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A few words.

21 December 2010

Mr Nathan Petrus
Director, Pricing and Analysis
Essential Services Commission of SA
GPO Box 2605
Adelaide SA 5001

Dear Nathan

Review of Gas Standing Contract Prices 2011/12 – 2013/14: Issues Paper

AGL welcomes the opportunity to comment on the Commission's Issue Paper regarding its Review of Gas Standing Contract Prices 2011/12 – 2013/14.

Introduction

AGL appreciates that in undertaking electricity and gas price reviews, the Commission has always been cognisant of the need to establish the regulated price at a level sufficient to facilitate competition and new entry in both the gas and electricity retail sectors, while ensuring prices remain at efficient levels.

However, as recognised by the Commission in its Issues Paper, competition in the gas market has recently slowed, with a current annualised churn rate of about 11%, down from an average of 15-20% in 2005-2007.

As summarised in the Issues Paper, the findings of ACIL Tasman's recent review of competition[1] attributed this low level of gas competition to relatively low margins:

> *"With respect to the gas retail market in South Australia, gas retailers viewed the retail margin as being the main issue for low participation. As the average South Australian gas consumer has a lower consumption profile relative to customers in other states, the retail margin in South Australia translates to a lower dollar margin (which can be easily eroded should an unforeseen event occur, e.g. new reporting requirement). In addition, participants considered the time and effort involved in negotiating access to gas pipelines in regional areas unjustified for the relative value of the customer."*[2]

AGL is of the view that for competition in the South Australian gas market to return to its previous strong levels, the Commission in this Review must fully consider a hypothetical stand alone retailer's costs and risks of supplying gas to small customers. This will ensure that competition will thrive, benefiting customers in the long-term.

AGL's specific comments on the gas retail cost stack components are outlined below.

Wholesale gas and transmission costs

In respect of commodity costs, AGL refers to its discussions with ESCSOA on gas prices in the context of the 2010 Review of Retail Electricity Standing Contract Price Path and the LRMC analysis.

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[1] ACIL Tasman: Competition in South Australia's retail energy markets – Report on interviews with participants", 24 June 2010.

[2] ESCOSA: "*Review of Gas Standing Contract Prices 2011/12 – 2013/14 - Issues Paper*", November 2010, page 14.

AGL supports Origin's views on the factors that drive the significant increased MDQ cost. It also agrees that factors such as the introduction of the Short Term Trading Market in SA have created additional risks which require further services to manage these risks.

<u>Retail operating costs (*ROC*)</u>

AGL supports the use of external benchmarks to determine the operating cost of a hypothetical gas retailer in South Australia. Given ESCOSA recently conducted a review of operating costs appropriate for a South Australian electricity retailer, it would be sensible to use the outcomes of that review in this gas price determination.

AGL therefore supports Origin's proposal to base its ROC on the Commission's recent electricity price determination.

<u>Customer acquisition costs (*CARC*)</u>

As outlined above, AGL is of the view that in setting a regulatory price path the Commission should consider the costs of a hypothetical efficient stand alone gas retailer. This principle is one that has been generally supported by regulators through various energy price reviews nationally.

AGL is therefore concerned with the Commission's suggestion that the CARC be based on the *marginal* cost of acquiring a gas customer over and above the cost of acquiring an electricity customer. Such an approach would be a significant departure from the principle that regulatory price reviews be based on the costs and risks of a standalone efficient retailer.

In addition, it may be very difficult to definitively determine the incremental gas CARC. To do so would involve making specific assumptions about the nature of the marketing campaigns undertaken in the electricity market and the extent to which gas marketing costs, and customer acquisitions / retentions are purely incremental. This would be an exercise fraught with difficulty.

Furthermore, AGL is concerned such an approach would make it difficult for retailers to recover their gas marketing costs. Such an outcome could have a detrimental impact on competition.

Therefore, AGL is of the view the gas CARC be considered for a stand alone gas retailer and that it be considered as part of the ROC.

<u>REES costs</u>

Given the uncertainty about the REES scheme beyond 2011, AGL does not believe it possible to set firm REES costs in the price path from 1 January 2012.

AGL agrees with Origin's approach that REES costs be considered under a pass-through event application for the period 1 January 2012 - 30th June 2014.

<u>Retail margin</u>

Low retail margins are a significant impediment to developing retail competition. As market contracts are usually discounted off standing contract prices, the regulated prices set an upper limit on the margins earned by second tier retailers. The benchmark margin must therefore be sufficient to attract new entrant retailers and to enable the transition to market based prices thereby reducing the reliance on regulated prices.

Given the fact that competition in the gas market has slowed in recent time, and this slow down has been attributed to low gas margins, AGL encourages the Commission to consider raising the benchmark margin.

AGL considers a retail margin of at least 13% of WEC + ROC to be appropriate to encourage participation of other retailers in the gas market in SA, even once the CARC is removed from the margin and accounted for in the ROC.

In you have any queries in relation to this submission please contact Michelle Shepherd on 0402 060 573.

Yours sincerely,

Beth Griggs
Head Regulated Pricing