Review of Regulated Retail Tariffs and Charges for Gas 2013-2016

Response to IPART Issues Paper

21 January 2013

ActewAGL

for you

Contents

1. Introduction

The New South Wales (NSW) Minister for Resources and Energy issued a Terms of Reference (TOR) on 27 September 2012 requesting that the Independent Pricing and Regulatory Tribunal (IPART) continue regulating default tariffs for small retail gas customers in NSW for the period 1 July 2013 to 30 June 2016. As part of its review, IPART invited gas retailers in NSW to submit revised voluntary transitional pricing arrangement (VTPA) proposals. ActewAGL Retail (ActewAGL) provided its revised VTPA proposal on 21 November 2012.

This submission responds to IPART's Issues Paper *Review of regulated retail tariffs and charges for gas 2010-13* (Issues Paper) released on 27 November 2012.

ActewAGL believes that full price deregulation would provide the full benefits of competition to flow to all stakeholders in New South Wales. However, given that regulation is to remain for a further three year period, ActewAGL agrees with IPART that "moving away from pricing agreements to a more prescriptive, and less light-handed form of regulation, would be a regressive step."[1] Specifically, ActewAGL supports VTPA's to be used as the light handed form of regulation.

In 2006, the Council of Australian Governments (COAG) committed to phase out retail price regulation where competition can be demonstrated.[2] Recently, the Standing Council on Energy and Resources (SCER) recommended to COAG that it reaffirm the commitment to deregulate retail prices where competition is effective.[3] SCER supports the need for retail energy markets characterised by strong competition which offer innovative products and services to the benefits of consumers.[4]

ActewAGL agrees with IPART "that a well-functioning competitive market can provide more effective customer protection and better customer outcomes than price regulation".[5] ActewAGL maintains that persisting with retail price regulation increases costs and risks for both retailers and consumers through potential distortions of the gas market, denying customers the benefits that flow from a truly competitive market free of unnecessary regulatory constraints. Accordingly, removing unnecessary regulation allows the competitive market to deliver better outcomes.

The current review by the Australian Energy Market Commission (AEMC) of the effectiveness of competition in the NSW retail energy market will assess "the state of competition and the extent to which it is deemed effective for small electricity and natural gas customers…"[6] and will make its recommendations in September 2013. The NSW Government will then determine its response to the AEMC's recommendations. In anticipation of the AEMC review, it is particularly important to maintain or reinforce the "light-handed" nature of IPART's VTPA approach.

To the extent VTPAs continue to be used, it is appropriate that retailers are subject to a weighted average price cap (WAPC) with no side constraints on individual tariffs. ActewAGL

[1] IPART 2012
[2] COAG 2006
[3] SCER 2012
[4] SCER 2012
[5] IPART 2012
[6] SCER 2012

proposes the continuation of the current VTPA based on an “R + N + C” (retail, network and carbon components) structure for setting prices but with greater flexibility to account for additional uncertainties in this regulatory period.

The main difference for this regulatory period compared to the last period is the increased and significant uncertainty regarding wholesale gas costs. ActewAGL has advised, in its November 2012 submission, that it has been unable to obtain firm forecasts of wholesale gas costs for years two and three of the regulatory period and requested IPART to set a price path for year one, with a single subsequent review of the wholesale cost of gas prior to year two for the final two years of the next VTPA period.

IPART has decided not to form a preliminary view in its Issues Paper[7] on ActewAGL’s proposal to manage whole gas cost uncertainty, which is similar to the approach suggested by the other Standard Retailers. Instead IPART has proposed 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.”[8] ActewAGL notes that IPART may engage external consultants to do this.

ActewAGL understands that the difficulty in forecasting wholesale gas costs for years two and three of the regulatory period has left IPART in a situation where it would prefer more information to assess the risks of continuing with a fixed retail price path. However, ActewAGL cautions IPART in the use of any benchmark wholesale costs as the basis for its regulatory decisions, particularly if they will be fixed in place for the three years. If Retailers are unable to reasonably forecast wholesale gas costs for the three year period, IPART, or its consultants, will not be in a better position to derive commensurate and acceptable estimates of the future wholesale gas cost. Moreover, ActewAGL considers that any move in the direction of detailed cost based reviews unnecessarily increases the regulatory burden and administrative costs and limits the value of the VTPA approach.

ActewAGL welcomes IPART’s preliminary view that Retailers be allowed to automatically pass through their actual network costs in the regulated retail prices and that a mechanism, similar to the one in place for the 2010-2013 regulatory period, be included to allow pass through of carbon costs in each year of the next regulatory period.

ActewAGL notes that IPART has sought comment on retaining the special circumstances provision and whether there should be a materiality threshold. IPART has noted that the clause provides little guidance on the scope of a review process, the types of events, the materiality threshold and the share of costs to be borne by the Standard Retailer versus customers.

ActewAGL believes that the broad nature of the current special circumstances clause is appropriate with a light handed regulatory mechanism and that there should not be any materiality threshold attached to it. The Standard Retailers have shown during the last two periods that they are circumspect in recovering cost variations by only using the clause in limited special circumstances. Experience with the current mechanism should assure IPART in relation to administrative costs. Moreover, each application is considered and controlled by IPART such that only approved costs will be passed on to customers.

ActewAGL looks forward to working with IPART in the review process of the upcoming VTPA.

[7] IPART 2012, p35
[8] IPART 2012, p36

2. Form of Regulation

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?

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

In the Issues Paper, IPART proposes the continued use of VTPAs because they 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
- 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.[9]

ActewAGL has consistently supported the deregulation of the retail gas market in NSW. The transition to a competitive market in NSW has already taken place, and further benefits will accrue to customers through deregulation, including competitive pricing and increased choice. ActewAGL strongly believes that regulated arrangements increase costs and risks for retailers and consumers through potential distortions to the gas market.

Given that regulated retail gas prices will remain, as directed by the NSW Minister for Resources and Energy, ActewAGL broadly agrees with IPART's view on the merits of continuing the regulation with VTPAs.

Increasing flexibility in the VTPAs and the form of regulation by incorporating ActewAGL's proposal for a wholesale gas cost review, during 2013-14, to apply for the final two years of the next VTPA period will assist in appropriately managing commercial uncertainties both for customers and Standard Retailers. ActewAGL encourages IPART to enable a transparent pass through of changes in any other costs outside retailers' control.

[9] IPART 2012, p18

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?

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

ActewAGL does not believe that there are structural impediments to competition and customer participation other than the overlay of price regulation in a market already open to full retail competition. The increase in competition over recent years, highlighted by an increase in customer switching rates, is evidence of this. Continued regulation remains the biggest risk to the ongoing development of efficient market operation and it is therefore important to ensure the VTPA remains flexible.

ActewAGL endorses IPART's inclination to continue to use a WAPC form of price control for the 2013 - 16 regulatory period and its preliminary views that a WAPC continues to be sufficient to promote efficiency and protect customers[10]. ActewAGL agrees that the WAPC is also consistent with the other objectives for the review[11].

ActewAGL considers a WAPC, with no side constraints on individual tariffs, to be appropriate for this review. ActewAGL believes that a departure from a WAPC should only take place if it were to assist a move to full deregulation of retail tariffs.

The only enhancement that ActewAGL suggests is to take account of current circumstances with the introduction a mechanism for a one-off review during 2013-14 of the wholesale gas cost to apply for the final 2 years of the next VTPA period. There is considerable uncertainty for the 2013 – 2016 period that, in ActewAGL's view, can best be addressed by a single review of this cost component prior to year two of the regulatory period. This enhancement would still fit within the WAPC and the VTPA framework.

[10] IPART 2012, p 28
[11] IPART 2012, p31

4. Managing risks and uncertainties

Distribution network costs

Is there any reason not to accept the Standard Retailer's proposal to pass through network costs to consumers?

ActewAGL supports IPART's preliminary view to accept the Standard Retailers' proposal to automatically pass through the actual network costs in regulated retail prices. As previously noted by ActewAGL[13], and also recognised by IPART in the Issues Paper[14], network distribution costs represent a significant portion of final retail tariffs and are not within the retailers' control. As noted by IPART, "requiring retailers to bear the risk associated with forecasting this costs is likely to increase the overall cost of supplying gas to customers [and] may also affect their financial viability."[15] ActewAGL also believes that if it was not certain that network costs would be passed through, retailers would need an increased risk premium to be compensated for the increased risk.

Costs associated with the Carbon Pricing Mechanism

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

ActewAGL supports IPART's preliminary view to continue the current carbon mechanism, as proposed by ActewAGL,[16] in the revised agreement for the 2013 – 2016 VTPA period. This includes an expected continuation of the same methodology for calculating the direct costs of complying with the scheme for years one and two of the next VTPA period. Should the carbon price float as currently legislated in year three of the next VTPA period, ActewAGL proposes to use a similar review process as in 2012-13.

As pointed out by IPART, ActewAGL has no control over the costs associated with the Carbon Pricing Mechanism. The current process allows pass through of the costs, in line with the intentions of the scheme, without excessive undue administrative costs.

[13] ActewAGL 2012, p8
[14] IPART 2012, p33
[15] IPART 2012, p33
[16] ActewAGL 2012, p34

Wholesale gas costs in 2014/15 and 2015/16

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

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?

ActewAGL believes there are significant risks and uncertainties arising from potential market and policy developments. It is therefore imperative that IPART considers these uncertainties and provides a flexible regime whereby material changes can be addressed through the VTPA process. ActewAGL has proposed a review of wholesale gas costs in 2013-14 in order to address such issues.

Management of the wholesale gas cost uncertainty in years two and three is the most significant change required for the new price agreements.

As described in its pricing proposal,[17] the management of wholesale gas purchases has been outsourced to AGL to manage ActewAGL's risk and benefit from economies of scale. As stated by AGL in its the submission to IPART:

> "The certainty available in the past has been possible as prices are underpinned by relatively stable pricing arrangements entered into by AGL. These pricing arrangements have provided the basis for IPART to determine the reasonableness of AGL's proposal. However, over the next VTPA, there is significant uncertainty in these arrangements." [18]

And:

> "Not only is AGL uncertain what its costs of supply will be over the period of the proposed VTPA, AGL is not able to include in public or confidential submissions any indications as to the expected outcomes of these GSA price reviews." [19]

For the reasons described above, ActewAGL remains uncertain of the wholesale gas cost for 2014/15 and 2015/16. While IPART has not formed a preliminary view on ActewAGL's proposal for treatment of wholesale gas costs, ActewAGL supports the view that "it is in the long-term interests of customers for regulated prices to reflect the movement in efficient costs."

IPART points out that a periodic review of wholesale gas costs "will have costs as well as benefits." [20] However, given that it is currently not possible to source reliable wholesale gas cost forecasts for 2014 - 2016, a risk premium would need to be added to any wholesale gas price forecast to reflect the uncertainty should a fixed three year cost

[17] ActewAGL 2012, p8
[18] AGL 2012, p4
[19] AGL 2012, p2
[20] IPART 2012, p35

estimate be set now. Given that wholesale gas represents about two thirds of the cost base for the R component, ActewAGL does not believe the three year forecast, with a risk premium attached, is in the interest of any participant in the market.

By setting the remaining price path in 2013-14, customers would have the certainty of being charged a cost reflective price and the retailer's risk would be appropriately managed. ActewAGL considers that the VTPA could be designed such that only the wholesale gas cost component is reviewed in 2013-14 to apply for the final two years of the next VTPA period and that the VTPA could incorporate a mechanism that updates the 'x-factor' for the last two years for the wholesale gas cost outcome.

Costs arising from unforeseen events or changes

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

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

Special circumstances provisions are important in providing retailers with sufficient flexibility to adjust prices in response to unforeseen changes impacting retailer costs. The continuation of a special circumstances provision allows retailers to recover these costs. To date, the special circumstances clause has worked well in terms of not being misused by Retailers and has provided some level of comfort over potential issues that can arise which are outside a retailers' control.

ActewAGL believes there should be no materiality threshold introduced in relation to the application of the special circumstances provision. There is an implicit materiality threshold in the form of a retailer's prudent commercial behaviour. ActewAGL suggests it is unlikely a retailer would trigger the special circumstances condition if the amount is not material due to the internal costs of conducting an application for a special circumstance price change. This has been borne out over previous and current regulatory periods.

The inclusion of a review of wholesale gas costs before the commencement of year two of the next VTPA period would be in addition to the special circumstances clause. Due to the review of the wholesale gas costs ActewAGL believes that the new agreement only can specify the R-component for the first year. Following the outcome of the wholesale gas review[21], the R component for the final two years could then be determined. Any review framework that is considered should be assessed against IPART's guiding principles and incorporate sufficient flexibility to accommodate uncertain price impacts.

[21] ActewAGL notes that all other costs of the R component would already have been reviewed and would not need to be updated.

5. Costs underlying the proposed prices

Wholesale gas costs

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?

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

The key factor affecting the wholesale gas costs for the next three years is the uncertainty surrounding the costs for years two and three of the regulatory period. As discussed above, ActewAGL has been unable to obtain firm forecasts of wholesale gas costs for these years from its wholesale gas provider, AGL.

ActewAGL understands that its inability to provide wholesale gas costs for years two and three of the regulatory period has left IPART in a situation where it is seeking more information. However, ActewAGL cautions IPART in the use of any benchmark wholesale costs as the basis for its regulatory decisions, particularly if they will be fixed in place for the three years. Although the following was aimed at electricity regulation, the risks of regulation in a competitive market are regularly reported and well recognised:

> [E]stablishing a market price for electricity at the retail level is extraordinarily complex.
>
> …Having customers buying at a fixed price but facing extremely volatile wholesale prices can transform a healthy firm to bankruptcy in a matter of weeks.
>
> ... if regulators also set retail prices, they are compounding the risks of regulatory failure because ... , but they are also overriding market determined costs that emerge from competition between generators and retailers themselves.[22]

ActewAGL points out that if Retailers are unable to forecast wholesale gas costs for the three year period, it is highly unlikely that IPART, or its consultants, will be better positioned to estimate efficient costs with more certainty. ActewAGL reiterates the importance of having a transparent and open process, in which both IPART and its consultant's methodologies for determining the wholesale gas costs are well understood by stakeholders.

However, if benchmarking is to be undertaken, ActewAGL considers that the characteristics of a prudent and efficient retail gas supplier should be those of a mass market new entrant.

[22] "Rules Distort Energy Market: Deregulation of retail prices would change the electricity sector for the better", *The Australian*, 30 April 2012, General News: p 12

Retail operating costs

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?

Since the 2010 review customers are switching at a far greater rate than in 2010, resulting in significant increases in costs of acquisition and retention. The AEMO reports for NSW that in December 2013[23] there were 19,272 customer transfers in contrast to only 9,185 in December 2010[24].

More activity has resulted in higher operating costs. This is compounded by the fact that ActewAGL is a relatively small payer in regional markets and incurs a premium in engaging third party sales channels.

ActewAGL notes IPART's intention to assess proposed retail operating costs through a combination of benchmarking and sourcing data from other jurisdictions and industries[25]. ActewAGL believes IPART's previous retail operating cost analysis and benchmarks are a valid starting point and are suitable for the purposes of this review. However, it is important when using benchmarks and analysis from previous review periods and other industries that they be updated to adequately reflect and account for industry differences, different economies of scale, market developments, geographical differences and changes from when the models were first constructed.

Retail margin

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?

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

ActewAGL notes that IPART 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." Given these are additional risks, the appropriate comparative regulatory (EBIT) margin should be at least 6.5%. ActewAGL further notes that the objective with the proposed wholesale gas adjustment mechanism is designed to help manage and neutralise a new additional risk. Therefore, a reduction in the retail margin is not appropriate.

[23] AEMO 2013, p.1
[24] AEMO 2012, p1
[25] IPART 2012, p41

Finally, ActewAGL's proposed EBIT margin of at least 6.5% is consistent with the EBITDA margin range accepted by IPART in its 2010 decision of 7.3% - 8.3%[26].

For the purposes of consistency, ActewAGL suggests that the retail margin should continue to be calculated and applied in the same manner as previous regulatory decisions. A change to how the margin is applied would require a new margin to be calculated. ActewAGL does not see any benefit from making any changes.

Miscellaneous charges

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

ActewAGL has not proposed any new miscellaneous charges. It has also proposed that the current clause relating to the introduction, amendment or removal of miscellaneous fees and charges remain.

ActewAGL believes it is reasonable for a retailer to introduce a credit card fee to the extent it reflects actual extra costs incurred by the retailer and is legally and legislatively permissible. The costs for retailers of credit card fees have increased over the last 5-10 years and ActewAGL therefore believes it would be reasonable to allow recovery of such fees.

[26] IPART's consultant SFG shows that an EBIT-margin of 5.7 – 6.7% translates to an EBITDA margin of 7.3-8.3% (page 4 of SFG's report "Estimation of a competitive profit margin for gas retailers in New South Wales, 24 May 2010)

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