Independent Pricing and Regulatory Tribunal

Review of regulated retail prices and charges for gas, 2013 to 2016

Gas — Issues Paper
November 2012

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Invitation for submissions

IPART invites written comment on this document and encourages all interested parties to provide submissions addressing the matters discussed.

Submissions are due by 21 January 2013.

We would prefer to receive them electronically via our online submission form <www.ipart.nsw.gov.au/Home/Consumer_Information/Lodge_a_submission>.

You can also send comments by fax to (02) 9290 2061, or by mail to:

Review of regulated retail prices and charges for gas 2013 to 2016
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Our normal practice is to make submissions publicly available on our website <www.ipart.nsw.gov.au>. If you wish to view copies of submissions but do not have access to the website, you can make alternative arrangements by telephoning one of the staff members listed on the previous page.

We may choose not to publish a submission—for example, if it contains confidential or commercially sensitive information. If your submission contains information that you do not wish to be publicly disclosed, please indicate this clearly at the time of making the submission. IPART will then make every effort to protect that information, but it could be disclosed under the *Government Information (Public Access) Act 2009* (NSW) or the *Independent Pricing and Regulatory Tribunal Act 1992* (NSW), or where otherwise required by law.

If you would like further information on making a submission, IPART's submission policy is available on our website.

Contents

Invitation for submissions **iii**

1 Introduction **1**
- 1.1 What IPART has been asked to do 1
- 1.2 IPART's proposed approach 2
- 1.3 Overview of Standard Retailers' proposals 4
- 1.4 IPART's preliminary views 5
- 1.5 How stakeholders can provide input to this review 6
- 1.6 List of issues on which IPART seeks comment 7
- 1.7 What the rest of this paper covers 8

2 Terms of reference and context for the review **9**
- 2.1 Terms of reference 9
- 2.2 Policy and regulatory developments 10
- 2.3 Market developments 14

3 Current pricing agreements **17**
- 3.1 How the current pricing agreements work 17
- 3.2 Why we intend to continue using pricing agreements 18

4 Overview of Standard Retailers' proposed pricing agreements **20**
- 4.1 Form of price control 22
- 4.2 Proposed change in the R component 22
- 4.3 Proposed change in the C component 24
- 4.4 Proposed change in the N component 25
- 4.5 Proposed mechanism for addressing unforeseen cost changes 25
- 4.6 Proposed price restructuring 25
- 4.7 Proposed changes to miscellaneous charges 25
- 4.8 What do these proposals mean for regulated retail gas prices? (N+R+C) 26

5 Form of price control **28**
- 5.1 Is a WAPC sufficient to promote efficiency and protect customers? 28
- 5.2 Is a WAPC consistent with other objectives for this review? 31

6 Additional mechanisms to address risks and uncertainties 32

6.1 Risk associated with distribution network costs 33

6.2 Risk associated with carbon costs 33

6.3 Risk associated with wholesale gas costs in 2014/15 and 2015/16 35

6.4 Risks associated with unforeseen events or changes (special circumstances) 36

7 Costs underlying the proposed prices 39

7.1 Wholesale gas costs 39

7.2 Retail operating costs 41

7.3 Retail margin 42

7.4 Miscellaneous charges 43

Appendices 45

A Terms of Reference 47

B Overview of the gas market 49

1 Introduction

While small customers in NSW can choose their gas retailer and enter into a market contract for the supply of gas, they can also be supplied by their standard gas retailer on prices regulated by the Independent Pricing and Regulatory Tribunal of NSW (IPART).[1]

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 of the gas Standard Retailers in NSW (known as Voluntary Transitional Pricing Agreements). The Standard Retailers then set their own regulated retail gas prices to comply with these agreements, and we monitor their compliance.

The current pricing agreements will expire on 30 June 2013. As the NSW Government has decided to continue providing small customers with the option of regulated retail gas prices until 2016, the Minister for Resources and Energy has asked us to put in place new regulatory arrangements for the period 1 July 2013 to 30 June 2016 (see **Attachment A**).

We have begun our review and intend to decide on the new arrangements by May 2013. The purpose of this paper is to identify and discuss the main issues we need to consider in this review, and set out our proposed approach and preliminary views. We invite all interested parties to comment on these issues and preliminary views.

1.1 What IPART has been asked to do

The Minister has asked IPART to continue to regulate retail gas prices, either by replacing the current Voluntary Transitional Pricing Agreements with new agreements, or making gas pricing orders under the *Gas Supply Act 1996* (the Act). The new regulatory arrangements will apply to the regulated retail prices and charges levied by the 4 gas standard retailers in NSW:

- **AGL**, which supplies gas to most of the small regulated retail customers in NSW, covering Sydney, Wollongong, Newcastle, Dubbo, Orange, Parkes, and parts of the Riverina region.

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

- **ActewAGL**, which supplies the regions around the NSW/ACT border (including Young, Goulburn, and Yass) and South East NSW (including Shoalhaven).
- **Origin Energy trading as Country Energy**, which supplies the South Western regions of NSW including Wagga Wagga and Gundagai and inland cities such as Tamworth.
- **Origin Energy**, which supplies customers on the NSW - Victorian border, including the Albury and the Murray Valley Towns.

In determining the new arrangements, we must ensure that regulated retail gas prices reflect the efficient costs of supplying gas to small retail customers on regulated prices. We must also take 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.

1.2 IPART's proposed approach

As noted above, we have regulated retail gas prices over the past decade by reaching an agreement with each Standard Retailer on a regulated price path for 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 approach has been successful in promoting the objectives of the Act. In our view, it has protected the interests of customers by limiting price increases to movements in efficient costs, encouraging retail competition, and minimising unnecessary regulatory intervention.

We also consider that this approach will continue to promote the objectives of the Act in the next regulatory period. Therefore, we intend to continue to use this light-handed approach, and aim to reach a new pricing agreement with each of the Standard Retailers. We will make a gas pricing order only if a mutually satisfactory agreement cannot be reached. In addition, we propose to engage with retailers, consumer groups, governments and other stakeholders during our review, to identify what else can be done to ensure that retail competition works well for small gas customers.

As we have done in the past, we intend to take a 'propose/respond' approach for this review. In line with this approach, we have invited each Standard Retailer to submit a proposal for a revised agreement to apply over the period 1 July 2013 to 30 June 2016. These proposals are available on our website.

In broad terms, our proposed approach for responding to these proposals includes the following 5 steps:

1. Carefully consider the terms of reference and context for this review to ensure we understand the matters we must take into account and the objectives we must aim to achieve through the pricing agreements or other arrangements we put in place.
2. Analyse 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 will consider:
   - 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
   - whether the forecast costs underlying the proposed prices are consistent with those an efficient and prudent retailer would incur in supplying small retail customers on regulated prices over this period
   - the likely impact of the proposed form of regulation and prices on competition and customer choice in relation to gas supply.
3. Based on the above analysis, decide whether or not to agree to each proposal. If we decide not to agree, we will convey our reasons to the Standard Retailer so it can submit a revised proposal that better meets the objectives and context for this review.
4. Where we agree to a proposal or revised proposal, estimate the average change in the Standard Retailer's regulated retail prices under the price path.
5. Assist Standard Retailers to communicate with customers by providing information on the impact of the new pricing agreements on customers.

Where a mutually satisfactory agreement cannot be reached in step 3, we will make a pricing order that sets a price path for the Standard Retailer over the regulatory period.

1.3 Overview of Standard Retailers' proposals

The Standard Retailers have proposed to retain the broad regulatory package included in previous agreements. In particular, they proposed to retain:

- the weighted average price cap (WAPC) form of price control
- the approach for determining the average regulated prices (ie, as the sum of network, retail and carbon cost components plus a mechanism to adjust these components to address 'special circumstances').[2]

However, the Standard Retailers have not proposed an average price path for each year of the 3-year regulatory period. Rather, they have proposed average regulated retail prices for 2013/14 only. These proposed prices include considerable increases (including forecast inflation of 2.5%), driven by a range of factors including higher charges for using the gas distribution network, higher wholesale gas costs and a higher retail margin.

The size of the increase varies by retailer and in some cases by region within the retailer's supply area. For a typical residential customer, the proposed average increases in regulated prices (including inflation of 2.5%) in 2013/14 are:

- 10.4% for AGL customers in Sydney, Hunter, Illawarra and Central Coast regions
- 7.2% for ActewAGL customers in the Capital region, 5.5% for customers in the Shoalhaven region, and 3.5% for customers in the Queanbeyan region
- 6.1% for Country Energy customers in the Wagga Wagga area
- 5.3% for Origin Energy customers in Albury, and 4.4% for Origin Energy customers in the Murray Valley region.

The Standard Retailers also proposed updating their average 2013/14 prices for 2014/15 and 2015/16 through a periodic review. They submitted that, in contrast to previous regulatory periods, there is considerable uncertainty about wholesale gas costs (which make up a large portion of the retail cost component of prices), and about the costs of complying with the carbon pricing mechanism over the coming period, particularly in 2014/15 and 2015/16. This uncertainty – which is due to potential policy, regulatory and market changes during the period – increases the risks associated with proposing a fixed price path over the period, including the risk that regulated prices over or under recover the efficient costs of supply.

In this context, the Standard Retailers consider that the objectives of the Act will be best met by providing flexibility in the pricing agreements. This includes greater sharing of risk associated with wholesale gas costs and carbon

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2 This includes passing through the network component of regulated retail prices, passing through a carbon component and specifying the retail component of prices (comprising wholesale costs, retail operating costs and retail margin).

uncertainty with customers. They propose that their average regulated prices for 2014/15 and 2015/16 be agreed through a periodic review, when additional information is available to update their carbon cost estimates and the wholesale gas cost element of the retail component of regulated tariffs. However, they propose to 'lock in' the other elements of the retail cost component (retail operating costs and retail margin), as well as regulated non-tariff charges.

1.4 IPART's preliminary views

While we have not made any firm decisions, we recognise that policy, regulatory and market factors are likely to affect the gas supply chain in ways that are not clear at this stage – and that this creates uncertainty and risks in forecasting the cost of supplying small retail customers over the next 3 years. However, we note the Standard Retailers' proposal to conduct periodic reviews to update the carbon and wholesale gas components of regulated retail prices will have costs as well as benefits. For example, it will reduce price certainty to retailers and customers, and add to the complexity and costs of the price setting process. Depending on the design of these reviews, it could also represent a move to a more prescriptive, less light-handed form of regulation.

While we have provided for annual reviews in our recent electricity determinations,[3] periodic reviews have not been necessary in the gas agreements to date, due to the relative stability in wholesale gas costs. Before making our decisions, we want to better understand the uncertainties about wholesale gas costs over the regulatory period, and the risks associated with establishing a fixed retail price path over the period. We also want to better understand the value stakeholders attach to price certainty. This will help us evaluate the costs and benefits of providing for periodic reviews of the wholesale cost component of retail prices, and the extent to which this may better meet the objectives of the Act.

In relation to the Standard Retailers' proposed increases in regulated retail gas prices and charges for 2013/14, we note that with the exception of 2012/13,[4] regulated retail gas prices have increased relatively modestly over the last 2 regulatory periods. However, we consider it likely that they will rise more significantly over the next 3 years. For example, prices for most gas customers in NSW will increase considerably, due to increases in gas network costs under distribution pricing determinations already in place[5] (as distribution network costs account for approximately 52% of a typical customer bill).[6]

3 To address the risks associated with the significant volatility in the costs of purchasing electricity, and changes in the costs of complying with 'green schemes' such as the RET.

4 Regulated retail gas prices increased due to the introduction of the carbon price and increases in gas distribution network costs.

5 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.

6 See Appendix B.

We also note that best practice retail price regulation – that ensures regulated prices reflect the efficient costs of supply – cannot protect customers from price increases driven by regulatory, policy and market factors. Nor can price regulation protect customers from general financial distress.

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. Therefore as part of this review, we will seek to identify any structural impediments to competition, and address these impediments where this is possible through the regulatory arrangements. We consider that a well-functioning competitive market is in the long-term interests of customers. It will also reduce the need for retail price regulation, and facilitate its removal at a time the NSW Government considers appropriate.

1.5 How stakeholders can provide input to this review

We will conduct a public consultation process to allow stakeholders to comment on our proposed approach and how it could be enhanced, and on the issues we need to consider. All stakeholders and interested parties are invited to make submissions in response to this paper and the Standard Retailers' proposals. These submissions are due on 21 January 2013. Details on how to make a submission can be found on page iii, at the front of this paper.

We will also meet with key stakeholders throughout the review period, and will form a working group to consider regulated retail charges.

Table 1.1 provides an indicative timetable for the review.

Table 1.1 Indicative timetable for IPART's 2013 review of regulated retail gas prices

Key tasks	Time
Receive final terms of reference and post on website	28 September 2012
Invite retailers to propose a revised pricing agreement	28 September 2012
Release issues paper and Standard Retailers' proposals and invite submissions	**27 November 2012**
Hold public forum on issues paper and Standard Retailers' proposals	3 December 2012
Receive stakeholder submissions on issues paper and Standard Retailers' proposals	21 January 2013
Release draft report and invite stakeholder submissions	**March 2013**
Hold public hearing on draft report	April 2013
Receive stakeholder submissions on draft report	May 2013
Release final report	**May 2013**

1.6 List of issues on which IPART seeks comment

Throughout this paper, we have identified the issues on which we particularly seek stakeholder comment at this stage of the review. Stakeholders may address all or some of these issues, and are also free to raise and discuss any other issues that they feel are relevant to the terms of reference. For convenience, a full list of the issues we seek comment on is provided below:

IPART seeks comments on the following

1	Are there any other contextual factors that we should consider that could materially affect our review?	16
2	Do pricing agreements continue to be an appropriate way to regulate the Standard Retailers' regulated retail prices, given the objectives and context for this review? How could we enhance the current approach?	19
3	What (if any) other forms of regulation should we consider?	19
4	Are there any other competitive developments in the retail gas market that are relevant for our review? Are there any structural impediments to competition and customer participation, and if so, can these be addressed through the regulatory arrangements?	31
5	Are there enhancements that can be made to our current Weighted Average Price Cap (WAPC) approach?	31
6	Is there any reason not to accept the Standard Retailers' proposal to pass through network costs to customers?	33
7	Are there enhancements that can be made to the proposed approach to managing uncertainty associated with the carbon pricing scheme?	34
8	How material are the potential policy, regulatory and market developments affecting the gas supply chain?	36
9	Is a mechanism to update the wholesale gas cost element of regulated retail prices an appropriate way to address the uncertainty in relation to wholesale gas costs? What are the implications for customers and what value do stakeholders attach to price certainty? How should this mechanism be designed to best meet the objectives for the review?	36
10	Should we retain the special circumstance clause in the new agreements? How would this clause sit alongside any periodic review of wholesale gas costs?	38

11 How should we review an application for a special circumstance price change? Should there be a materiality threshold? And if so, what should that threshold be? 38

12 What is the prudent and efficient level of wholesale gas costs for each Standard Retailer over the next 3 years? What are the key factors affecting these costs? 41

13 How should we characterise a prudent and efficient retail gas supplier for benchmarking purposes? 41

14 What is the prudent and efficient level of retail costs for each Standard Retailer over the next 3 years? Have there been any significant changes in gas retail business activities since the 2010 review? 42

15 What is appropriate retail margin for each Standard Retailer over the next 3 years? Has there been any change in the level of systematic risk or other business-specific risks the Standard Retailers will face over the next 3 years and to what extent should these be compensated for in the retail margin? 43

16 Should the retail margin continue to be expressed as a fixed proportion of costs? To which cost components should the retail margin be applied? 43

17 Is it reasonable for a Standard Retailer to introduce a new fee for payment of gas bills by customer using credit and debit cards? 43

1.7 What the rest of this paper covers

The rest of this paper discusses each step in our proposed approach for the review in more detail, and outlines our preliminary thinking on some of the issues we will consider. It 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 explains how the current pricing agreements work, and why we propose to continue using this approach for the 2013 regulatory period
- Chapter 4 summarises the Standard Retailers' proposals for new agreements, how these proposals differ from the current agreements, and the implications for retail prices
- Chapters 5 and 6 discuss the issues we need to consider in deciding whether the form of regulation included in the Standard Retailers' proposed agreements are reasonable and consistent with the objectives for this review
- Chapter 7 discusses the costs involved in supplying gas to small retail customers, and the issues we need to consider in assessing whether the costs underlying the Standard Retailers' proposals are efficient.

2 Terms of reference and context for the review

The first step of our proposed approach for this review is to consider our terms of reference and the context for the review. We need to ensure we understand the matters we are required to consider and the objectives we aim to achieve in reaching new pricing agreements with the gas Standard Retailers.

The sections below outline our terms of reference and the key policy, regulatory and market developments that form the context for this review. For further context**, Appendix B** provides an overview of the gas market in NSW.

2.1 Terms of reference

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). The terms of reference 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 of the Act lists a number of objectives, which are:

- 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
- 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
- to facilitate the continuity of supply of natural gas to customers, and
- to promote the safe use of gas.

Our preliminary view is that we can best meet these objectives by regulating retail gas prices in the long-term interest of customers. We consider that this encompasses:

- encouraging the efficient use of gas by setting regulated prices to recover efficient costs
- promoting customer choice and efficient entry and investment in the retail gas market by ensuring regulated retail prices provide an appropriate return, promoting regulatory certainty and transparency in regulatory decision-making and, where possible, reducing any barriers to entry and customer participation in the retail market
- ensuring the financial viability of efficient retailers by taking account of the risks faced by efficient and prudent gas retailers.

2.1.2 Review of costs of supply

We consider that it is necessary to review the costs involved in supplying natural gas to small retail customers. We intend to do this as part of step 2 of our proposed approach, which involves analysing the Standard Retailers' proposals to determine whether they are reasonable and reflect the costs an efficient and prudent retailer would incur over the next 3 years. See Chapter 7 for more information on this review.

2.2 Policy and regulatory developments

The period in which we will be conducting this review coincides with a period of policy and regulatory developments with the potential to affect the gas industry. In particular, they 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.

2.2.1 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, which commenced on 1 July 2012, places direct costs on around 320 entities by requiring them to pay for their greenhouse gas emissions.[7] 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 3 years,[8] the Carbon Pricing Mechanism will transition into 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 2015/16 (the final year of the regulatory period). We will need to take account of this – and if there are major material policy changes – in deciding on the form of regulation and other elements of the regulatory package included in the pricing agreements.

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 Climate Change Authority is currently reviewing the RET scheme, and will report on its findings and recommendations by the end of 2012. The potential for changes in the scheme's policy and regulating settings makes it difficult to forecast its likely impact on the gas industry over the 2013 regulatory period.

2.2.2 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).

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

8 The carbon price started at a fixed price $23 per tonne of CO_2e in 2012 and will rise at 2.5% (plus inflation) for the next two years. See http://www.cleanenergyfuture.gov.au/clean-energy-future/an-overview-of-the-clean-energy-legislative-package/.

In 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, and were a major driver of the increase in regulated retail gas prices in those years.[9]

As Table 2.1 shows, AGL customers as well as ActewAGL customers in the Capital region face further material increases in average network costs in 2013/14 and 2014/15.

Table 2.1 Regulated gas distribution access arrangements

Gas retail supplier	Gas distribution network supplier	Period of access arrangement	Estimate of average real price increase 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[c]	3.4% in 2013, 0% pa from 2014 to 2017

[a] Estimated price increases exclude inflation.

[b] Based on capacity and throughput charges.

[c] Based on AER draft decision.

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 Draft Decision Envestra Ltd Albury & Victoria Gas Distribution System 2013 – 2017*, September 2012, p 21.

For most customers, the change in these costs in 2015/16 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.

9 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.

Several policy and regulatory developments may influence these costs, including the AER's new determinations which will apply under amended National Gas Rules (NGR)[10] and potential changes to the Limited Merits Review Regime for gas businesses.[11]

2.2.3 Development of the NSW coal seam gas industry

Following the discovery of significant reserves of coal seam-gas (CSG) in NSW[12] and technological advances that allow CSG to be extracted, the NSW Government is considering the role of coal seam gas in meeting the state's future energy demand.[13] It 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.

If the industry develops sufficiently, it may increase the domestic gas supply[14] sufficiently to put downward pressure on wholesale gas costs over the 2013 regulatory period. However, the likely extent and rate of its development is still uncertain.

Several CSG production projects are at various stages of the planning approval process in NSW. For instance, AGL is seeking approval to expand production at its Camden Gas Project to supply up to 15% of the NSW market.[15] In addition, AGL's Gloucester Gas Project, which could meet the gas demand of more than one million homes, is currently undergoing environmental assessment.[16] The NSW Government is also developing a Gas Industry Development Plan to ensure necessary policy frameworks are in place to support the appropriate development of all aspects of the gas industry, including securing gas supply to meet NSW's needs for gas as a transitional electricity fuel.[17]

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10 In August 2012, the AEMC released a draft determination and draft amendments to the economic regulation provisions in the NGR.

11 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.

12 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.

13 NSW Government submission to the Inquiry into Coal Seam Gas, September 2011, p 8.

14 Currently, there is only one gas production facility in NSW, supplying around 6% of the state gas demand. See http://agk.com.au/camden/assets/pdf/Camdenabout%20CSG.pdf.

15 NSW Government submission to the Inquiry into Coal Seam Gas, September 2011, p 6.

16 See http://agk.com.au/gloucester/index.php/the-project/.

17 NSW Government, submission to Draft Energy White Paper, April 2012, p 2.

The NSW Government intends to develop this in a way which builds on existing national gas market frameworks.[18] However, at this stage, it has not decided on the specific policy and regulatory settings that will apply to the development of the CSG industry in the state. This adds to the uncertainties associated with forecasting the costs of supplying gas to small retail customers over the regulatory period.

2.3 Market developments

Since our last review of regulated retail gas prices, a range of market developments have occurred or been initiated that 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.

2.3.1 Increased international demand for gas

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.

If these LNG projects proceed as planned, large volumes of domestic gas production could be diverted to international markets. As a result, Australia's domestic gas users may need to compete with international users, and domestic gas prices may rise towards international prices.

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, including 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 economic recovery. In addition, the precise timing of many of LNG projects in Australia is not known. The development of the LNG industry may also require additional investments in transmission pipelines in Australia, which could affect the price of transporting gas over long distances.

Increased demand from international markets and higher domestic gas prices may lead to additional domestic gas production (such as CSG supply in NSW). These changing market dynamics have the potential to lead to increasing levels of price uncertainty in the domestic gas market.

18 ibid

2.3.2 The NSW Government's energy asset sale program

In March 2011, the NSW Government sold the retail businesses of EnergyAustralia, Country Energy and Integral Energy as part of its reform of the state's energy sector. Country Energy and Integral Energy's retail business were sold to Origin Energy, a licensed electricity retailer and a gas Standard Retailer. EnergyAustralia's retail business was sold to TRUenergy, which recently rebranded as EnergyAustralia.

We will examine the implications of these developments for competition across the retail gas market in NSW.

2.3.3 Continued development of competition and customer participation in the NSW retail gas market

Since we undertook our last review in 2009 there has been considerable change in the NSW retail gas market. Small customers are increasingly participating in the competitive market by moving from regulated prices to market contracts.

In June 2009, more than half of small customers were on regulated gas prices.[19] However, as at 30 June 2012, this proportion had dropped to around 30% although this trend is not uniform across the supply areas. A similar trend is apparent in the retail electricity market. Because small customers have gas bundled with electricity it is likely that the recent significant increases in electricity prices have contributed to more customers seeking a better deal on their combined energy bills via a market contract.

2.3.4 AEMC review of retail market competition

The NSW Government (along with other Australian governments) has agreed to phase out retail electricity and gas price regulation where it can be demonstrated that effective competition exists.[20]

The Government will decide whether to end price regulation after considering advice on the competitiveness of the retail market from the Australian Energy Market Commission (AEMC). The AEMC will review the effectiveness of competition in the NSW electricity and gas retail market and will make its recommendations in September 2013.

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

20 Council of Australian Governments' Meeting, *Communique*, 10 February 2006, Appendix A to Attachment B, p 8.

2.3.5 Price reviews under AGL's gas supply agreements

AGL's pricing proposal indicates that there also important contextual market factors specifically relevant to AGL. A number of AGL's long term gas supply agreements are subject to price reviews over the next 3 years. AGL considers that this creates uncertainty as to the costs it may face over the next 3 years, and limits its ability to participate in our review which seeks to put prices in place for the next 3 years.

IPART seeks comments on the following

1 Are there any other contextual factors that we should consider that could materially affect our review?

3 Current pricing agreements

As Chapter 1 noted, over the past 10 years we have regulated retail gas prices by reaching a pricing agreement with each Standard Retailer. These retailers then set their own regulated prices in compliance with that agreement, and we monitor their compliance. We intend to continue to use this relatively light-handed approach for the next 3 years. We consider it has been successful in promoting the objectives of the Act to date, and continues to be an appropriate and effective approach for promoting those objectives. We will only make a gas pricing order if we cannot reach a mutually satisfactory pricing agreement with the retailer concerned.

The sections below explain how the current pricing agreements work, and discuss why we propose to continue these arrangements for the next 3 years.

3.1 How the current pricing agreements work

Under the current agreements, the Standard Retailers agreed to set their regulated tariffs in each year of the regulatory period subject to:

- A weighted average price cap (WAPC) on 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 though of the network component of prices. The 'N component' reflects the distribution network costs levied on retailers for using the gas distribution network.
- Pass though of the carbon component of prices. The 'C component' reflects the costs of complying with national climate change measures including the Carbon Pricing Mechanism.

The Standard Retailers also agreed to limit the increase in their regulated fees and charges (or miscellaneous charges) by the change in CPI in the previous calendar year. Further, they agreed not to vary existing miscellaneous charges, and/or introduce new miscellaneous charges without IPART's agreement.

In addition, IPART agreed that the Standard Retailers could apply to us for approval to set their regulated tariffs above the limit imposed by the WAPC in certain specified circumstances. For example, these circumstances included unanticipated increases in the costs of supplying gas due to regulatory or taxation changes. On receipt of such an application, we agreed to review the application and decide to approve or not approve the price increase.

In putting in place these agreements we considered that this 'regulatory package' was likely to facilitate cost-reflective retail prices and promote competition by allowing the Standard Retailers to set the retail prices component of prices subject to a WAPC, and passing through 'uncontrollable costs' such as network costs and the costs of complying with the carbon price. We considered that the package also represented an appropriate balance between regulatory certainty, in terms of 'locking in' average movements in the retail component of prices, and regulatory flexibility by providing a mechanism that allowed the Standard Retailers to seek our approval to vary prices in special circumstances.

3.2 Why we intend to continue using pricing agreements

As part of the 2010 review, we undertook a detailed build-up of the cost of supplying gas to small customers in NSW over the 2010 regulatory period. This analysis and independent expert advice enabled us to decide whether the Standard Retailers' proposals were reasonable, and reflected the efficient and prudent costs incurred by a retailer, given our requirements under the Act and the context of the review.

In our view, these agreements have been successful in:

- protecting customers by limiting movements in regulated gas prices to movements in efficient costs
- providing a stable path of relatively small increases in the retail component of those prices[21]
- encouraging retail competition and customer participation in the competitive gas market, including encouraging customers to move off regulated prices
- transitioning towards the removal of retail price regulation, by allowing retailers to set their individual prices (within an average cap) and encouraging them to take ownership of pricing decisions
- ensuring the financial viability of the Standard Retailers by allowing them to pass through movements in uncontrollable network and carbon costs and providing a mechanism to manage uncertainties due to the potential for regulatory and policy changes
- minimising unnecessary regulatory intervention and the administrative costs of detailed regulatory decisions.

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21 Over time the retail components have broadly increased by inflation. The network and carbon components were the major drivers of price increases in 2012/13. See http://www.ipart.nsw.gov.au/Home/Industries/Gas/Reviews.

In our view, moving away from pricing agreements to a more prescriptive, and less light-handed form of regulation, would be a regressive step. Therefore, we will only make a gas pricing order if we cannot reach a mutually satisfactory pricing agreement with the retailer concerned.

Nevertheless, we are interested in stakeholders' views on whether there are any new developments or contextual reasons that suggest the current light-handed approach to regulating retail tariffs may need to be modified or enhanced, or that an alternative form of regulation better meets the objectives for this review.

IPART seeks comments on the following

2 Do pricing agreements continue to be an appropriate way to regulate the Standard Retailers' regulated retail prices, given the objectives and context for this review? How could we enhance the current approach?

3 What (if any) other forms of regulation should we consider?

4 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 4.1 summarises the proposal submitted by each Standard Retailers, and the sections below provide more detail on the individual components of the proposals, and discuss their implications for regulated retail gas prices over the regulatory period. The proposals themselves are available on our website.

Table 4.1 Summary of Standard Retailers' proposals for regulated retail gas tariffs for 2013/14 to 2015/16

	AGL	ActewAGL	Country Energy	Origin Energy
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 prices for 2013/14	CPI + 7.7%	CPI + 4.6%for Capital region, CPI + 2.9% for Shoalhaven, and CPI + 1.0% for Queanbeyan	CPI + 3.5%	CPI + 2.8% for Albury and CPI + 1.9% for Murray Valley region
Prices for 2014/15 and 2015/16	To be advised	To be advised	To be advised	To be advised
R component	Lock-in retail operating costs and retail margin, and review and update gas commodity costs in early 2014	Lock-in retail operating costs and retail margin, and review and update gas commodity costs in early 2014	Lock-in retail operating costs and retail margin, and review and update gas commodity costs in early 2014 and 2015	Lock-in retail operating costs and retail margin, and review and update gas commodity costs in early 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
Unforseen cost changes	Address through special circumstances clause	Address through special circumstances clause	Address through special circumstances clause	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

4.1 Form of price control

Each of the Standard Retailers has proposed to continue with the current 'R+C+N' approach to regulating retail tariffs where:

- R is the retail cost component
- C is cost of complying with the Carbon Pricing Mechanism
- N is the distribution network cost component.

In addition, each of the Standard Retailers has proposed to retain the WAPC form of price control. Under the WAPC, the Standard Retailers are able to change their individual regulated tariffs or component of these tariffs (such as the fixed service and variable usage charges) as long as the overall increase in their average regulated tariffs does not exceed the WAPC.

4.2 Proposed change in the R component

The retail component includes 3 elements: wholesale gas costs, retail operating costs and an allowance for a retail margin. These costs are typically considered to be within the control of retailers.

Table 4.2 summarises each Standard Retailers' proposed retail costs for 2013/14.

Table 4.2 Standard Retailers' proposed retail costs for 2013/14 ($ nominal)

	AGL	ActewAGL	Country Energy	Origin Energy
Proposed wholesale gas costs	8.26/GJ	confidential	confidential	confidential
Proposed retail operating costs	$112 per customer[a]	confidential	Around $100 per customer	Around $100 per customer
Proposed retail margin	8%	6.5%[b]	confidential	confidential
Total % increase in R component	**CPI + 7.7%**	**CPI + 1.5%**	**CPI + 4.2%**	**CPI+5.3%**

[a] Includes carbon related operating costs.

[b] Refers to EBIT Margin.

Note: AGL assumed a CPI of 2.5% to convert $2012/13 to $2013/14, while Origin Energy assumed an inflation rate of 2.8%. ActewAGL reported costs in 2012/13 dollars.

Source: Standard Retailers' proposals.

4.2.1 Wholesale gas costs

Wholesale costs include the costs of purchasing the underlying gas commodity from producers, transporting it long distances via transmission pipelines, and meeting additional peak demand requirements. As part of its 2010 review, IPART assessed the prudent and efficient level of wholesale gas costs for each Standard Retailer over the 2010-2013 regulatory period. Compared to this assessment, each of the Standard Retailers has proposed a real increase in wholesale costs for 2013/14, citing a range of reasons, including real increases in estimated and actual costs under existing contracts.

AGL has also proposed to include a risk allowance for gas commodity costs, the estimated arbitration costs averaged over 3 years, and charges payable to the Australian Energy Market Operator (AEMO).

The Standard Retailers did not propose wholesale gas costs for 2014/15 or 2015/16. Instead, they proposed that these costs be reviewed and updated in early 2015 (or in some cases early 2015 and 2016). See section 4.2.4 below.

4.2.2 Retail operating costs

Each of the Standard Retailers has proposed increases in retail operating costs for 2013/14. Standard Retailers have submitted that there are a range of factors influencing retail costs including inflationary pressures as well as increasing customer switching which has increased acquisition and retention cost.

AGL has proposed to include carbon related operating expenditure in their operating cost.

4.2.3 Retail margin

AGL proposed to increase in its retail margin from 5.7% to 8% in 2013/14, and lock in this amount (in percentage terms) for the following 2 years.

ActewAGL submits that an EBIT retail margin of at least 6.5% is required in order to fully compensate retailers for the systematic risk they incur.

Country Energy proposes to increase its retail margin gradually over the regulatory period, so that it reaches the range previously determined by IPART as reasonable in 2015/16[22]. Based on the proposed price increase for 2013/14 and its assessment of wholesale costs, it submits that it would earn a negative retail margin in 2013/14.

Origin Energy proposes to increase its margin in 2013/14.

22 For the 2010 review, IPART recommended a range for the retail margin of 7.3% to 8.3% of EBITA.

4.2.4 Review of wholesale gas costs for 2014/15 and 2015/16

In their proposals, the Standard Retailers indicated that several uncertainties made it difficult for them to forecast their wholesale gas costs for second and third years of the regulatory period. In particular:

- AGL submitted that some of its long-term gas supply agreements are subject to price reviews over the regulatory period, and that putting forward a view on costs beyond the first year of the period might influence the review process in a way that is not in the best interest of customers.
- ActewAGL indicated that as it outsources the management of its wholesale gas purchases to AGL, it is unable to obtain reliable forecasts of its wholesale costs for the final 2 years of the period.
- Country Energy and Origin Energy submitted that their wholesale gas costs will be affected by LNG developments over the regulatory period, and these are uncertain at this stage (see section 6.3 for more information).

To manage these uncertainties, each Standard Retailer proposed that their wholesale gas costs be reviewed and updated for 2014/15 and 2015/16:

- AGL and ActewAGL proposed that their gas commodity costs for both years be reviewed and updated early in 2014, once the prices under AGL's long-term gas supply agreements are finalised.
- Country Energy and Origin Energy proposed that their gas commodity costs be reviewed and updated through periodic reviews in early 2014 and 2015.

4.3 Proposed change in the C component

The Standard Retailers proposed to calculate the costs of complying with the Carbon Pricing Mechanism over the regulatory period using the same methodology approved by IPART as part of our review of the carbon cost component for 2012/13. They also proposed to increase the carbon cost component established by this review in 2013/14 and 2014/15 to reflect the legislated real increases in the permit price of 2.4% per year.

However, because the carbon price moves from a known fixed price to an unknown market-based price on 1 July 2015, the Standard Retailers proposed that the carbon cost component for 2015/16 be reviewed and updated in early 2015. As noted above, Country Energy and Origin Energy proposed that this occur as part of their proposed periodic review of wholesale gas costs.

4.4 Proposed change in the N component

As noted above, the Standard Retailers propose to pass through the cost of the distribution network charges they pay the network businesses. As the majority of these charges are regulated by the Australian Energy Regulator, the retailers have no control over these costs. Therefore it is appropriate that they be passed through to customers.

As Chapter 2 discussed, the average change in distribution network charges that Origin Energy and Country Energy will pay for some of its supply area are known for each year of the regulatory period. However, those that AGL, ActewAGL and Country Energy (in the rest of its supply area) are only known for 2013/14 and 2014/15. Chapter 2 provides information on the approved average increases in distribution network prices in each supply area.

4.5 Proposed mechanism for addressing unforeseen cost changes

Each of the Standard Retailers proposed to retain the special circumstances clause in the current pricing agreements to address unforeseen changes in their costs. This clause allows the Standard Retailers to vary regulated prices by more than the WAPC to recover unforeseen changes in their cost arising from regulatory changes, taxation changes, unanticipated field price reviews or fundamental changes to gas market frameworks and arrangements.

4.6 Proposed price restructuring

Only ActewAGL proposed to restructure its regulated retail prices. Currently, this retailer has 3 sets of location-specific regulated prices.[23] Each price includes a fixed charge and variable usage charges. Residential customers either pay a lower fixed charge and a single usage rate, or a higher fixed charge and a usage rate that declines when specified daily consumption levels are reached. It proposed reducing the number of regulated prices available in each region to one residential and one commercial. ActewAGL did not provide information on the customer impacts of the proposed price restructuring.

4.7 Proposed changes to miscellaneous charges

Miscellaneous charges are the fees the Standard Retailers levy on customers on regulated tariffs when they take or fail to take certain actions. Thus, they do not relate to the routine retail supply services, but arise from particular events associated with the supply of energy to individual customers.

23 For Queanbeyan and Bungendore, the Capital region (Boorowa, Goulburn, Yass and Young) and Shoalhaven respectively.

Some Standard Retailers proposed changes to their miscellaneous charges over the regulatory period. In particular:

- AGL proposed to introduce a merchant service fee of 0.6% for accounts paid by credit card and debit transactions, on the assumption that the National Energy Customer Framework is introduced on the 1 July 2013. It proposed to increase its other miscellaneous charges by no more than the change in the CPI in each year of the regulatory period.
- Country Energy proposed aligning its miscellaneous charges with those levied by Origin Energy in the Albury/Murray Valley regions. This means that its late payment fee would increase from $7.70 in 2012/13 to $12.00 in 2013/14, while its dishonoured payment fee would fall from twice the bank fee to $26.10. It would also introduce a new account establishment fee of $32.60 for new customers.
- ActewAGL proposed to increase its miscellaneous charges by the change in the CPI in each year of the regulatory period.

4.8 What do these proposals mean for regulated retail gas prices? (N+R+C)

The proposed nominal increase[24] in regulated retail gas prices from 1 July 2013 will vary for a typical residential customer, depending on their Standard Retailers. This increase is:

- 10.4% for AGL's customers, (or an extra $84 per annum for a typical customer using 23 GJ/year)
- 7.2% for ActewAGL customers in the Capital region, 5.5% for customers in the Shoalhaven region, and 3.5% for customers in the Queanbeyan region[25] (or an extra $31 to $81 per annum for a typical customer bill)[26]
- 6.1% for Country Energy's customers (or an extra $43 per annum for a typical customer using 32 GJ/year)
- 5.3% for Origin Energy's customers in Albury (or an extra $43 per annum for a typical customer using 46 GJ/year) and 4.4% for Origin Energy's customers in the Murray Valley region (or an extra $47 per annum for a typical customer using 46 GJ/year).

24 We have assumed forecast inflation of 2.5% in 2013/14.

25 ActewAGL customers may also be affected by the proposed price restructuring. These customers may face price changes that are above or below the average price change.

26 This assumes a typical customer uses 40GJ, 16GJ and 49GJ of gas per annum in the Capital, Shoalhaven and Queanbeyan regions respectively. Impact on bills includes GST.

The majority of regulated gas customers in NSW are supplied by AGL. The main drivers of the proposed increases in AGL's residential regulated retail gas prices in 2013/14 are:

- increasing distribution network costs, which add on average 4.0% to customer bills from 1 July 2013[27]
- an increasing retail margin, which adds 2.9% to customer bills
- assumed inflation of 2.5%.

Proposed price changes in 2014/15 and 2014/15 are uncertain at this stage and depend on:

- distribution network charges – as Chapter 2 noted, several policy and regulatory developments, including new AER decisions on network charges, may influence these costs
- any review of the wholesale cost components of retail prices
- any review of the carbon component of retail prices when the flexible carbon pricing mechanism commences.

[27] Since the distribution network charges account for around 52% of residential customer's gas bills in AGL's supply area, the increases in network prices have considerable impact on bills.

5 Form of price control

One of the key questions we will consider in analysing the Standard Retailers' proposals is whether their proposed form of price control is reasonable and consistent with objectives and context for this review. As Chapter 4 discussed, the Standard Retailers propose to retain the weighted average price cap (WAPC) form of price control included in their current agreements.

With a WAPC, each Standard Retailers sets its own regulated prices, but must ensure that the annual average change in these prices does not exceed the 'cap' specified in its pricing agreement. This cap reflects the estimated change in the efficient costs of supplying small customers on regulated prices in each year of the regulatory period. This means that the WAPC limits the change in average regulated prices to the change in efficient costs, but does not limit the increase in any individual regulated price. This allows Standard Retailers to set individual prices in line with the costs of supplying different customers. This recognises that Standard Retailers are likely to better understand their own cost drivers and the demand for their products.

To decide whether a WAPC continues to be an appropriate form of price control we need to consider whether, when combined with the disciplines imposed by competition in the NSW gas market, it will promote efficiency and protect customers by ensuring prices are set in line with the efficient costs of supply. We also need to consider whether it is consistent with the other objectives for this review, including promoting customer choice and development of competition in the long-term interests of customers.

The sections below discuss these issues and our preliminary views.

5.1 Is a WAPC sufficient to promote efficiency and protect customers?

Our preliminary view is that in the context of the state's retail gas market, a WAPC (with no additional side constraints) continues to be sufficient to promote efficiency and protect customers. This view is based on preliminary analysis that suggests that:

- the level of competition in the retail gas market is increasing
- there is no evidence of customer segmentation

- each Standard Retailer only has a small number of regulated tariffs.

Together, these findings suggest that there is little scope for the Standard Retailers to set individual prices materially above the costs of supply without the risk of losing customers, or to increase individual regulated prices by significantly more than the average increase allowed by the WAPC.

5.1.1 Increasing competition in retail gas market

The Standard Retailers' ability to set individual regulated prices materially above the cost of supply (while still complying with the WAPC) depends partly on the level of competition in the retail gas market. For example, if there was insufficient rivalry between gas retailers, or customers could not easily compare price and service offerings and transfer between retailers, then they may be able to set regulated prices for some customers above the costs of supply without much risk of them moving to another retailer.

Our preliminary analysis suggests that the level of competition in the NSW retail gas market has increased since our last review. For example:

- Fewer customers remain on regulated prices. Over the past 3 years, the proportion of small customers on regulated prices has decreased from around 50% to less than 30%.
- Non-regulated prices offer competitive discounts. Some current market offers provide discounts of around 3% to 9% off regulated prices.[28]
- New retailers have entered the market and won market share from the existing retailers (Standard Retailers and non-Standard Retailers).
- Customer information on energy prices is more readily available. Websites such as www.myenergyoffers.nsw.gov.au now make it easier for customers to compare gas and electricity market offers in their area. In addition, price disclosure guidelines for retailers operating in NSW have been established to improve price transparency for customers in assessing retail market offers.

In addition, in its pricing proposal, AGL noted that churn (or switching) rates in NSW's retail gas market have been relatively high, particularly over the past 12 months.[29] Switching rates provide an indication of customer activity, as they measure the number of times customers change retail supplier.

28 Based on discounts observed in www.myenergyoffers.nsw.gov.au, November 2012.

29 AGL, *Proposed VTPA for NSW regulated gas prices from 1 July 2013 to 30 June 2016*, 9 November 2012, p 6.

The increase in market activity is likely to be partly due to customers seeking a better deal following the significant increases in electricity and gas prices in recent years. As gas is a secondary fuel source, competitive activity in the retail electricity market can have a flow-on affect in the retail gas market. For example, the significant discounts currently available on electricity prices may encourage some dual fuel customers to also seek out more competitive gas prices. However there are some key structural differences in the gas and electricity markets and these may impact on the development of competition in the respective markets.

We recognise that these developments in the competitive market may not be uniform across NSW. For example, the proportion of customers remaining on the regulated retail prices is higher in the Albury, Murray Valley and Wagga Wagga areas. At this stage we do not fully understand why some customers continue to rely on regulated prices.

We are interested in understanding what can be done to facilitate retail market competition in NSW over the next 3 years. We consider that a well-functioning competitive market can provide benefits for customers. In general, we consider that a well-functioning competitive market can provide more effective customer protection and better customer outcomes than price regulation.

We seek stakeholder comment on whether there are any structural impediments to competition in NSW and across each of the supply areas, including any barriers to retail entry, and whether these can be addressed through the regulatory arrangements. We also seek stakeholder comment on whether there any barriers to effective customer participation in the competitive market.

5.1.2 No evidence of customer segmentation

The Standard Retailers could segment their regulated customers if, for example, they were able to identify a group that were unlikely to be offered a market contract, or unlikely to have sufficient understanding of the competitive market to seek one out. They may be able to move these customers on to higher regulated prices without the risk of them moving to another retailer.

We have found no evidence to suggest that the Standard Retailers have sought to act to segment customers by using different prices, or to price in a way that hinders competition. In fact, there has been a trend towards reducing the number of regulated prices, which greatly reduces the potential for the Standard Retailers to set a regulated price that varies significantly from the average regulated price. This is discussed further below.

5.1.3 Small number of regulated prices

The WAPC form of price control is more effective in protecting customers from individual regulated tariffs increasing materially above the cost of supply when the Standard Retailers have only a small number of regulated prices each. This is because with a small number of regulated tariffs, there is little scope to increase any individual tariff or tariff component by much more than average increase allowed under its WAPC.

Currently, each Standard Retailer has a small number of regulated retail tariffs:

- AGL has 2 – one each for residential and small business customers.
- ActewAGL has multiple tariffs available in each region, but has proposed reducing this to 6 – one each for residential and small business customers in each of its 3 NSW regions.[30]
- Country Energy and Origin Energy have a limited number, which mainly vary due to location (reflecting different network prices), and the type of use (such as off-peak or hot water use).

5.2 Is a WAPC consistent with other objectives for this review?

Our preliminary view is that a WAPC is consistent with the other objectives for this review. In particular, we consider a WAPC facilitates the development of competition and customer choice because it provides the Standard Retailers with sufficient flexibility in setting their prices, and allows them to take ownership of their pricing decisions. We also note it helps provide regulatory certainty for stakeholders, as they are already reasonably familiar with this approach.

In light of all of the above, we are inclined to agree to the Standard Retailers' proposal to continue to use a WAPC form of price control for the 2013 regulatory period. However, we are interested in stakeholders' views on whether there are any new developments or contextual factors that suggest that the current WAPC approach may need to be modified or enhanced, or that an alternative approach better meets the objectives for this review.

IPART seeks comments on the following

4 Are there any other competitive developments in the retail gas market that are relevant for our review? Are there any structural impediments to competition and customer participation, and if so, can these be addressed through the regulatory arrangements?

5 Are there enhancements that can be made to our current Weighted Average Price Cap (WAPC) approach?

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30 ActewAGL, *Review of Regulated Retail Tariffs and Charges for Gas 2013-2016*, 9 November 2012, p 6.

6 Additional mechanisms to address risks and uncertainties

A second key issue we will consider in analysing the Standard Retailers' proposals is whether there is the need for the additional regulatory mechanisms they have proposed to address certain risks and uncertainties they will face over the next 3 years.

Whenever we agree to pricing proposals that rely on forecasts of costs over the regulatory period, there is a risk that the costs that 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, 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 the cost with a high degree of certainty, it can be addressed through additional regulatory mechanisms.

The Standard Retailers have proposed additional regulatory mechanisms to address risks associated with 4 specific categories of cost:

- the distribution network costs they will incur over the regulatory period
- the costs associated with the Carbon Pricing Mechanism in 2015/16
- wholesale gas costs in 2014/15 and 2015/16
- costs that arise from unforeseen events or changes.

To decide whether to agree to their proposed mechanisms, we need to consider whether it is appropriate to manage these risks through an additional regulatory mechanism, and whether the proposed mechanism will manage the risk efficiently. This involves considering whether the risk is within the Standard Retailers' control, and the proposed mechanism's implications, such as the incentives it creates for the retailers and its impact on competition and ultimately prices.

6.1 Risk associated with distribution network costs

Distribution network costs are the charges all retailers incur for using distribution network services to transport gas from 'city gates' to their customers' premises.[31] These charges are typically regulated by the AER,[32] and retailers have no ability to control or influence them. In addition, there is uncertainty about how the regulated fees for some of the Standard Retailers will change in the third year of the regulatory period, as the access arrangements governing them will expire on 30 June 2015. To address the risk arising from these circumstances, all 4 Standard Retailers proposed that they be allowed to automatically pass through their actual network costs in regulated retail prices.

Our preliminary view is to accept this proposal. We note that regulators (including IPART) allow retailers to pass through network costs. We consider that requiring retailers to bear the risk associated with forecasting this cost is likely to increase the overall cost of supplying gas to customers. It may also affect their financial viability, given the uncertainty in relation to network costs over this regulatory period and their significance in terms of the overall cost of supplying gas to customers. This would not be in the long-term interest of customers.

IPART seeks comments on the following

6 Is there a ny reason not to accept the Standard Retailers' proposal to pass through network costs to customers?

6.2 Risk associated with carbon costs

As Chapter 2 discussed, the Commonwealth Government's Carbon Pricing Mechanism imposes direct and indirect costs on all gas retailers. The direct costs are the costs of carbon emissions associated with the extraction, transportation and consumption of gas. They can be calculated using the carbon price (legislated at \$23/tonne CO_2, in 2012/13) and the amount of emissions at each stage of the supply chain. The indirect costs are relatively minor, and include increased operating costs associated with complying with the scheme.

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31 Gas distribution networks transport gas from transmission pipelines to end customers. City gates (or gate stations) link transmission pipelines with distribution networks. The gates measure the natural gas entering a distribution system for billing and gas balancing purposes.

32 Given their natural monopoly characteristics, gas distribution networks are generally subject to regulation under network access arrangements by the AER. The main aim of regulating a distribution network is to ensure that energy retailers and other third parties can negotiate access on reasonable terms and conditions. There are 2 unregulated gas distribution supply areas in NSW.

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. 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 where 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.[33]

All 4 Standard Retailers have proposed to include a similar mechanism to allow them to pass through their carbon costs in each year of the 2013 regulatory period. In the first 2 years – when the carbon price is fixed and specified in legislation – they proposed updating the costs they passed through in 2012/13 in line with the legislated change in the carbon price (CPI + 2.4% per annum). For the third year – when the carbon price will be set by the market and therefore is highly uncertain at this time – they proposed a similar review process as we used in 2012/13. The Standard Retailers have proposed to use the same methodology for calculating the direct costs of complying with the scheme.

Our preliminary view is to include the proposed mechanism – or an enhanced version of it – in the new pricing agreements. We consider it appropriate for the Standard Retailers to pass through the additional costs associated with the Carbon Pricing Mechanism, as they have no control over these costs. We also consider that the review process used in 2012/13 was successful in ensuring that regulated prices move in line with the carbon costs incurred by efficient and prudent retailers.

We note that using the same methodology for calculating the direct costs of complying with the scheme will minimise the administrative costs of updating the carbon component and provide regulatory and price certainty to stakeholders.

IPART seeks comments on the following

7 Are there enhancements that can be made to the proposed approach to managing uncertainty associated with the carbon pricing scheme?

33 Further details of our recent review of the Standard Retailers' proposed carbon component of retail prices can be found http://www.ipart.nsw.gov.au/Home/Industries/Gas/Reviews/Retail_Pricing/Review_of_regulated_gas_retail_tariffs_and_charges_2013_to_2016.

6.3 Risk associated with wholesale gas costs in 2014/15 and 2015/16

The retailers have submitted that, in contrast to previous regulatory periods, there is considerable uncertainty about wholesale gas costs over the regulatory period, particularly in 2014/15 and 2015/16. This uncertainty is due to the likelihood of policy, regulatory and market changes during the period (see Chapter 2) and the fact that some of AGL's long-term gas supply agreements will be renegotiated during the period.

The uncertainty increases the risks associated with proposing a fixed price path over the period, including the risk that regulated prices over or under recover the efficient costs of supply. This risk is significant, as wholesale gas costs make up a large portion of the retail cost component of prices.

In this context, the Standard Retailers consider that the objectives of the Act will be best met by providing flexibility in the pricing agreements. While they have proposed average regulated prices for 2013/14, they proposed that these prices for 2014/15 and 2015/16 be agreed through a periodic review, when additional information is available to update their wholesale gas cost estimates.

We have not formed a preliminary view on this proposal, as we do not have sufficient understanding of the uncertainties related to wholesale gas costs over the next few years. We note that unlike distribution network costs, wholesale gas costs have typically been seen as 'controllable costs'. However this does not necessarily mean they can be forecast with a high degree of certainty in the coming years.

In addition, we recognise that policy, regulatory and market factors are likely to affect the gas supply chain in ways that are not clear at this stage – and that this uncertainty creates challenges and risks in forecasting the cost of supplying small retail customers over the next 3 years. However, the Standard Retailers' proposal to conduct periodic reviews to update the wholesale gas costs included in regulated retail prices will have costs as well as benefits. For example, it will reduce price certainty to retailers and customers, and introduce additional complexity to the price setting process. Depending on the mechanics of these reviews, it could also represent a move to a more prescriptive, less light-handed form of regulation.

In our view, it is in the long-term interests of customers for regulated prices to reflect the movement in efficient costs. While we have provided for annual reviews in our recent electricity determinations,[34] they have not been necessary in the gas agreements to date, due to the relative stability in wholesale gas costs.

34 To address the risks associated with the significant volatility in the costs of purchasing electricity, and changes in the costs of complying with 'green schemes such as the RET.

To help us make our decisions in relation to addressing the risks associated with forecasting wholesale gas costs, we intend to explore the likely uncertainties about these costs, particularly in 2014/15 and 2015/16, and the risks associated with establishing a fixed retail price path. We may engage expert assistance to assist us with better understanding this uncertainty, including the key factors that may influence gas wholesale costs over the period.

We will also consider how any periodic review of the wholesale gas costs included in regulated prices should be designed. As for the proposed review of carbon costs, we will need to find the right balance between providing regulatory certainty and regulatory flexibility. Providing regulatory certainty – for example, by agreeing on the methodology to be used – can provide a degree of price certainty and can minimise administrative costs. On the other hand, providing regulatory flexibility can ensure changes in circumstances are taken into account and involve a less prescriptive approach.

We also want to better understand the value stakeholders attach to price certainty. This will help us evaluate the costs and benefits of providing for periodic reviews of the wholesale cost component of retail prices, and the extent to which this may better meet the objectives for this review.

IPART seeks comments on the following

8 How material are the potential policy, regulatory and market developments affecting the gas supply chain?

9 Is a mechanism to update the wholesale gas cost element of regulated retail prices an appropriate way to address the uncertainty in relation to wholesale gas costs? What are the implications for customers and what value do stakeholders attach to price certainty? How should this mechanism be designed to best meet the objectives for the review?

6.4 Risks associated with unforeseen events or changes (special circumstances)

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 tariffs 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.

In the 2007 regulatory period, 3 of the Standard Retailers made an application under the special circumstances clause.[35] In the current period, none of the Standard Retailers made an application under this clause.

For the 2013 regulatory period, the Standard Retailers have proposed retaining the special circumstances clause of the existing agreement.

There is the possibility that material, unforseen or unanticipated changes in costs will occur due to forecasting risk or other events that are unable to be predicted, planned for, or reasonably insured against.

The special circumstances clause in the existing agreements provides little guidance on the scope of IPART's review process for costs associated with these events, including the types of events where it would be appropriate to pass-through the resulting costs to regulated customers, the materiality threshold for these events, and the share of costs to be borne by the Standard Retailer versus customers.

We note that the special circumstances clause is intended to deal with issues/events that are not already covered by the regulatory package. In considering the appropriate design of the special circumstances review process, we will need to take account of factors such as whether the agreements include a periodic review of wholesale gas costs, and if so, whether there remains material risk of underestimating or overestimating costs. Further we would need to consider the ability of the Standard Retailers to manage any cost changes including the incentives created as part of this review. We will also need to consider the administrative costs associated with such reviews. Increasing the scope of a special circumstances review will increase costs and uncertainty and extend the required timeframes.

In addition, we note that the scope of a special circumstances review essentially allocates some risks to customers, which suggests that the Standard Retailers should not be compensated for these risks elsewhere, such as in the retail margin. This is consistent with the approach taken in the 2010 review, under which the retail margin range that we considered reasonable over the 2010 regulatory period was for compensation for systematic risk only.

It may be appropriate to incorporate a threshold for change into the special circumstances clause, recognising the principle of materiality, and the objective of regulatory efficiency including minimising administrative costs.

35 For example see http://www.ipart.nsw.gov.au/Home/Industries/Gas/Reviews/Retail_Pricing/AGL_Retail_Energy_proposal_for_price_increase_under_Special_Circumstances_Provision.

We note that a higher threshold may result in the Standard Retailers being exposed to costs significantly above those they forecast, which may have a significant impact on their financial viability as well as the development of the competitive market. Conversely, a lower threshold could mean that we need to review the pricing agreements annually, which would not be consistent with light-handed regulation or encouraging the Standard Retailers to manage small cost changes which would be viewed as part of the ordinary operation of business.

IPART seeks comments on the following

10 Should we retain the special circumstance clause in the new agreements? How would this clause sit alongside any periodic review of wholesale gas costs?

11 How should we review an application for a special circumstance price change? Should there be a materiality threshold? And if so, what should that threshold be?

7 Costs underlying the proposed prices

Another important question we will consider in analysing the Standard Retailers' proposals is whether the forecast costs underlying their proposed prices are consistent with those an efficient and prudent retailer would incur in supplying small retail customers on regulated prices over this period. We will also seek to ensure that costs are not recovered more than once.

As previous chapters have discussed, the Standard Retailers' costs include 3 components: retail costs, carbon costs and network costs ('R+C+N' components). They have proposed to pass through their actual carbon costs and network costs to customers via the C and N components of regulated retail tariffs (see Chapter 6). Therefore the forecast costs we will consider in this step of our proposed approach are those included in the retail (R) component of regulated retail tariffs:

- wholesale gas costs
- retail operating costs, and
- a retail margin.

We will also consider the costs that underlie their regulated non-tariff fees and charges (miscellaneous charges).

We have not formed any preliminary views on the efficiency of the retailers' proposed costs at this stage. The sections below discuss how we propose to assess each of the above costs.

7.1 Wholesale gas costs

Gas retailers typically procure wholesale gas, and generally its transmission to the city gates, via long-term bilateral contracts with gas producers and transmission asset owners. They typically hold a portfolio of commercial-in-confidence gas supply contracts with varying expiry dates. The terms and conditions of each supply contract are likely to vary, depending on the geographic location and capacity of the relevant gas field and associated processing facilities, as well as the allocation of risks between the retailer and producer. The charges for gas transmission are also likely to vary depending on the distance over which gas must be transported, the productive efficiency of the pipeline and the utilisation of its capacity.

These arrangements for procuring gas suggest that there may be a wide range of wholesale gas costs, largely determined by confidential agreements, which are difficult to compare. They also mean there is likely to be limited publicly available data we can use to estimate an appropriate allowance for the wholesale costs associated with serving regulated gas customers in NSW. In previous reviews, we have analysed the Standard Retailers' actual and forecast wholesale costs, and formed a view on whether these costs are reasonable.

For this review, each of the Standard Retailers has proposed real increases in wholesale gas cost for 2013/14. For example, AGL has calculated these increases by indexing the amount of wholesale gas costs that we determined were efficient and prudent in our 2010 review, and incorporating any actual and forecast increases in these costs they have incurred or expect to incur under their existing portfolio of gas contracts.

We are not able to provide the details of the retailers' forecast costs due to the confidential nature of information on gas wholesale costs. Nevertheless, we will assess the reasonableness of these costs to ensure that the proposed prices are in the long-term interests of customers. We will consider the overall level of the costs, as well as the allocation of costs between customers on regulated tariffs and market contracts. We will ensure that costs are not recovered more than once.

We intend to establish a set of benchmark wholesale gas costs to assist us with our assessment. This set of costs would aim to reflect the costs an efficient and prudent retailer would incur in supplying small customers in each of the supply area, including:

- base gas supply costs
- additional deliverability costs (to service peak demand)
- transmission costs, and
- other costs.

Establishing these benchmark costs would require us to consider the characteristics of an efficient and prudent retail gas supplier. We would like to know whether there is more public information available to assist us with this task than there was at the time of the 2010 review.

In addition to helping us assessing the reasonableness of the Standard Retailers' proposed wholesale costs, a set of benchmark costs would have further benefits. For example, it may create stronger incentives for retailers to reduce their wholesale costs by decoupling regulated prices from the Standard Retailers' actual costs.[36] It may also reduce the data we need to obtain from the Standard

36 This is the approach we take in other industries such as electricity. Setting cost allowances that are decoupled from regulated entities actual costs provides incentives for them to reduce their costs as they retain any profits (or bear any losses). This is typically known as 'incentive regulation'.

Retailers and improve the transparency of our decisions in relation to the reasonable cost of supply gas customers. In addition, it may assist us in updating the wholesale gas cost element of retail prices in any periodic review.

As Chapter 6 discussed, we also intend to carefully consider the uncertainties associated with forecasting gas commodity costs in NSW in the second and third years of the regulatory period. (See section 6.3 for more information.)

We may seek expert advice to assist us with considering the wholesale costs an efficient and prudent retailer would incur over the regulatory period.

IPART seeks comment on the following

12 What is the prudent and efficient level of wholesale gas costs for each Stan dard Retailer over the next 3 years? What are the key factors affecting these costs?

13 How should we characterise a prudent and efficient retail gas supplier for benchmarking purposes?

7.2 Retail operating costs

Retailers incur a range of costs in performing their retail business functions, including costs related to billing, marketing, providing customers advisory services, advertising, and handling customer inquiries. We will need to assess the Standard Retailers' proposed operating costs for serving regulated customers.

Each of the Standard Retailers has proposed increases in these costs for 2013/14. They have submitted that a range of factors is influencing retail costs, including inflationary pressure and higher customer switching rates which has increased their customer acquisition and retention costs.

We propose to assess the Standard Retailers proposed retail operating costs over the 2013 regulatory period through a combination of benchmarking and sourcing data from other jurisdictions and industries. We will make use of the analysis of retail operating costs being conducted for the 2013 review of regulated electricity prices, and will also seek information from the Standard Retailers and other stakeholders.

In assessing the proposed retail operating costs we will consider:

- whether gas retailers are likely to face any change in costs over the 2013 regulatory period that they have not faced in past years, and
- whether previous analysis and benchmarks are still a valid starting point, and if not, whether there are any alternative approaches.

IPART seeks comment on the following

14 What is the prudent and efficient level of retail costs for each Standard Retailer over the next 3 years? Have there been any significant changes in gas retail business activities since the 2010 review?

7.3 Retail margin

Gas retailers effectively play a buffering role between the supply and demand sides of the markets. They buy gas from suppliers and then generally sell this to customers at a fixed price. In doing so, they face a range of risks, some of which are systematic risks stemming from variations in economic conditions and demand. These systemic risks arise because the costs of gas retailing are largely fixed, while revenue varies with demand. It is reasonable for the Standard Retailers to earn a retail margin that compensates them for these risks.

Each of the Standard Retailers has proposed a retail margin expressed as a fixed percentage of its total sales to regulated customers. In addition:

- AGL, Country Energy and Origin Energy proposed to increase this percentage towards the upper bound of the range we previously considered reasonable (7.3% - 8.3% EBITDA).[37]
- ActewAGL has proposed a margin of 6.5% (on an EBIT basis), which is towards the upper bound of the EBITDA range we previously considered reasonable.

We note that AGL's proposal to increase its retail margin to 8% of the total cost to supply small customers on regulated tariffs is the primary driver of its proposed overall increase in the retail component of these tariffs in 2013/14.

For the 2013 review, we will consider the appropriate retail margin for gas retailers in NSW. In doing so, we will take account of the range we previously considered reasonable, whether there are any market or industry changes that may affect the systematic risks facing gas retail business, and whether or not any additional risks are most appropriately compensated for in the retail margin. We will also consider the analysis on the retail margin being undertaken for the review of regulated electricity prices, taking account the differences between the industries. In addition, we will consider how the Standard Retailers proposals to include additional mechanisms, such as the review of wholesale gas costs or carbon cost-as well as the scope for reopening the agreement affect the risks they face.

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[37] Our final decision for the 2010 review noted that we considered that a reasonable retail margin range was 7.3% to 8.3% in our final decision. See IPART, *Review of regulated tariffs and charges for gas 2010-2013 - Final Report*, June 2010, p 32.

In general, we consider that the retail margin should reflect the systematic risk facing retailers in supplying gas to customers. However we seek stakeholder comment on whether the margin for the 2013 regulatory period should also reflect other risks.

IPART seeks comment on the following

15 What is an appropriate retail margin for each Standard Retailer over the next 3 years? Has there been any change in the level of systematic risk or other business-specific risks the Standard Retailers will face over the next 3 years, and to what extent should these be compensated for in the retail margin?

16 Should the retail margin continue to be expressed as a fixed proportion of costs? To which cost components should the retail margin be applied?

7.4 Miscellaneous charges

As Chapter 4 discussed, AGL, ActewAGL and Origin Energy proposed to increase their current miscellaneous fees by no more than the change in the CPI in each year of the regulatory period. AGL also proposed to introduce a 0.6% merchant service fee for bills paid by credit and debit card. Country Energy (which is owned by Origin Energy) proposed to align its miscellaneous fees with the fees Origin Energy charges regulated customers in the Albury/Murray Valley regions.

In assessing the Standard Retailers' proposed increases in miscellaneous charges, we will consider the relationship between these fees and retail operating costs. We will seek to ensure that these costs are recovered only once (either through miscellaneous charges or retail operating costs).

In relation to AGL's proposed introduction of a merchant fee for bills paid by credit and debit card, we note that none of the Standard Retailers currently charge such a fee. We will seek to ensure that the costs associated with merchant fees are not recovered twice.

In relation to Country Energy's proposal to align its miscellaneous charges with those charged in another supply region, we will consider whether there is any reason for the costs incurred for these services to differ across supply regions.

IPART seeks comment on the following

17 Is it reasonable for a Standard Retailer to introduce a new fee for payment of gas bills by customer using credit and debit cards?

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 Boxal
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.

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V12/4188

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

Chris Hartcher MP

Encl. 27·9·12

B Overview of the gas market

The supply of gas begins with ex-field production, when conventional or coal seam gas is extracted from wells in explored fields and processed where necessary to remove impurities. The gas is then transported, often over long distances, from the gas fields to customers, across 2 types of networks:

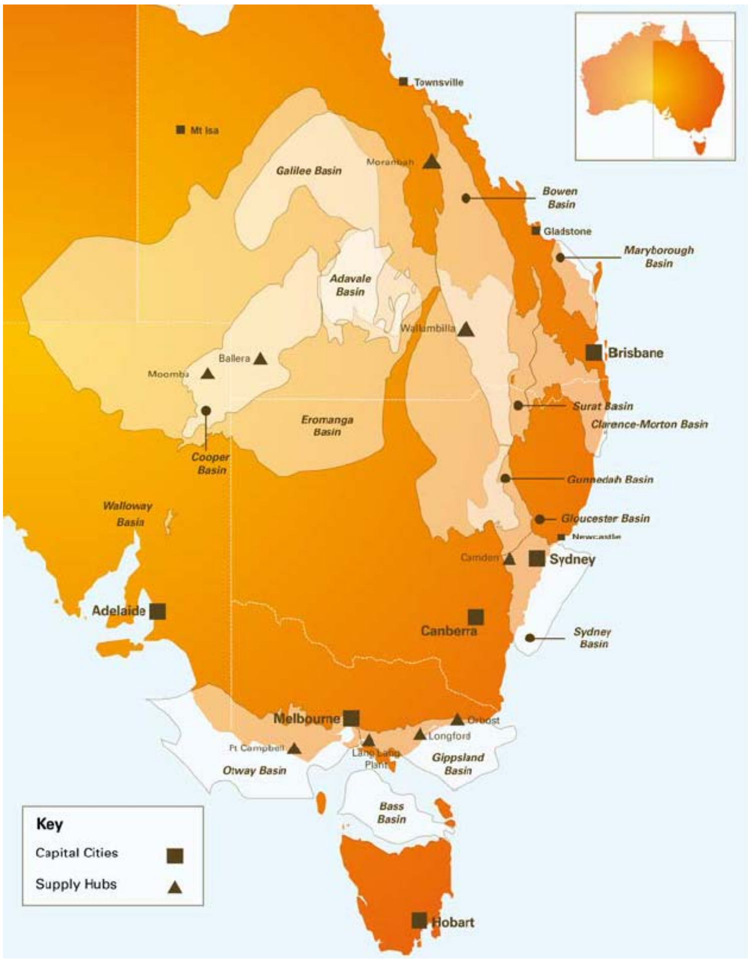
- high pressure transmission pipelines, which transport gas from gas fields to large customers and distribution networks in metropolitan and regional areas
- low pressure distribution networks, which transport gas from points along the transmission pipelines to customers in cities, towns and regional communities.

The supply chain is completed by retailers, who buy the gas commodity and package it with transmission and distribution services to sell to residential, commercial and industrial customers.

B.1 Gas production

The geography of Australia's gas basins and transmission networks gives rise to 3 distinct regional markets – Eastern Australia, Western Australia and the Northern Territory. The gas basins in Eastern Australia are shown in Figure B.1 below.

Figure B.1 Sources of gas in Eastern Australia



Data source: Core Energy Group, *Eastern & Southern Australia: Existing Gas Reserves & Resources*, 2012, p 4.

Table B.1 Sources of natural gas to NSW as at June 2011

Basin	Conventional/CSG	Location	2P reserve estimates August 2011[a]	2010/11 production
Cooper	Conventional	SA/QLD (onshore)	1373 PJ	96 PJ
Otway	Conventional	SA/VIC (onshore)	939 PJ	106 PJ
Bass	Conventional	VIC (offshore)	268 PJ	18 PJ
Gippsland	Conventional	VIC (offshore)	4571 PJ	252 PJ
NSW basins	CSG	NSW	2910 PJ	6 PJ
Bowen/Surat	CSG/Conventional	QLD	35169 PJ	235 PJ
Totals			**45230 PJ**	**713 PJ**

[a] 2P jointly refers to proved and probable reserves, defined as the volumes of gas reserves which, under current economic and operating conditions, are commercially recoverable with a probability of at least 50%.

Data Source: AER, *State of the Market 2011,* p 79.

NSW sources most of its gas from the Cooper Basin in South Australia and the Gippsland Basin in Victoria.[38] Gas from Queensland has been available to NSW since January 2009, with completion of the Queensland to SA/NSW Pipeline (QSN Link).

A small quantity of gas is produced in NSW, where commercial production of coal seam gas began in the Sydney Basin in 1996, and more recently in the Gunnedah Basin.[39] While proven and probable reserves in NSW are estimated at 2910 PJ, coal seam gas production in the state was limited to 6 PJ in 2010/11.

In the Sydney Basin gas is sourced from the coal seam gas (CSG) fields in Camden, 100% owned by AGL.[40]

B.2 Gas transmission

Transmission pipelines enable gas to be transported under high pressure from gas production facilities to city gates (the entry point to the distribution system) or to users located on the transmission pipeline. The transmission pipelines that transport gas from the onshore and offshore gas basins to NSW are listed in Table B.2 below.

Table B.2 Major transmission pipelines to NSW

Pipeline	Origin	End Users	Regulation
Moomba to Sydney Pipeline (MSP)	Moomba	Sydney Canberra	Unregulated between Moomba and Marsden (73% unregulated)
Eastern Gas Pipeline (EGP)	Victorian Gas Distribution Network (Longford)	Sydney Canberra	Unregulated
Interconnect (Wodonga to Wagga Wagga)	Victorian Gas Distribution Network (Wodonga)	Sydney Canberra (through the MSP)	Unregulated
Queensland to Sydney link (QSN link)	Queensland	SA Sydney (through MSP) Canberra (through MSP)	Unregulated

Source: NERA Consulting, The Gas Supply Chain in Eastern Australia, Owen Inquiry into Electricity Supply in NSW, Availability and Cost of Gas for NSW Baseload Production.

38 AER, *State of the Energy Market* 2011, p 95.

39 AER, *State of the Energy Market* 2011, p 79.

40 In 2009 AGL acquired Sydney Gas Limited and became 100% owner and operator of the project. See http://agk.com.au/camden/index.php/the-project/.

Australia's gas transmission pipeline network has almost trebled in length since the early 1990s. Large investments have been invested in new gas transmission pipelines and expansions since 2000, including the construction of the EGP, the Interconnect and the QSN link, facilitating the increase of supply alternatives available to buyers in NSW. (Before 2000, only gas produced in SA was available in NSW.)[41]

B.3 Gas distribution

Jemena Gas Networks (NSW) Ltd (Jemena) (a subsidiary of Singapore Power International Pty Ltd) owns most of the NSW Gas Distribution Network (24,430 km of mains) which enables gas transported via the EGP and MSP and gas produced by the Sydney Gas Company to be sold in Sydney. Gas produced by the Sydney Gas Company at Camden is supplied directly into the distribution system.

The distribution system in Canberra (4,160 km of mains) is owned by Actew Corporation and Jemena, who have a 50:50 joint venture arrangement. The distribution network in Canberra enables gas transported via the EGP and MSP to be sold into Canberra. A second pipeline located between Hoskinstown and Fyshwick acts a storage vessel during peak times.

Envestra owns the Wagga Wagga distribution network (680 km of mains), while the APA Group[42] owns the Central Ranges System which covers the region around Tamworth (180 km of mains).[43]

B.4 Gas retailing

For residential customers, retailers are responsible for securing the supply of gas. They need to have arrangements in place to transport gas on the NSW distribution system and pay market participant fees to the market operator, the AEMO. In NSW, while there is some government ownership of the gas retail sector,[44] it has always been mainly in private hands.

The Standard Retailers covered by this review are AGL, ActewAGL, Origin Energy (trading under the Country Energy brand name) and Origin Energy.

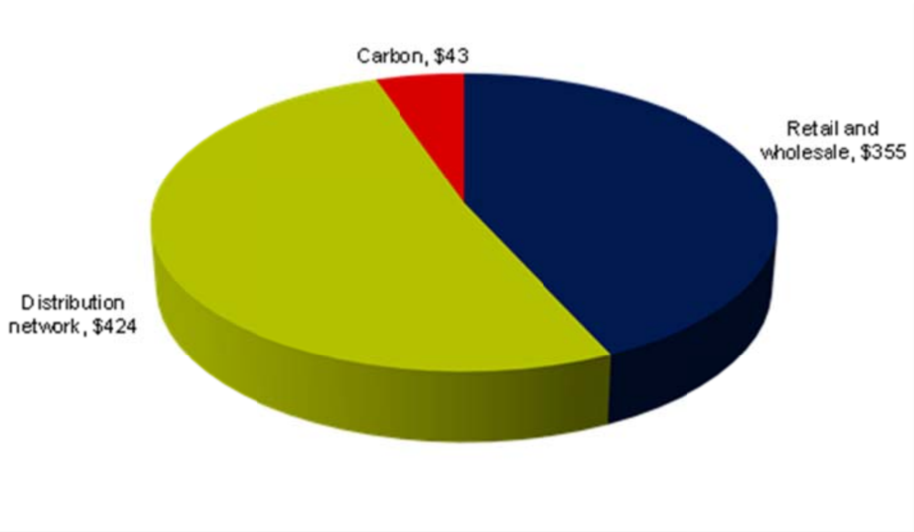
41 AER, *State of the Energy Market 2008*, p 252.
42 Comprising of the Australian Pipeline Trust and APT Investment Trust.
43 AER, *State of the Energy Market 2011*, p 97.
44 For instance, ActewAGL is a joint venture between ACTEW Corporation, an ACT Government owned business and AGL.

B.5 Typical customer bills

A typical customer bill is made up of the costs of the various components involved in supplying gas to small customers as described above.

Figure B.2 shows the make-up of a typical regulated residential retail customer bill in AGL's supply area in 2012/13. Around 43% of a typical customer bill or $355 per year is made up of the retail component, including wholesale gas costs. The costs associated with the carbon price will represent around 5% of a typical customer bill, or $43 per year in 2012/13.[45] The costs associated with using the gas distribution network will represent around 52% of a typical customer bill, or $424 per year in 2012/13.

Figure B.2 Components of a typical regulated residential retail gas bill in AGL's supply area in 2012/13 ($, including inflation)



Note: Costs calculated for a typical regulated residential gas customer in AGL's supply area using 23 GJ per year. Includes GST.

Data source: IPART.

45 This percentage is likely to differ in other supply areas due to the underlying network prices.