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2 May 2007

Mr Jim Cox
CEO
Independent Pricing and Regulatory Tribunal
PO Box Q290
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Dear Mr Cox,

Regulated Electricity Tariffs 2007 to 2010

AGL Energy Ltd (AGL) welcomed the opportunity to participate in the recent open forum on the Tribunal's draft determination relating to regulated electricity tariffs and charges for small customers 2007 to 2010.

AGL notes that the review is clearly aimed at promoting retail competition and investment in the NSW electricity industry. AGL considers that the draft decision represents outcomes that will clearly move tariffs to being more cost reflective and will assist in enabling the NSW electricity market to being more competitive.

Notwithstanding this there are a number of matters raised at the public forum which AGL considers warrants further consideration by the Tribunal, in particular the impact of the current shift in wholesale electricity costs. AGL provides the following comments on the draft report:

- AGL supports the weighted average pricing cap approach to price regulation and supports the removal of the side constraints on tariff changes as this will enable the unwinding of any remaining cross subsidies

- AGL agrees with the Tribunal's decision to base energy cost allowances on the market-based prices. However, AGL's experience in NSW and other jurisdictions suggests that the conclusion by Frontier Economics that market based wholesale costs in 2009/2010 will be closely aligned with the LRMC does not give sufficient recognition of the market risks faced by retailers. These risks include loadshape, churn, weather, liquidity and force majeure risks. AGL notes that these risks are assessed at around $6.50/MWh in 2007/08 but reduce to around $0.30/MWh in 2010. The Tribunal is determining energy costs at a point in time and it would be generally expected that retailer risks are likely to be greater over time as there is increasing uncertainty in forecasting such things as load and load shape.

- The wholesale costs across the NEM have escalated by between 60-130% for 2007/08 flat swaps in recent months and that swap contracts for the remaining years of the price determination have also increased significantly. AGL notes that the consultants modelling was undertaken before the recent substantial increases in wholesale costs occurred. It would be appropriate for the consultants to rerun their modelling to assess the impact of the uplift in wholesale costs on the benchmark costs.

- AGL is supportive of the Tribunal's decision in respect of operating costs. While the cost to serve of $75 per customer is below current benchmark costs existing in other jurisdictions the inclusion of customer acquisition costs is appropriate. The Tribunal's view that the residential customers will remain with their retailer for a period of 8 years would be longer than expected based on experience in the more competitive jurisdictions. Notwithstanding this, the resultant total retailer operating cost of $110 per customer on balance is reasonable and appropriate.

- A retail margin of 5% EBITDA (as a percentage of sales) is an increase on previously allowed margins by the Tribunal and reflects a recognition that with the progressive removal of the ETEF, incumbent retailers will be exposed to higher risks (akin to those faced by new entrant retailers). The proposed margin is below investment market expectations over the longer term.

- AGL supports the inclusion of passthrough mechanisms that allow retailers to passthrough costs associated with certain regulatory or taxation events. AGL notes the Tribunal has established a threshold test for these passthroughs.

- The significant increases in wholesale costs received particular focus and attention at the public forum. There was some discussion as to whether the increase in wholesale costs will be sustained and lead to a substantial increase in the 2009/2010 energy cost. A passthrough mechanism was suggested as one method to deal with this uncertainty.

- AGL strongly supports any appropriate mechanisms that ensure that these costs are reflected in the prices to customers. If price caps do not reflect the true costs of purchasing and supplying electricity to customers then there is a risk that there will be insufficient investment in future generating capacity and a heightened potential for retailer failure and at worst market failure.

- A critical issue for the Tribunal's consideration is the impact of these wholesale costs on retailers in the intervening years of 2007/08 and 2008/09. Accordingly, if a passthrough mechanism is the approach adopted by the Tribunal it should be considered in each year of the price determination and not solely applied for 2009/10. This is particularly important as the price path proposed by the Tribunal transitions towards the 2009/2010 end state and the ETEF arrangements are progressively removed.

- In these intervening years new entrants retailers can only purchase their energy from the market and are therefore likely to experience higher energy costs than the incumbent retailers who have access to the ETEF. Accordingly, establishing the ETEF wholesale price consistent with market prices is more likely to achieve a competitively neutral market place.

- AGL notes that the regulated tariff is about setting a price for those customers who have yet to exercise their choice to move to a market contract and in doing so promoting retail competition and an environment for future investment in the electricity industry. AGL supports the Tribunal consideration that more transparent approaches to dealing with customers experiencing financial hardship is warranted and we consider that attempts to address these customers circumstances through tariffs is not appropriate.

Should you wish to further discuss any of the above matters or require any further information please give me a call.

Sean Kelly

Sean Kelly
General Manager Energy Regulation