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20 May 2013

Mr James Cox
Chief Executive Officer
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

By email: ipart@ipart.nsw.gov.au

Dear Mr Cox,

Review of regulated retail prices and charges for gas, 2013 to 2016 – AGL's Revised Pricing Proposal

AGL welcomes the opportunity to comment on the Independent Pricing and Regulatory Tribunal ('IPART')'s Draft Decision on the Review of regulated retail prices and charges for gas, 2013 to 2016, April 2013 ('Draft Decision'). AGL's comments should be read in conjunction with AGL's gas pricing proposal which was submitted to IPART in November 2012 and AGL's submission to IPART's Issues Paper in January 2013.

Draft Decision

In the Draft Decision, IPART has confirmed AGL's proposal to continue with the current light-handed form of regulation under an N+R+C approach and has agreed to the following:

- Using a weighted average price cap form of price control for the retail component.
- Passing through network charges.
- Passing through the carbon component as proposed ($1.72/GJ for 2013/14).
- Providing a mechanism for special circumstances.
- Increasing miscellaneous charges by up to CPI.
- Introduction of a merchant service fee under the National Energy Customer Framework ('NECF').

The Draft Decision has two key variances from AGL's proposal.

Firstly, IPART did not agree with AGL's proposed increase in the Retail Component of average regulated prices for2013/14 of CPI+7.7%. Instead, IPART considered that an increase of CPI+5.1% to be consistent with balancing the longer and shorter term objectives for this review. In making this decision, IPART has stated that they had not assessed and decided on the individual cost components and have exercised their own judgement to decide whether the total proposed change was reasonable.

Secondly, given the current uncertainty of AGL's negotiations with its gas suppliers, AGL had proposed a review of the gas commodity cost only in early 2014 to finalise the price path in the second and third year of the regulatory period. Although, IPART has agreed to set a price path for the first year of the regulatory period only, IPART has proposed periodic reviews of the Retail Components for the second and third years of the regulatory period.

General comments

AGL supports IPART's view that competition is sufficiently effective in the NSW gas retail market to protect customers from prices being set above efficient levels. The level of competition as represented by the gas churn rate in NSW has continued to remain high and currently matches the electricity churn rate in electricity. In addition, the movement in customers from regulated gas prices has continued since AGL's pricing proposal was submitted. AGL estimates that currently less than 25% of customers in NSW remain on regulated prices.

In AGL's view, the current review has been conducted in the proper spirit of a light handed approach whereby IPART has formed an independent view of costs especially the wholesale gas costs and has taken a holistic view of the price proposal rather than a strict costs build-up. AGL notes that IPART has to make a judgement on where the balance is between the various objectives of the review. While AGL has a slightly different view of where that balance rests, AGL accepts IPARTs Draft Determination and has amended its application accordingly. AGL will further explore this issue in the next periodic review.

AGL's comments on the Retail Component

The Retail Component comprises three main components – wholesale costs, retail costs and retail margin. In AGL's view, to establish a regulated retail price which facilitates competition, these components should be based on market benchmarks rather than costs based on incumbent retailers.

Wholesale costs

IPART had engaged ACIL Tasman to assess the range of benchmark wholesale cost of gas for 2013 to 2016 for Standard Retailers in NSW. AGL's proposed wholesale cost of $8.26/GJ in 2013/14 is materially below ACIL Tasman's assessment of the efficient wholesale cost of gas for AGL of $8.85/GJ. As noted by ACIL Tasman, AGL's proposed costs reflect legacy contract costs.

Retail costs

AGL notes that IPART's assessment of the reasonable range for retail operating costs of $91 to $110 per customer has not included acquisition and retention costs based on the view that competition for gas customers tended to focus on dual fuel customers so that some of the costs associated with customer acquisition and retention costs are shared across electricity and gas customers[1].

AGL markets electricity and gas both separately and on a dual fuel basis. Commissions and incentives are paid on each account signed through the various channels such as brokers, comparator sites and telemarketing. Dual fuel accounts are treated as two separate accounts. Therefore, the acquisition and retention costs for gas customers should not be underestimated. AGL supports IPART's approach in the Draft Determination for regulated retail prices for electricity, 2013-16, where IPART's consideration of the costs of acquisition and retention costs also includes indirect costs in terms of ongoing market discounts. To be consistent, a similar approach should be adopted when setting regulated retail prices for gas.

Retail margin

AGL had proposed a price path based on a retail margin of 8% which AGL considers to be appropriate. This was also within the reasonable range of retail margin based on the 2010 review.

Based on updated advice from SFG in 2013, IPART has re-assessed the reasonable range of retail margin to be 6.3% to 7.3%. One of the key drivers in the expected returns methodology used by SFG is the propostion of costs which is unrelated to volume. Energy costs are assumed to be largely variable. AGL believes that this understates the fixed proportion of costs as it does not acknowledge to existence of take-or-pay obligations.

In AGL's view, the retail margin should not be assessed in isolation to the other components of the Retail Component. AGL's proposed wholesale costs reflect AGL's legacy supply contracts. If ACIL's assessment of the market benchmark for wholesale costs is used, the retail margin would be 6.1% based on AGL's original proposed increase, which is below the low end of the revised reasonable range.

AGL's revised pricing proposal for R and C for 2013/14

AGL had originally proposed an increase in the Retail Component of CPI+7.7%. Whilst AGL remains of the view that a reasonable retail margin would be in line with the benchmark used in the 2010 review, AGL has revised its pricing proposal to increase the Retail Component by

[1] Review of regulated retail prices and charges for gas, 2013 to 2016, Gas-Draft Report, April 2013, Appendix F, page 84

CPI+5.1% in line with the Draft Decision. Based on AGL's proposed costs, this will provide a retail margin of 6.7%. However it is important to recognise that, if ACIL's estimate of wholesale costs are taken into account, adopting the Draft Decision's price change will only provide a retail margin of 5.4%.

Revised pricing proposal	2013/14
Retail Component (R)	CPI+5.1%

With a change in CPI based on the March 2013 quarter of 2.5%, the average increase in the Retail Component for 2013/14 will be 7.73%.

The proposed Carbon Component based on the legislated price of $24.15/tonne in 2013/14 remains unchanged given IPART's agreement to the proposal.

Based on the draft Jemena network charges for 2013/14 which are expected to increase by 11.7% on average, total retail price (N+R+C) will increase on average by 9.2%.

Periodic reviews for 2014/15 and 2015/16

AGL's proposal, as submitted in November 2012, contained an approach whereby the Retail Component was 'locked in' apart from specific changes to wholesale costs with respect to the price path for 2014/15 and 2015/16. These cannot be identified until early 2014. AGL's proposal did not involve a complete re-assessment of the Retail Component each year but merely the finalisation of one component (i.e. gas commodity cost) of an otherwise pre-determined wholesale cost in a once-off review of the price path for the last two years of the regulatory period.

In the Draft Decision, IPART has proposed an alternative approach which involves annual reviews of the Retail and Carbon Components in the second and third years of the regulatory period. This is in recognition of the emerging changes in the wholesale gas market influenced by the development of liquefied natural gas ('LNG') facilities on the eastern coast of Australia which could link domestic gas markets with the international LNG and oil markets. In addition, there is also uncertainty in forecasting carbon costs as the carbon price, if it continues, will move from a fixed to a market-based price in 2015.

Although this approach will involve a broader review than initially proposed, AGL supports IPART's proposal for the periodic reviews outlined in the Draft Decision. Depending on the clarity which AGL will have on its future wholesale costs, AGL may be in a position to propose a price path in 2014 for the last two years of the regulatory period which could be based on a market benchmark for wholesale costs, and retail costs which include customer acquisition and retention costs and indirect costs.

If you have any questions in relation to this revised proposal, please contact Meng Goh on (02) 9921 2221 or mgoh@agl.com.au.

Yours sincerely,

Beth Griggs
Head of Energy Market Regulation