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Dr Peter Boxall, AO
Chairman
Independent Pricing and Regulatory Tribunal
PO Box Q290, QVB Post Office
QVB Post Office NSW 1230

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

Dear Dr Boxall,

Early Termination Fees – Electricity – Issues Paper

AGL Energy welcomes the opportunity to comment on the Independent Pricing and Regulatory Tribunal (IPART)'s Issues Paper on Early Termination Fees (the **Issues Paper**), August 2013.

Background

IPART has released an Issues Paper to investigate and determine the price cap relating to one component of the early termination fee (ETF) which energy retailers may charge if a market contract is terminated prior to the specified period in the contract. IPART has referred to this component as the "base ETF" which "reflect[s] a retailer's reasonable costs in giving effect to the early termination of the contract". This review does not cover other components of the ETF which include unrecovered inducement costs due to the early termination of the contract. AGL notes that IPART intends to balance the policy intent of providing protection to customers with the impact that regulating EFTs may have on retail prices and the competitive market.

The four key questions raised in the Issues Paper are considered below.

The types of costs that retailers typically seek to recover through their current ETFs

AGL offers three general types of contracts to customers:

- fixed benefit period contracts (Select products),
- fixed term contracts (Advantage products), and
- non-term contracts (Freedom products).

AGL has currently standardised ETFs across state and fuel on Select and Advantage contracts:

- in the first year, $75 for residential customers and $100 for small business customers, including GST, and

- in the second year, $50 for residential customers and $75 for small business customers, including GST.

Typically, the costs that AGL considers in setting the level of ETFs include:

- incentives or inducements provided to the customer upfront (not included in this review),

- costs to acquire and establish a contract:
  - generation, postage and printing costs (where applicable) relating to confirmation packs,
  - back office processing to establish an account in the customer data system,
  - direct costs of acquiring a customer through a variety of channels (such as aggregators, brokers, telemarketing online, etc.)

- costs to close a contract:
  - generation, postage and printing costs (where applicable) relating to the final bill
  - handling calls relating to cancellations in the contact centre
  - back office processing cost to close account
  - bad debts associated with final bill payment
  - breaking of hedging arrangements relating to the contracts.

These costs are generally consistent with the costs which IPART has outlined in the Issues Paper.

At AGL, ETFs are not designed to fully recover the costs associated with early termination with fixed term contracts. In setting the level of ETF, AGL recognises that an ETF which is too high could deter customers from entering into the contracts. Therefore, setting the level of ETF requires judgement to balance cost recovery against the risk of deterring customers from signing up. This helps to explain the lack of a clear relationship, as noted by IPART, between the level of the ETF and other features of the product, aside from the costs arising from different retail strategies (e.g. a focus on certain channels to acquire customers).

The costs, consistent with the terms of reference, which can be included in the base ETF cap

IPART has considered the costs a retailer would avoid if the customer had not signed the contract with the costs that would be incurred if the customer did not complete the contract. IPART is seeking comments on how to interpret the costs of giving effect to early terminations. A broad interpretation would include costs associated with establishing the contract such as customer acquisition costs and administration costs of establishing a new account while a narrow interpretation would exclude them.

IPART has identified five general types of costs (Tables 3.1 & 3.2) in the Issues Paper. In general, AGL agrees that these types of costs should be considered. However, AGL has not undertaken a full assessment of all costs which may relate to early termination, for example, by conducting an activity based costing study. AGL seeks only to recover the main costs which can be identified as outlined earlier. Some costs identified by IPART are relevant avoidable costs such as costs relating to the establishment of the retail contracts and the management of renewable energy obligations, but are difficult to determine without a detailed study.

In AGL’s view, acquisition costs which are incurred upfront are expected to be recovered over the life of the contract. Early termination removes the opportunity for these costs to be fully recovered. It is therefore reasonable that a base ETF include an amortisation of acquisition costs.

AGL does not consider acquisition costs, administration costs and hedging costs to be costs of lost supply and lost profit. Forgone profit or retail margin is not included when setting the ETF.

Given that the costs have not been assessed comprehensively, in setting a regulated price cap, it is important that a broader interpretation is adopted. In any case, as mentioned above, AGL does not set the level of ETF on a fully cost reflective basis and a balance is required to ensure that the level of ETF does not deter customers from taking up the market offer.

The level and range of the costs reasonably associated with giving effect to early termination

AGL has provided confidential information to IPART about the range of costs which could be considered to set the base ETF.

AGL's comments on the types of costs identified by IPART are as follow:

- Customer acquisition and marketing costs:

  Retailers use a range of channels to acquire customers. These include aggregators, brokers, inbound and outbound telemarketing, online and comparator websites.[1] The level of competition in the market also has an impact on these costs. AGL has provided estimates of the direct channel costs to IPART. However, a useful reference is the 'cost per lead sale' reported in AGL's full year results to 30 June 2013. This cost which is similar to customer acquisition cost amounted to $221 per new customer in 2012/13 and since January 2011, these costs have averaged $198 per new customer.[2]

- Investments made on behalf of customer:

  These costs are difficult to determine and AGL has not included any estimates for these costs.

- Administrative costs of establishing a new account:

  AGL has reported an average cost of $6 per new customer on sales fulfilment activities.[3] These costs have been incurred to process new customers onto AGL systems.

- Energy purchase portfolio adjustment cost:

  AGL has proposed the use of a put option as a proxy for the cost of adjusting the energy portfolio. AGL notes that IPART intends to engage a consultant to provide expert advice on the approach for estimating the energy purchase adjustment costs.

- Administrative costs of finalising account:

  AGL agrees that in addition to administrative costs, the costs relating to finalising the account should include the expected increase in bad debts due to early termination.

The impact of the introduction of a base ETF cap for consumer prices and the competitive market

As retailers have different retail strategies, it is important that IPART does not set the base ETF at a level which constrain retailers' ability to set terms and conditions which reflect their cost structures. AGL agrees with IPART's concern that setting a base ETF which is too low will have a detrimental impact on product diversity and service quality.

In a competitive retail energy market as in NSW, retailers carefully consider the need to have a balance between full cost recovery and the customers' negative view of ETFs. On this basis, AGL considers that retail competition would limit the risk of setting the ETF cap too high. If the ETF exceeds underlying costs, retailers will 'discount' the ETF. From a marketing perspective, there is little advantage in having a high ETF.

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[1] Since March 2013, AGL has ceased unsolicited door to door energy sales activity to residential customers.
[2] AGL annual results to 30 June 2013, Appendix 4E statement to the Australian Stock Exchange, page 14. It should be noted that the 'cost per lead sale' includes upfront incentives.
[3] Ibid

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

Yours sincerely,

Beth Griggs
Head of Energy Market Regulation