AGL Response to the Independent Pricing and Regulatory Tribunal

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

21 January 2013

Executive Summary

AGL welcomes the opportunity to provide comment on the IPART Issues Paper. This submission should be considered in the context of AGL's gas pricing proposal which was provided to IPART in November 2012.

While AGL continues to advocate price deregulation, AGL understands that IPART is currently obliged to continue with price regulation. On this basis, AGL is of the view that pricing arrangements should be as light handed as possible to allow flexibility and a simple transition to price deregulation within, or following, this regulatory period .

Therefore, it is appropriate that IPART continue to apply the current pricing agreement framework of using an R + N + C approach, based on a weighted average price cap (WAPC). Network costs are outside the control of retailers and make up about 50 per cent of the retail price while considerable uncertainty also surrounds the future of carbon pricing. Consequently, a failure to effectively pass through these costs over the period would impose significant additional risk onto retailers. The proposed N + R +C approach is relatively simple and allows retail prices to be adjusted in a straightforward manner to recognise these cost changes.

In its pricing proposal to IPART, AGL highlighted the market developments and price reviews which are in progress that deter AGL from estimating, and indeed, from commenting on future movements of wholesale gas costs. Consequently, AGL has proposed a specific price path for 2013-14 but has proposed that the price path for 2014-15 and 2015-16 be finalised at a later date. As it is not possible to forecast wholesale gas costs in these circumstances, AGL believes that this approach is the only viable alternative at this point in time. AGL has offered as much certainty as possible by 'locking' down all other costs within the Retail Component except the gas commodity cost.

In relation to other cost components, retail operating cost is based on the mid-point of the benchmarks which IPART assessed in the 2010 review and the retail margin allowance is set at a reasonable level. In nominating the level of retail margin, AGL is cognisant that until recently, the churn rate in the NSW gas market has been the lowest of all the electricity and gas markets in the NEM. A suitable margin is therefore required to encourage competitive activity.

1. Introduction

AGL welcomes the opportunity to make this submission to the Independent Pricing and Regulatory Tribunal (IPART) in respect of the *Review of regulated retail prices and charges for gas 2013 to 2016 - Issues Paper* (Issues Paper), released in November 2012.

This submission should be considered in the context of AGL's gas pricing proposal which was provided to IPART in November 2012 and AGL's submission to IPART's *Review of regulated retail price and charges for electricity 2013 to 2016 – Issues Paper* in December 2012.

With the announcement by the SA Government on 18 December 2012 to deregulate prices in the retail electricity and gas markets, the NSW gas market remains the only jurisdiction with price regulation in the retail gas market in the NEM region. Whilst IPART has previously stated that price regulation should be removed where there is effective competition, AGL acknowledges that IPART is constrained by the Terms of Reference.

Over the 2013-16 period there will be a number of uncertainties, particularly:

- market developments in the east-cost gas market as noted by IPART;
- the AER review of gas network charges from 1 July 2015; and
- the future of carbon pricing (contingent on the 2013 federal election and, if continued, the flexible pricing from 1 July 2015).

Under the R+N+C approach, the network charges and carbon costs will be passed through subject to a methodology to be determined for carbon costs in 2015-16. The retail component is proposed only for 2013-14 as AGL's wholesale gas costs over the review period are currently under arbitration and therefore unknown.

This submission to the Issues Paper should be read on the basis that in AGL's view, the current pricing approach is generally reasonable and should be extended over 2013-16. However, there should also be adjustments to include real increases in certain cost components which the current price path has not anticipated and, considering that the level of competitive activities can be improved, to set regulated prices based on a reasonable margin.

2. Terms of reference and context for the review

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

In Section 2.3 of the Issues Paper, IPART has highlighted all the relevant policy, regulatory and market developments which could materially affect this review.

AGL's proposal had focussed on the uncertainty due to the price reviews with AGL's major wholesale suppliers and the state of competition in the gas retail market.

3. Current pricing agreements

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?

The current voluntary transitional pricing agreement (VTPA) adopted an R + N + C approach based on a weighted average price cap (WAPC) and a price path set by IPART after a review of retailers' proposals.

Market developments, network pricing and carbon pricing have made it difficult to set a precise price path for 2013-16. In the AGL's pricing proposal, the uncertainty facing AGL with respect to wholesale gas supply and carbon pricing over the period was highlighted. Given the requirement to continue with regulation, pricing arrangements should be as light handed as possible to allow flexibility. AGL has already noted that only about 30% of gas customers in NSW remained on regulated prices. AGL anticipates the proportion of customers on regulated contracts will continue to decline.

AGL agrees that the current VTPA has been successful for the reasons listed by IPART in the Issues Paper. Unless IPART is able to shift to a price monitoring role instead of price setting, the current approach should continue.

4. Form of price control

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?

The level of churn activity in the NSW retail gas market has been high in recent months but it is not possible to conclude if this likely to continue. Prior to this, the churn rate had been the lowest of the electricity and gas markets in the NEM. In order to enhance this recent level of activity, whilst also noting the recent trend that the share of gas customers on regulated prices is likely to decline to 25% by the commencement of the next VTPA, AGL has proposed a retail margin allowance which is within a reasonable range.

In a competitive market, if regulated prices are set too high the excess margin will be eroded away through competition from other retailers and will also encourage more customers on regulated prices to consider market offers.

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

Since 1 July 2010, AGL's retail gas prices have been restructured to reflect the network tariffs. This has allowed network pricing signals to be communicated to end users. However, to minimise the price impact, the Retail Component of the retail prices has not been fully aligned. The WAPC approach allows the Retail Component to be re-aligned each year while taking into account the impact on customers.

In AGL's view, the current WAPC approach continues to be appropriate. AGL has no request for any change to this approach considering that AGL has only two regulated gas retail tariffs – one each for residential and small business customers.

5. Additional mechanisms to address risks and uncertainties

5.1 Risk associated with distribution network costs

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

AGL's pricing proposal to pass through network costs under the 'R+N+C' approach is consistent with the current 2010-13 pricing agreement and the approach for NSW electricity regulated retail prices. Retailers have no control over network costs and comprise approximately 50 per cent of the retail price. Retailers would be exposed to unsustainable levels of risk if retailers were not permitted to pass these costs through completely.

The current Jemena Access Arrangement for NSW gas distribution networks will expire in June 2015, at the end of the second year of the price path. The next price path is subject to review by the AER and any changes should be passed through.

5.2 Risk associated with carbon costs

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

The proposed approach for setting the direct cost of the carbon pricing scheme is relatively simple and allows retail prices to be adjusted in a straightforward manner if this scheme is removed.

However, if the scheme continues, there will be uncertainty during the flexible pricing period from 1 July 2015 and AGL considers that the proposed deferral in setting the 2015-16 carbon component until 2015 is appropriate to minimise forecast risk.

It should be noted that proposed carbon costs for 2014/15 have been estimated on the basis that the relevant upstream emissions factor published in the National Greenhouse Accounts Factors is unchanged from 2012/13. If during the price path the emissions factor is changed in a later publication of the NGA Factors, the upstream emissions allowance in the C component should be amended accordingly.

5.3 Risk associated with 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?

AGL has stated in its proposal that it cannot offer a view of wholesale gas costs, either in respect of likely actual costs or 'appropriate benchmarks', without potentially prejudicing its current price reviews with its gas suppliers.

Recognising the objectives for this review, AGL has proposed a specific price path for 2013-14 with the price path for 2014-15 and 2015-16 to be finalised at a later date.

This proposal, acknowledging the commercial risks in the wholesale gas market, offers as much certainty as possible by 'locking' down all components of the Retail Component with the exception of gas commodity cost.

IPART has requested stakeholder feedback on whether a mechanism to update the wholesale gas cost element is an appropriate way to address the uncertainty in relation to wholesale gas costs, and if a mechanism is recommended then how it should be designed. AGL is of the view that any mechanism should allow for AGL to recover the costs to supply gas to standing contract customers. As the largest Standard Retailer for natural gas in NSW, the impact of not being able to recover these updated costs would be substantial for AGL and not in the long term interests of our customers or competition in the retail gas market. AGL proposes that a mechanism be established where AGL will provide IPART with documentation setting out the change in wholesale gas costs (in real terms) on a confidential basis. AGL welcomes consultation with IPART on this to ensure that it meets their requirements for evidencing the change in the efficient costs of supply.

AGL is firmly of the view that it is not possible to forecast the wholesale cost for the entire period of the VTPA in these circumstances, and that the measures proposed by AGL present the only viable option.

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

Should we retain the special circumstance 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 circumstance price change? Should there be a materiality threshold? And if so, what should that threshold be?

The special circumstance clause (clause 4.9) in the current VTPA states that:

> *"...special circumstances include, but are not limited to, events that result in changes to costs such as regulatory changes, taxation changes, unanticipated field price review or fundamental changes to gas market frameworks and arrangements*."

This clause covers a broad range of changes which are beyond the control of retailers and complements any periodic review of wholesale gas costs.

AGL views the special circumstances clause as operating completely separately from the process that would be required to finalise the gas commodity cost for the second and third year of the VTPA. The finalisation of the gas costs would be a very straight forward process scheduled under the VTPA, whereby AGL would provide IPART with information required to identify the real change to the existing gas commodity cost for those years. The special circumstances clause is intended to cover a broad range of eventualities, and the process required in any review conducted by IPART as a result of a special circumstances application would need to be determined by IPART at the relevant time.

AGL recommends the retention of the special circumstance clause without a materiality threshold as in the current VTPA. The timing and justification processes under clause 4.8 impose sufficient discipline on the retailers to only invoke this clause if the costs are significant enough to do so. This is clearly demonstrated by the fact that there has been no application for a special circumstance by any standard retailer over the three year period of the current VTPA (2010-13).

6. Costs underlying the proposed prices

6.1 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?

IPART has suggested that the use of benchmarks for wholesale costs could create stronger incentives for retailers to reduce their wholesale costs by decoupling regulated prices from the Standard Retailer's actual costs.

While AGL appreciates the reasons IPART is considering in the development of such benchmarks, AGL does not agree with this suggestion for the following reasons:

- In its pricing proposal, AGL has highlighted the wholesale gas supply price reviews which are in progress and the implications of commenting on wholesale costs. This includes any reference to benchmark costs. AGL would effectively be precluded from commenting as these comments could affect AGL's ability to best protect its position in the gas price reviews;
- AGL has suggested as a basis for the wholesale cost component under the VTPA the wholesale costs determined to be efficient and prudent in the 2010 review. Under AGL's proposed VTPA, these costs for 2014/14 would be inflation adjusted initially, and then adjusted for any real increases;
- If the benchmark cost is set below actual costs, it would affect the level of discounts and retail competition and would impede any move towards price deregulation; and
- As a retailer which services a range of market segments including large industrial customers, it is in AGL's interest to minimise costs across its portfolio, regardless of whether a benchmark exists.

From AGL's perspective, an efficient and prudent retailer will continue to be a retailer which sources gas on a 50:50 basis from Moomba (in South Australia) and Longford (in Victoria) via the Moomba-Sydney Pipeline and the Eastern Gas Pipeline respectively. The wholesale gas costs in the 2010 review had been based on AGL's contracts as they had been re-set following price reviews which had concluded and therefore represent the most current prices at that time.

6.2 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?

In AGL's gas pricing proposal, the retail operating costs have been based on the mid-point of the benchmarks which IPART has assessed in the 2010 review. Including the incremental operating costs related to the carbon pricing scheme which was put forward in 2012 to establish the Carbon Component (C), AGL's proposed retail operating costs amounts to $112 per customer in 2012-13, compared with IPART's benchmark retail operating costs for electricity of $123 per customer.

In its submission to IPART's *Issues Paper* on the *Review of regulated retail prices and charges for electricity 2013 to 2016* in December 2012, AGL provided details of AGL's net operating costs per customer across its total electricity and gas customer base. This was about $140 per customer. This was based on information provided to the Australian Stock Exchange in an Appendix 4E report which is publicly available. Although it is arguable that these costs should be adjusted to reflect the definition of operating costs for regulatory purposes, these costs are nevertheless instructive.

6.3 Retail margin

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 be compensated for in the retail margin?

AGL has previously submitted in the 2010 review that a retail margin of up to 8 per cent would provide the appropriate reward for the risks associated with retailing gas in NSW and provide an incentive for new retailers to actively compete in the market. As noted earlier, until recently, the churn rate in the NSW gas market has been the lowest of all the electricity and gas markets in the NEM. To encourage competitive activity, it is important that the retail margin allowance is set at a reasonable level.

AGL's proposed retail margin is set within the reasonable range of 7.3per cent to 8.3 per cent which IPART determined in the 2010 review.

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

AGL has proposed that the retail margin should be set as a percentage of revenue. This can be considered as a fixed proportion of total costs including wholesale gas costs, network costs and retail operating costs. The retail margin accounts for retailers' risk (as well as return on investment) and this risk increases as costs increase.

6.4 Miscellaneous charges

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

For a number of years, AGL has charged customers on market contracts a merchant fee. AGL has proposed, under the National Energy Customer Framework, a merchant fee for customers on regulated prices. This is to ensure that AGL recovers costs specifically from customers who create these costs. Customers can avoid this cost through other payment methods.

AGL notes that fees and charges are already treated as an offset or a reduction of operating costs in AGL's publicly reported 'net' operating costs (discussed earlier).