AGL Submission to IPART Issues Paper

Review of regulated retail tariffs and charges for gas 2010 - 2013

Date: 18 December 2009

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Introduction

AGL welcomes the opportunity to provide this submission to the Independent Pricing and Regulatory Tribunal ***(IPART)*** in respect of the Review of regulated retail tariffs and charges for gas 2010-2013 Issues paper ***(Issues Paper)***. The Issues paper follows the Direction and Terms of Reference ***(TOR)*** issued by the NSW Minister for Energy on 19 August 2009 requesting IPART to continue regulating retail tariffs and charges for a further three year period to 2013.

AGL is committed to providing its customers with gas and electricity at reasonable prices and has always endeavoured to ensure its prices reflect the costs and risks incurred in supplying gas and electricity. AGL has proposed that a continuation of the Voluntary Transitional Pricing Agreements ***(VTPAs),*** altered to allow the pass through of network and carbon related costs, as the most appropriate form of price regulation, which will allow the objectives under section 3 of the Gas Supply Act 1996 to be met, which 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 facilitate the continuity of supply of natural gas to customers; and
- To promote the safe use of gas.

The VTPA proposed by AGL for the forthcoming regulatory period is based on a predetermined threshold index on all tariff categories for the retail component of the total default tariff. Under the proposed VTPA, average price variations that are less than or equal to the threshold index would be allowed. Where AGL applies for an increase outside the threshold index for the retail component, regulatory review and approval by IPART is required. The benefits of continuing with this light-handed approach are as follows:

- Meets the government's policy objectives;
- Ensures a stable price path in transition to market based default prices;
- Allows year to year variations of retailer costs to be managed more effectively (by providing a smooth price path to customers);
- Promotes competition in the energy market and ensuring the public receives the benefit of a competitive market by allowing a more flexible approach to pricing which can be more reflective of market conditions and result in more efficient market outcomes; and
- Generally reduces the need for regulatory intervention in the market as reviews will only be required for 'CPI plus[1]' proposals.

AGL also notes that provision of pass through arrangements for both network operator charges and the market costs associated with the introduction of the Carbon Pollution Reduction Scheme ***(CPRS)*** will provide retailers with the security and flexibility to ensure recovery of network charges and market carbon costs whilst providing a degree of comfort to consumers through incorporation of a 'regulatory oversight' function by IPART, whereby, IPART can undertake a review of the pass

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[1] In the case of AGL's proposal where annual increases are limited to CPI on average.

through amount post adjustment should there be any concern or as a matter of general review.

It is also apparent from the commentary by IPART in the Issues paper that VTPAs are to be considered a stepping stone towards deregulation. A continuation of these light handed pricing arrangements, limited where possible to regulatory oversight will continue to assist the market to develop both in terms of competition and reducing customer reliance on regulatory tariffs. It would be sensible that the next step for NSW gas tariffs is for the complete removal of regulatory review and approval whilst maintaining regulatory oversight. AGL therefore, recommends that IPART consider including recommendation to the NSW Minister for Energy in its draft decision that removal of retail price regulation should be considered at the end of the forthcoming regulatory period (2010 – 2013).

AGL looks forward to assisting IPART in its review and therefore, where relevant and appropriate, has provided response to the specific questions raised by IPART in the Issues paper.

Approach to the form of Regulation

Continuation of Voluntary Transitional Pricing Agreements

Do Voluntary Transitional Pricing Agreements (VTPAs) continue to be an appropriate form of regulation for the Standard Retailers' regulated retail gas tariffs, given the objectives and context for this review? Are there enhancements that can be made to the current approach?

AGL's preferred position is the complete removal of retail price regulation, allowing the market to set efficient and competitive gas prices through vigorous competition. However, in the absence of a deregulated pricing regime AGL considers that VTPAs have been, and continue to be, an effective form of regulation and an appropriate transitional measure. The VTPAs allow a retailer the flexibility to adjust tariffs annually without the requirement for costly regulatory approval processes, yet retaining a level of 'safety net' regulation for small gas customers.

Where the prices determined under the VTPAs are such that retailers are able to operate sustainably in the market, VTPAs allow the relevant objectives under the Gas Supply Act 1996 to be met, specifically that the VTPAs are developed so as:

- 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 develop
- To regulate gas reticulation and gas supply, so as to protect the interests of customers and to promote customer choice in relation to gas supply
- To facilitate the continuity of supply of natural gas to customers and
- To promote the safe use of gas.

What (if any) other forms of regulation should we consider?

As noted above, AGL is of the view that the removal of retail price regulation where a market has demonstrated effective competition is the most effective means of ensuring market competitive pricing. However, as a transitional measure in the interim period leading to the AEMC review of competition and subsequent recommendations for removal of price regulation by the AEMC, AGL believes that VTPAs present the most efficient, effective and appropriate form of light-handed price regulation.

Proposed approach for reaching new VTPAs

Is there adequate information available for customers to make informed choices when choosing a gas supplier? If not, what measure could be implemented to address this?

AGL believes there is sufficient publicly available information for customers to enable exercise of choice of retailer and/or product. This information includes retailer websites and comparison and information sites (e.g. Go Switch, Switchwise, Energy Watch, ChoiceSwitcg.com.au, shoparound.com.au, to name a few). While many tools are computer and Internet based, customers are still able to make contact with retailers via contact centres to obtain information from a contact centre representative.

In addition, AGL notes that full retail competition has been in place in NSW since January 2002 – a period of 8 years. Since this time, the level of retailer activity and customer participation (either by a customer switching products or consciously deciding to stay on a regulated product) has increased. The gas market currently demonstrates a number of the characteristics of a competitive market, specifically:

- The 2006 IPART household survey[2] identified that there is a very large percentage, 93%, of customers who are aware they can choose their gas supplier – a considerable increase on from the 2003 survey which produced a result of 76%.
- Customers have choice, in that there are around 14 licensed retailers in NSW of which around 7 are currently servicing the residential and/or business market[3].
- The NSW energy market is a 'warm active market' ranked 5th in the world for customer switching[4]; and
- There exists a broad range of market offers available for customers to choose from.

AGL has outlined in previous submissions to IPART that the necessary features to assess that a market exhibits effective or workable competition is consistent with those identified by KPMG, in its report on the Effectiveness of Competition and Retail Energy Price Regulation, which are[5]:

- Customers are aware that they have a choice;
- Customer know how to exercise choice and it is easy to do; and
- Choices (i.e. Offers) are being made available to them.

AGL is of the view that the NSW gas market currently exhibits these features.

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[2] Independent Pricing and Regulatory Tribunal *"Residential energy and water use in Sydney, the Blue Mountains and Illawarra, Results from the 2006 household survey"*, Research Paper, November 2007, p. 5

[3] Information from IPART website: http://www.ipart.nsw.gov.au/electricity/licensing.asp

[4] VaasaETT Utility, *"Customer Switching Research Project – World Energy Retail Market Ranking"*, Fourth Edition, October 2008

[5] KPMG "*The Effectiveness of Competition and Retail Energy Price Regulation*", A discussion paper prepared by KPMG for the Energy Retailers Association of Australia, December 2003, p.4

Are the proposed assessment criteria appropriate to guide our analysis and decision-making for this review?

The Tribunal has opted for the following assessment criteria to guide it in undertaking its analysis, testing options and making decisions for the 2010 Determination.

1. *Protect small retail customers by:*
   - (a) *resulting in prices that are based on the efficient cost of supplying gas to small retail customers; and*
   - (b) *facilitating the development of effective retail competition*
2. *Be consistent with the aim of promoting the efficient, safe and reliable supply and use of gas*
3. *Be consistent with the aim of reducing customers' reliance on regulated retail tariffs*
4. *Be consistent with principles of regulatory best practice by:*
   - (a) *ensuring that where possible, decisions are made by parties in the best position to make those decisions (avoid micro-management)*
   - (b) *being practical, pragmatic and feasible*
   - (c) *being simple and understandable*
   - (d) *being targeted at the regulatory objectives*
   - (e) *being proportionate with the problem*
   - (f) *being internally consistent*
   - (g) *being as transparent as possible.*

AGL supports the stated assessment criteria, and notes that the success of the regulatory process in achieving the stated aims above is to ensure that tariffs are set at levels which aim to allow retailers to recover the efficient and prudent costs to service the regulated customer base whilst maintaining a sustainable business. Tariffs set at these levels will, continue to encourage retailer participation and rivalry in the NSW gas market,   increasing general competition and the number of competitive market contracts available to small retail customers.

Standard Retailer proposed VTPAs

Do stakeholders consider that the Standard Retailers' proposals are reasonable in general? Are there any specific issues or individual components of the proposals that stakeholders wish to comment on?

AGL has reviewed the proposals submitted to IPART for review by Origin Energy, Country Energy and ActewAGL. AGL generally supports the positions taken by each of the Standard Retailers and considers that each retailer should be provided the opportunity to tailor a VTPA to reflect their operating cost and tariff structure and retailing environment.

Setting regulated tariffs

How should regulated tariffs be set?

Does a WAPC best meet the objectives for this review? Are there enhancements that can be made to the current approach?

Is there any evidence to suggest that a WAPC is inappropriate? Are there other approaches to setting retail tariffs that IPART should consider?

A weighted average price cap on the 'retail component' with full pass through of network charges and market based costs referable to any regulatory changes such as the Carbon Pollution Reduction Scheme ***(CPRS)*** should be adopted as the form of regulation for the next 3 years. It is AGL's experience that in markets at a similar stage of competitive development to NSW this approach provides standard retailers with the flexibility to:

- appropriately rebalance tariffs;
- unwind any remaining cross subsidies that are not sustainable in a competitive market; and
- ensure that any network price signals (with respect to demand management) flow through to customers.

This form of price regulation will best meet the objectives for this review by allowing retailers the flexibility to maintain cost reflective tariffs, as a transitional approach to de-regulation.

AGL continues to support this light-handed form of regulation, and does not believe there is any benefit in introducing another approach. AGL cannot see the benefit in moving away from a WAPC approach and that the current approach has been generally accepted by the Standard Retailers.

Risks and Uncertainties

How should the risks and uncertainties be addressed?

Should IPART accept the Standard Retailers' proposal to pass network charges through to customers?

In order to adequately address the risks and uncertainties in retailing gas and in order to meet the policy objectives of removing customer reliance on regulated tariffs it is essential that network charges are passed directly through to customers. As noted previously, the ability by Standard retailers to pass through network costs will ensure that any network price signals flow through to customers.

What is the most appropriate way to address uncertain costs associated with national climate change measures in the new VTPAs?

If the Standard Retailers set retail prices based on their own forecasts of CPRS permit costs, should this forecast ever be reconciled with the actual costs of permits?

As outlined in AGL's proposal, there is still a significant degree of uncertainty attached to the final form or the CPRS and therefore the impact the CPRS will have on the cost structure of gas retailers. Further, once the CPRS is finalised, there will remain a significant degree of difficulty attached to forecasting the Australian Emissions Unit ***(AEU)*** price, which will be a key assumption in forecasting the additional costs incurred by retailers.

AGL has proposed provisions in the revised VTPA that will permit sufficient flexibility to account for this uncertainty while ensuring there is provision for oversight that will provide IPART, consumers and the government with a level of comfort as to the appropriateness of the pass-through amount.

Furthermore, AGL considers that there is likely to be sufficient transparency in the actual carbon price and the forecast carbon price incorporated in the default tariffs and that if it a material variance is apparent, AGL will consult with IPART on any required adjustments.

Is the Standard Retailer the only party who should trigger special circumstances and a review of re-opening of a VTPA?

How should IPART conduct a review of an application for a special circumstance price change?

Should there be a materiality threshold to trigger a special circumstances review? And if so, what should that threshold be?

Pass through arrangements, such as a special circumstances price change are extremely important in regulatory price review decisions to ensure the continued feasibility of a retailing business in the event that an unforeseen significant market event occurs.

A request for a pass-through should be a commercial decision of the individual retailer, who is best placed to determine if the pass-through amount warrants recovering via tariff adjustment, and is also best placed to trigger a review whether a special circumstances event or a re-opening of the VTPA.

VTPA arrangements are, in nature, a light-handed pricing arrangement which, from time to time may result in a small mismatch of costs/revenue to the retailer. It is AGL's experience that a retailer will only seek to recover additional costs via a special circumstance price change where the unexpected increase in costs is significantly substantial making the costs impossible to absorb.

AGL consider the current process for review of an application for a special circumstance price change is appropriate and does not require modification.

The efficient costs of gas supply

Assessing wholesale gas costs

Have there been any significant changes to retail business activities since the 2007 review? And if so, what are the implications for wholesale gas costs?

Is IPART's proposed approach to assessing wholesale gas costs for the 2010 review appropriate? If not, what are the alternative approaches?

As noted in AGL's VTPA proposal, AGL has entered into a number of long term gas supply agreements, where prices have been recently set either through negotiation or arbitration. AGL has taken into account the changes in wholesale gas costs resulting from the recent contract re-negotiations for the forthcoming regulatory period, including an amount commensurate with the market operational risk likely to be incurred by a gas retailer in NSW.

The most significant changes to gas retail business activities since 2007 has been the planned introduction of the Short term trading market ***(STTM)*** in 2010 and the CPRS in 2011. Both will bring about significant market operating risks to gas retailers. There has also been an increase in the export of LNG, which, in the future is very likely to have an effect on local wholesale gas prices due primarily to offshore demand and export parity pricing.

AGL generally supports the approach adopted by IPART to review wholesale gas costs. As outlined in AGL's proposal, gas retailers take a portfolio approach to their gas supply and contracting arrangements – retailers do not enter into specific supply arrangements to service a specific customer segment. This can create some difficulty in allocating a wholesale gas cost to a particular customer segment. While AGL is strongly of the view that wherever possible, publicly available information sources should be used to assist in determining a benchmark delivered gas cost, AGL has provided confidential information to IPART to assist in its review.

Retail operating costs and retail margin

Have there been any significant changes to retail business activities since the 2007 review? And if so, what are the implications for retail operating costs?

Are previous retail operating cost analyses and benchmarks a valid starting point? If not what are the alternative approaches?

Have there been any significant changes to retail business activities since the 2007 review? And if so, what are the implications for the retail margin?

AGL strongly supports the use of publicly available benchmarks as a valid starting point for any retail operating cost and margin analysis to be undertaken by IPART. AGL considers the operating cost benchmark set by IPART in the 2007 electricity retail price review would provide a reasonable starting point, provided appropriate adjustments are made to take into consideration any changes in operating environments (both internal and external) that have occurred since the original benchmark data was complied. Utilising benchmark data where possible provides a greater level of consistency across regulatory reviews.

The following are some areas that AGL suggests would need to be considered in adjusting existing benchmark data for this review:

- the implementation of the CPRS – will necessitate a degree of increased operating cost, including pre-implementation set up costs and post implementation ongoing maintenance;
- administration costs associated with the introduction of, and obligations imposed on retailers by the STTM; and
- increased requirement for assistance programs for customers in financial hardship, especially in the current environment and increasing energy prices. Contact centre operations will require greater resourcing for detailing to customer assistance, in addition to the likeliness of increases in bad debts.

AGL would be willing to assist IPART in determining an appropriate retail operating cost benchmark that will incorporate the above changes. AGL has also provided information to IPART in its VTPA proposal on appropriate benchmark ranges.

Can the supply of gas be considered an essential service? If not, to what extent are the risks inherent in gas retailing different to those in electricity?

To what extent, if any, are the risks inherent in retailing gas in NSW different to those in other jurisdictions?

Retailing gas in NSW carries risks that are not common to other jurisdictions. As outlined in AGL's proposal, the current operating arrangements between gas retailers and network operators in NSW result in costs and risks not experienced in other jurisdictions, such as the requirement on AGL to settle its distribution network charges on a more frequent basis than most jurisdictions / fuels / 2^{nd} tier gas suppliers in NSW. This requires AGL to fund greater working capital requirements.

Is IPART's proposed approach to assessing the retail margin for the 2010 review appropriate? If not, what are the alternate approaches?

AGL's views on whether the margin analysis proposed is appropriate will be reliant on the extent to which the identified risks are adequately addressed in the wholesale gas cost, the retail operating cost and the form of price control (e.g. permitting direct pass through of network charges and carbon charges).

We note that Strategic Finance Group ***(SFG)*** are utilising three approaches to determine a range for the retail margin allowance – the bottom-up approach, the expected returns approach and benchmarking.

There are a number of alternative approaches that can be adopted to establish an appropriate level of retailer margin. AGL generally supports a retail margin based on a percentage of total sales, however would support the SFG approach subject to the use of relevant industry data for benchmarking and an appropriate WACC.

Irrespective of the approach, the level of margin must be sufficient to attract new entrant retailers and the calculation should be transparent. Low retail margins are a significant impediment to developing competition and to future investment in generation capacity. AGL has proposed a retail margin of between 6.5% and 8% would be appropriate for a Standard retailer in NSW. These margins are considered reasonable for the risk profile of retailing energy and are not inconsistent with retail margins considered in other jurisdictions.

Non-tariff fees and charges

Non-tariff fees and charges should, consistent with the objectives of cost reflectivity, be determined on a cost reflective basis and be applied to customers who incur the costs.

Is it reasonable for the Standard Retailers to introduce a new fee for the payment of gas bills by customers using a credit card?

Following submission of AGL's proposed VTPA to IPART for approval, it has been brought to AGL's attention that due to current legislative constraints, a merchant service fee cannot be imposed in NSW for customers on regulated contracts. As a result, AGL will not be pursuing this charge.

Is it reasonable for the Standard Retailers to change the level of the late payment fee?

Late payment fees should be applied on a cost reflective basis and should be applied to the customers who have, through their own actions, caused additional costs to be incurred by the retailer. Late payment fees are designed to encourage customers to meet their obligation to pay their accounts by the due date. This charge is completely avoidable by the customer.

AGL currently charges $14 for those customers on electricity market contracts in NSW that make a late payment. This amount is cost reflective and calculated and charged to customers on a fair and reasonable basis.

Do other retailers add a premium to miscellaneous charges imposed by distribution network operators? Is it reasonable to add a premium onto network miscellaneous charges?

AGL is aware of a number of instances where AGL and/or other retailers apply a charge in addition to the network charge to recover the administrative costs associated with acting as agent for the network operator and are willing to happy to provide this information to IPART separately to assist in the review