proposed price changes are reasonable has included making our own estimates of the efficient costs of gas supply. This enabled us to compare the retailers' proposals with our cost estimates and assess the extent to which they reflect these efficient costs and meet other objectives.

As Chapter 2 discussed, policy, regulatory and market factors are likely to affect the gas supply chain in ways that are not clear at this stage. These factors – particularly the significant structural changes occurring in the wholesale gas market – create a high degree of uncertainty and risk in forecasting the cost of gas supply over the next 3 years. This also makes it challenging for us to get the balance 'right' between the shorter and longer term interests of customers in setting regulated prices.

3.2.3 Addressing these uncertainties and challenges

Given the above, our approach for this review included making an assessment of the Standard Retailers' proposals, and exercising our judgement to decide whether they are reasonable and balance the longer and shorter term objectives for this price review. In contrast to our approach for the 2013 regulated electricity price review, we have not assessed and made decisions on the individual forecast cost components of the retailers' proposals. Rather:

- ▼ As part of Step 2, we formed our own view on the reasonable range of the forecast cost of supplying small retail customers on regulated prices over the 2013 period. The approach we used for this is discussed in Chapter 5 and 6.
- ▼ In Step 3, we exercised our judgement to determine the reasonable change in the Retail and Carbon components of regulated prices – ie, those that IPART regulates – this is necessary to balance the longer and shorter term objectives.
- ▼ In Step 4, we agreed to a retailer's proposal where the change in the Retail and Carbon components of its proposed regulated prices was consistent with the reasonable change we determined, having regard to relevant submissions made to the review.

We consider that this approach is appropriate given the terms of reference and context for this review. We also consider it is consistent with the more light-handed approach to regulation we have historically used for regulated retail gas prices.

4 Assessing the Standard Retailers' proposed form of regulation

As Chapter 3 discussed, the first step in our analytical approach for this review was to assess each Standard Retailer's proposed pricing agreement, taking into account stakeholders' comments made to the review. The first part of this assessment focused on the proposed form of regulation – including the main form of price control and any additional regulatory mechanisms.

All of the Standard Retailers proposed to retain the broad regulatory package included in their previous agreements. In particular, they proposed to retain:

- ▼ A weighted average price cap (WAPC) form of price control³² for the retail component of prices. This R component reflects the controllable costs retailers incur in supplying gas to customers, including wholesale and gas transmission costs, retail operating costs and a retail margin.
- ▼ Pass through of the network component of prices. The 'N component' reflects the distribution network costs levied on retailers for using the gas distribution network. This cost is typically regulated by the Australian Energy Regulator.
- ▼ Pass through of the carbon component of prices. The 'C component' reflects the costs of complying with national climate change measures including the carbon pricing mechanism. This cost is estimated by the retailers and approved by IPART.
- ▼ The approach for setting average regulated prices (ie, as the sum of the R, N and C components)
- ▼ The mechanism for adjusting these components to address 'special circumstances'.

In addition, they proposed to introduce additional mechanisms – periodic reviews of the R and C components for 2014/15 and 2015/16 – to address the uncertainty about wholesale gas costs and the costs of complying with carbon-related policies and regulation.

The sections below explain our final decisions in relation to the Standard Retailer's proposed regulatory packages for the next 3 years.

³² Under the WAPC Standard Retailers are able change their individual retail regulated prices or components of these tariffs (such as fixed service or variable charges) as long as the overall increase in average regulated tariffs does not exceed the WAPC.

4.1 Overview of final decision on form of regulation

Our final decision is to agree to the Standard Retailers' proposed regulatory package (including AGL's revised proposal submitted in May 2013). The proposed form of regulation will continue to allow the Standard Retailers to set the retail cost component of regulated prices subject to a WAPC, and pass through 'uncontrollable costs' such as the network and carbon cost components. We consider this is consistent with the objectives to protect the interests of customers and encourage retail competition, and minimises unnecessary regulatory intervention.

The proposed periodic reviews of the retail and carbon cost components of regulated prices in 2014/15 and 2015/16 will provide more flexibility than previous agreements. We consider this is appropriate and consistent with the objectives for the review. Given the higher level of risk and uncertainty over the 2013 period, this approach is more likely to result in prices that reflect the cost of supply and minimise the risk of regulated retail prices distorting the competitive market.

We recognise that the periodic reviews will result in less price certainty for customers, and will potentially increase the administrative costs of price updates. However, on balance, we consider that introducing these reviews to manage the additional risks and uncertainties over the period is in the long-term interests of customers.

4.2 Form of price control

- 1 IPART's final decision is to agree to the Standard Retailers' proposals to retain the WAPC on the R component (with no additional side constraints) and pass through the N and C components.

To help us consider the Standard Retailers' proposed regulatory package, particularly the form of price control, we assessed the level of competition in the NSW retail gas market (see **Appendix D**). We found that this competition has increased since our last review. We also formed a view that competition in this market is now effective enough to provide sufficient protection to customers, as well as offering them more choices and better price and service outcomes. Thus we consider it is reasonable to continue using a light-handed form of price control, such as a WAPC for the R component of regulated prices.

We also consider that a WAPC is likely to result in prices reflect the cost of supply and minimise the risk of regulated retail prices distorting the competitive market. This is because this form of price control recognises that retailers have a better understanding than the regulator of the underlying cost of supply and demand for their individual price offerings.

As Standard Retailers have little scope to manage network costs and carbon costs, it also makes sense to allow these costs to be passed through into regulated prices to ensure they remain cost reflective.

In their responses to our draft report, the majority of stakeholders supported the continuation of the WAPC applied to the Retail component of regulated prices.³³ Most stakeholders also saw merits in continuing the current approach where network charges and carbon costs are passed through into regulated prices.³⁴ Therefore we consider it appropriate to maintain these regulatory settings to continue to promote the interests of customers.

4.3 Additional regulatory mechanisms to address risk

2 IPART's final decision is to agree to the Standard Retailers' proposals to include additional regulatory mechanisms to address risk, including their proposals to:

- retain the current special circumstances clause in the agreements
- introduce a separate clause specifically to allow regulated prices to be adjusted following changes to carbon related policy decisions that materially change a retailers' costs in supplying customers
- introduce periodic reviews of the retail cost component in 2014/15 and 2015/16 to address the risk related to wholesale gas costs over the regulatory period
- introduce periodic reviews of the carbon cost component in 2014/15 and 2015/16 to address the risk related to this cost over the regulatory period.

Whenever we agree to pricing proposals that rely on forecasts of costs over the regulatory period, there is a risk that the costs an efficient and prudent retailer incurs will differ from the forecast costs. For example, this may be because the Standard Retailers and IPART did not have reliable information or made incorrect assumptions in forecasting the costs, or because unanticipated events or circumstances affected the costs.

To some extent, this risk is considered an ordinary part of business and is compensated for through the retail margin, which rewards a business for the systematic risk it faces. However, where the risk (or the cost) is considered to be outside of the regulated entity's control, or contextual factors make it difficult to forecast with a high degree of certainty, it can be addressed through additional regulatory mechanisms.

The Standard Retailers' proposed 3 additional regulatory mechanisms for the 2013 period: a special circumstances clause, periodic reviews of the R cost component, and periodic reviews of the C cost component.

³³ Origin Energy submission, May 2013, p 1; AGL submission, May 2013, p 1; EnergyAustralia submission, May 2013, p 2.

³⁴ Ibid.

4.3.1 Special circumstances clause

In any regulatory period, the Standard Retailers may incur costs that were unanticipated at the time of our review. In the current agreements, this risk is addressed through the inclusion of a special circumstances clause. This clause specifies that the Standard Retailer may apply to IPART to vary its regulated prices outside the WAPC limit in special circumstances that give rise to changes in costs. These circumstances include, but are not limited to:

- ▼ regulatory changes
- ▼ taxation changes, and
- ▼ unanticipated gas field price reviews.

For the 2013 regulatory period, each of the Standard Retailers proposed retaining the special circumstance clause in its existing VPA. They also proposed to introduce a separate clause specifically to allow regulated prices to be adjusted following changes to carbon related policy and regulatory decisions that materially change a retailers' costs in supplying customers.

Stakeholders were broadly supportive of retaining the special circumstance clause in the current pricing agreements.³⁵ However, we did not receive stakeholder comment relating to the proposed mechanism to manage the risk associated with changes to carbon related policies.

We consider both these proposals to be reasonable. There is always a risk that a special or exceptional circumstance may materially increase or decrease the cost of supply over the regulatory period. The gas market is changing and will be significantly influenced by new sources of supply and demand, as well as carbon and other renewables policies. This increases the risk associated with circumstances that may materially increase or decrease the cost of supply over the period. In our view, to continue to balance the objectives in the Act (promoting efficiency, competition etc) we need to ensure that material cost increases and decreases are reflected in regulated prices.

4.3.2 Periodic reviews of the R component in 2014/15 and 2015/16

The Standard Retailers' proposed providing for a periodic review of the retail cost component in the second and third years of the regulatory period to address the risk associated with forecasting wholesale gas costs in advance. Periodic reviews are typically designed to manage costs that are difficult to estimate in advance and cannot be controlled by the retailer.

³⁵ Origin Energy submission, May 2013, p 2; AGL submission, May 2013, p 1; EnergyAustralia submission, May 2013, p 2.

While costs associated with purchasing the underlying gas commodity from producers have been considered 'controllable' in the past, the potential for increasing uncertainty in gas prices introduces an unprecedented level of uncertainty in gas commodity costs over the 2013 regulatory period. As Chapter 2 discussed, these costs are likely to be influenced by the development of liquefied natural gas (LNG) facilities on the eastern coast of Australia. These facilities will mean that Australia's domestic gas markets will be increasingly influenced by the international market.

The international market - particularly international demand - for gas is changing the incentives faced by domestic producers and consumers of gas. In the longer term, we expect gas prices to rise towards international levels, increasing the costs of supplying gas to retail customers. However, this process of price transition is unlikely to be smooth with the changing market dynamics having the potential to lead to increasing levels of price uncertainty in the gas market in the medium term. (**Appendix E** provides further detail on the uncertainties in the gas market in the medium term.)

In considering the proposal to introduce a periodic review of the R component, we took account of the level of risk associated with forecasting wholesale gas costs for the 2013 regulatory period, and stakeholders' comments on this issue. We also considered whether a periodic review is an efficient and reasonable means to address this risk, given the objectives for this period.

We concluded that the risk associated with setting a 3-year price path is significant. The high degree of uncertainty about these costs means that there is a risk that setting the R component without providing for a periodic review would result in prices that are:

- ▼ Significantly below the efficient costs of supplying small customers, so retailers cannot recover from customers the price they pay for gas under their contracts. This would not be in the long-term interests of customers, as it could affect their financial viability and harm competition in the gas retail market, or,
- ▼ Significantly above the efficient costs of supplying small customers, which also would not be in the interests of customers.

We consider providing additional flexibility in the agreements through periodic reviews of the wholesale gas costs within the R component is an efficient way of managing this risk. We recognise that this will reduce price certainty for customers, and may involve additional complexity and administrative costs in updating prices in future years. However, on balance, we consider the risk of putting in place a fixed price path outweighs the cost of providing additional flexibility in the agreements.

Most stakeholders supported the introduction of a periodic review of the Retail component of regulated prices as the best way to managing the risks associated with forecasting wholesale gas costs.³⁶

In relation to the design of the periodic review to manage this risk, we considered the trade-off between providing regulatory certainty by agreeing on the methodology for conducting the review, and providing flexibility to ensure that this method can take account of the circumstances at the time of the review and to avoid a move to a more prescriptive, less light-handed form of regulation. We formed the view that there is a risk in 'locking in' a methodology for this review. Therefore as part of the periodic review, we will invite Standard Retailers to propose a change in the R component that captures new information on wholesale gas costs and other related costs, including the retail margin.

4.3.3 Periodic reviews of the C component in 2014/15 and 2015/16

The Standard Retailers also proposed introducing periodic reviews of the carbon cost component to address certain risks and uncertainties related to carbon costs over the next 3 years. As Chapter 2 discussed, the Commonwealth Government's carbon pricing mechanism imposes direct and indirect costs on all gas retailers. The current agreements include a mechanism to allow the Standard Retailers to pass through these additional carbon costs in regulated retail prices, after approval by IPART.³⁷

Standard Retailers proposed to include a similar mechanism to allow them to pass through carbon costs in each year of the 2013 regulatory period, and for the amount to be passed through in 2014/15 and 2015/16 to be determined in 2014 and 2015 when further information is available. This proposal was supported by stakeholders' comments on this issue.³⁸

We consider it appropriate for the Standard Retailers to pass through the additional costs associated with the carbon price, as they have no control over these costs. We also recognise the uncertainty in relation to carbon costs, particularly as in 2015/16 the carbon price will be set by the market rather being fixed and specified in legislation.

³⁶ AGL submission, May 2013, p 3; EnergyAustralia submission, May 2013, p 1; Origin Energy submission, May 2013, p 1.

³⁷ This mechanism was necessary because at the time the agreements were made, there was no certainty about when the Carbon Pricing Mechanism would commence and what the carbon price would be. Once these facts were known, the Standard Retailers proposed to increase prices in 2012/13 to reflect their additional costs. We assessed these proposals and found they were in accordance with the agreement, and reflected the additional costs that they are likely to incur as a result of the introduction of the carbon price. Further details of our recent review of the Standard Retailers' proposed carbon component of retail prices can be found [here](#).

³⁸ Origin Energy submission, May 2013, p 2; AGL submission, May 2013, p 3; EnergyAustralia submission, May 2013, p 2.

5 Assessing the proposed increase in the retail component

The retail or R component of regulated retail gas prices reflects the controllable costs they incur in supplying gas to customers. These include wholesale and gas transmission costs, retail operating costs and a retail margin.

Each of the Standard Retailers proposed an increase in this R component in 2013/14. In line with the approach discussed in Chapter 3, we assessed each retailer's proposed increase to decide whether it is reasonable and balances the longer and shorter term objectives for this price review.

To help us with this, we analysed the retail costs that a benchmark retailer would incur in supplying gas to customers. However, in contrast to our approach for the 2013 regulated electricity price review, we did not assess and make decisions on each of the individual forecast cost components of the retailers' proposals. Instead, we used a more holistic approach that involved, for each Standard Retailer:

- ▼ analysing each of the retail costs of supply to form our own view of the range for each of these costs in 2013/14
- ▼ using the above ranges to form our view of the reasonable change in the R component in 2013/14
- ▼ deciding whether to agree to the retailer's proposed change in the R component based on whether or not it is consistent with this reasonable change.

Stakeholders broadly supported the holistic approach taken by IPART to assess the Standard Retailer's proposals.³⁹

The sections below provide an overview of our final decisions and then discuss the analysis which helped us in making these decisions.

³⁹ EnergyAustralia submission, May 2013, p 2.

5.1 Overview of final decisions on proposed increase in the R component

- 3 IPART's final decisions on the proposed increase in the R component of regulated retail gas prices are to:
- agree to AGL's revised proposal on the change in the R component of CPI+ 5.1%
 - agree to ActewAGL's proposed increase of CPI + 1.5%
 - agree to Origin's (Wagga Wagga) proposed increase of CPI + 4.9%
 - agree to Origin Energy's (Albury/Murray Valley) proposed increase of CPI + 5.7%.

These final decisions reflect our assessment of whether the Standard Retailers' proposed change to the R component are reasonable and balance the longer and shorter term objectives for this price review. In making this assessment, we took account of:

- ▼ expert advice on the prudent, efficient wholesale gas costs for each Standard Retailer
- ▼ our own analysis of forecast retail operating costs
- ▼ SFG's updated advice on an appropriate retail margin to be factored into regulated gas prices
- ▼ stakeholder submissions made to the review.

5.2 Analysing the retail costs of supply

As noted above, the retail costs of gas supply include wholesale gas costs, retail operating costs and a retail margin.

5.2.1 Wholesale gas costs

As discussed in Chapter 2, the 2013 to 2016 regulatory period is characterised by an unprecedented level of uncertainty in domestic gas markets.

In the longer term, we expect gas prices to rise towards international levels, increasing the costs of supplying gas to retail customers. However, this process of price transition is unlikely to be smooth with the changing market dynamics having the potential to lead to increasing levels of price uncertainty in the gas market in the medium term. These uncertainties may result in different views about current and future gas prices in NSW, particularly from 2014/15, as well as different views on the costs of supplying gas to retail customers.

To assess the Standard Retailers' proposed increase in the R component of its regulated gas prices we considered the likely range of wholesale gas costs for 2013/14. To understand the likely range of wholesale gas costs in supplying gas to customers we have:

- ▼ Engaged ACIL Tasman (ACIL) to forecast a range of benchmark wholesale costs faced by a prudent and efficient retailer over the regulatory period. ACIL's estimates of \$7.86/GJ to \$9.00/GJ⁴⁰ reflect the increasing prices that may be available to retailers under new long term contracts in supplying gas to customers, and the considerable uncertainty in the estimates.
- ▼ Considered the benchmark costs that were established as part of IPART's 2010 review. MMA's estimates of \$6.67/GJ to \$7.85/GJ⁴¹ reflect the low and stable domestic gas prices that some retailers may have access to under long term (legacy) contracts that were signed prior to these supply and demand uncertainties.

In our view, this presents us with a range of costs that captures the uncertainty in relation to estimates of wholesale gas costs for 2013/14, including the uncertainty associated with estimates of gas prices available to retailers under both existing and new contracts in supplying gas to customers.

This range of wholesale gas costs is set out in Table 5.1.

Table 5.1 Range of wholesale gas costs for 2013/14 (\$2012/13/GJ)

	AGL	ActewAGL	Origin (Albury/Murray)	Origin (Wagga Wagga)
MMA estimates	7.85	7.68	7.36	6.67
ACIL estimates	8.60	8.75	7.86	9.00
Range of wholesale gas costs	7.85-8.60	7.68-8.75	7.36-7.86	6.67- 9.00

Note: ACIL figures were deflated from \$2013/14 using inflation of 2.8% and MMA figures were converted from \$2009/10 to \$2012/13 using inflation of 8.1%.

We have not assessed and made a decision on the wholesale gas cost components underlying the retailers' proposals. Indeed, some of them did not provide this level of detail, and only proposed the total change in the R component. Of those that did, we found that their forecast gas were within this range, typically above the MMA forecasts but below the ACIL forecasts. ACIL concluded that this is most likely because Standard Retailers proposals' reflect the prices they expect to pay under legacy contracts entered into a number of years ago.

⁴⁰ Converted to \$2012/13.

⁴¹ Escalated to \$2012/13. McLennan Magasanik Associates (MMA), *Gas Retail Price Review – Wholesale Gas Costs, Final Report to Independent Pricing and Regulatory Tribunal*, May 2010. See here.

Further information on this analysis is provided in Appendix E. ACIL's report is available on our website.⁴²

5.2.2 Retail operating costs

Retail operating costs are defined as the operating costs an efficient retailer would incur in performing the retail functions required to serve its customer base. This includes the costs of billing and revenue collection, call centres, marketing, and an appropriate allocation of corporate overheads. Retail costs could also include the costs associated with customer acquisition and retention.

Based on our own analysis, we formed the view that a range for retail operating costs in 2013/14 is \$91 to \$110 per customer. Most of the Standard Retailers provided their proposed retail operating cost component on a confidential basis. Their proposals did not necessarily fall within this range.

However, we note that retailers have a range of views about how retail operating costs should be estimated – including, for example, whether they should reflect the costs of a standalone gas retailer or the incremental costs of supplying a gas customer to a dual fuel retailer, and the extent to which they should include the costs associated with customer acquisition. AGL submitted that acquisition and retention costs for gas customers should not be underestimated given that incentives paid through various marketing channels are paid on each electricity and gas account.⁴³

More information on our analysis of retail operating costs is provided in Appendix F.

5.2.3 Retail margin

We engaged Strategic Finance Group (SFG) to assist us in estimating an appropriate range for the retail margin of gas retail suppliers. SFG's final advice is that this range is 6.3% to 7.3% of earnings before interest, tax, depreciation and amortisation (EBITDA).⁴⁴ This is lower than the range IPART determined to be reasonable as part of the 2010 determination, which was 7.3% to 8.3% of EBITDA.

More information on SFG's analysis is provided in Appendix G. SFG's final report is available on our website.⁴⁵

⁴² ACIL Tasman, *Costs of gas for the 2013 to 2016 regulatory period*, Final Report, Public Version, June April 2013. See here.

⁴³ AGL submission, May 2013, p 2.

⁴⁴ This range reflects the results of all 3 of the approaches it used, and places equal weight on each result.

⁴⁵ SFG, *Estimation of the regulated profit margin for gas retailers in New South Wales*, Final Report, June 2013.

5.3 Assessing Standard Retailers' proposed R components with our view of the reasonable range for 2013/14

Based on the analysis discussed above, we formed a view on the reasonable change in the R component in 2013/14 for each Standard Retailer.

Then we compared this to each retailer's proposed change in R component for 2013/14, to decide whether this total proposed change is reasonable and balances the longer and shorter term objectives for this price review. We did not assess and make a decision on cost components underlying the retailers' proposals.

In its response to our draft report, EnergyAustralia submitted that regulated prices are based heavily on the Standard Retailer's costs and that regulated prices should be set at a level that allows non-standard retailers to compete in the market.⁴⁶

We do not agree that our final decision is based on Standard Retailer's costs. We have analysed the costs that benchmark retailers would incur in supplying gas to small customers. However, we did not assess and make decisions on each of the forecast cost components of the retailer's proposals. Instead, we used a more holistic approach, which involved forming a view on the reasonable range of the overall change of the R component in 2013/14. In forming a view on the reasonable range of the overall change in the R component, we took account of the objectives of the Act, particularly protecting the interests of customers, promoting customer choice, and encouraging the development of a competitive gas market. We are confident that our final decision appropriately balances efficient prices in the short term and facilitating competition and the longer term customer interests.

The following sections outline our assessment and final decisions on the total change in the R component for each Standard Retailer. Note that for indicative purposes only, the tables in these sections present several examples of the different combinations of individual cost components that are consistent with the overall change in the R component. In our view, each of these combinations appropriately balances the longer and shorter term objectives for this price review.

For instance, to set regulated gas prices at a level that promotes the longer term interests of customers by creating incentives for retailers to enter the market and compete for customers, and for customers to seek out better offers in the competitive market, we could agree to:

- ▼ higher wholesale gas costs, to reflect the potentially higher gas costs incurred by new retailers entering the market

⁴⁶ EnergyAustralia submission, May 2013, p 2.

- ▼ higher retail costs, to reflect the higher retail operating costs that a new retailer with a smaller customer base would incur, or the higher customer acquisition costs required to build a customer base
- ▼ higher retail margin, to potentially reflect the additional risk or higher variability in cash flow faced by a new entrant.

However, we note that using the top end of the reasonable range for all 3 underlying cost components is likely to lead to an upward bias on regulated retail prices, and is unlikely to balance the longer and shorter term objectives for this price review.

5.3.1 Our assessment of AGL's proposed increase in the R component

AGL initially proposed an increase in the R component of its regulated gas prices of **CPI +7.7%** for 2013/14. We sought a revised proposal from AGL in relation to the change in the R component for 2013/14 that took account of the following views:

- ▼ that the change to the R component needs to balance the longer and shorter term objectives for this price review
- ▼ that we consider the reasonable increase in the R component to be **CPI + 5.1%**.

In May 2013, AGL provided a revised proposal to increase the R component by **CPI+ 5.1%**, consistent with our draft decision.

We considered that an increase in the R component of **CPI+ 5.1%** (Table 5.2) appropriately balances:

- ▼ efficient cost recovery and the need to protect customers from prices that are higher than efficient levels in the short term by limiting price increases to movements in efficient costs, and
- ▼ the interests of customers in the long term by setting regulated retail prices that create sufficient incentives for retailers to compete and customers to participate in the market.

Table 5.2 AGL's initial proposal on the change in the R component compared to IPART's view of the change in 2013/14 (\$2012/13)

	IPART	Example 1	AGL
Wholesale gas costs (\$/GJ)		8.05 ^a	8.05 ^a
Retail operating costs (\$/customer)		112 ^b	112 ^b
Retail margin (% EBITDA)		6.7	8.0
Total increase in R component	CPI + 5.1%	CPI + 5.1%	CPI + 7.7%

^a AGL proposed wholesale gas costs.

^b AGL proposed retail costs, including an allowance for customer acquisition and retention costs.

We have made a final decision to agree with AGL's revised proposal to increase the R component by **CPI+ 5.1%**. In our view, the revised proposal better balances the longer and shorter term objectives for this price review.

However, we did not assess and make a decision on the individual cost components underlying the retailers' proposals. Rather we have exercised our own judgement to decide whether this total proposed change is reasonable.

5.3.2 Our assessment of ActewAGL's proposed increase in the R component

ActewAGL proposed an increase in the R component of its regulated gas prices of **CPI + 1.5%** for 2013/14. We consider that increases in the R component of **CPI to CPI+1.5%** (Table 5.3) appropriately balances:

- ▼ efficient cost recovery and the need to protect customers from prices that are higher than efficient levels in the short term by limiting price increases to movements in efficient costs, and
- ▼ the interests of customers in the long term by setting regulated retail prices that create sufficient incentives for retailers to compete and customers to participate in the market.

Table 5.3 ActewAGL's proposed change in the R component compared to IPART's view of the range for this change in 2013/14 (\$2012/13)

	IPART	Example 1	Example 2	ActewAGL
Wholesale gas costs (\$/GJ)		8.75	8.75	
Retail operating costs (\$/customer)		98	101	
Retail margin (% EBITDA)		6.3	6.7	
Total increase in R component	CPI to CPI +1.5%	CPI	CPI + 1.5 %	CPI + 1.5%

We have made a final decision to agree with ActewAGL's proposed increase in the R component of its regulated gas prices given that it is within the range we consider balances the longer and shorter term objectives for this price review.

5.3.3 Our assessment of Origin Energy's (Albury/Murray Valley) proposed increase in the R component

Origin Energy proposed an increase in the R component of its regulated gas prices for the Albury/Murray Valley region of **CPI + 5.7%** for 2013/14.⁴⁷ We consider that increases in the R component of **CPI+ 7.7 to CPI + 8.9%** (Table 5.4) appropriately balances:

- ▼ efficient cost recovery and the need to protect customers from prices that are higher than efficient levels in the short term; and
- ▼ the interests of customers in the long term by setting regulated retail prices that create sufficient incentives for retailers to compete and customers to participate in the market.

Table 5.4 Origin Energy's (Albury/ Murray Valley) proposed change in the R component compared to IPART's view of the range for this change in 2013/14 (\$2012/13)

	IPART	Example 1	Example 2	Origin Energy
Wholesale gas costs (\$/GJ)		7.61	7.36	
Retail operating costs (\$/customer)		90	110	
Retail margin (% EBITDA)		6.8	6.7	
Total increase in R component	CPI + 7.7 to 8.9%	CPI + 7.7%	CPI + 8.9%	CPI + 5.7%

Origin Energy's proposed increase in the R component is below the range we consider balances the longer and shorter term objectives for this price review. Origin Energy has indicated that it intends to transition its proposed regulated gas prices to a higher, more appropriate level over the regulatory period. It made this decision after considering the customer impacts of increasing prices to the appropriate level over one year.

We have made a final decision to agree with Origin Energy's proposed increase in the R component of its regulated gas prices for 2013/14 given that this component will be updated through the annual review process in 2014 and 2015.

⁴⁷ Origin Energy originally proposed an increase in the Retail Component of its regulated retail prices of CPI + 5.3%. Origin Energy revised this proposal to exclude the Carbon Costs which have been included in the Carbon Component (refer Chapter 6 on Carbon Component for 2013/14).

As part of this annual review process Origin Energy can propose a change in the R component that captures new information on wholesale gas costs and other related costs, including the retail margin.

5.3.4 Our assessment of Origin Energy's (Wagga Wagga) proposed increase in the R component

Origin Energy proposed an increase in the R component of its regulated gas prices for the Wagga Wagga region of **CPI + 4.9%** for 2013/14.⁴⁸ We consider that increases in the R component of **CPI + 18.9% to CPI + 21.4%** (Table 5.5) appropriately balances:

- ▼ efficient cost recovery and the need to protect customers from prices that are higher than efficient levels in the short term, and
- ▼ the interests of customers in the long term by setting regulated retail prices that create sufficient incentives for retailers to compete and customers to participate in the market.

Table 5.5 Origin Energy's (Wagga Wagga) proposed change in the R component compared to IPART's view of the range for this change in 2013/14 (\$2012/13)

	IPART	Example 1	Example 2	Origin Energy
Wholesale gas costs (\$/GJ)		7.84	7.84	
Retail operating costs (\$/customer)		90	100	
Retail margin (% EBITDA)		6.3	6.3	
Total increase in R component	CPI + 18.9 to CPI+ 21.4%	CPI + 18.9%	CPI + 21.4%	CPI + 4.9%

Origin Energy's proposed increase in the R component is below the range we consider balances the longer and shorter term objectives for this price review. Origin Energy has indicated that it intends to transition its proposed regulated gas prices to a higher, more appropriate level over the regulatory period. It made this decision after considering the customer impacts of increasing prices to the appropriate level over one year.

⁴⁸ Origin Energy originally proposed an increase in the Retail Component of its regulated retail prices of CPI + 4.2%. Origin Energy revised this proposal to exclude the Carbon Costs which have been included in the Carbon Component (refer Chapter 6 on Carbon Component for 2013/14).

We have made a final decision to agree with Origin Energy's proposed increase in the R component of its regulated gas prices for 2013/14 given that this component will be updated through the annual review process in 2014 and 2015. As part of this annual review process Origin Energy can propose a change in the R component that captures new information on wholesale gas costs and other related costs, including the retail margin.

6 Assessing the proposed increase in the carbon component

In supplying their customers, Standard Retailer's incur costs in complying with the Commonwealth Government's carbon pricing mechanism. This mechanism, which commenced on 1 July 2012, places direct costs on around 375 entities by requiring them to pay for their greenhouse gas emissions. Many of these liable entities will be part of the gas supply chain that delivers gas to households and businesses in NSW.

As Chapter 4 discussed, we made a final decision to agree to the Standard Retailers' proposal to pass through the carbon costs they incur via the C component of regulated gas prices. We also made a final decision to set the C component for 2013/14 only, and set this component for 2014/15 and 2015/16 through annual reviews.

Each Standard Retailer proposed a level for the C component in 2013/14. The sections below outline our final decisions on these proposals, and our assessment of the reasonableness of the proposals.

6.1 Overview of final decisions on proposed C component

- 4 IPART's final decisions on the proposed C component of regulated retail gas prices are to:
 - Agree to AGL's proposal of \$1.72/GJ.
 - Agree to ActewAGL's proposal of \$1.72/GJ.
 - Agree to Origin Energy's (Albury Murray) proposal of \$1.56/GJ.
 - Agree to Origin (Wagga Wagga) proposal of \$1.63/GJ.

Each Standard Retailer's proposed C component reflects the legislated increase in the carbon price in 2013/14. Note that the decisions above are expressed in nominal amounts.

6.2 Our assessment of the proposed C component

Under the *Clean Energy Act 2011* (Cth) (the Act) upstream gas producers and network operators will be liable for the emissions associated with their facilities, and natural gas retailers will be liable for the downstream emissions associated with their customers' usage of gas.

The carbon component of regulated gas prices needs to reflect an estimate of the costs that are directly payable by many of the entities along the supply chain. This includes costs of carbon emissions associated with extracting gas, transporting it over the transmission and distribution networks, and its consumption by retail customers.

The direct impact of the carbon price on retail gas prices is a function of the cost of carbon emissions from 1 July 2013 (legislated at \$24.15/tonne CO₂, in 2013/14) and the amount of emissions at each stage of the supply chain.

In assessing each Standard Retailer's proposed C component for 2013/14 we have:

1. Considered the total direct costs of complying with the carbon pricing mechanism for 2012/13. (See Box 6.1 for detail on how we assessed the Standard Retailers' proposals in 2012 for the C component in 2012/13.) We excluded any carbon-related operating expenditure from the carbon component.⁴⁹
2. Increased this amount by the legislated increase of 5.0% in the carbon price for 2013/14.
3. Applied a retail margin (in line with the Standard Retailer's proposal) to provide a total C component for 2013/14.

We have agreed to the Standard Retailer's proposals given they are consistent with our assessment of the cost of complying with the carbon price.

⁴⁹ As part of the 2012/13 Carbon Component we agreed to the Standard Retailers' proposal to include an amount to reflect the incremental operating costs associated with complying with the Carbon Pricing Mechanism. See [here](#) for further detail.

Box 6.1 IPART's 2012 assessment of the standard retailers' Carbon Component

Our assessment of the standard retailers' proposals involved the following steps:

- ▼ We considered how the Act is likely to impose liability on the various elements of the gas supply chain (including whether gas suppliers are directly liable to surrender carbon permits) and the extent to which any carbon related costs associated with gas distribution will be captured in gas network distribution prices.
 - ▼ We considered each retailer's estimates of its individual carbon cost components, and compared the methodology proposed by them for calculating upstream and downstream emissions costs with methodologies used to calculate liability under the Act.
 - ▼ Where possible, we compared the information and calculations provided by retailers against publicly available information.
 - ▼ We compared information provided by retailers to assess whether the cost differences resulting from different methodologies were material and, if so, whether they could be justified (for example, if they could be justified as a result of gas being sourced from different fields). We used different sources of information to assist with this task.
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7 | Non-tariff fees and charges

In addition to charges for gas supply, energy retailers levy non-tariff fees and charges (or miscellaneous charges). These charges arise from particular events associated with the supply of energy to individual customers – for example, as a result of a request from a customer, or when a customer takes (or fails to take) certain actions.

Miscellaneous charges are not consistent across the Standard Retailers, and comprise both retail and network charges. Retail miscellaneous charges are levied by the Standard Retailers. They are set via each retailer’s pricing agreement, which specifies the maximum level for each charge. Retail miscellaneous charges include:

- ▼ late payment fees and associated charges
- ▼ security deposits
- ▼ dishonoured payment fees, and
- ▼ account establishment fees.

Network miscellaneous charges are levied by network distribution service providers, but are passed through to the customer by the retailer. They may include fees for special meter reads, network disconnection and reconnection and permanent disconnection. In general, network miscellaneous charges are set in the network service provider’s Access Arrangements which are regulated by the AER.

The sections below set out our findings on the Standard Retailers’ proposals in relation to late payment fees, administration fees and other retail miscellaneous charges for regulated customers. Consistent with our approach for this review, we considered whether the proposed charges are reasonable and reflect the costs that an efficient and prudent retailer would incur in providing the services to which they relate.

7.1 Overview of final decisions on miscellaneous charges

5 IPART's final decisions are to:

- agree to the proposals by AGL, ActewAGL and Origin Energy (Albury Murray Valley) to index their existing retail miscellaneous charges by the change in the CPI
- agree to the proposal by Origin Energy to increase its retail miscellaneous charges in the Wagga Wagga supply area to the same level as those in the Albury Murray Valley area
- note that the introduction of the National Energy Customer Framework (NECF) will facilitate AGL and Origin Energy introducing a Merchant Service Fee, which both of them propose to levy at 0.6%
- refer to the NECF to specify the circumstances under which the late payment fee must be waived and the conditions for the imposition and level of security deposits
- allow each Standard Retailer to pass through to customers network miscellaneous charges and to add the regulated retail administration fee
- retain the provisions from the 2010 agreements in relation to notifying and approving miscellaneous charges.

The resulting retail miscellaneous charges for each Standard Retailer are set out in Table 7.1.

Table 7.1 Retail miscellaneous charges (\$2012/13), excluding GST

Fee	AGL	ActewAGL	Origin (Albury Murray Valley and Wagga Wagga)
Late payment fee	11.64	12.38	12.00 ^a
Account Establishment Fee	25.28	25.18	31.81
Account Establishment Fee (pensioners)		12.38	
Dishonoured payment	26.90	26.88	25.47
Retail administration fee	2.64		2.50
Collector call fee	38.24		
Attendance (debt collection) first visit		38.20	
High bill field visit		60.87	

^a Origin Energy does not propose to increase the late payment fee by CPI.

7.2 National Energy Customer Framework (NECF)

Since we made the 2010 determination, the NSW Government has announced that the National Energy Customer Framework (NECF) will commence in NSW on 1 July 2013. The NECF includes a set of National Electricity Retail Rules (the Rules), which include provisions for the level and imposition of security deposits, as well as provisions about the imposition of late payment fees. As part of the NECF, the NSW Government has also developed the *National Energy Retail Law (Adoption) Regulation 2013* (the Regulation). The Regulation, which will commence on 1 July 2013, includes additional conditions about the imposition of the late payment fee. Both the Rules and the Regulation will apply to all customers, and there are some specific provisions that apply to those on regulated prices.

As the NECF will commence on 1 July 2013 (the first day of the 2013 regulatory period), the VPAs should refer to the relevant provisions in the Rules and Regulation that deal with the level and imposition of security deposits and the imposition of late payment fees, rather than specify provisions in relation to security deposits and late payment fees.

7.3 Late payment fees

Late payment fees are charged when customers pay their gas bill after the due date. We have considered in detail the level of late payment fee, and the circumstances in which the retailers are entitled and not entitled to levy this fee.

For the 2010 price review, most of the Standard Retailers proposed 'cost reflective' late payment fees, which IPART agreed to. For the 2013 review, AGL, ActewAGL and Origin Energy (Albury Murray) proposed CPI adjustments to these fees. We consider that this proposal is reasonable, and therefore made a final decision to agree to it.

However, for its 2010 pricing agreement, Country Energy proposed a late payment fee of \$7.50 to align this fee with its late payment fee for its regulated electricity customers. Since then, Country Energy has been sold to Origin Energy. Further, the late payment fee in electricity is now increasing to cost reflective levels and will be set at the \$10.90 (ex GST). In light of this, Origin Energy has proposed to increase its late payment fee to \$12 in the Wagga Wagga supply area, to bring it into line with its late payment fee in the Albury Murray Valley area. We consider this is reasonable, and is consistent with the approaches used to set the late payment fee for other regulated gas customers in NSW. Therefore, we have agreed to this proposal.

Under the current pricing agreements, the circumstances in which the Standard Retailers can levy the late payment fee vary, reflecting each retailer's historic practices. However, we consider it appropriate to adopt the provisions under the Rules and the Regulation (under the NECF) in relation to when the Standard Retailers **cannot** impose a late payment fee. These include:

- ▼ If the customer is a hardship customer.
- ▼ If the time for payment of the bill concerned has been extended and that time has not expired.
- ▼ If that bill, or another bill given to the customer under the contract is the subject of a matter being considered by the energy ombudsman.
- ▼ If the bill is subject to an arrangement to pay by instalment under a payment plan.
- ▼ If any part of the bill is paid by a voucher issued under the Energy Accounts Payment Assistance Scheme.
- ▼ If the retailer is aware that the customer has sought assistance to pay the bill for a participating community welfare organisation that issues such vouchers.

7.4 Security deposits

The Rules (under the NECF) also set out provisions relating to the level and circumstances under which a security deposit can be collected. We consider that it is appropriate to adopt these provisions. Generally, the Rules provide that the maximum level of the security deposit is 37.5% of the average annual gas account, and that:

- ▼ For residential customers, a security deposit can be required prior to commencement of supply only if the customer:
 - has an outstanding debt owed to the Standard Retailer in relation to an energy retail bill and the customer has refused and refuses to make an arrangement to pay that debt, or
 - has been responsible for the illegal use of energy within the previous 2 years
 - does not have a satisfactory credit history in the reasonable opinion of the Standard Retailer, and has been offered a payment plan and has refused or failed to agree to this offer
 - refused to provide acceptable identification.
- ▼ For business customers, security deposits can be required only if the customer:
 - does not have a satisfactory credit history in the reasonable opinion of Standard Retailer, or
 - is a new business, or
 - was responsible for the illegal use of energy within the past 2 years.

7.5 Administration charge on network non-tariff fees and charges

As noted above, networks also levy miscellaneous fees for certain services. Typically, these include special meter readings, meter testing and disconnection/reconnection of gas supply. The fees differ across networks.

The gas retailers are the interface between the gas networks and the customer. Retailers state that they incur costs taking calls, requesting the network service, advising customers of costs, processing orders, including fees on customer accounts and collecting the revenue.

For the 2010 price review, AGL and Origin Energy proposed to include an administration fee on network non-tariff fees and charges in their new pricing agreements, and we agreed with a \$2.50 charge, which has subsequently been indexed for inflation. For the 2013 review, these Standard Retailers proposed to increase this charge by the change in the CPI. We consider this to be reasonable and have agreed to their proposals.

7.6 Other miscellaneous charges

Most Standard Retailers charge other non-tariff fees – such as a fee to establish an account and for dishonoured. Some charge miscellaneous fees in relation to disconnection or potential disconnection. For example, these may include collector call fees (where the premises are visited to disconnect supply but the customer agrees to make a payment), high bill field visit fees and disconnection fees. However, in some cases, this type of miscellaneous fee is levied by the network service provider. Standard Retailers should provide this information on their websites.

The Standard Retailers proposed to increase the other miscellaneous fees they levy by the change in the CPI or less. We consider that it is reasonable for the retailers to maintain the real level of existing fees and charges, and therefore we agree to these proposals. Origin Energy proposed Origin Energy (Wagga Wagga) miscellaneous charges to be set at the same level as the Origin Energy regulated charges for Albury and the Murray.

We note that AGL and Origin Energy propose to introduce a 0.6% merchant service fee for accounts paid by credit card. While such a fee is currently inconsistent with the *Gas Supply (Natural Gas Retail Competition) Regulation 2001*, the introduction of the NECF would remove this constraint. The merchant service fee is not a regulated charge.

8 Impact of price increases on customers

The impact of the increases in regulated gas price from 1 July 2013 on individual customers will vary – depending on factors such as their gas usage and Standard Retailer, the regulated price they are on, and how they respond to the price increases (eg, whether they can reduce their usage to manage their bills).

Given this, we conducted a set of analyses to explore the likely range of impacts on customers. In particular, we analysed:

- ▼ the impact of the final decision on annual gas bills for typical residential and small business customers for each Standard Retailer
- ▼ the impact of the final decision on both gas and energy bills as a proportion of household disposable income, and how this varies for different households in the metropolitan NSW
- ▼ which types of household are most likely to have difficulty accommodating any further increase in energy prices.

The sections below summarise our key findings then discuss our analysis in detail. They also provide a brief overview of who uses gas in NSW, and what gas is used for.

8.1 Overview of key findings on the impact of the price increases on customers

Under our final decision, the annual gas bills of ‘typical customers’ – those with the ‘typical’ gas usage in metropolitan NSW and in non-metropolitan NSW – increase by:

- ▼ about \$46 to \$76 for residential customers, and
- ▼ about \$163 to \$356 for small business customers in 2013/14.

We recognise that these indicative increases in regulated gas prices are relatively high compared to previous years. They also come after a sustained period of large increases in energy (ie, gas and electricity) prices. For example, gas prices increased by about 10% in real terms on 1 July 2012. In addition regulated retail electricity prices have doubled in real terms since 2002/03, with most of the increase occurring after 2007/08. Consequently, to consider the impact of the gas price increases on household energy affordability, we looked at both gas bills and combined electricity and gas (ie, energy) bills.

A useful measure of energy affordability is the proportion of household disposable income spent on energy. Our analysis indicates that for the **majority** of households (around 80%) that use gas, gas bills will represent less than 2% of their disposable income in 2013/14 and energy bills will represent less than 6% of their disposable income. However, some low-income households will spend more than 6% of their disposable income on energy. Some of these households already find it difficult to pay their energy bills and further price increases may exacerbate energy affordability for low income households. The households most likely to be affected are those who have low-incomes⁵⁰ as well as one or more of the following characteristics:

- ▼ high energy usage that is difficult to reduce
- ▼ high housing costs.

We note that gas and electricity supply disconnections due to non-payment of bills increased in 2011/12, and there was a rapid growth in demand for Energy Accounts Payment Assistance scheme (EAPA) vouchers.

8.2 Who uses gas and what for?

Only some NSW households use gas⁵¹ - about half of households in the Sydney metropolitan area⁵² and about 40% of all NSW households.⁵³ Around 85% of households on a regulated gas tariff live in AGL's supply area, which covers Sydney, Wollongong, Newcastle, Dubbo, Orange, Parkes, and parts of the Riverina region

⁵⁰ To simplify our analysis, we define low-income households as those with incomes below \$39,000 per year. However, large households with higher incomes may face similar financial circumstances. In particular, there are likely to be a number of these households in the \$39,000 to \$48,000 income band.

⁵¹ Throughout this report, 'gas' means mains gas, which refers to gas supplied by gas distribution pipes connected to the dwelling.

⁵² IPART, *Residential Energy and Water Use in Sydney, the Blue Mountains and Illawarra - Results from the 2010 household survey*, December 2010, p 75.

⁵³ Calculated from information provided By Jemena Gas Networks.

Gas is more commonly used by higher income households than those with lower incomes. For example, our Sydney (2010) household survey found that about 60% of high-income households use gas compared to about 40% of low-income households.⁵⁴

Gas is used instead of electricity for cooking, hot water and/or space heating. Some households use gas for all 3 purposes, while others use it for only 1 or 2 purposes. In Sydney in 2010, about one third of households with gas used it for cooking and hot water and another third used it for all 3 purposes.⁵⁵

How much gas a household uses depends on a number of factors, including:⁵⁶

- ▼ What it uses gas for. Households that use gas only for cooking use a small amount of gas, while those that use gas for 2 or 3 purposes use far more gas.⁵⁷
- ▼ How many people are in the household, particularly if gas is used for hot water.
- ▼ The type and size of dwelling, particularly if gas is used for heating.
- ▼ The climate zone, particularly if gas is used for heating.

8.3 Impact of final decision on typical customer bills in each supply area

We cannot calculate how our final decisions will affect individual customers' annual gas bills. This impact will depend on how much gas they use, which of their Standard Retailers' regulated prices they are on, and how the Standard Retailer changes these individual price. However to estimate the potential impact, we have calculated an indicative annual gas bill for residential and business customers with average usage in each gas supply area (Table 8.1 and 8.2).⁵⁸

⁵⁴ IPART, *Residential Energy and Water Use in Sydney, the Blue Mountains and Illawarra - Results from the 2010 household survey*, Appendix E, Table 1, December 2010.

⁵⁵ IPART, *Residential Energy and Water Use in Sydney, the Blue Mountains and Illawarra - Results from the 2010 household survey*, December 2010, pp 82-83.

⁵⁶ See IPART, *Determinants of residential energy and water consumption in Sydney and surrounds. Regression analysis of the 2008 and 2010 household survey data*, December 2011, Chapter 4.

⁵⁷ For example, our household surveys show that Sydney households that use gas for cooking only use on average less than 9 GJ of gas per year. Households that use gas for all 3 purposes on average use more than 25 GJ per year (IPART, *Residential Energy and Water Use in Sydney, the Blue Mountains and Illawarra - Results from the 2010 household survey*, December 2010, pp 85-86).

⁵⁸ AGL, the Standard Retailer for the Sydney metropolitan region, has only one regulated tariff for residential customers and one for business customers. The other standard retailers have a number of different residential and business tariffs, and supply more than 1 region (with different regional network tariffs).

This analysis indicates that in 2013/14:⁵⁹

- ▼ Typical residential customers will face an increase of between \$46 and \$76 in their annual gas bill.
- ▼ Typical small business customers using will face increases of between \$163 and \$356 in their annual gas bill.

Table 8.1 Indicative annual bill for typical residential customers of each Standard Retailer (nominal \$, inc GST)

	Current bill (2012/13)	Estimated bill (2013/14)	\$ increase
AGL	822	898	76
ActewAGL	1,217	1,283	66
Origin Energy (Wagga Wagga)	965	1021	56
Origin Energy (Albury/Murray valley)	886	933	46

Note: This assumes a typical customer uses 23 GJ, 45 GJ, 37 GJ, and 45 GJ of gas per annum in the AGL, ActewAGL, Origin Energy (Wagga Wagga) and Origin Energy (Murray Valley) areas respectively. Bills are for regulated prices and include GST.

Source: AGL, ActewAGL, Country Energy and Origin; IPART calculations.

Table 8.2 Indicative annual bill for typical business customers of each Standard Retailer (nominal \$, excl GST)

	Current bill (2012/13)	Estimated bill (2013/14)	\$ increase
AGL	3,864	4,220	356
ActewAGL	4,423	4,665	242
Origin Energy (Wagga Wagga)	3,262	3,452	190
Origin Energy (Albury/Murray valley)	3,133	3,296	163

Note: This assumes a typical customer uses 184 GJ, 229 GJ, 231 GJ and 209 GJ of gas per annum in the AGL, ActewAGL, Origin Energy (Wagga Wagga) and Origin Energy (Murray Valley) areas respectively. Bills are for regulated prices and exclude GST.

Source: AGL, ActewAGL, Country Energy and Origin; IPART calculations.

⁵⁹ The increases in typical gas bills do not take account of any increases in energy rebates available to low and middle-income households from 1 July 2013.

8.4 Gas and energy bills as a proportion of disposable income

To consider the impact of the final decision on households we focused primarily on household energy bills as a proportion of household disposable income, where disposable income means income after accounting for tax.⁶⁰ This is a useful measure, as it takes into account movements in household incomes as well as energy bills. In addition:

- ▼ We looked at both gas bills and combined electricity and gas (ie, energy) bills. We looked at energy bills because this provides a more complete picture of energy affordability than looking just at gas bills.
- ▼ We focused our analysis on metropolitan NSW (Sydney, Blue Mountains, Illawarra, Hunter and Central Coast) because we have detailed information on energy usage, energy costs, and household characteristics from our Household Surveys in these areas. We included in the analysis only households that use both mains gas and electricity (ie, dual fuel households).
- ▼ We took into account rebates on energy bills, but we show gas bills without energy rebates.⁶¹

The sections below discuss the key factors that influence energy affordability and then discuss the key findings of our analysis.

8.4.1 What factors influence energy bills as a proportion of disposable income?

There are many interrelated factors that influence what proportion of a household's disposable income its energy bills represent. The main factors are the size of the household's disposable income, as well as how much energy it uses, and the prices it pays for energy.

Household income

Household income varies widely across NSW. For example, the median disposable household income in some postcode areas of Sydney exceeds \$120,000 per annum, while in other areas (particularly inland) it is less than \$40,000 per annum.⁶²

⁶⁰ We also took into account the Commonwealth Government's Household Assistance Package, which was introduced in 2012 to compensate households for the introduction of the carbon. For an explanation of how we did this, and for more information about the Package, see IPART, *Changes in regulated electricity retail prices from 1 July 2012. Electricity – Final Report*, June 2012, pp 68-69 and 76-82.

⁶¹ The rebates are for energy, and typically appear on a customer's electricity bill.

⁶² Based on the ABS 2011 Census, inflated to 2013/14 prices using the change in average weekly earnings until 2011/12 and for 2012/13 and 2013/14 using the NSW Treasury's forecast increase in the average wage index of 3.5%.

Energy usage

Household energy usage also varies widely. We know from our household surveys that some of the major drivers of this usage relate to a household:⁶³

- ▼ **Characteristics.** For example, these include the number of people in the household, the household structure (eg, family with young children, or older adults with no children at home, etc), household income and dwelling type (eg, a detached house, or a semi-detached dwelling or apartment).
- ▼ **Location.** This is because different areas of NSW have different temperatures in winter and summer, which influences the amount of energy required for heating and cooling. In addition, housing stock differs across NSW. In inland areas it is predominantly detached houses, whereas in the coastal areas it tends to include more semi-detached dwellings and units.⁶⁴ Detached houses generally require more energy for heating and cooling.
- ▼ **Energy-using appliances and usage patterns.** For example, this includes the number, type and efficiency of the large energy-using appliances the household owns, and how often it uses them.

Energy prices

The prices a household pays for energy depends mainly on which supply area it is located in, as this is a big driver of its retailer's costs in buying and transporting energy.

A household's energy prices also depend on whether or not it has a controlled load electricity supply, because electricity that is on a controlled load price is cheaper than other types of energy.⁶⁵

In addition, these prices depend on whether or not the household uses gas as well as electricity, and if so, how many of its large energy-using appliances run on gas. Households that use gas pay 2 service availability charges, and may therefore pay higher bills if they do not use much gas. On the other hand, households that use large amounts of gas (particularly for heating) may pay lower bills because gas usage charges are lower than electricity usage charges for non-controlled load electricity. Households in metropolitan NSW are much more likely to use gas, as access to gas distribution networks is limited outside Sydney.

⁶³ See IPART, *Determinants of residential energy and water consumption in Sydney and surrounds. Regression analysis of the 2008 and 2010 household survey data*, December 2011.

⁶⁴ For example, in Sydney and surrounding areas, detached dwellings made up 61% of the dwelling stock in 2011, while outside of Sydney these dwellings made up 83% of the dwelling stock. (ABS 2011 Census, *Basic Community Profile for Greater Sydney*, Table 31 and *Basic Community Profile for Rest of NSW*, Table 31.)

⁶⁵ Analysis of our household survey data suggests that controlled load electricity is cheaper than gas. See IPART, *Determinants of residential energy and water consumption in Sydney and surrounds - Regression analysis of the 2008 and 2010 household survey data*, December 2011, pp 45-55.

A household's final energy bill also depends on whether or not it receives a rebate.

8.4.2 How do gas bills as a proportion of disposable income vary in metropolitan NSW?

Our household surveys in the Sydney, Blue Mountains, Illawarra, Hunter and Central Coast areas provide a good profile of gas use according to different household characteristics and income categories in metropolitan NSW. Using these data, information about residential gas usage⁶⁶ and our draft determination on regulated gas prices, we found that more than 75% of households in this area will spend less than 2% of their disposable income on gas bills in 2013/14. In addition, only about 6% are likely to spend more than 4% of their disposable income on gas bills.

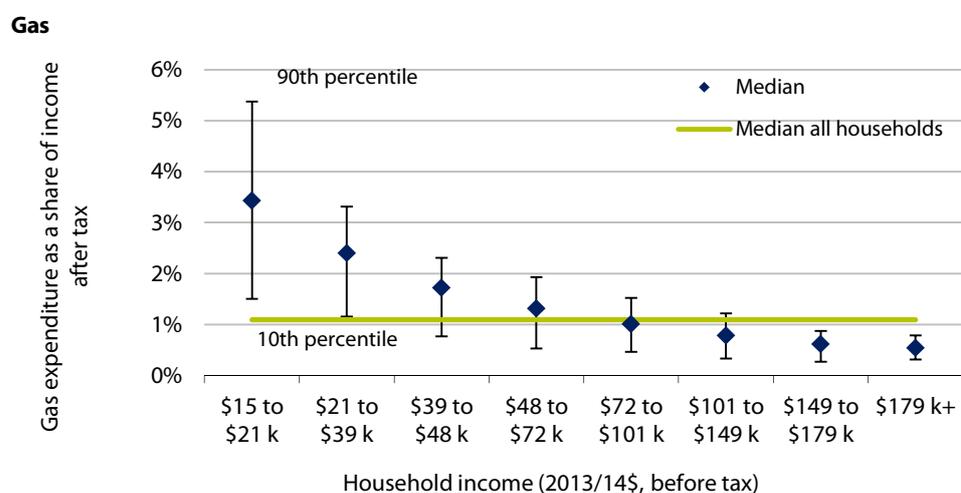
As Figure 8.1 shows, median household spending on gas across all income categories will be just over 1% of disposable income. However, looking in different income categories, median household spending on gas varies quite widely:

- ▼ In the middle and higher income categories (more than \$48,000 per year), median household spending on gas will range from 0.5% to 1.5% of disposable income.
- ▼ In the 2 low-income categories (\$39,000 or less per year), median spending on gas will range from around 2.5% to 3.5% of disposable incomes.

⁶⁶ Information from Jemena Gas Networks NSW shows that gas usage per residential customer has remained more or less unchanged since our survey.

Between households with similar disposable incomes in the lower income categories, there is substantial variation. For example, in the lowest income category households with median gas use are likely to spend about 3.5% of their disposable income on gas, while those in the 10th percentile will spend about 1.5%, and those in the 90th percentile will spend more than 5%. In the second lowest income category, median households will spend about 2.5% of their disposable income on gas, but those in the 90th percentile will spend more than 3% on gas.⁶⁷

Figure 8.1 Annual spending on gas as a share of disposable household income — Sydney and surrounding regions, 2013/14



Note: The income for the middle of each band is used to calculate disposable income. Disposable income as a share of household income is derived from ABS household income distribution data for 2009/10. Income for each band is inflated to 2011/12 using the change in average weekly earnings. Income forecasts for 2012/13 and 2013/14 use NSW Treasury's forecast increase in the average wage index of 3.5%. Disposable income in 2012/13 and 2013/14 is further adjusted for the impact of the carbon compensation package. Distributions are presented without weighting survey responses.

A **percentile** is the value below which a certain percentage of observations fall. For example, the 10th percentile is the value below which 10% of the observations may be found. In the above diagram, 10% of customers in each income band would fall below the bottom of the vertical line (paying less than that amount) and 10% of customers would pay more than the top of the vertical line.

Sources: IPART Household Surveys, 2008 and 2010; ABS, ABS, *Average weekly earnings, Australia*, November 2012, Catalogue 6302.0, Table 11A; NSW Government, *2012-13 Half-Yearly Review*, 20 December 2012, p 26.

⁶⁷ For information about why energy bills vary so much between low-income households in Sydney, see IPART, *Changes in regulated electricity retail prices from 1 July 2012 – Final Report*, June 2012, Appendix E.

8.4.3 How do energy bills as a proportion of disposable income vary in metropolitan NSW?

We also looked at expenditure by dual fuel households on energy as a proportion of disposable income. Using the data on electricity and gas usage from our household surveys data, information about changes in average energy usage since our surveys⁶⁸ and our final decisions on regulated electricity and gas prices, we found that more than 75% of all dual fuel households in the Sydney metropolitan area will spend less than 6% of their disposable income on energy bills in 2013/14. In addition, only 6% of household in this area are likely to spend more than 10% of their disposable income on energy.

As Figure 8.2 shows, median household spending on energy across all income categories will be just less than 4% of disposable income. However, again looking in different income categories, median household spending on energy varies quite widely:

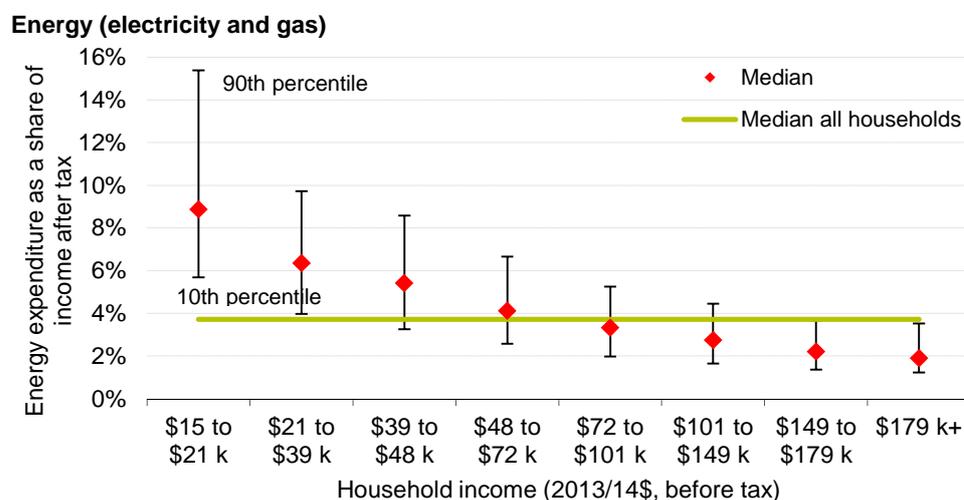
- ▼ In the middle and higher income categories (more than \$48,000 per year), median household spending on energy will range from about 2% to 4% of disposable income.
- ▼ In the 2 low-income categories (\$39,000 or less per year), median spending on energy will range from around 6% to 9% of disposable incomes.

Between households with similar disposable incomes in the lower income categories, there is substantial variation for energy (as there was for gas). For example, in the lowest income category households with median energy use are likely to spend about 9% of their disposable income on energy, while those in the 10th percentile will spend about 6%, and those in the 90th percentile will spend more than 15%. In the second lowest income category, median households will spend about 6% of their disposable income on energy, but those in the 90th percentile will spend almost 10% on energy.⁶⁹

⁶⁸ Information from the NSW electricity network businesses shows that average electricity consumption per household fell by about 9% between 2009/10 and 2011/12.

⁶⁹ For information about why energy bills vary so much between low-income households in Sydney, see IPART, *Changes in regulated electricity retail prices from 1 July 2012 - Final Report*, June 2012, Appendix E.

Figure 8.2 Annual spending on energy as a share of disposable household income — Sydney and surrounding regions, 2013/14



Note: The income for the middle of each band is used to calculate disposable income. Disposable income as a share of household income is derived from ABS household income distribution data for 2009/10. Income for each band is inflated to 2011/12 using the change in average weekly earnings. Income forecasts for 2012/13 and 2013/14 use NSW Treasury's forecast increase in the average wage index of 3.5%. Disposable income in 2012/13 and 2013/14 is further adjusted for the impact of the carbon compensation package. Customer bills have been adjusted to reflect lower average electricity consumption per household. Customer bills are net of the Low Income Household Rebate. Distributions are presented without weighting survey responses.

A **percentile** is the value below which a certain percentage of observations fall. For example, the 10th percentile is the value below which 10% of the observations may be found. In the above diagram, 10% of customers in each income band would fall below the bottom of the vertical line (paying less than that amount) and 10% of customers would pay more than the top of the vertical line.

Sources: IPART Household Surveys, 2008 and 2010; ABS, ABS, *Average weekly earnings, Australia*, November 2012, Catalogue 6302.0, Table 11A; NSW Government, *2012-13 Half-Yearly Review*, 20 December 2012, p 26; Consumption data from Jemana Gas Networks NSW, Ausgrid, Endeavour Energy and Essential Energy; IPART calculations.

8.5 Household types most likely to be having difficulty paying their energy bills

As discussed above, more than 75% of dual fuel households in metropolitan NSW will spend less than 6% of their disposable income on energy bills in 2013/14, and about half will spend less than 4%. This suggests that most households can afford to pay their energy bills without foregoing other essential purchases, and will be able to accommodate the increase in regulated gas prices on 1 July 2013/14 without too much difficulty.

However, our analysis suggests that some households may already experience some difficulty in paying their energy bills and will find it difficult to accommodate any further increases in energy prices. These are households that have:

- ▼ low disposable incomes, and
- ▼ high energy use which is difficult to reduce.

A household's ability to reduce its energy usage in response to higher prices depends largely on what drives its current usage, and the extent to which these drivers are within their control. For example, it may be difficult for a low-income household to reduce its usage if the usage is high for one or more of the following reasons:

- ▼ there are many people in the household⁷⁰
- ▼ the household has few occupants but lives in a 'family sized' detached house
- ▼ the dwelling and appliances are not energy efficient but the household has insufficient income to make improvements
- ▼ the dwelling is rented and the landlord is unwilling to make it more energy efficient (for example, by replacing an old hot water system or an old stove)
- ▼ the household lives in an area with more extreme temperatures.

In addition, some low-income households pay a large part of their disposable income in housing costs.⁷¹ These households are likely to be the most affected by high energy bills. For example, our 2010 household survey found that 24% of low-income households that are paying off mortgages had approached their electricity supplier because they had experienced financial difficulties paying their electricity bills over the past year.⁷² For low-income renters, the corresponding figure was 18%, while for low-income households that had paid off their home it was only 5%.

One indicator of the prevalence of households having difficulty paying their energy bills is the number having their gas and electricity supply disconnected due to non-payment. For gas, the number of NSW residential customers disconnected for non-payment of bills increased by 15% between 2010/11 and 2011/12. As a percentage of total residential gas customers in NSW, the rate of residential disconnections in 2011/12 was 1.8% which is higher than the residential disconnection rate for electricity of 0.8% (discussed below).⁷³

⁷⁰ The number of people in the household (particularly people aged 16 year or older) is one of the main reasons why low-income households use such different amount of energy. (See IPART, *Changes in regulated electricity retail prices from 1 July 2012 – Final Report*, June 2012, Appendix E.6.)

⁷¹ For example, 17% of Sydney households in this income category were renting privately, and 5% were paying off their home in 2010 (IPART 2010, *Residential energy and water use in Sydney, the Blue Mountains and Illawarra: Results from the 2010 household survey – Research Report*, December, Appendix E, Table 1).

⁷² IPART, *Residential energy and water use in Sydney, the Blue Mountains and Illawarra: Results from the 2010 household survey – Research Report*, December 2010, Figure 8.5, p 141.

⁷³ Information on gas disconnections from IPART, *Customers service performance of gas retail suppliers 1 July 2007 – 30 June 2012 – Information Paper*, December 2012, pp 7-8.

For electricity, the number of NSW residential customers disconnected for non-payment of bills increased by 25% between 2010/11 and 2011/12. As a percentage of total residential customers, the rate of disconnections due to non-payment increased from 0.6% to 0.8%.⁷⁴

Another indicator is the growth in demand for Energy Accounts Payment Assistance scheme (EAPA) vouchers in 2011/12 compared to previous years. The Energy Accounts Payment Assistance operates to provide short-term relief to people experiencing financial stress. Community welfare groups have indicated a heightened demand for EAPA vouchers in 2011/12.⁷⁵

⁷⁴ IPART, *Customers service performance of electricity retail suppliers 1 July 2007 – 30 June 2012 – Information Paper*, December 2012, pp 7-8.

⁷⁵ *Ibid*, p 6.



Appendices

A Terms of Reference



Chris Hartcher MP
Minister for Resources and Energy
Special Minister of State and
Minister for the Central Coast

V12/4188

Dr Peter Boxall
Chairman
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB POST OFFICE NSW 1230

Dear Dr Boxall

Pursuant to section 43EA(1) of the *Electricity Supply Act 1995* (the Act), I am referring to the Tribunal for investigation and report, the determination of regulated electricity retail tariffs and charges in New South Wales for the period from 1 July 2013 to 30 June 2016. Please find further details in the attached Terms of Reference to the Tribunal.

I confirm that an amendment regulation will be made to extend the operation of Part 4, Division 5 of the Act to 30 June 2016, under which the Tribunal's determination may be made.

With regard to gas tariffs and charges, I note that the current standard tariffs for gas small retail customers, previously agreed by the Tribunal and the standard gas retailers under Voluntary Transitional Pricing Arrangements (VTPAs) are due to expire on 30 June 2013.

I further request that the Tribunal continue to regulate the standard tariffs for small retail gas customers for the period 1 July 2013 to 30 June 2016, in accordance with section 27 of the *Gas Supply Act 1996* (the Act). I request that the Tribunal ensure that either new VTPAs or gas pricing orders are in place for the period 1 July 2013 to 30 June 2016.

In regulating such prices, the Tribunal should ensure that the objects under section 3 of the Act are taken into consideration, and that stakeholders are consulted as part of the review process. In order to ensure that standard retail gas tariffs reflect the efficient costs of supplying natural gas to small retail customers, I request the Tribunal to consider whether it should undertake a review of these costs, and to undertake such a review if deemed necessary.

I look forward to the Tribunal's final report on both these matters in time for commencement on 1 July 2013.

GPO Box 5341, Sydney NSW 2001
Phone: (61 2) 9228 5289 Fax: (61 2) 9228 3448 Email: office@hartcher.minister.nsw.gov.au

If you require further information on this matter, please contact Jessie Foran, Senior Policy Advisor for Energy, in my office on (02) 9228 5289.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Chris Hartcher'.

Chris Hartcher MP

Encl. 27.9.12

B Overview of Standard Retailers' proposed pricing agreements

All 4 Standard Retailers have proposed to retain the broad regulatory package within their current pricing agreements, including:

- ▼ a weighted average price cap (WAPC) form of price control
- ▼ several additional regulatory mechanisms to address risk and uncertainties.

However, the Standard Retailers have departed from the current agreements by proposing an average price path for the first year of the regulatory period only (2013/14), rather than for all 3 years. Instead, they have outlined an approach for updating prices for 2014/15 and 2015/16 through a 'periodic review'. They have submitted that the uncertainties about wholesale gas costs for the last 2 years of the regulatory period mean that they are not in a position to propose the retail component of prices for these years. However, they have proposed to 'lock in' the other elements of the retail component, including retail operating costs and the retail margin.

Table B.1 summarises the proposal submitted by each Standard Retailers. The proposals themselves are available on our website.

Table B.1 Summary of Standard Retailers' proposals for regulated retail gas tariffs for 2013/14 to 2015/16

	AGL	ActewAGL	Origin Energy (Wagga Wagga)	Origin Energy (Albury/Murray Valley)
Form of price control	Continue using WAPC based on a R+C+N structure	Continue using WAPC based on a R+C+N structure	Continue using WAPC based on a R+C+N structure	Continue using WAPC based on a R+C+N structure
Proposed R component for 2013/14	CPI + 5.1% (revised proposal)	CPI + 1.5%	CPI + 4.9% (revised proposal)	CPI + 5.7% (revised proposal)
R component for 2014/15 and 2015/16	To be advised	To be advised	To be advised	To be advised
R component	To be updated in 2014 and 2015 (revised proposal)	To be updated in 2014 and 2015	To be updated in 2014 and 2015	To be updated in 2014 and 2015
C component	Increase carbon costs in line with movements in the carbon price. Update carbon price for 2015/16 prior to price change	Increase carbon costs in line with movements in the carbon price. Update carbon price for 2015/16 prior to price change	Increase carbon costs in line with movements in the carbon price. Update carbon price for 2015/16 prior to price change	Increase carbon costs in line with movements in the carbon price. Update carbon price for 2015/16 prior to price change
N component	Automatically pass through of regulated distribution network costs	Automatically pass through of regulated distribution network costs	Automatically pass through of regulated distribution network costs	Automatically pass through of regulated distribution network costs
Unforeseen cost changes	Address through special circumstances clause			
Tariff restructuring	-	Reduce number of regulated tariffs available in each region	-	-
Miscellaneous charges	Introduce a merchant service fee of 0.6% for credit and debit transactions, and increase other fees by no more than CPI	Increase by no more than CPI in each year of the regulatory period	Align with charges that apply in the Albury/Murray Valley regions	Increase in 2013/14 by no more than CPI

C Assessment of competition in the retail market

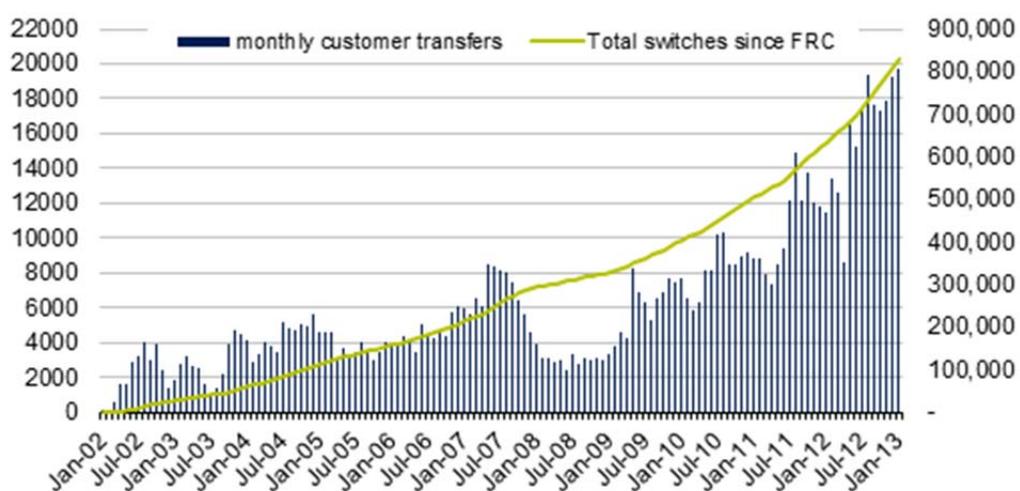
As Chapter 2 outlined, since we undertook our last review of regulated prices in 2009, the competitiveness of the retail gas market in NSW has increased. In undertaking the analysis for this report, we formed a view that competition in the market is now effective enough to provide sufficient protection to customers, as more choices and better price and service outcomes.

This appendix provides some further detail on our analysis. It also summarises some findings from recent surveys commissioned by the Australian Energy Market Commission (AEMC), as part of its ongoing review of competition in retail energy markets in NSW.

C.1 Small customers are increasingly participating in the competitive market

One indicator of the extent to which customers are participating in the competitive market is the rate at which they are switching between retailers. The latest data from the Australian Energy Market Operator (AEMO) shows that gas customers are switching retailers at historically high rates (Figure C.1).

Figure C.1 Customer transfers in NSW and ACT



Data source: AEMO.

The increased switching activity is largely the result of customers responding to market offers. Retailers are currently offering significant discounts off regulated prices for both electricity and gas. Our *myenergyoffers*⁷⁶ website shows that discounts of around 3% to 10% off regulated gas prices are available, with the higher discounts typically relating to dual fuel customers. Because gas is a bundled product with electricity, it is likely that some of the activity in the gas market has been driven by customers seeking to reduce both their electricity and gas bills.

Access to price discounts has also encouraged more customers to move off regulated prices to take up market offers. During our last review in 2009, more than half of small gas customers in NSW were on regulated prices.⁷⁷ This proportion had now dropped to around 28%,⁷⁸ although this trend is not uniform across supply areas.

C.2 AEMC findings on competition in the retail gas market in NSW

As part of its review of retail competition in NSW, the AEMC engaged Roy Morgan Research to conduct a survey of residential customers of electricity and gas in NSW.⁷⁹ Some of the findings from the survey include:

- ▼ 86% of residential customers were aware that they could choose their gas supplier.
- ▼ Around 1 in 3 gas customers had been approached by a retailer with an offer to buy gas (and 1 in 5 had approached their gas retailer to enquire about gas pricing information).
- ▼ Around 1 in 3 gas customers had switched energy companies since 2002, with the most common reason for switching relating to financial benefits/cost savings.
- ▼ For those gas customers who had not switched retailers, the most common reasons were 'satisfaction with current retailer' and 'too much effort'.
- ▼ Around 85% of gas customers who had switched retailers found the process easy.
- ▼ 65% of customers who had switched retailers were satisfied with their new retailer (another 29% are neither satisfied nor dissatisfied).

⁷⁶ www.myenergyoffers.nsw.gov.au; accessed April 2013.

⁷⁷ IPART, *Review of regulated retail tariffs and charges for gas 2010-2013 – Final Report*, June 2010, p 21.

⁷⁸ Based on information provided by the Standard Retailers as at 30 June 2012 and April 2013.

⁷⁹ Roy Morgan Research, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, February 2013.

Overall, these survey results indicate an active retail market in NSW for electricity and gas. The results suggest there is relatively more activity in electricity compared to gas. This might be because gas is generally the secondary fuel source, and customers may be focussing more on electricity as this is the largest component of energy bills.

In general, there is a strong awareness of options available in the competitive market. Many gas customers have exercised choice through changing their energy arrangements. The process of switching retailers is relatively easy and most customers have been satisfied with the outcomes of this switching.

One area where the market could be improved is the provision of information. When asked whether they agreed that the information provided by an energy retailer seeking their business was sufficient to make a choice, around 35% of gas customers who had been approached said they disagreed either somewhat or strongly.⁸⁰ The responses from electricity customers were similar. This suggests that retailers could act to improve the quality and suitability of market information, to encourage and facilitate further reduction in customer reliance on regulated prices.

⁸⁰ Roy Morgan Research, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, February 2013, p 16.

D Wholesale gas costs

Wholesale gas costs include the costs of purchasing the underlying gas commodity from producers, securing additional deliverability to meet peak demand requirements, transporting it long distances via transmission pipelines and paying market-related costs.

D.1 Overview of range of wholesale gas costs

As discussed in Chapter 2, the 2013 to 2016 regulatory period is characterised by an unprecedented level of uncertainty in domestic gas markets. This uncertainty relates to the supply and demand dynamics in the Eastern Australian gas markets in the medium term.

In the longer term, we expect gas prices to rise towards international levels, increasing the costs of supplying gas to retail customers. However, this process of price transition is unlikely to be smooth with the changing market dynamics having the potential to lead to increasing levels of price uncertainty in the gas market in the medium term.

These uncertainties may result in different views about current and future gas prices in NSW, particularly from 2014/15, as well as different views on the costs of supplying gas to retail customers.

Standard Retailers have typically had access to low and stable domestic gas prices under long term (legacy) contracts that were signed prior to these supply and demand uncertainties. The benchmark costs that were established as part of IPART's 2010 review reflected the relatively low gas prices that were available to retailers in supplying gas to small retail customers.

Estimates of gas prices under new long term contracts reflect the increasing influence of the international market on Australia's domestic gas markets. This market - particularly the international demand for gas - is changing the incentives faced by domestic producers and consumers of gas. We engaged ACIL Tasman (ACIL) as part of the 2013 review to forecast a range of benchmark wholesale costs faced by a prudent and efficient retailer over the regulatory period. ACIL's estimates reflect the increasing prices that are likely available to retailers under new long term contracts in supplying gas to customers. However,

the wide range in the forecasts indicates the considerable price uncertainty in the gas market in the medium term.

We have agreed to the Standard Retailers' proposal to manage this uncertainty through periodic reviews of wholesale gas costs. To assess the Standard Retailers' proposed increase in the R component of its regulated gas prices we considered the range of likely wholesale gas costs for 2013/14. To understand the likely range of wholesale gas costs in supplying gas to customers we have considered both the:

- ▼ Estimates provided by MMA as part of our 2010 review and indexed these in line with broader price movements in the economy.
- ▼ Estimates provided by ACIL as part of this 2013 review.

In our view, this presents us with a range of costs that captures the uncertainty in relation to estimates of wholesale gas costs for 2013/14, including the uncertainty associated with estimates of gas prices available to retailers under both existing and new short term and long term contracts in supplying gas to customers.

This range is set out in Table D.1.

Table D.1 Range of wholesale gas costs for 2013/14 (\$2012/13/GJ)

	AGL	ActewAGL	Origin (Country Energy)	Origin (Albury/Murray)
MMA estimates	7.85	7.68	6.67	7.36
ACIL estimates	8.60	8.75	9.00	7.86
Range	7.85-8.60	7.68-8.75	6.67-9.00	7.36-7.86

Note: ACIL figures were deflated from \$2013/14 using inflation of 2.8% and MMA figures were converted from \$2009/10 to \$2012/13 using inflation of 8.1%.

Source: ACIL Tasman, Cost of gas for the 2013 to 2016 regulatory period, Final report, June 2013, McLennan Magasanik Associates (MMA), Gas Retail Price Review – Wholesale Gas Costs, Final Report to Independent Pricing and Regulatory Tribunal, May 2010.

We did not make a decision on the wholesale gas cost components underlying the retailers' proposals. Indeed, some of them did not provide this level of detail, and only proposed the total change in the R component. Of those that did provide estimates of wholesale costs, they were within the range outlined above.

We engaged Frontier Economics (Frontier) to estimate the marginal cost of supplying gas to gas-fired power stations in Australia as part of our electricity review. We note that these consultants have different views on future gas prices, particularly from 2014/15, partly driven by different views on how gas supplies committed to LNG developments should be treated in the modelling of gas prices and the extent to which there are separate 'domestic' and 'export'

markets.⁸¹ We also note that Frontier's estimates of the marginal cost of supplying gas to a gas-fired power station are not directly comparable to the ACIL analysis.

Submissions on our electricity draft report provided comment on ACIL's and Frontier's gas price forecasts, particularly in relation to the modelling methodologies.⁸² We will be reviewing wholesale gas costs as part of the gas and electricity periodic reviews in 2014 and 2015. As part of these reviews we will consider the key modelling assumptions, including the treatment of gas supplies committed to LNG developments.

D.2 Our assessment of the range of wholesale gas costs

Wholesale gas costs include the costs of purchasing the underlying gas commodity from producers, securing additional deliverability to meet peak demand requirements, transporting it long distances via transmission pipelines and paying market-related costs.

D.2.1 Gas commodity costs

The largest element of wholesale gas costs are the gas commodity costs, which reflects the costs of purchasing the underlying commodity from upstream gas producers. Gas retailers typically purchase gas under long term contracts with gas producers.

The largest element of uncertainty in relation to wholesale gas costs are the gas commodity costs and the prices that retailers incur in procuring gas for their customers.

Uncertainty in gas commodity costs over the regulatory period

The prices that retailers pay for gas under these contracts will reflect a range of factors including the supply and demand dynamics in the domestic market as well as contract specific factors that determine how prices are to be adjusted through time.

⁸¹ ACIL considers that current gas supplies that are committed to the LNG developments should not be included in the gas supply curve. It has determined the marginal price of gas after removing the committed reserves from the supply curve. See, ACIL Tasman, *Cost of gas for the 2013 to 2016 regulatory period*, Final report, June 2013. In contrast, Frontier Economics considers that this approach is akin to modelling separate gas markets in eastern Australia: a domestic gas market and an export gas market. Frontier's approach is to determine the marginal price of gas considering supply and demand from both 'domestic' and 'export' markets (ie, treating it as a single market).

⁸² See IPART, *Review of regulated retail prices for electricity, 2013 to 2016 - Final Report*, June 2013.

MMA's assessment of gas commodity costs as part of the 2010 review was undertaken in an environment of low and stable domestic gas prices. These prices typically reflected the cost of gas extraction and production from conventional gas fields across Eastern Australia. This is because gas producers typically did not have a profitable alternative than selling to domestic gas customers such as gas retailers, power stations and industrial customers. These dynamics have been reflected in low gas prices on the Short Term Trading Market, which in Sydney has averaged around \$4.50/GJ since its commencement in September 2010.⁸³

These low and stable domestic gas prices have typically provided for relatively small increases in retail gas prices. The pricing agreements that we have had with the Standard Retailers for over a decade have typically resulted in the retail component of regulated prices moving in line with CPI.⁸⁴

The Eastern Australian wholesale gas market is undergoing unprecedented change. Currently there is significant investment in liquefied natural gas (LNG) facilities on the eastern coast of Australia. These facilities convert natural gas into liquid form, making it easier to store and transport over long distances. Increasingly, Australia's domestic gas markets will be influenced by the international market. This market – particularly the international demand for gas – is changing the incentives faced by domestic producers and consumers of gas.

Higher international prices for gas have altered the expectations of some domestic gas producers. Domestic gas producers may increasingly view the international market as an alternative customer base to traditional domestic customers that provides them with the opportunity to secure higher prices. This has been reflected in the prices negotiated between domestic gas producers and customers under new long term contracts.

However, the ability of gas producers to secure higher prices is likely to depend on a range of factors including international gas prices, LNG export capacity and the behaviour of other domestic gas producers. All of these factors are highly uncertain at this stage.

On the demand side there is uncertainty in relation to the level of international and domestic demand for gas. For example, industry experts disagree about the timing and number of LNG trains likely to be operating in Queensland by 2020 that will allow gas to be exported to the international market. There is also uncertainty in relation to levels of domestic demand with the carbon pricing mechanism and the RET both creating incentives for investment in lower carbon emission electricity generation, which influences the demand for wholesale gas and gas transmission services.

⁸³ <http://www.aemo.com.au/Gas/Market-Data/Short-Term-Trading-Market-Data>

⁸⁴ In February 2008, AGL applied to increase the R component of regulated retail prices above CPI following 'special circumstances' in 2008. See [here](#).

On the supply side, there is uncertainty about the impact of the development of the coal seam gas industry. The expectations of higher international prices for gas may in turn provide incentives for further development of gas supplies, particularly from non-conventional sources such as new CSG developments. These additional sources of supply could act as a significant competitive restraint on the behaviour of other gas producers. However, the timing, availability and cost of gas supplied by CSG developments across Eastern Australian remain unclear, as is the extent to which it will assist in meeting the additional international demand for gas. Industry experts also disagree about the extent to which CSG developments committed to the LNG trains will impact the domestic gas prices and the extent to which modelling of domestic gas prices should account for these CSG developments.

In the longer term, we expect gas prices to rise towards international levels, increasing the costs of supplying gas to retail customers. However, this process of price transition is unlikely to be smooth with the changing market dynamics having the potential to lead to increasing levels of price uncertainty in the gas market in the medium term.

We engaged ACIL to help us understand the level of uncertainty in relation to gas commodity costs, and the potential range of gas costs that retailers would incur in procuring gas for their customers over the regulatory period.

To understand this uncertainty ACIL modelled 3 scenarios that reflected different 'states of the world' and involved differing assumptions in relation to:

1. future LNG prices
2. the timing and number of LNG facilities to be built in Queensland in the near future
3. the timing, availability and costs of CSG produced in Queensland.

The scenarios resulted in materially different gas prices.

Under ACIL's **low price scenario** domestic gas prices are based on the long run marginal costs of supply. This scenario assumes that gas producers are unable to access higher international prices and there is competition among domestic producers such that prices tend to reflect the cost of gas supply.

Under ACIL's **medium price scenario** domestic gas prices are driven by international LNG prices. This scenario assumes that additional export capacity provides domestic gas producers with an additional source of demand, allowing them to secure high international LNG prices from either these international customers or domestic customers.

Under ACIL's **high price scenario** domestic gas prices are driven by international LNG prices and short term production constraints.

While there are a range of modelling assumptions that underpin these gas price forecast, one of the more significant assumptions relates to how gas supplies committed to LNG developments should be treated. ACIL has assumed that gas supplies committed to the LNG developments are not part of the gas supply curve.⁸⁵

The significant variation in gas prices under these scenarios is shown in Table D.2 below.

Table D.2 ACIL's final estimates of gas commodity costs at Longford and Cooper Basin over the regulatory period (\$/GJ, \$2013/14)

	low price scenario	medium price scenario	high price scenario
Cooper Basin	5.57-6.35	9.99-10.16	13.99-14.28
Longford	4.68-4.85	7.90-8.02	11.48-11.94

Source: ACIL Tasman, *Cost of gas for the 2013 to 2016 regulatory period*, Final Report, June 2013.

There is significant uncertainty in relation to the medium-term supply and demand dynamics in the Australian market. Therefore, there are increasing levels of price uncertainty in the gas market in the medium term.

ACIL's final advice is that in the short term (ie, for 2013/14) gas prices are more likely to reflect the marginal cost of supply suggesting that prices may not be significantly different from historic levels. However, the marginal cost of new sources of gas supply may be higher than in the past, partly driven by ACIL's assumption to remove gas supplies committed to LNG developments from the supply curve. This is highlighted in ACIL's advice.

ACIL's final advice is that in the medium term prices are more likely to reflect the international price, suggesting that gas prices will be significantly above historic levels.

We have agreed to include additional flexibility in the pricing agreements through periodic reviews of regulated retail prices. We consider this to be an efficient way of managing the risk and uncertainty in relation to forecasting gas costs. Therefore, we have not formed a view on the potential change in gas commodity costs over the period. As part of the 2014 review Standard Retailers will have the opportunity to provide updated information on gas commodity costs. In assessing Standard Retailers' proposals we will consider the information available on the supply and demand dynamics in the market and other industry reports we consider appropriate. We may also engage expert advice, and consider the appropriateness of any gas modelling assumptions.

⁸⁵ See, ACIL Tasman, *Cost of gas for the 2013 to 2016 regulatory period*, Final report, June 2013. This is consistent with the view submitted by EnergyAustralia in response to IPART's draft electricity report. See EnergyAustralia submission, May 2013, p 39.

Uncertainty in gas commodity costs for 2013/14

To assess the Standard Retailers' proposed increase in the R component for 2013/14 we need to consider the range of likely wholesale gas costs for 2013/14.

There is still a level of uncertainty in relation to gas commodity costs for 2013/14. This is because Standard Retailers' proposals may reflect gas commodity costs under long term legacy contracts that may diverge from costs incurred under new contracts.

To understand the likely range of wholesale gas costs in supplying gas to customers we have considered both the:

- ▼ Estimates provided by MMA as part of the 2010 review and indexed these in line with broader price movements in the economy.
- ▼ Estimates provided by ACIL under their low price scenario.⁸⁶

In our view, this presents us with a range of costs that captures the uncertainty in relation to estimates of wholesale gas costs for 2013/14, including the uncertainty associated with estimates of gas prices available to retailers under both existing and new short term and long term contracts in supplying gas to customers.

Table D.3 Range of wholesale gas costs for 2013/14 (\$2012/13/GJ)

	AGL	ActewAGL	Origin (Wagga Wagga)	Origin (Albury/Murray)
MMA estimates	7.85	7.68	6.67	7.36
ACIL estimates	8.60	8.75	9.00	7.86
Range	7.85-8.60	7.68-8.75	6.67-9.00	7.36-7.86

Note: ACIL figures were deflated from \$2013/14 using inflation of 2.8% and MMA figures were converted from \$2009/10 to \$2012/13 using inflation of 8.1%.

Source: ACIL Tasman, Cost of gas for the 2013 to 2016 regulatory period, Final report, June 2013, McLennan Magasanik Associates (MMA), *Gas Retail Price Review – Wholesale Gas Costs, Final Report to Independent Pricing and Regulatory Tribunal*, May 2010.

We did not assess and make a decision on the wholesale gas cost components underlying the retailers' proposals. Indeed, some of them did not provide this level of detail, and only proposed the total change in the R component. Of those that did provide estimates of wholesale costs, they were within the range outlined above.

⁸⁶ To estimate the gas commodity costs in each supply area ACIL made assumptions about the sources of supply. It projected the gas commodity at the production node most likely to supply each supply area. For AGL ACIL assumed that an equal share of gas is sourced from Longford and Moomba.

D.2.2 Additional deliverability costs

Additional deliverability, above that provided for in base gas contracts, is required to service peak demand. Additional deliverability can be provided in a number of ways⁸⁷ and will typically involve a combination of approaches with the cheapest source being used first.

Retailers have proposed to retain the same broad assumptions used to calculate the costs of meeting additional peak demand as part of the 2010 review of gas prices.

ACIL has assessed whether the methodology and assumptions used to establish the benchmark gas costs for the 2010 review are still appropriate for the next regulatory period. They concluded that the key elements of the methodology employed in the 2010 review remain appropriate for the 2013 to 2016 period.

D.2.3 Transmission costs

The transmission of gas through large pipelines (haulage) attracts tariffs based largely on capacity reservation payments (\$/GJ MDQ), which generally vary inversely with load factors. That is, a higher customer load factor (less peaky) leads to lower transmission costs per GJ transported, with very little costs relying on actual throughput.⁸⁸

ACIL compared the transmission costs proposed by each Standard Retailer to those it estimated using published transmission tariffs and the customer load factors underlying the retailer's proposals. ACIL considers that the proposed transmission costs are consistent with their calculations.

⁸⁷ Through the portfolio of base gas supply contracts, additional contracted gas supply (eg, a contract for additional "winter" MDQ), linepack, 'park and loan' services within pipelines (where available), underground storage, LNG storage, spot markets (where available) and customer interruptions.

⁸⁸ Additional cost relating to throughput may include for system use gas (for use in compressors or lost during transmission) and odourisation.

E Analysis of retail operating costs

As Chapter 5 indicated, retail operating costs are the costs an efficient retailer would incur in performing the retail functions required to serve its small customer base. These include customer service (eg, operating call centres, billing and collecting revenue), finance, IT systems and regulation (eg, paying licence fees), marketing, and an appropriate allocation of corporate overheads.

E.1 Overview of range of retail costs

After considering both the benchmarking and bottom-up analysis outlined below, IPART found that the reasonable range for retail operating costs is between \$91 per customer and \$110 per customer. This does not include costs associated with acquiring and retaining customers. In our view, competition for gas customers tends to focus on dual fuel customers, meaning that some of the costs associated with customer acquisition and retention costs are shared across electricity and gas customers. As Chapter 3 discussed, we have not assessed and made decisions on the individual forecast cost components of the retailers' proposals. Our approach for this review includes making an assessment of the Standard Retailers' overall proposals, and to decide whether they are reasonable and balance the longer and shorter term objectives for this price review.

E.2 Our assessment of the range of retail costs

We assessed the forecast retail operating costs (ROC) proposed by each of the Standard Retailers over the 2013 regulatory period using a combination of bottom-up and benchmarking analysis.⁸⁹ Our bottom-up cost analysis assessed each retailer's forecast ROC per customer based on data supplied by the electricity and gas Standard Retailers. As part of this analysis, we subjected these data to reasonableness tests. Our benchmarking analysis considered whether the analysis and benchmarks we have used for our 2013 review of regulated electricity prices are a valid reference point.

⁸⁹ Data provided by ActewAGL and Origin Energy are reported on a dollars per customer basis from 2013/14 to 2015/16. Data provided by AGL are reported on a dollars per gigajoule basis from 2013/14 to 2014/15 only.

E.2.1 Findings of benchmarking analysis

Information provided by the Standard Retailers suggests that their estimated ROC is in the range of \$91 to \$106 per gas customer, with a mid-point of \$99 per customer in 2013/14. This midpoint remains relatively constant over the 2013 regulatory period.

We examined the cost categories, where provided, included in these ROC forecasts and observed consistency between the Standard Retailers. We excluded costs associated with depreciations and customer acquisition costs to ensure consistency between retailers and made adjustments to account for the differences in bad debts between gas and electricity customers.

We found that the forecast ROC for 2013/14 is higher than their forecasts for the 2010 regulatory period (Table F.1). The mid-point of their forecasts is higher by \$11 per customer. We note this is less than the increase in forecast electricity ROC based on the information provided by Standard Retailers (an average increase of \$29 per customer from 2009 to 2016). The estimates of costs provided by retailers have also converged, with the range being narrower than that from information provided in 2010.

Table E.1 IPART's estimates of actual and forecast ROC per customer – all Standard Retailers (\$2012/13, \$/customer)

	Forecast costs 2010/11 to 2012/13 \$/customer	Forecast costs 2013/14 to 2014/15 \$/customer
Mid-point	88	99
Minimum	71	91
Maximum	105	106

Data source: Data provided by Standard Retailers and IPART.

E.2.2 Findings of benchmarking analysis

In our electricity final determination, we set the level of ROC at \$110 per customer. This allowance excludes advertising costs. If these are also excluded for gas retailers then the gas forecast ROC fall to a mid-point of \$93 per customer, with a range of \$84 to \$103 per customer. Hence, gas retail operating costs are in the order of \$17 per customer lower than our final decision for electricity retail operating costs. This is consistent with the information submitted by gas Standard Retailers.

Standard Retailers have indicated that the most significant difference between electricity and gas retail costs is costs associated with bad debts. Because electricity bills are higher than gas bills, bad debt costs are around twice as high for electricity compared to gas.

Table E.2 Gas and electricity comparison (2012/13 dollars, \$/customer)

Item	Range	Midpoint
	\$/customer	\$/customer
Electricity final decision	106-112	110
Electricity adjusted for lower gas bad debts		99
Gas equivalent	84-103	93

Data source: Data provided by Standard Retailers and IPART.

E.2.3 Drivers of cost gas and electricity ROC changes

Submissions by gas retailers focused on rising customer acquisition and retention costs driven by higher levels of customer switching.⁹⁰ EnergyAustralia submitted that many of the trends observed in electricity ROC will also occur for gas:

That is, the introduction of National Energy Customer Framework (NECF), the increasing digitalisation of energy sales and services will also increase gas ROC during the next regulatory period. In addition, we are working with AEMO and the gas industry on B2B (business to business) gas hub in the NSW and ACT retail gas markets to improve the automation of distributor-retailer management of customer transfers and service orders. We expect this to lead to improvements to customer service and competition; however, it does add costs through participating in forums and in making changes to systems, processes and staff training.⁹¹

Electricity Standard Retailers suggested that increased ROC since the 2010 determination are being driven by additional bad debts derived from increases in network and carbon costs and declining economic conditions; increases in the number of connections with solar panels; and the *Clean Energy Act 2011*. This will also have some relevance for bad debts associated with gas retail, although bad debt costs are lower for gas.

As noted above, we have not made an explicit allowance for the costs associated with customer acquisition and retention.

In its response to our draft report, AGL submitted that IPART's assessment of a range for retail operating costs underestimates the costs of acquiring and retaining customers, and supported the approach to CARC taken in our electricity review that has regard to indirect costs in terms of ongoing market discounts.⁹²

⁹⁰ ActewAGL submission to Issues Paper, January 2013.

⁹¹ EnergyAustralia submission to Issues Paper, January 2013.

⁹² AGL submission, May 2013, p 2.

In contrast to our approach for the 2013 electricity review, we have not set cost allowances for gas retailers based on the short term efficient costs of supply, and then set a CARC allowance that reflected our view of the additional incentive required to promote competition in the retail market. Instead, our approach for this review included making an assessment of the Standard Retailers' overall proposals, and exercising our own judgement to decide whether they were reasonable and balanced the longer and shorter term objectives for this price review. We also consider this to be more consistent with the light handed intent of VPAs.

F Analysis on retail margin

The Standard Retailers face a range of risks. Some of these are systematic risks associated with supplying gas to small customers on regulated tariffs. These systematic risks stem from things such as variations in demand and economic conditions. Given these risks, it is reasonable for the Standard Retailers to earn a retail margin.

To assist us with determining whether Standard Retailers' overall pricing proposals are reasonable we asked SFG to assess and advise us on the range for the retail margin. This appendix provides an overview of our finding and SFG's advice. SFG's final report is available on our website.⁹³

F.1 Overview of our finding on the range for the retail margin

After considering SFG's advice and stakeholder submissions, we made a finding that a range for an appropriate retail margin for a gas Standard Retailer is in the range 6.3% to 7.3% of EBITDA.

F.2 SFG's assessment of the range for the retail margin

SFG estimated the range for the retail margin using 3 approaches:

- ▼ the expected returns approach
- ▼ the benchmarking approach, and
- ▼ the bottom-up approach.

It then recommended the range for the retail margin is from 6.3% to 7.3% of EBITDA. This range reflects the results of all 3 of the approaches it used, and places equal weight on each result.

SFG's recommended range is lower than the range it recommended for the 2010 gas price review (7.3% to 8.3% of EBITDA). Its final report indicates that primary reason for this change is the substantial increase in the gas Standard Retailers' cost estimates compared to 2010. An increase in costs implies that in percentage terms the estimated margin will decrease.

⁹³ SFG, *Estimation of a competitive profit margin for gas retailers in New South Wales*, Final Report, June 2013.

However, SFG's recommended range is higher than the range it recommended for the electricity Standard Retailers as part of our 2013 electricity price review. SFG's draft report attributes this primarily to the proportion of fixed costs of a gas retailer compared to an electricity retailer. Based on information provided by the Standard Retailers, SFG assumed that for electricity retailers, 20% of costs was unrelated to volume, whereas for gas retailers, 30% was unrelated to volume. This captures how much variation in earnings is expected to be observed with fluctuations in volume. SFG indicates that gas businesses would have greater percentage variation in earnings for the same percentage variation in volume.

The following sections summarise SFG's estimates for the retail margin using each of the 3 approaches. All are based on EBITDA.

F.2.1 Expected returns approach

The expected returns approach is based on the principle that businesses should be compensated for the systematic risk to which they are exposed. This approach estimates the expected cashflows that a retailer will earn and the systematic risk associated with these cashflows, and determines a retail margin that will compensate investors for this systematic risk.

AGL disagreed with the assumption used to calculate the retail margin that energy costs are largely related to volume. It submitted that this does not acknowledge the existence of take-or-pay obligations.⁹⁴

SFG's assumption that gas commodity and transmission costs are primarily variable is based on information provided by the Standard Retailers for the 2010 review. As we have not received any additional evidence to the contrary, our view is that the nature of the charges under Standard Retailer's existing long term contracts is unlikely to have changed.

SFG's estimated for the retail margin using the expected returns approach was 4.7% to 6.0⁹⁵%.

⁹⁴ AGL submission, May 2013, p 2.

⁹⁵ SFG, *Estimation of a competitive profit margin for gas retailers in New South Wales*, Final Report, June 2013.

F.2.2 Benchmarking approach

The benchmarking approach develops a range for the retail margin based on the retail margins earned by comparable retail businesses listed on the stock exchange. For this analysis, SFG used the same approach and data set as it used in advising us on the appropriate retail margin for electricity Standard Retailers for our recent draft determination on regulated electricity prices. SFG's estimated range for the retail margin using the benchmarking approach was 6.2% to 6.4%.

F.2.3 Bottom-up approach

The bottom-up approach estimates the return that a retail business requires for each of the individual risks that it faces in providing the retail service, and combines these individual components of the margin to determine a total retail margin. For this calculation, it is important that a consistent approach is used to consider the risks in each of the cost categories (wholesale gas costs, retail operating costs and retail margin).

SFG's estimate of the retail margin using this approach was 8.1% to 9.6%.