Independent Pricing and Regulatory Tribunal

Review of regulated retail prices and charges for gas from 1 July 2016

Energy — Issues Paper
November 2015

IPART
New South Wales

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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 18 December 2015.

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 mail to:

2016 review of regulated retail gas prices
Independent Pricing and Regulatory Tribunal
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Late submissions may not be accepted at the discretion of the Tribunal. Our normal practice is to make submissions publicly available on our website <www.ipart.nsw.gov.au> as soon as possible after the closing date for submissions. 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.

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1 Introduction

Residential and small business gas customers in NSW have been able to choose their gas retailer and enter into market contracts for the supply of gas for more than 10 years. While most have taken up this opportunity, just under 20%[1] of customers remain on regulated prices under a standard contract with one of the Standard Retailers in this state – AGL, ActewAGL and Origin Energy.

The Independent Pricing and Regulatory Tribunal of NSW (IPART) is responsible for regulating the retail gas prices the Standard Retailers charge customers who are still on standard contracts. We use a light-handed regulatory approach that involves reaching voluntary pricing arrangements (VPAs) with each Standard Retailer. As the current VPAs are due to expire on 30 June 2016, the Minister for Industry, Resources and Energy (the Minister) has asked us to reach new VPAs for the period 1 July 2016 to 30 June 2017.

This Issues Paper sets out our proposed process and approach for this review and outlines our preliminary views on some issues. It also explains how stakeholders can provide input to the review, and identifies the issues on which we particularly seek stakeholder comment.

1.1 What we have been asked to do

The Minister has asked us to continue to regulate retail prices, fees and charges for small retail gas customers for another year in accordance with section 27 of the *Gas Supply Act 1996* (the Act). He has also asked us to continue to use our current light-handed approach, and to:

- forecast indicative retail gas prices for each year of the period 1 July 2017 to 30 June 2019, and
- review the competitiveness of the retail gas market in NSW and provide advice on any additional measures to strengthen competition in the NSW retail gas market.

1 Based on information provided by the Standard Retailers and IPART compliance database as at 30 June 2015.

The Minister recently announced that the NSW Government will look to deregulate retail gas prices from 1 July 2017 if there is an increase in competition, particularly in regional areas of the state.[2]

1.2 How we propose to approach this review

We intend to use an approach similar to the one we have used for previous reviews of regulated retail gas prices. In line with this approach, we have invited each Standard Retailer to propose a new VPA to apply from 1 July 2016 to 30 June 2017, including proposed average price changes in 2016-17, and indicative average price changes in 2017-18 and 2018-19.

We will assess each retailer's proposal to determine whether the average price change in 2016-17 is reasonable and balances the objectives in the *Gas Supply Act 1996*. Our proposed approach to this assessment is discussed in more detail later in this paper.

1.3 A competitive market provides the best outcomes for customers

As part of our 2013 retail gas pricing review we found that competition was protecting customers, as well as offering more choices and better price and service outcomes. In June this year the Australian Energy Market Commission (AEMC) found that competition in NSW's retail gas market is effective, although less intense in regional areas of the state.[3] As part of this review, we will review the competitiveness of the retail gas market and identify any measures that will promote competition, particularly in regional NSW. In our view, a competitive market provides the best outcomes for customers.

1.4 How stakeholders can provide input to this review

For this review, we will undertake our own analysis, obtain expert advice and conduct a public consultation process. This Issues Paper is the first step in our consultation process, and identifies the key issues on which we seek stakeholder input.

We invite all stakeholders and interested parties to make submissions in response to the paper by 18 December 2015. (Details on how to make a submission can be found on page iii.)

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2 Minister for Industry, Resources and Energy, *Media Release - Driving competition and transparency across the resources and energy sectors*, 1 October 2015.

3 AEMC, *2015 Retail Competition Review, Final Report*, June 2015, pp 87-125.

We will also publish the Standard Retailers' proposals on our website and invite stakeholders to make submissions in response to them.

We will release a Draft Report in April 2016, and invite stakeholder to respond to this review by making a submission or attending a public hearing in April 2016. We will consider all stakeholder comments before making our final decisions and releasing our Final Report in June 2016.

Table 1.1 provides an indicative timetable for the review. We will update this timetable on our website as the review progresses.

Table 1.1 Indicative timetable for this review

Milestone	Date
Release Issues Paper	**12 November 2015**
Receive stakeholder submissions on Issues Paper	18 December 2015
Receive pricing proposals from Standard Retailers	22 January 2016
Receive stakeholder submissions on pricing proposals	February 2015
Release Draft Report	**April 2016**
Hold public hearing on Draft Report	Late April 2016
Receive stakeholder submissions on Draft Report	Early May 2016
Release Final Report	**Early June 2016**

1.5 What the rest of this paper covers

The rest of this paper discusses our proposed approach to the review in more detail. It is structured as follows:

- Chapter 2 outlines the context for the review, including our terms of reference, and the gas market and regulatory developments that we need to take into consideration.
- Chapter 3 provides an overview of our proposed approach for making our decisions in line with our terms of reference.
- Chapters 4 to 6 discuss three of the key steps in this proposed approach in more detail:
  - assessing competition in the retail gas market
  - assessing the retailers' proposed approach for determining average prices, form of price control and mechanisms to manage risk, and
  - assessing the retailers' proposed average price changes and forecast costs.

1.6 List of issues on which we seek 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:

1 Are there any other contextual factors that we should consider that could materially affect our review? 12

2 Do you agree with our proposed approach to the review? Are there any ways we can improve this approach? 14

3 Do you agree with the indicators we propose to use to assess competition in the retail gas market (barriers to entry, expansion and exit, customer participation and outcomes, price movements, and price and product diversity)? Are there other indicators or sources of information we should consider? 20

4 Do you agree with our preliminary views to retain the approach to determining average price changes, the weighted average price cap form of price control and the special circumstances clause? If not, why? 22

5 How would an efficient new entrant gas retailer purchase its gas requirement for 2016-17? Would it purchase gas through bilateral contracts, spot market transactions or a mix of the two? 25

6 Given the uncertainty in wholesale markets, what is the likely length of new domestic wholesale gas contracts negotiated in 2016-17? 26

7 Are there any other changes in non-price terms and conditions in domestic gas contracts we should consider in determining wholesale gas costs for an efficient new entrant retailer? Why? 27

8 Do you agree that prices of new domestic gas contracts are likely to be indexed to oil prices? If not, why? 27

9 How are low oil prices likely to affect wholesale gas costs for an efficient new entrant retailer in 2016-17? 27

10 Are there any other issues we should consider in forecasting wholesale gas costs for an efficient new entrant retailer in 2016-17? 28

11 What is the prudent and efficient level of retail operating costs for Standard Retailers in 2016-17? Do you agree with our proposed approach for estimating these costs? If not, how can we improve our approach? 29

12 What is an appropriate retail margin for 2016-17? Do you agree with our proposed approach for estimating the retail margin? If not, how can we improve our approach? 30

2 Context for the review

In conducting this review and making our decisions, we need to ensure we comply with the Minister's referral letter and the objectives of the *Gas Supply Act 1996* (the Act). We also need to take account of the key market and regulatory developments that form the context for the review.

2.1 Minister's referral letter

The Minister for Industry, Resources and Energy has asked IPART to continue to regulate retail prices, fees and charges for small retail gas customers for the period 1 July 2016 to 30 June 2017, in accordance with section 27 of the Act. In particular, we are to continue to use a light-handed approach to regulation by reaching voluntary pricing agreements with the Standard Retailers for this period.

As part of our review, we have also been asked to:

- forecast indicative retail gas prices for each year from 1 July 2017 to 30 June 2019, and
- review the competitiveness of the retail gas market in NSW and provide advice on any additional measures that could be implemented to strengthen competition in the NSW retail gas market.

In reviewing the competitiveness of the market, we are to consider:

- the pass-through of network price reductions into retail market contracts. This may include the extent of price decreases, the timeliness of price changes, and communication around price changes
- the diversity in retail market offers to cater to different market segments. This may include competition on the fixed supply charge.

The Minister's referral letter is provided in Appendix A.

2.2 Objectives of the Act

The Act has a number of objectives, which IPART aims to achieve through the regulation of retail gas prices. These objects, which are set out in section 3, 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
- 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 retail gas prices promoting the long-term interest of gas customers. We consider that this encompasses:

- encouraging the efficient use of gas by setting regulated prices to recover the efficient costs of supply
- 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.

In addition, section 3(5) of the Act imposes duties on IPART and the Minister which are relevant to the regulation of retail gas prices. Those duties, which apply in relation to NSW's gas users, are to promote the efficient and safe use of gas.

2.3 Market and regulatory developments

There are several substantial developments in the gas market and regulatory environment that we need to take into account in this review. These include:

- the ongoing changes in the wholesale gas market in eastern Australia,
- other regulatory reviews of this wholesale market,
- other regulatory reviews of competition in the retail gas market in NSW, and

- changes to gas distribution network prices in NSW as a result of the Australian Energy Regulator (AER)'s decisions.

2.3.1 Ongoing change in eastern Australia's wholesale gas market

There has been substantial change in the east coast gas market over the past several years, and this change will continue in the coming years. Due to the recent commencement of liquid natural gas (LNG) exports from Queensland, domestic gas prices are now being influenced by international gas prices. By the time all six planned LNG plants are operating, east coast gas production would almost need to triple relative to 2014 levels to meet demand from LNG exports and domestic users.[4] There is some uncertainty about whether there are sufficient domestic gas supplies to meet LNG export commitments. With many domestic gas supply agreements expiring, market uncertainty may be reflected in negotiations for domestic gas supplies.[5]

2.3.2 Other regulatory reviews of eastern Australia's wholesale gas market

Partly in response to this substantial change, the Australian Competition and Consumer Commission (ACCC) and the AEMC are currently conducting reviews of various aspects of the wholesale gas market. The period in which these reviews are being conducted coincides with our review period.

ACCC's East Coast Gas Inquiry

The ACCC is conducting an inquiry in response to concerns by market participants and governments about the efficiency and effectiveness of the wholesale supply of gas in eastern Australia. The inquiry will examine the structure of the gas industry, focusing on the:

- supply and demand characteristics
- gas supply and transportation arrangements
- ability of industry participants to access gas reserves and key infrastructure
- pricing outcomes
- availability and accuracy of information
- dynamics of gas trading, and
- nature of interactions between industry participants.[6]

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4 ACCC, East Coast Gas Inquiry – Issues Paper, June 2015, p 8.
5 Ibid, pp 8-9.
6 Ibid, p 4.

The ACCC will use its findings to assess the state of competition in the wholesale supply of gas. It released an issues paper in June 2015, and will provide a final report by April 2016.

AEMC's East Coast Wholesale Gas Market and Pipeline Frameworks Review

The AEMC is reviewing the design, function and roles of short-term trading gas markets and gas transportation arrangements in eastern Australia, at the request of the COAG Energy Council. The review has two stages, and the AEMC released a final report for Stage 1 in July 2015.

This report outlined areas where reforms may be required to accommodate the changing dynamics created by LNG exports and coal seam gas production, and recommended immediate actions for consideration by the Energy Council to enhance the transparency and efficiency of the market.[7]

In the Stage 2 of the review, the AEMC will develop more options to promote long-term gas market development and to enable the rules governing the markets and pipelines to be fit for purpose in the new gas environment.[8] The AEMC will release a final report for Stage 2 sometime in 2016 after it has considered responses from the COAG Energy Council and Victorian Government.

AEMC's Victorian Declared Wholesale Gas Market Review

The AEMC is also reviewing the pipeline capacity, investment, planning, and risk management mechanisms in the Victorian Declared Wholesale Gas Market (DWGM) at the request of the Victorian Government. This review will identify reforms to improve liquidity, transparency and flexibility of the Victorian gas market in light of significant structural changes resulting from the development of LNG exports.

The AEMC undertook the first stage of this review as part of the East Coast Wholesale Gas Market and Pipeline Frameworks Review, and is due to release a draft report in December 2015. It will release a final report in 2016 after considering responses from the COAG Energy Council and Victorian Government.

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7 The AEMC recommended i) creating a new gas price index (led by the Australian Bureau of Statistics) which measures the trends in prices payable under bilateral contracts over time to improve price transparency, ii) harmonising gas market start times across three spot markets to reduce compliance costs and barriers to trading across multiple hubs, iii) removing the restriction that only AEMO or the Victorian Government can propose rule changes regarding the DWGM to reduce a barrier for smaller market participants and potential new entrants to influence market development, and iv) enhancing information to improve gas pipeline trading capacity.

8 AEMC, *East Coast Wholesale Gas Market and Pipeline Frameworks Review – Stage 1 Final Report,* 23 July 2015.

2.3.3 Other regulatory reviews of competition in the NSW retail gas market

The AEMC conducts annual reviews of competition in retail electricity and gas markets in all jurisdictions of the National Energy Market. In its most recent review (completed in June 2015) it found that competition in NSW's retail gas market is effective, although less intense in regional areas of the state.[9] In October 2015, the AEMC has published an approach paper for its 2016 annual review of competition, which sets out its intended approach for the review and seeks stakeholder submission on the approach and on the state of competition. The AEMC will release a Final Report in June 2016.[10]

As noted above, the Minister recently announced that the NSW Government will look to deregulate retail gas prices from 1 July 2017 if there is an increase in competition, particularly in regional areas of the state.

2.3.4 Changes to gas distribution network prices

The gas distribution networks across NSW charge retailers for using the network to deliver gas to their customers. Network costs typically make up around half of the total retail bill. The Standard Retailers have no control over these costs as in most areas of NSW network prices are regulated by the AER. (The exceptions are the Shoalhaven and Wagga Wagga and surrounding areas, where prices are unregulated.)

As Figure 2.1 shows, the largest gas distribution network in NSW is owned and operated by Jemena. AGL is the Standard Retailer in the Jemena network area, and supplies gas to around 80%[11] of all customers who remain on a standard contract with regulated prices.

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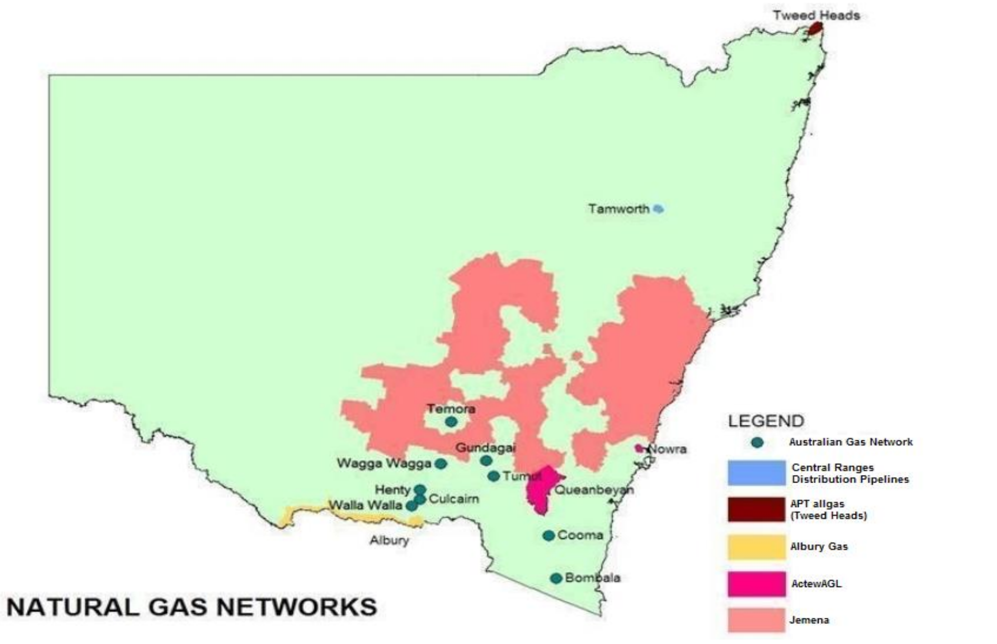
9 AEMC, *2015 Retail Competition Review, Final Report*, June 2015, pp 87-125.

10 http://www.aemc.gov.au/Markets-Reviews-Advice/2016-Retail-Competition-Review, accessed on 2 November 2015.

11 Based on information provided by the Standard Retailers.

Figure 2.1 NSW/ACT gas network areas



Note: IPART does not have a pricing agreement that covers the Tweed Heads network. This is part of the south-east Queensland distribution network area.

Data source: Adapted from NSW Department of Industry, Resources & Energy, *Gas connections*, http://www.resourcesandenergy.nsw.gov.au/energy-consumers/energy-providers/household-gas-connections, accessed on 12 October 2015.

In 2016-17, Jemena's average network prices are expected to fall by around 12%, while those of other regulated networks are expected to remain unchanged (see Table 2.1). However, Jemena's prices are not yet certain. In June 2015, it applied to the Australian Competition Tribunal for merits review and the Federal Court for judicial review of the AER's final decision for its 2015-20 access arrangement.[12] Depending on the final outcome of the merits review, actual network price changes in the Jemena network could be higher or lower than in Table 2.1.

To the extent that network price changes are different across network areas, this will likely contribute to varying changes in overall retail prices for the Standard Retailers.

12 https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/jemena-gas-networks-nsw-access-arrangement-2015-20/appeal, accessed on 23 October 2015.

Table 2.1 Regulated gas distribution access arrangements

Standard Retailer	Gas distribution network supplier	Estimate of average real network price change in 2016-17
AGL	Jemena	-12.00%[a]
ActewAGL	Jemena (Capital region NSW)	-12.00%[a]
	ActewAGL (Queanbeyan)	Not available
	ActewAGL (Shoalhaven)	Not regulated
Origin Energy	Australian Gas Network (Wagga Wagga and surrounding areas)	Not regulated
	Australian Gas Network (Albury)	0%[b]
	Australian Gas Network (Murray Valley)	Not regulated
	Central Ranges Distribution Pipeline (Tamworth)	0%[c]

[a] The AER's final decision on Jemena's X-factors for the 2015-20 access arrangement period. AER, *Jemena Gas Networks (NSW) Ltd Access Arrangement 2015-20 Final Decision Overview*, June 2015, p 21.

[b] The AER's final decision on X-factor. AER, *Access Arrangement Final Decision Envestra Ltd 2013-2017 Part 1*, March 2013, p 14.

[c] IPART, *Access Arrangement for the Central Ranges Pipeline Gas Network*, November 2005, p 15.

Note: Australian Gas Network was previously known as Envestra.

Table 2.1 shows that some gas networks are regulated (ie, 'covered' pipelines) and others are unregulated. Section 15 of the National Gas Law (NGL) sets out the criteria for pipelines to be covered by regulation:

a) that access (or increased access) to pipeline services provided by means of the pipeline would promote a material increase in competition in at least 1 market (whether or not in Australia), other than the market for the pipeline services provided by means of the pipeline;

b) that it would be uneconomic for anyone to develop another pipeline to provide the pipeline services provided by means of the pipeline;

c) that access (or increased access) to the pipeline services provided by means of the pipeline can be provided without undue risk to human health or safety;

d) that access (or increased access) to the pipeline services provided by means of the pipeline would not be contrary to the public interest.

In April 2015 the Minister decided to revoke coverage of Envestra's Wagga Wagga Gas Distribution Network (WWGDN). The Minister was not satisfied that the WWGDN meets all the coverage criteria set out in section 15 of the NGL.[13] Network prices in the Shoalhaven and Murray Valley areas are also not regulated by the AER.[14] Where pipelines are not regulated, retailers would generally negotiate terms and conditions for pipeline access.

IPART seeks comment on the following

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

13 In its application for revocation, Envestra argued that the WWGDN does not satisfy criteria (a) and (d) of pipeline coverage criteria set out in section 15 of the NGL. In relation to criterion (a), Envestra contended that continued coverage of the network will not promote a material increase in competition in dependent markets and noted that coverage to date appears to have had no material effect on competition. In relation to criterion (d), it argued that where criterion (a) is not satisfied there are no competition benefits arising from coverage, and stated that it is unaware of any other public benefits arising from coverage of the WWGDN. See http://www.aemc.gov.au/Energy-Rules/National-gas-rules/Gas-scheme-register/NSW-Envestra-(Wagga-Wagga)-Gas-Network?folderId=25906, accessed on 4 November 2015.

14 https://www.aer.gov.au/networks-pipelines/service-providers-assets/wagga-wagga-gas-distribution-network-0 accessed on 4 November 2015.

3 Our proposed approach

To reach a VPA with each of the Standard Retailers for 2016-17 and respond to the other requests in the Minister's referral letter, we propose to take the following steps:

1. Ask each of the Standard Retailers to propose a new VPA to apply from 1 July 2016 to 30 June 2017, which covers:
   a) its proposed approach for determining average prices, form of price control and mechanisms to manage risk and uncertainty, and
   b) its proposed average changes in regulated retail tariffs and charges for 2016-17, the forecast costs underlying these price changes, and indicative forecast costs for 2017-18 and 2018-19.
2. Assess the level of competition in the retail gas market in NSW and identify any measures that will strengthen competition.
3. Assess each Standard Retailer's proposed regulatory arrangements , including the approach for determining average prices, form of price control and mechanisms to manage risk and uncertainty, taking into account the review context discussed in Chapter 2 and our assessment of the level of competition in the NSW retail gas market in Step 2.
4. Assess each Standard Retailer's proposed average price changes in 2016-17, the forecast costs underlying these price changes, and the indicative forecast costs for 2017-18 and 2018-19. We will focus on whether the forecast costs underlying proposed price changes are consistent with those an efficient and prudent retailer would incur in supplying small retail customers on regulated tariffs in 2016-17, and thus whether the proposed average price changes are reasonable.
5. Based on our assessments in Steps 3 and 4, decide whether or not to agree to each Standard Retailer's proposed VPA. In making this decision, we will consider whether the VPA is reasonable and balances the objectives in the *Gas Supply Act 1996*. If we decide not to agree, we will discuss our reasons with the Standard Retailer and invite it to submit a revised proposal. (Box 3.1 summarises our proposed approach.)

Once we agree to a proposed or revised proposed VPA, the Standard Retailers will set their regulated retail gas prices to comply with the average price changes set out in the agreement, and we will monitor their compliance.

If agreement cannot be reached, we will make a gas pricing order to fix retail gas tariffs and charges for regulated offer customers for 2016-17, as provided for in Part 2, Division 3 of the Act. (While this Division has ceased to have effect, the NSW Government has indicated it that will revive it in the Act prior to 1 July 2016.)

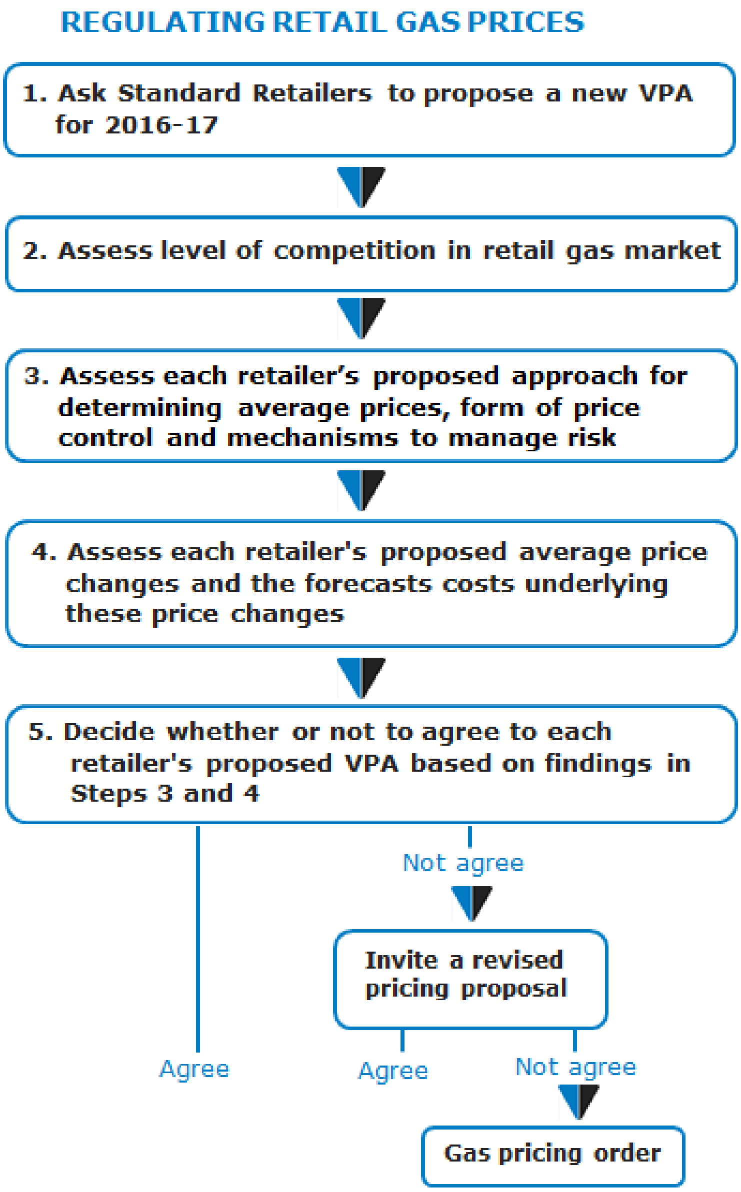
As Chapter 1 indicated, we have already taken Step 1 of our proposed approach – asking the Standard Retailers to propose a new VPA. We expect to receive these proposals by 22 January 2016, and will publish them on our website and invite stakeholder comments.

The next chapters discuss Steps 2, 3 and 4 in more detail.

IPART seeks comments on the following

2 Do you agree with our proposed approach to the review? Are there any ways we can improve this approach?

Box 3.1 Summary of our proposed approach



4 Assessing competition in the retail gas market

Step 2 of our proposed approach for reaching new VPAs for 2016-17 is to assess the level of competition in the retail gas market in NSW. We will use the findings of this step to inform our assessment of each retailer's proposed form of price control (within Step 3 of our approach).

We will also review the competitiveness of the retail gas market to identify and recommend additional measures to strengthen competition, as requested in the Minster's referral letter. The Minister recently announced that the NSW Government will look to deregulate retail gas prices from 1 July 2017 if there is an increase in competition, particularly in regional areas of the state.[15]

In our view, a competitive market provides the best form of protection for customers, and provides more choices and better price and service outcomes. Retail price regulation cannot protect customers from price increases driven by regulatory, policy and market factors, nor can it protect vulnerable households that may be experiencing affordability problems. Rather it is important to ensure that any specific groups of customers that cannot readily access the competitive market, or require financial assistance are specifically considered and targeted responses are developed.

In conducting our assessment, we propose to place an emphasis on competition in regional areas, and to consider four competition indicators:

1. barriers to entry, exit and expansion
2. customer participation and outcomes
3. price movements, and
4. rivalry and price and product diversity.

We considered these same indicators in our 2015 retail electricity market monitoring review. The AEMC also uses similar indicators in its annual competition reviews.

15 Minister for Industry, Resources and Energy, *Media Release - Driving competition and transparency across the resources and energy sectors*, 1 October 2015.

4.1 Barriers to entry, exit and expansion

In our view, the most important indicator for a competitive market is low barriers to entry, exit and expansion. These barriers may include economic, legal and regulatory impediments that affect retailers' ability to enter the retail gas market in NSW, expand their share of this market, and exit the market.

Low barriers to entry mean that new retailers are able to enter the market and compete for customers – and therefore that incumbent retailers face an ongoing threat of competition from new entrants. This threat of competition provides the most effective protection for customers from the exercise of market power.

We propose to assess this indicator by considering information from the AEMC's recent competition reviews, by undertaking our own analysis, and through discussions with retailers and other market participants. The AEMC's 2015 competition review found that retailers' had mixed views on the extent of barriers to entry in the retail gas market. Retailers identified the following barriers:

- wholesale gas market conditions (including access to, and price of wholesale gas given market changes and uncertainty)
- capacity on transmission pipelines
- retail price regulation
- issues associated with the Sydney short-term trading market (including complexity, inability to effectively hedge risks and prudential requirements)
- lack of harmonisation of business-to-business procedures, and
- in regional areas, the relatively small size of the customer base, higher customer acquisition costs and limited geographical pipeline coverage.[16]

Using the AEMC's findings as a starting point, we propose to conduct our own analysis of:

- changes in market share, and
- new retailers that have entered or left the market.

We also propose to hold discussions with retailers and other market participants to discuss market barriers, with a focus in regional areas. In relation to the Shoalhaven area where there is no retail competition, we consider that a mechanism needs to be put in place to enable customers to transfer to another retailer. We made a recommendation in this regard in our 2014 final report for retail gas prices,[17] and understand that the NSW Government is currently working on putting such a mechanism in place.

16 AEMC, *2015 Retail Competition Review, Final Report*, June 2015, pp 112-114.
17 IPART, *Changes in regulated retail gas prices from 1 July 2014 – Final Report*, June 2014, p 9.

4.2 Customer participation and outcomes

Customer participation refers to customers being aware of the choices available to them in the market, and investigating the offers available to them to identify a better gas plan or retailer for their circumstances. Customer outcomes refer to how satisfied customers are with their participation in the market and with their retailer in general.

Much of the information needed to assess customer outcomes needs to be gathered from customer surveys. The AEMC conducts these surveys annually and we do not propose to duplicate this work for our review. Instead, we propose to rely on the survey findings from the AEMC's 2015 review.[18] For example, this review found that in NSW:

- 88% of residential gas customers were aware that they can choose their retailer. In regional NSW, 83% of customers were aware they can choose their gas retailer, up from 67% in 2014.
- Around 12% of customers switched gas retailers in 2013-14, and up to 24% changed gas plan with their existing retailer. Over the last five years, gas switching rates were higher than for other products and services, including car, home and health insurance, banking and internet services.
- 87% of residential customers who switched gas retailers or gas plans were happy with the decision.
- Most customers were satisfied with their gas retailer, although there was an increase in gas-related complaints made to the Energy and Water Ombudsman NSW (EWON) in 2013-14.[19]

We will supplement the AEMC's findings with updated information on customer switching statistics from the AER and complaints data from EWON and the AER. We will also consider submissions made to the AEMC's Approach Paper for the 2016 review. This paper invites stakeholders to comment on the current state of competition in retail energy markets.

4.3 Price movements

We propose to assess whether the retail gas price changes that occurred in 2015-16 are consistent with a competitive market. In a competitive market, we would expect that in the long term, retail prices would change broadly in line with efficient cost changes. In the short term, price movements may be greater than or less than changes in efficient costs, but we would likely see some general relationship between prices and costs.

18 The AEMC's 2016 final report will not be completed in time for our review.

19 AEMC, *2015 Retail Competition Review, Final Report*, June 2015, pp 87-125.

In line with our referral, as part of our assessment of price movements we will consider the pass-through of network price reductions into retail market contracts. This will include the extent of price changes, the timeliness of price changes, and communication around price changes.

We propose to analyse the extent and timeliness of price changes in 2015-16 from information in Energy Made Easy. We will also compare the extent of price changes with the changes in underlying network costs.

We propose to consider communication of price changes in 2015-16 using information from the AER. Requirements on retailers to communicate price changes are set out in the National Energy Retail Law (Retail Law) and the AER Retail Pricing Information Guidelines (Guidelines).[20] Retailers must publish an Energy Price Fact Sheet, which must include information on whether a retailer may vary the prices that apply to an offer and, if the price may vary, how and when small customers will be notified of price variations. The AER is responsible for monitoring, investigating and enforcing compliance with the obligations under the Retail Law.

4.4 Rivalry and price and product diversity

In a competitive market we would expect to see active rivalry between retailers and a range of different price and service offerings to meet the needs of customers. To assess this indicator, we propose to consider the results of the retailer surveys conducted for the AEMC's 2015 competition review, and analyse the market offers available on the Energy Made Easy website.

As required by our referral, we will also assess the diversity in fixed supply charges in retail market offers. To do this, we will review a sample of fixed supply charges in market contracts, and compare this with the underlying network fixed supply charge. In a competitive market, we would expect to see a range of different fixed supply charges to meet the needs of different customers.

Table 4.1 below provides some preliminary analysis of the gas offers published on the Energy Made Easy website. It shows that:

- in some areas there is a single retailer operating in the market, and
- there is a large difference between the number of retailers competing for customers/offers available to customers in metropolitan and regional residential customers.

As part of our review, we will identify if there are any ways to increase the number of market offers available in regional areas.

20 National Energy Retail Law (NSW), s24 and s37.

Table 4.1 Gas offers published in Energy Made Easy (residential customers)

Town/area	Sample postcode(s)	No. of offers	No. of retailers	Gas distributor
Sydney area	2040	28	7	Jemena
Newcastle area	2300	28	7	Jemena
Albury/Murray Valley	2640/2713	7	2	Australian Gas Networks
Queanbeyan	2620	3	2	ActewAGL
Cooma/Bombala	2630/2632	4	1 (Origin)	Australian Gas Networks
Temora/Culcairn/ Henty/Walla Walla	2666/2660/ 2658/2659	4	1 (Origin)	Australian Gas Networks
Gundagai/Tumut	2722/2720	4	1 (Origin)	Australian Gas Networks
Wagga Wagga / Uranquinty	2650/2652	4	1 (Origin)	Australian Gas Networks
Tamworth	2340	4	1 (Origin)	APA Group
Nowra (Shoalhaven)	2541	1	1 (ActewAGL)	ActewAGL

Note: Based on offers published on the Energy Made Easy website as at 6 November 2015. The Energy Made Easy website may not have all offers published, and actual offers available may vary over time.

Source: www.energymadeeasy.gov.au, accessed on 6 November 2015.

IPART seeks comment on the following

3 Do you agree with the indicators we propose to use to assess competition in the retail gas market (barriers to entry, expansion and exit, customer participation and outcomes, price movements, and price and product diversity)? Are there other indicators or sources of information we should consider?

5 Assessing each retailer's proposed regulatory arrangements

As part of their proposed new VPAs, we have asked the Standard Retailers to propose the arrangements to govern how their regulated retail gas prices can change in 2016-17, including:

- the approach for determining average price changes
- the form of price control, and
- mechanism(s) for managing risk and uncertainty.

The sections below discuss each of these mechanisms, and how we propose to assess them and our preliminary views (where we have them).

5.1 Approach for determining average regulated prices

Under the current VPAs, average regulated prices are determined as the sum of:

- the Retail Component, including wholesale gas and transmission costs, retail operating costs and a retail margin, and
- the Network Component, including gas distribution costs.[21]

The approach is consistent with the form of price control under the current VPAs (discussed below). Our preliminary view is that the Retail Component + Network Component approach for determining average regulated prices should also be retained.

5.2 Form of price control

Under the current VPAs, the amount by which the Retail Component of regulated retail gas prices can change is governed by a weighted-average price cap (WAPC). The Network Component (which is regulated by the AER) is passed directly through to retail prices.

Under the WAPC, the Standard Retailers can set the Retail Component of their regulated prices themselves, but must ensure that the overall change in their average regulated price does not exceed the cap specified in the VPAs.

21 Previously there was also a separate Carbon Component however this component was removed from regulated gas prices following the repeal of the Carbon Pricing Mechanism.

Our preliminary view is that the WAPC form of price control should be retained for the Retail Component. We consider that a WAPC allows flexibility for Standard Retailers to rebalance and restructure their regulated prices to be cost-reflective, and would promote competition in the long-term interests of customers.

In addition, our preliminary view is that the Network Component should continue to be passed directly through into retail prices. Retailers have no control over network costs and prices. Passing them through into retail prices ensures they can recover these costs.

5.3 Mechanisms for managing risk and uncertainty

Whenever we agree to pricing proposals that rely on forecasts of costs over the regulatory period, there is a risk the costs that an efficient and prudent retailer incurs 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 current VPAs include a clause that specifies that the Standard Retailers may apply to IPART to vary regulated prices outside the WAPC in special circumstances. These circumstances include, but are not limited to, regulatory changes, taxation changes, and unanticipated gas field price reviews.

Our preliminary view is that the existing special circumstances clause should be retained. We consider it provides an appropriate balance between regulatory certainty (in terms of 'locking in' average price movements) and regulatory flexibility, by providing a mechanism that allows the Standard Retailers to seek our approval to vary prices in special circumstances.

IPART seeks comment on the following

4 Do you agree with our preliminary views to retain the approach to determining average price changes, the weighted average price cap form of price control and the special circumstances clause? If not, why?

6 Assessing each retailer's proposed average changes in regulated prices, fees and charges

As part of their proposed new VPAs, the Standard Retailers will propose average changes in the Retail Component of their regulated prices in 2016-17 as well as changes in the regulated miscellaneous fees and charges. We have also asked them to provide the forecast costs underlying their proposed average price changes in 2016-17, and their indicative average price changes and forecast costs for 2017-18 and 2018-19.

The sections below outline how we propose to assess their proposed average change in the Retail Component and miscellaneous fees and charges.

6.1 Proposed average change in Retail Component

To assess the Standard Retailers' proposed average change in the Retail Component in 2016-17, we will analyse the forecast costs that are recovered through this component of regulated retail prices. These costs include:

- **Wholesale gas costs**, which are the costs faced by an efficient retailer to meet the demand of its customers over a regulatory period. These costs generally include:
  - the costs of purchasing the underlying gas commodity from upstream gas producers (ie, gas commodity cost)
  - additional deliverability costs associated with meeting peak demand requirements
  - transporting gas long distances via transmission pipelines (ie, transmission costs), and
  - market-related costs.
- **Retail operating costs**, which are the costs an efficient retailer would incur in performing the retail functions required to serve its customers.
- **Retail margin**, which is a margin that an efficient retailer should be allowed to earn to compensate it for systematic risks associated with supplying gas to small customers.

We propose to assess whether the Standard Retailer's forecast costs underlying the proposed Retail Component are consistent with those an efficient and prudent retailer would incur in supplying small retail customers on regulated prices in 2016-17. While we will examine the indicative forecast costs for 2017-18 and 2018-19, we will not be making any decisions for those years. Therefore, the main focus of our assessment will be 2016-17.

6.1.1 Wholesale gas costs

We propose to commission expert advice on wholesale gas costs for an efficient new entrant retailer serving small customers in NSW in 2016-17. We have identified a number of issues we will ask our consultant to address, and on which we seek stakeholder comment. These are discussed below and include:

- how an efficient retailer is likely to procure wholesale gas for 2016-17
- what changes are likely in new domestic gas supply contracts
- how low oil prices are likely to affect wholesale gas costs for a new entrant, and
- other issues relevant to determining wholesale gas costs.

How would an efficient retailer procure wholesale gas?

A new entrant retailer could purchase wholesale gas through bilateral contracts, the short-term trading markets (STTM) and/or other sources.

Typically, large wholesale gas customers (ie, retailers, large industrials, mining companies, gas fired generators and LNG proponents) enter into long-term gas supply agreements (GSAs) for a period of 20 years or longer with gas producers. These contracts set out:

- the volume of gas to be supplied by the producer
- the price to be paid by the buyer, and
- other terms and conditions which the gas will be made available.

The contracts also usually include "take or pay requirements", which specify a minimum quantity (as a proportion of the total contracted quantity) that must be paid for each year. In addition, they typically include provisions for the price to increase in line with CPI, and for periodic price reviews to be conducted every three to five years.[22]

22 NERA, *The Gas Supply Chain in Eastern Australia – A report to the Australian Energy Market Commission*, June 2007, pp 24-25.

Large wholesale gas customers may either enter into a single GSA or hold a portfolio of different GSAs in terms of the sources of gas (ie, basins), terms and conditions and contract lengths. In our previous reviews, we estimated efficient wholesale gas costs for a new entrant retailer which procures its gas requirement by entering into these long-term bilateral contracts.

Large wholesale gas customers can also purchase gas from the STTM hubs in Adelaide, Sydney and Brisbane without having to enter into long-term contracts. The STTMs were established in Adelaide and Sydney in September 2010 and Brisbane in December 2011 to facilitate short-term gas trading using market-driven prices and to improve price discovery. The majority of trades that occur on the STTMs are within-participants. This is because while the majority of gas bought and sold on the east coast is through long term bilateral contracts (ie, outside the STTMs), all gas delivered to the hub is required to be transacted through the STTMs. This results in the same entity (eg, AGL) selling gas into the STTMs and purchasing it back each day.

However, there is evidence that trading volumes between different entities in the STTMs are increasing. Some large wholesale gas customers are increasingly using the STTMs to fill supply gaps, and others are entirely relying on the short term markets to procure its gas requirement to supply small customers.[23] Some market participants found the STTMs useful as a way of initially entering the gas market before committing to bilateral gas supply and transportation agreements.[24]

IPART seeks comments on the following

5 How would an efficient new entrant gas retailer purchase its gas requirement for 2016-17? Would it purchase gas through bilateral contracts, spot market transactions or a mix of the two?

What changes are likely in new domestic gas supply contracts?

As Chapter 2 discussed, the eastern Australian gas market is undergoing substantial changes following the commencement of LNG exports. These changes are creating uncertainty around how the market may develop in the near future, and this uncertainty is affecting negotiations for the supply of gas.

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23 http://www.accc.gov.au/speech/the-importance-of-adequate-competition-for-the-east-coast-gas-market accessed on 17 September 2015.

24 AEMC, *East coast wholesale gas market and pipeline frameworks review – Stage 1 Final report*, 23 July 2015, p 112.

One of the potential changes could be in relation to the length of gas supply contract. Previously, contracts with a length of 20 years or longer were most common as they provide reliable revenue streams to sellers and security of gas supply to buyers, given high risks associated with gas exploration and production. However, it has been reported that an increasing number of contracts negotiated recently have a much shorter length.[25] Due to uncertainty in the eastern Australian domestic gas market, both buyers and sellers seem to be seeking more flexibility in their gas supply and demand, and favouring shorter term contracts as a way of managing their risk associated with increasing uncertainty in gas market.[26]

Another potential change could be in relation to the indexing arrangements for contract prices. Previously, contract prices in domestic gas supply contracts on the east coast have been linked to the CPI.[27] However, Australian gas exports have traditionally been referenced to the benchmark oil price because the early use of gas was as a substitute for oil.[28] In the Asia-Pacific gas market, LNG contract prices are linked to crude oil spot prices based on the Japan Customs-cleared Crude (JCC) Index pricing mechanism. Now that domestic gas producers on the east coast have an option to sell gas overseas, domestic gas contracts are likely to shift from CPI-linked prices to oil-linked prices, or a combination of these index pricing mechanisms.

There is some evidence that this is already occurring. For example, Jacobs SKM reported that a number of new contracts, which were negotiated since the LNG projects entered their construction phases, had some oil-linked pricing components.[29] AGL has recently entered a gas supply agreement with Esso Australia Resources and BHP Billiton (Bass Strait) commencing in January 2018 and announced that the new contract has oil-linked pricing components.[30]

IPART seeks comments on the following

6 Given the uncertainty in wholesale markets, what is the likely length of new domestic wholesale gas contracts negotiated in 2016-17?

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25 ACCC, *East Coast Gas Inquiry – Issues paper*, 4 June 2015.

26 BHP, *Public submission to the ACCC East Coast Gas Inquiry*, July 2015; Santos, *Public submission to the ACCC East Coast Gas Inquiry*, July 2015.

27 NERA, *The Gas Supply Chain in Eastern Australia – A report to the Australian Energy Market Commission*, June 2007, pp 24-25.

28 More recently there have been calls by BHP Billiton to sever this link as the economic relationship between oil prices and LNG prices is less clear. See Sydney Morning Herald, *BHP Billiton and Santos split on oil-linked LNG pricing, October 2014, at* http://www.smh.com.au/business/mining-and-resources/bhp-billiton-and-santos-split-on-oillinked-lng-pricing-20141013-115o24.html, accessed on 5 November 2015.

29 Jacobs SKM, *New contract gas price projections*, 4 April 2014, p 1.

30 AGL, *AGL secures gas supply until 2020 with Bass Strait agreement – ASX & media release*, 9 April 2015.

7 Are there any other changes in non-price terms and conditions in domestic gas contracts we should consider in determining wholesale gas costs for an efficient new entrant retailer? Why?

8 Do you agree that prices of new domestic gas contracts are likely to be indexed to oil prices? If not, why?

How are low oil prices likely to affect wholesale gas costs for a new entrant retailer?

Given that Asian LNG prices are an important factor influencing domestic gas prices, and Asian LNG prices are indexed to oil prices, we need to consider how the current low oil prices are likely to affect an efficient new entrant gas retailer in 2016-17.

Since our 2014 review of regulated retail gas prices in June 2014, oil prices have fallen by more than half[31], resulting in lower Asian LNG prices. We consider that regardless of how a new entrant retailer purchases gas (ie, through bilateral contracts or on STTMs), low oil prices are likely to have an impact on wholesale gas costs. However, over a similar period to the fall in oil prices, the Australian dollar has depreciated against the US dollar. As LNG prices are denominated in US dollars, this is likely to offset some of the fall in LNG prices resulting from low oil prices.

In our 2015 Fact Sheet, we decided that on balance, the allowance for wholesale gas costs included in regulated retail gas prices for 2015-16 was appropriate and reflected the efficient costs faced by a new entrant retailer. If retailers were able to meet their efficient wholesale gas costs for less than allowed for in the regulated prices, competition would ensure that the prices offered in the competitive market reflect these lower costs.[32]

IPART seeks comments on the following

9 How are low oil prices likely to affect wholesale gas costs for an efficient new entrant retailer in 2016-17?

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31 U.S. Energy Information Administration http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=pet&s=rbrte&f=m, accessed on 9 November 2015.

32 IPART, *Fact Sheet - Change in regulated retail gas prices from 1 July 2015*, June 2015, pp 4-5.

Other relevant issues in determining efficient wholesale gas costs

We have identified a number of other issues that will need to be considered in determining efficient wholesale gas costs. These include:

- **The availability of cheap 'ramp gas' from Queensland.** There may be substantial quantities of ramp gas available at relatively low cost due to long lead times to bring CSG wells into production for LNG exports. If so, this may affect the gas purchasing strategies of a new entrant retailer in 2016-17.
- **Likely sources of gas.** Historically, the main sources of gas supply have been conventional gas fields in central Australia (ie, Cooper Basin) and in the Bass Strait region of southern Australia (ie, Gippsland, Otway and Bass Basins).[33] Since the commencement of LNG exports, it has been reported that large volumes of gas produced in Cooper and Surat-Bowen Basins started being re-directed to Queensland LNG projects. Consequently, the main source of gas for domestic users in south-eastern Australia is expected to be offshore Victoria.[34]
- **Issues associated with accessing transmission pipelines.** When large wholesale gas customers enter GSAs, they also enter gas transportation agreements (GTAs) with gas pipeline owners, typically for the same period as the GSAs.[35] Currently, the transmission sector of the eastern Australian gas market is in the hands of a few operators. As Chapter 4 outlined, we propose to consider the capacity of transmission pipelines as part of our assessment of competition.

IPART seeks comment on the following

10 Are there any other issues we should consider in forecasting wholesale gas costs for an efficient new entrant retailer in 2016-17?

6.1.2 Retail operating costs

Retail operating costs are the costs an efficient retailer would incur in performing the retail functions required to serve its customers. These include customer service (eg, operating call centres, billing and collecting revenue), finance, IT systems and regulation (eg, paying licence fees), marketing, and an appropriate allocation of corporate overheads. Retail operating costs could also include the costs associated with customer acquisition and retention.[36]

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33 ACIL Tasman, *Cost of gas for the 2013 to 2016 regulatory period – A report on the wholesale cost of gas for the review for Standard Retailers in New South Wales*, 13 June 2013, p 12.

34 ACCC, *East Coast Gas Inquiry – Issues paper*, 4 June 2015, p 8.

35 Pipeline operators sell transport services, limited by their pipeline capacity, to gas 'shippers'. Many large gas buyers act as their own shipper. http://www.aemc.gov.au/Australias-Energy-Market/Gas/Networks, accessed on 22 September 2015.

36 Customer acquisition and retention costs include marketing campaigns, discounts and other incentives for customers to switch retailers or market offers.

In our 2013 review, we assessed the forecast retail operating costs (ROC) proposed by each of the Standard Retailers using a combination of bottom-up and benchmarking approaches. We found that the reasonable range for the ROC is between $91 and $110 per customer. These estimates did not include direct customer acquisition and retention costs (CARC).[37]

The purpose of including a CARC allowance in regulated retail prices is to encourage the development of a competitive market in gas. Our view is that a level of CARC should be allowed that will lead to a reasonable transition to a largely deregulated market for gas. In our 2014 review, we found there was no clear need for an **additional** CARC allowance in regulated gas prices for retailers in Jemena's gas network area.[38]

We propose to use a similar approach to assessing forecast ROC for this review – including using both the bottom-up analysis and benchmarking analysis to establish efficient ROC for 2016-17. Appendix B provides more information these analyses.

IPART seeks comments on the following

11 What is the prudent and efficient level of retail operating costs for Standard Retailers in 2016-17? Do you agree with our proposed approach for estimating these costs? If not, how can we improve our approach?

6.1.3 Retail margin

The Standard Retailers face a range of risks. Some of these are systematic risks associated with supplying gas to small customers on regulated tariffs. These systematic risks stem from factors such as variations in demand and economic conditions. Given these risks, it is reasonable for the Standard Retailers to earn a retail margin.

For our 2013 review, we engaged SFG Consulting (SFG) to provide advice on an appropriate retail margin for a gas retailer. SFG estimated retail margins using three approaches:

- expected return approach
- benchmarking approach, and
- bottom-up approach.

It placed an equal weight on the results from each of the three approaches, and recommended a retail margin range of 6.3% to 7.3% of EBITDA.[39]

37 IPART, *Review of regulated retail prices and charges for gas – Final Report*, June 2013, Appendix E.
38 IPART, *Changes in regulated retail gas prices from 1 July 2014 – Final Report*, June 2014, Appendix B, p 54.
39 IPART, *Review of regulated retail prices and charges for gas – Final Report*, June 2013, Appendix F, p 84.

We propose to use a similar approach this year, including considering results from the expected return, benchmarking and bottom-up approaches to establish an efficient retail margin for 2016-17. Appendix C provides more information on these three approaches.

IPART seeks comments on the following

12 What is an appropriate retail margin for 2016-17? Do you agree with our proposed approach for estimating the retail margin? If not, how can we improve our approach?

6.2 Miscellaneous fees and charges

In addition to charges for gas supply, energy retailers levy non-tariff fees and charges (or miscellaneous charges). These charges arise from particular events associated with the supply of energy to individual customers – for example, as a result of a request from a customer, or when a customer takes (or fails to take) certain actions.

Miscellaneous charges are not consistent across the Standard Retailers, and comprise both retail and network charges. Retail miscellaneous charges are levied by the Standard Retailers. They are set via each retailer's pricing agreement, which specifies the maximum level for each charge. Retail miscellaneous charges include:

- late payment fees and associated charges
- security deposits
- dishonoured payment fees, and
- account establishment fees.

Network miscellaneous charges are levied by network distribution service providers, and are passed through to the customer by the retailer. They may include fees for special meter reads, network disconnection and reconnection and permanent disconnection. In general, network miscellaneous charges are set in the network service provider's Access Arrangements which are regulated by the AER.

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).

Appendices

A Minister's referral letter

IPART

D15/24231

The Hon Anthony Roberts MP
Minister for Industry, Resources and Energy

V15/5860

RECEIVED
INDEPENDENT PRICING & REGULATORY TRIBUNAL

Dr Peter Boxall
Chairman
Independent Pricing and Regulatory Tribunal
PO Box K35
Haymarket Post Shop
NSW 1240

Peter

Dear Dr Boxall

I am writing to request that the Independent Pricing and Regulatory Tribunal (the Tribunal) continue to regulate the retail tariffs and charges for small retail gas customers for the period 1 July 2016 to 30 June 2017, in accordance with section 27 of the *Gas Supply Act 1996* (the Act). As part of this review I would ask that you also forecast indicative retail gas prices for each year from 1 July 2017 to 30 June 2019 and provide advice to Government on any additional measures that could be implemented to strengthen competition in the NSW retail gas market.

To date, the Tribunal has successfully pursued a light-handed approach to regulation through the use of voluntary pricing agreements between itself and each regulated offer retailer (that is, Origin Energy, AGL and ActewAGL). I ask that the Tribunal continue to take this approach.

However, it is important to ensure that the Tribunal is provided with the appropriate tools to carry out its retail price regulation activities. This includes the ability to issue Gas Pricing Orders in the event that it and the regulated offer retailers are unable to come to an agreement. To this end, I confirm that the NSW Government will be reviving the Gas Pricing Orders provisions in the Act, prior to 1 July 2016.

There are a number of changes occurring in the gas market, such as the implementation of the NSW Gas Plan, gas production developments along the east coast, and improvements in the Business to Business Procedures for gas market participants. All of these developments will have an impact on residential and small business consumers through the number of retailers and level of gas offers in the market.

The recent NSW Government advertising campaign, *The Power's in Your Hands*, promoted customer participation in the competitive market and aimed to maximise awareness of changes in the NSW electricity market; educate consumers that changing energy plans is easy and worthwhile; and to provide energy consumers with access to sufficient information to make informed decisions.

However, the NSW Government acknowledges that customers in some areas of New South Wales may have limited offers to choose between. The Government asks IPART to review the competitiveness of the retail gas market through NSW. In particular, IPART is asked to consider:

- the pass through of network price reductions into retail market contracts. This may include the extent of price decreases, the timeliness of price changes and communication around price changes; and
- the diversity in retail market offers to cater to different market segments. This may include competition on the fixed supply charge.

The NSW Government recognises the need to respond to developments in retail gas competition to ensure that customers can benefit from competitive market offers.

The Tribunal is to carry out its retail gas price regulation activities unless otherwise advised by me.

Yours sincerely

Anthony Roberts MP
Minister for Industry, Resources and Energy

B Retail operating costs

Retail operating costs (ROC) are the costs an efficient retailer would incur in performing the retail functions required to serve its customers. These functions include:

- customer service (eg, operating call centres, billing and collecting revenue)
- finance, IT systems and regulation (eg, paying licence fees)
- marketing, and
- an appropriate allocation of corporate overheads.

In our 2013 review, after considering both the benchmarking and bottom-up analysis outlined below, we found that the reasonable range for retail operating costs was between $91 per customer and $110 per customer. The lower bound of the range was given by the minimum ROC estimate based on our bottom-up analysis. The upper bound was given by our final decision on the ROC allowance for electricity retailers over the 2013 regulatory period based on the benchmarking approach.[40]

As Chapter 5 discussed, we proposed to assess the Standard Retailer's forecast ROC using both bottom-up and benchmarking approaches. These approaches are outlined below.

B.1 Bottom-up approach

The bottom-up approach involves undertaking detailed financial analysis of the retail operating costs. Under this approach, we assess each Standard Retailer's forecast ROC per customer based on data supplied by electricity and gas retailers.

40 The ROC allowance for electricity retailers in our 2013 review excluded customer acquisition and retention costs.

In our 2013 review, information provided by the retailers indicated a ROC between $91 and $106 per customer, with a mid-point of $99 per customer in 2013-14. We examined various cost categories of the ROC including service costs, corporate overhead costs, bad debt and other costs, and observed consistency between retailers. We excluded costs associated with depreciations and customer acquisition costs to ensure consistency between retailers and made adjustments to account for the differences in bad debts between gas and electricity customers.

To conduct similar bottom-up analysis for this current review, we will need to obtain information from gas retailers on their current operating costs.[41]

B.2 Benchmarking approach

The benchmarking approach involves comparing ROCs adopted in other jurisdictions, and of comparable listed companies. In our 2013 review, to determine the ROC allowance for gas retailers we considered our analysis of the ROC allowance for electricity retailers.

ROC estimates provided by regulated electricity Standard Retailers were in the range of $106 to $112 per customer for 2013-14. Our final decision on the ROC allowance for electricity retailers was $110 per customer. As discussed above, the upper bound of the reasonable ROC range that we determined for gas retailers was based on our final decision on the ROC allowance for electricity retailers in the 2013 review.

The ROC estimates for electricity excluded advertising costs. Excluding advertising costs, the midpoint ROCs provided by gas retailers decreased to $93 per customer, with a range of $84 to $103 per customer. Hence, the ROC for gas retailers was around $17 per customer lower than our final decision on the ROC allowance for electricity retailers.[42]

41 IPART, *Review of regulated retail prices and charges for gas – Final Report*, June 2013, Appendix E, pp 80-82.

42 Ibid.

C Retail margin

As Chapter 5 discussed, the Standard Retailers face a range of risks, some of which are systematic risks associated with supplying gas to small customers on regulated prices. These systematic risks stem from factors such as variations in demand and economic conditions. Given these risks, it is reasonable for the Standard Retailers to earn a retail margin.

For our 2013 review, SFG Consulting (SFG) used the following three approaches to estimate a reasonable range for this margin.

C.1 Expected returns approach

The expected returns approach estimates the expected cash flows that a retailer will earn and the systematic risk associated with these cash flows, and determines a retail margin that will compensate investors for this systematic risk. This approach is based on the principle that businesses should be compensated for the systematic risk to which they are exposed. Based on the expected returns approach, SFG concluded that for energy retailers an appropriate EBIT margin range is 3.6% to 4.9%, which is equivalent to an EBITDA margin range of 4.7% to 6.0%.[43]

C.2 Benchmarking approach

The benchmarking approach involves estimating retail margins of a set of comparable companies listed firms. SFG analysed profit margins of 692 listed retailers in the US, UK, Australia, Canada and New Zealand. SFG considered the EBIT margin is more appropriate for listed retailers than the EBITDA margin as retailers tend to be more capital intensive and incurring higher depreciation charges than energy retailers.[44] To arrive at an EBITDA margin for energy retailers, SFG estimated EBIT margins for listed retailers and then added energy retailers' typical depreciation and amortisation rate. Based on the benchmarking approach, SFG concluded that an appropriate EBIT margin range is 5.1% to 5.4%, which is equivalent to an EBITDA margin range of 6.2% to 6.4%.[45]

43 SFG, *Estimation of the regulated profit margin for gas retailers in New South Wales,* 4 June 2013, p 6; IPART, *Review of regulated retail prices and charges for gas – Final Report*, June 2013, Appendix F.

44 SFG, *Estimation of the regulated profit margin for gas retailers in New South Wales,* 4 June 2013, p 22.

45 Ibid.

C.3 Bottom-up approach

The bottom-up approach assumes the consideration paid for acquisition of retail electricity and gas businesses reflects the market value of an energy retailer, and the retail margin would provide an appropriate return on investment. The approach estimates the market value of an energy retail business using historical acquisition transaction prices and finds an EBIT which sets the present value of expected cash flows equal to the estimated market value. Based on the bottom-up approach, SFG concluded that a reasonable EBIT margin is 6.8% to 8.3% which is equivalent to an EBITDA margin range of 7.9% to 9.4.[46]

[46] SFG, *Estimation of the regulated profit margin for gas retailers in New South Wales,* 4 June 2013, p 6.