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A few words.

9 May 2011

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: Draft Determination

AGL welcomes the opportunity to comment on the Commission's Draft Determination regarding its Review of Gas Standing Contract Prices 2011/12 – 2013/14 (***Draft Determination***).

As highlighted in AGL's submission to the Commission's Issues Paper on this matter, competition in the gas market has recently slowed. In order for competition to return to its previous strong levels, the Commission must ensure that gas prices allow retailers the ability to recover the cost of acquiring and administering customer accounts as well as managing the risks associated with supplying gas to them at a fixed price.

In this context AGL urges the Commission to reconsider its Draft Determination in relation to Retail Operating Costs (***ROC***), in particular customer acquisition and retention costs (***CARC***) and future efficiency gains. In addition, the Commission should account for the risks associated with the short term trading market (***STTM***).

Retail Operating Costs

Customer Acquisition and Retention Costs

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 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 to AGL's concern about the Commission moving away from this important regulatory principle, AGL does not believe that removing 30% of the CARC from the retail operating cost allowance will allow dual fuel retailers to recover their CARC. This is due to the fact that retailers do not always acquire the gas and electricity account from the same customer at the same time.

This arises when a retailer already has a household electricity account but not the gas account. For example, in AGL's case the electricity account may be a standing contract account and AGL may only win the gas account; or the customer may have signed a fixed term contract for electricity with a retailer but not accepted a gas offer. In this situation the CARC is not a marginal cost and will represent the entire cost of acquiring a customer.

In addition, AGL does not support the adjustment to the CARC for a lower switching rate. This will only result in the switching rate staying at the current low level, as retailers will not be able to recover the costs of acquiring an increased number of customers in a competitive market and as a result retailers will not participate in the gas market.

AGL is taking action toward creating a sustainable energy future for our investors, communities and customers. Key actions are:
› Being selected as a member of the Dow Jones Sustainability Index 2006/07
› Gaining accreditation under the National GreenPower Accreditation Program for AGL Green Energy®, AGL Green Living® and AGL Green Spirit
› Being selected as a constituent of the FTSE4Good Index Series

AGL would expect that under the Relative Price Movement index competition in the electricity market will be enhanced; and with a corresponding reasonable outcome on gas prices, gas competition should also develop. AGL is concerned that keeping CARC costs below reasonable levels will not allow gas competition to develop beyond the current low levels.

Future efficiency gains

The Commission has determined that a base-ROC efficiency of CPI-2% per annum in the second and third year of the price path period is appropriate. This arises from expected efficiency gains resulting from improvements Origin has chosen to make to its systems and processes to enhance its customer service.

AGL is concerned about the Commission applying the efficiency gain, for the following reasons:

- In making its Determination, the Commission should consider the ROC of a 'benchmark efficient retailer'. AGL is concerned instead the Commission has focussed too narrowly on the specific circumstances of Origin's operating model, rather than the costs experienced by a 'benchmark retailer'. The standing contract prices set a cap on retail prices – retailers with more efficient systems will be able to compete more effectively under that cap. In making the assumption that these efficiencies will be experienced by all retailers, the Commission risks setting the regulated price too low and distorting the competitive process. Given the Commission's decision on the CARC, which already suppresses the ROC, a further 2% reduction in the ROC may make it difficult for second tier retailers to remain competitive; and

- Even if it were appropriate to consider Origin's specific circumstances, it cannot be assumed that these efficiencies will be as immediate as assumed by the Commission. Origin's investment has been undertaken at a considerable cost and risk. As is often the case with business transformations, efficiencies are not always realised in full in the short time. The real reduction in the allowance for ROC does not incentivise incumbent retailers to make such investments as the potential efficiency savings to the business are taken away before they are even realised. This presents a risk to the economic feasibility of such projects going forward.

AGL urges the Commission to reconsider its Draft Determination on this matter.

Short term trading market costs

AGL is concerned the Commission has not made an allowance for costs associated with STTM risks. This is despite the fact that under the previous price path, the Commission had made an allowance for costs associated with the Swing Gas market.

Under any traded market there are risks which must be managed by retailers. Given the prudent nature of retailers supplying energy to small customers, retailers are primarily concerned with managing the *downside* risk rather than seeking to gain from speculative trading.

AGL believes that making an allowance for the downside risk of the STTM will allow retailers to self-insure against losses which are likely to arise from operating in the STTM. AGL believes this is a legitimate cost of participating in the SA gas market and should be recognised in the Commission's final price determination.

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In you have any queries in relation to this submission please contact Meng Goh on (02)9921 2221.

Yours sincerely,

Beth Griggs
Head Regulated Pricing

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