

REVIEW OF RETAIL GAS PRICES IN NSW 1 JULY 2007 TO 30 JUNE 2010

DRAFT VOLUNTARY TRANSITIONAL PRICING ARRANGEMENTS: EXPLANATORY NOTE

1 INTRODUCTION

This note explains the background to the review of retail gas prices currently being undertaken by the Independent Pricing and Regulatory Tribunal (the Tribunal). It summarises the draft voluntary transitional pricing arrangements (VTPAs) that are proposed for the period 1 July 2007 to 30 June 2010 for each standard supplier of gas in NSW, and discusses the main reasons underlying the Tribunal's proposed approach.

The Tribunal has invited public submissions on the draft VTPAs by 4 May 2007.

2 BACKGROUND

2.1 The Gas Sector in NSW

Competition in the retail gas sector was introduced in stages from 1999 to 2002, and all customers are now able to choose their supplier. The Tribunal continues to regulate "default" retail prices for small gas customers (those consuming less than 1 terajoule per year, or around \$15,000 worth), where they have not chosen to enter into a negotiated customer supply contract. Each region of NSW has a nominated standard retail gas supplier – AGL Retail Energy, Country Energy, Origin Energy, ActewAGL or Sun Gas.

Under Section 27 of the *Gas Supply Act 1996*, the Tribunal has the option of establishing a gas pricing order that regulates tariffs, fees and other charges for small retail customers. Instead, the Tribunal has established VTPAs with each standard supplier (excluding Sun Gas¹). The current VTPAs have applied since July 2004 and expire on 30 June 2007.

The current VTPAs allow suppliers to increase default tariffs on average by up to the change in the consumer price index (CPI) each year (CPI+5% for the Murray Valley district). The VTPAs also specify that no residential customer's bill may increase by more than the change in CPI+5% or by \$15 (ex GST), whichever is greater. This limit applies for the same pattern and volume of gas usage and excludes non-tariff charges.

2.2 The Review of Retail Gas Prices

The Minister for Energy wrote to the Tribunal on 30 June 2006² requesting that the Tribunal:

¹ Sun Gas is a Queensland supplier which also supplies a small number of customers located in the Tweed area of NSW. To date Sun Gas' small customers have been charged the retail prices regulated by the Queensland Government. With the removal of gas retail price regulation in Queensland these customers will have access to the competitive retail market in Queensland. The NSW Minister for Energy has requested the Tribunal to monitor the prices offered by Queensland suppliers to NSW customers and, if there is evidence they are being significantly disadvantaged, to consider the implementation of a gas pricing mechanism.

²<http://www.ipart.nsw.gov.au/files/Letter%20from%20the%20Minister%20-%20Investigation%20and%20report%20on%20Regulated%20Retail%20Tariffs%20and%20Charges%20-%201%20July%202007%20to%2030%20June%202010.%20website.PDF>

1. continue regulating default tariffs for small retail gas customers, and
2. ensure either new voluntary pricing principles or a gas pricing order operate from 1 July 2007 to 30 June 2010.

The Tribunal must report to the Minister by 14 June 2007.

The Minister has requested that the Tribunal take into consideration the objectives under Section 3 of the *Gas Supply Act 1996*. These are:

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; and
3. to promote the safe use of gas.

The Tribunal has invited public submissions on two occasions during the review:

1. in September 2006 the Tribunal invited submissions on the form of regulation to apply to standard suppliers; and
2. the Tribunal has invited submissions on the draft VTPAs by 4 May 2007.

3 SUMMARY OF THE DRAFT VTPAS

The draft VTPAs for 2007 to 2010 for each standard supplier are available on the Tribunal's website³. The main characteristics of the draft VTPAs are as follows:

- The form of price control proposed is a weighted average price cap (WAPC), which has already been implemented under the existing VTPAs. The WAPC limits the increase in average default prices, weighted by consumption (for variable charges) and by customer numbers (for fixed charges).
- The proposed limit on the maximum change in average default prices is the change in the consumer price index (CPI) in each year, for all areas except the Murray Valley district supplied by Origin Energy. In the Murray Valley district the proposed limit on the change in average prices is CPI+2% per annum.
- The suppliers can apply to the Tribunal for an increase in average default prices that exceeds the maximum defined in the draft VTPAs under special circumstances.

The main changes proposed compared to the existing VTPAs are as follows:

- the draft VTPAs do not contain any constraint on the change in individual customer bills. As noted above, the current VTPAs constrain the maximum change in an individual customer's bill in each year.
- the maximum change in weighted average prices proposed for the Murray Valley area of Origin Energy is CPI+2% per annum, compared to CPI+5% in the current VTPA.

³http://www.ipart.nsw.gov.au/investigation_content.asp?industry=1§or=1&inquiry=113&doctype=25&doccategory=1&docgroup=1

The reasons for these proposed changes are discussed in more detail in section 4 below.

A number of more minor changes are also proposed:

- the notice period for the businesses to inform the Tribunal of special circumstances can be varied with the agreement of the Tribunal and the supplier. This provides flexibility where the change in circumstances is relatively straightforward (and so can be assessed in less than 4 months), or where it requires more complex analysis (entailing a longer lead time before prices changes are approved). The examples of special circumstances noted in the draft VTPAs have been expanded to include regulatory changes and taxation changes, recognising that these events could significantly affect the underlying costs of retail gas supply.
- A new clause has been included which requires the standard suppliers to publish changes to regulated prices within 5 calendar days of the Tribunal approving those prices. The prompt publication of prices assists transparency for both customers and competing retailers, and enhances the development of the competitive market.
- The calculation of the CPI has been varied slightly to ensure consistency with the calculation used for NSW gas networks and the NSW retail electricity sector.

4 REASONS FOR THE TRIBUNAL'S APPROACH

This section discusses the Tribunal's reasons for supporting the draft VTPAs in the form proposed.

4.1 Form of Regulation – VTPAs

The continued regulation of default prices for small customers has been seen as a stepping stone towards a removal of formal price regulation once the competitive market has matured. The VTPAs are voluntary agreements between the Tribunal and each standard supplier, and as such are a relatively light handed form of regulation. Nonetheless, the ability to establish a gas pricing order under the *Gas Supply Act 1996* acts as a fall-back option if it is not possible to agree a satisfactory voluntary arrangement.

The use of VTPAs as the form of regulation for retail gas prices received broad support from the suppliers and from those who made submissions to the Tribunal in October 2006. The Tribunal considers that the VTPAs have been an effective form of regulation for the retail gas sector to date, and can see no basis to move away from this form of regulation at this time.

4.2 Price Control – WAPC with a CPI limit

The WAPC limits *average* price increases, protecting customer interests by limiting the increase in revenue from regulated customers (for a given consumption pattern). It also gives the suppliers scope to restructure tariffs, as long as the average price constraint is met. This allows suppliers to more closely align tariffs with costs, or to simplify tariffs over time. To date the WAPC on retail gas prices has been an effective regulatory approach, and the Tribunal sees no reason to move away from this form of price control.

The Tribunal considers that the proposed limit on the increase in average prices of CPI (for all areas except the Murray Valley district) - which is consistent with the current VTPAs - is appropriate. Previous analysis by the Tribunal has concluded that gas retail tariffs are

broadly cost reflective. The CPI takes into account changes in costs and productivity improvements in the economy more broadly. The Tribunal considered an alternative approach, which would involve a detailed assessment of the underlying costs of the retail gas sector in NSW. However, the regulatory costs of this approach would be significant, and in the Tribunal's view are likely to outweigh any potential benefits.

The draft VTPAs represent a progression towards the removal of price regulation, while maintaining a safety net provision for both customers (by continuing existing price constraints) and suppliers (who can trigger a review if costs change significantly). If costs fall significantly there will be an incentive for competitive retailers to offer price reductions to customers. In this way the draft VTPAs meet the objects of the Act both in promoting competition and protecting the interests of consumers.

In relation to the Murray Valley area, the Tribunal supports a reduction in the limit on the annual increase in average weighted default prices from CPI+5% to CPI+2%. This reflects the progress Origin Energy has made towards achieving cost reflective tariffs in the Murray Valley area.

4.3 Removal of Constraints on Individual Customer Bills

The WAPC limits the change in average default prices, but does not limit the price increase to an individual customer. As a result, previous VTPAs have also included constraints on increases in individual customer's bills, which were designed to limit price shocks. While successful in achieving this goal, they also limit tariff rationalisation and restructuring. Furthermore, they limit the businesses' ability to respond to changes in the underlying costs of supplying different types of customers. Thus they may be inconsistent with the price signals customers would receive in a competitive market.

There may be concern that the removal of the constraint on customer bills could provide opportunities for incumbent suppliers to act strategically to inhibit competition. For example, suppliers could maintain some tariffs below fully cost-reflective levels in order to dampen competition and maintain their customer base. On the other side, suppliers could increase tariffs above cost-reflective levels if there are customer groups that are less likely to enter the competitive market ('sticky' customers).

The ability of suppliers to increase regulated tariffs significantly above cost-reflective levels depends on their ability to segment different types of customers, and on the competitiveness of the market. The Tribunal reviewed the effectiveness of competition in the gas market in 2004 and concluded that competition was developing but could not yet be characterised as "effective". There is indicative evidence that the competitive market has continued to mature since the last review:

- While AGL remains the dominant retailer to small customers in NSW, its market share (using customer numbers) has fallen.
- New gas retailers have successfully entered the market. Furthermore, several suppliers (both standard and second-tier) have indicated they offer competitive gas contracts across a wide area of New South Wales (where gas is connected).
- Over 64,000 customers (around 5.5%) switched supplier in the year to March 2007. Since full retail contestability was introduced 225, 872 customers have switched supplier,

representing 19.5% of customers⁴. In addition, there will be customers who have switched from a regulated to a negotiated tariff with the same retailer. (This does not show up in these statistics. Conversely, if a customer switched retailer twice, it would be counted as 2 switches in these statistics.)

- Preliminary data from the 2006 IPART household survey shows that around 94% of respondents with mains gas were aware they could choose their gas supplier (up from 77% in 2003)⁵. Forty-four percent of households surveyed had been approached by their original supplier to enter a competitive gas contract, and of these 46% had entered a contract. Thirty-six per cent of households surveyed had been approached by an alternative supplier, and of these 24% had entered a contract.

Importantly, there is no evidence that under the current WAPC the gas suppliers have sought to act strategically to segment customers using different tariffs and to price in a way that hinders competition. In fact, there has been a trend towards reducing the number of regulated tariffs. For example, AGL currently has only two regulated tariffs for residential customers, and is planning to reduce this to one from July 2007. Other suppliers also have a limited number of regulated residential tariffs, which mainly vary due to location (reflecting different network tariffs), and the type of use (such as off-peak or hot water use).

In addition, the VTPAs do not preclude the introduction of a gas pricing order in the future, if evidence emerges that the standard suppliers are acting to disadvantage some customer groups. This fall-back option offers acts as an important regulatory protection for small customers.

Furthermore, the Tribunal considers that where possible there should be consistency in the regulation of the gas and electricity sectors. In its current review of retail electricity prices the Tribunal has proposed a WAPC with no constraint on individual customer bills, which is consistent with the approach proposed in the draft VTPAs.

For these reasons the Tribunal supports the removal of the constraint on individual customer bills.

⁴ Source: Gas Market Company website.

http://www.gasmarketco.com.au/grids/gmc_template_c.asp?id=575&area=96

⁵The 2003 survey results are available on IPART's website at

<http://www.ipart.nsw.gov.au/files/Research%20Paper%20-%202013%20December%202004%20-%20Residential%20energy%20use%20in%20Sydney,%20the%20Blue%20Mountains%20and%20Illawarra%20Results%20from%20the%202003%20household%20survey%20-%20APD.pdf> . A report on the 2006 household survey will contain more detailed analysis of gas customers and will be available on IPART's website later in 2007.