Restraint in the face of uncertainty –

PIAC submission to IPART's draft report: *Changes in regulated retail gas prices from 1 July 2014*

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Introduction

The Public Interest Advocacy Centre

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit law and policy organisation that works for a fair, just and democratic society, empowering citizens, consumers and communities by taking strategic action on public interest issues.

PIAC identifies public interest issues and, where possible and appropriate, works co-operatively with other organisations to advocate for individuals and groups affected. PIAC seeks to:

- expose and redress unjust or unsafe practices, deficient laws or policies;
- promote accountable, transparent and responsive government;
- encourage, influence and inform public debate on issues affecting legal and democratic rights;
- promote the development of law that reflects the public interest;
- develop and assist community organisations with a public interest focus to pursue the interests of the communities they represent;
- develop models to respond to unmet legal need; and
- maintain an effective and sustainable organisation.

Established in July 1982 as an initiative of the (then) Law Foundation of New South Wales, with support from the NSW Legal Aid Commission, PIAC was the first, and remains the only broadly based public interest legal centre in Australia. Financial support for PIAC comes primarily from the NSW Public Purpose Fund and the Commonwealth and State Community Legal Services Program. PIAC also receives funding from NSW Trade & Investment for its work on energy and water, and from Allens for its Indigenous Justice Program. PIAC also generates income from project and case grants, seminars, consultancy fees, donations and recovery of costs in legal actions.

Energy + Water Consumers' Advocacy Program

This program was established at PIAC as the Utilities Consumers' Advocacy Program in 1998 with NSW Government funding. The aim of the program is to develop policy and advocate in the interests of low-income and other residential consumers in the NSW energy and water markets. PIAC receives policy input to the program from a community-based reference group whose members include:

- Council of Social Service of NSW (NCOSS);
- Combined Pensioners and Superannuants Association of NSW;
- St Vincent de Paul (NSW);
- Ethnic Communities Council NSW;
- Rural and remote consumers;
- Retirement Villages Residents Association;
- Physical Disability Council NSW; and
- Affiliated Residential Park Residents Association.

1. The current review

PIAC thanks the NSW Independent Pricing and Regulatory Tribunal (IPART) for the opportunity to provide comment on its Draft Report *Changes in regulated retail prices from 1 July 2014* (the Draft Report). The Draft Report outlines significant increases in the cap on regulated gas prices in NSW over two years, from 1 July 2014.[1]

IPART regulates gas prices in NSW through Voluntary Pricing Agreements (VPA) with the three Standard Retailers. These Standard Retailers then set their prices in line with the VPA, with IPART monitoring the compliance of retailers with the agreements. In 2013, IPART reached a VPA with the retailers covering the three years from 1 July 2013. However, due to the significant uncertainty around wholesale gas prices in Australia, IPART only determined final prices for the 2013-14 year.[2] The current review will set prices for the remaining two years of the VPA. The Draft Report notes that IPART has made 'draft decisions to agree to each Standard Retailer's proposed increase in average regulated prices over the two years'.[3]

1.1 Proposed prices by location

The Draft Report outlines draft price increases by Standard Retailer and distribution area as follows:[4]

- 17.6% for AGL, which supplies gas to over 80% of small regulated retail customers in NSW, covering Sydney, Wollongong, Newcastle, Dubbo, Orange, Parkes, and parts of the Riverina region. The draft decision represents an increase of 16.9% in 2014/15 and 0.7% in 2015/16. The 2014/15 increase adds an extra $152 to an average residential customer's annual bill;

- 17.5% for ActewAGL, which supplies the regions around the NSW/ACT border (including Young, Goulburn, and Yass) and South East NSW (including Shoalhaven). The draft decision represents an increase of 17% in 2014/15 and 0.4% in 2015/16. The 2014/15 increase adds an extra $219 to an average residential customer's annual bill;

- 14.4% for Origin Energy (Albury/Murray Valley), which supplies customers on the NSW - Victorian border, including the Albury and the Murray Valley Towns. The draft decision represents an increase of 18.6% in 2014/15 and a decrease of 3.4% in 2015/16. The 2014/15 increase adds an extra $173 to an average residential customer's annual bill; and

- 19.4% for Origin Energy (Wagga Wagga), which supplies the South Western regions of NSW including Wagga Wagga and Gundagai and inland cities such as Tamworth. The draft decision represents an increase of 21.8% in 2014/15 and a decrease of 2% in 2015/16. The 2014/15 increase adds an extra $224 to an average residential customer's annual bill.

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1 IPART, *Changes in regulated retail gas prices from 1 July 2014—Draft Report,* 2014, 1.
2 Ibid.
3 Ibid, 3.
4 Ibid, 2-3.

2. IPART's approach and entry of new suppliers

The Draft Report notes that in setting regulated prices, IPART has balanced two different objectives:

- encouraging efficiency and protecting customers 'from prices that are higher than efficient levels in the short term by setting prices that reflect the efficient cost of supply';[5] and
- supporting the interests of consumers in the long term, through setting prices that 'create sufficient incentive for retailers to compete and customers to participate in the market'.[6]

2.1 Encouraging new entrants

In pursuit of the second of these objectives, IPART has chosen to set the regulated price to reflect the estimated costs a new retailer is projected to face in entering the small retail gas market. This approach is in line with other recent decisions by IPART, including in relation to retail electricity prices and a cap on base early termination fees.

In previous reviews, PIAC has highlighted concerns about this approach, including that it provides windfall gains to incumbent retailers.[7] In the case of gas prices in the next few years, this approach leads to very significant price increases, not because of domestic demand factors, but because of the internationalisation of Australia's gas markets and the associated increase in wholesale gas prices (discussed further below). This is because a new retailer would be forced to sign new contracts for wholesale gas, while existing gas retailers may have existing contracts at lower prices. Origin Energy's submission, for instance, suggests retailers have sufficient contracts to meet all domestic demand until around 2017.[8]

PIAC also notes that there is a large difference between existing gas contract prices and forecasts of new contract price. This means that incumbent gas retailers will receive very substantial windfall gains, at the cost of their existing customers.

Further, due to a number of factors, PIAC believes that at this stage, it is not appropriate or necessary for IPART to be setting prices in order to encourage new suppliers into the market. While competition in NSW has been found to be (largely) effective by the AEMC, the majority of that competition is between the incumbent retailers, particularly now Australian Power and Gas has been taken over by AGL. Given the current uncertainty surrounding wholesale gas markets, it is extremely unlikely that new entrants will take on the risk of entering the small retail gas market during the current VPA period, as discussed in Section 2.2 below.

2.2 Barriers to entry

As previously stated, there is significant uncertainty surrounding the future of wholesale gas price in Australia. However, this is not the only potential barrier to entry into the retail gas market for a new retailer.

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5 Ibid, 7.

6 Ibid.

7 See for example: PIAC, *A Friendly Goodbye*, 2013, 4. Available at: www.piac.asn.au/publication/2013/09/friendly-goodbye.

8 Core Energy Group, *Gas, Power and LNG Outlook to 2033*, 2013, in Origin Energy, *Submission to Independent Pricing and Regulatory Tribunal on the review of regulated gas retail tariffs and charges from 1 July 2014 to 30 June 2016,* 2014, 6. Available at: http://www.ipart.nsw.gov.au/Home/Industries/Gas/Reviews/Retail_Pricing/Changes_in_regulated_gas_retail_prices_from_1_July_2014.

Firstly, PIAC takes the view that even if the regulated retail price contained a sufficient wholesale gas cost allowance, it is doubtful whether a new retailer could obtain a gas contract at any price. PIAC submits it would be more likely that where existing customers are looking to sign long-term contracts for future supply, a producer would favour selling to a customer with whom there is an existing relationship. Focusing on existing customers (including existing retailers), would remove any concerns that gas producers might have about the credit worthiness of a new entrant, especially at a time of rising gas prices and regional shortages.

Secondly, new entrants face significant potential risks associated with transmission costs. PIAC understands that contracts for the use of transmission pipelines in NSW are usually for a long-term and must be signed based on a fixed forecast of capacity demanded. A new entrant takes on a significant risk in signing a long-term capacity contract as they may not sign enough customers to transport gas to fill that capacity and are, therefore, left with stranded fixed costs.

Thirdly, there are also costs and other risks associated operating in the Short Term Trading Market (STTM) for gas that would need to be paid by a new entrant. While the STTM is largely a gas balancing market, it does require a new entrant to invest in systems, staff and processes to manage their gas portfolio and gas balancing requirements. Depending on their success (or lack thereof) in obtaining customers, suppliers risk failing to recover these additional costs.

Finally, PIAC notes that the NSW Government has recently announced that retail electricity prices will be deregulated in NSW from 1 July 2014.[9] This announcement followed a review of the effectiveness of competition in NSW retail energy markets, released by the Australian Energy Market Commission (AEMC) in October 2013. The AEMC review found that effective competition existed not only in retail electricity markets, but also retail gas markets (with the exception of ActewAGL customers in the Shoalhaven area).[10] The Draft Report also asserts IPART's view that 'competition in the retail gas market is now effective enough to provide sufficient protection to consumers'.[11]

In light of these positions from IPART and the AEMC, PIAC submits that there is significant uncertainty surrounding the possible deregulation of retail gas prices in NSW. PIAC is of the view that this uncertainty constitutes a further barrier to entry for new suppliers into that market.

When all these barriers are considered, it is extremely unlikely that new retailers will seek to enter the small retail gas market over the remainder of the period of the current VPA in any event. PIAC, therefore, recommends that IPART focus on the objective of protecting consumers from prices that are 'higher than efficient levels' in the short term, by setting a regulated retail price for gas that more closely reflects 'the efficient cost of supply'.[12]

Recommendation 1

PIAC recommends that IPART set regulated retail gas prices at a level that reflects the efficient cost of supply, rather than the costs that would be faced by a hypothetical new supplier entering the market.

9 O'Farrell, B, *Media release–Delivering lower electricity prices for NSW households,* 2014. Available at: www.resourcesandenergy.nsw.gov.au/__data/assets/pdf_file/0019/512614/Retail-price-deregulation-7-4-14.pdf
10 AEMC, *Review of competition in Retail Electricity and Natural Gas markets in NSW–Final Report,* 2013, 51.
11 IPART, above n 1, 7.
12 Ibid.

3. Wholesale gas prices

The largest driver of the draft price rise is the increase in wholesale gas costs (although PIAC notes that wholesale and retail costs are not disaggregated in the Draft Report, making detailed analysis difficult). The increase in wholesale gas costs is being driven by the development of liquid natural gas (LNG) export facilities in Gladstone in Queensland. It is widely forecast that the development of export facilities will lead to a tripling of LNG demand on the Australian east coast.

The extra competition for gas from international consumers will push up prices in Australia to the international levels, less the cost of delivering the commodity to another country (known as the 'netback' price at Gladstone). There is no doubt that the demand for gas and the wholesale price for new gas contracts in Queensland will increase as a result of the LNG expansion, and this will have a ripple effect on gas prices across the east coast. This does not mean there is a shortage of gas on the east coast, but it does mean there is significant competition for gas over the coming years.

However, as acknowledged in the Draft Report, 'there is considerable uncertainty about how fast and how far prices will rise' as a result of the internationalisation of the wholesale gas market in Australia.[13] Similarly, there is uncertainty about the extent to which these higher prices ex Queensland will flow through to other states, including NSW.[14] Advice commissioned by IPART from Jacobs SKM arrived at a 'reasonable range' for wholesale gas costs of \$6.25–\$9.00/GJ in 2014/15 (a 31% variation) and \$6.75–\$9.00 in 2015/16 (a 25% variation) in NSW.[15]

In contrast to this advice, AGL notes in its VPA proposal to this price determination process that public information on recent gas sales agreements indicates that 'the market price is currently between \$6 to \$7/GJ'.[16] In light of the discussion above regarding new entrants into the gas market, PIAC submits that it is more appropriate for IPART to set retail gas prices based on current wholesale prices—in line with IPART's first objective, above.

These prices are at the lower end of the reasonable range referred to above. Consequently, PIAC recommends that IPART set the cap on the cost of gas for Standard Contracts at no higher than \$7/GJ for 2014/15. This is still significantly above the current gas supply contracts with existing retailers, all of which extend beyond the VPA period.

Recommendation 2

PIAC recommends that IPART calculate gas costs for Standard Contracts using commodity costs that are no higher than \$7 for 2014/15, noting this still allows a significant margin for existing gas retailers.

13 Ibid, 13.

14 For instance, the maximum gas price in NSW for new entrant gas supply would be the price at Gladstone, less transportation costs between Moomba and Gladstone (with a final delivered Sydney 'city gate' price to include transmission from Moomba to Sydney.

15 Ibid, 20.

16 AGL, *VPA–Proposed price path for NSW regulated gas prices from 1 July 2014 to 30 June 2016 – public submission*, 2014, 4. Available at: www.ipart.nsw.gov.au/Home/Industries/Gas/Reviews/Retail_Pricing/Changes_in_regulated_gas_retail_prices_from_1_July_2014.

4. Price path and potential to damage the market

As noted in section 1.1 above, the Standard Retailers have proposed significant increases in prices for 2014/15, driven mainly by increases in the wholesale/retail cost component. In the following year, these prices are set to increase by 3.2%-5.4%.[17] However, IPART has modelled prices based on the cost of the carbon tax being removed from gas prices for the 2015/16 year, resulting in either modest increases (0.7% for AGL and 0.4% for ActewAGL) or decreases (1.7% for Origin Wagga Wagga; 3.4% for Origin Albury/Murray Valley).

This price path places significant price increases in the first year of the determination, and does not represent a 'smoothed' price path across the VPA period. PIAC argues that such a price path as set out in the Draft Report will be highly disruptive and detrimental for gas consumers. PIAC further argues that such a price path could be damaging to the gas market.

When price-sensitive consumers are faced with higher prices for a good or service, they will naturally seek to reduce their consumption of that good, or at least examine options for doing so. In the case of gas consumers, some have the option of replacing their gas appliances (such as stoves, water and space heaters) with electrical alternatives. Given the magnitude of the price increases, large numbers of consumers may make such a choice. As a result, there is a danger that the gas supply market could enter into a 'death spiral', with suppliers increasing prices in order to recover their fixed costs from a smaller customer base, thereby increasing the number of consumers who substitute electrical appliances for gas appliances (the so-called 'death spiral').

PIAC notes that those living in rental accommodation, including many low-income consumers, may not have this option. Low-income consumers who own their own home may also not be in a position to make the necessary capital investment to make this change. Improving energy affordability for these consumers is discussed further under Affordability, below.

Such a market dynamic could result in suppliers exiting the market. This would not be in the long-term interests of consumers and would also not 'encourage the development of a competitive market in gas', which IPART is required to consider under the *Gas Supply Act 1996*.[18] That is, potential new entrants will be reluctant to make long-term investments in the retail gas market if they perceive it to be in decline, even if it is profitable in the short term. Accordingly, PIAC recommends that IPART smooth the increase in gas prices over the two remaining years of the determination, in order to avoid potentially damaging shocks to the small retail gas market.

Moreover, the uncertainty around future gas prices warrants IPART taking a more conservative approach to these increases, with lower increases in the 2014/15 year, and flexibility to adjust in 2015/16 as the NSW gas supply/demand outlook becomes clearer. This would also limit the opportunity for excess profits by incumbents in the next year.

Recommendation 3

PIAC recommends that IPART smooth the increase in retail gas prices over the two remaining years of the VPA, retaining some flexibility to adjust prices in 2015/16.

17 IPART, above n 1, 5.
18 Ibid, 7.

5. Origin Energy prices for Albury/Murray Valley

PIAC is concerned by the proposal from Origin Energy regarding prices for the Albury/Murray Valley standard supply area. This area is connected directly to the Victorian gas transmission network, and is supplied from the Gippsland Basin gas fields. Gas prices in Victoria are forecast to remain below those elsewhere on the east coast in the coming years 'due to constraints on the Eastern Gas Pipeline and the Victorian Interconnector'.[19] That is, there is a limit to how much Victorian gas can compete in the wider NSW gas market over the VPA period that acts as a break on gas prices for customers supplied from the Victorian gas supply network. In addition, average Victorian gas transmission prices over the period show real price reductions in 2014 and 2015, with CPI beyond that.[20]

There is no objective support available for the increases proposed by Origin Energy to the delivered price of gas to the Albury and Murray Valley regions, and Origin Energy has provided no supporting data itself.

As a result, PIAC takes the view that retail/wholesale prices for the Albury/Murray Valley area will not increase by the amount proposed by Origin Energy in the remaining two years of the VPA (16.4% in 2014/15).[21] This is a position consistent with the statements in AGL's proposal, which suggest that gas commodity costs for Victoria (Longford) will be $5.59/GJ for 2014/15 and $6.50/GJ for 2015/16.[22]

Given the size of the proposed price increase, the Origin Energy proposal also contains a most concerning lack of detail. For example, the section on wholesale gas costs runs to a mere three paragraphs and contains no figures whatsoever.[23] In contrast, AGL has devoted an entire chapter of its proposal to this subject, including outlining changes in various cost components.[24]

PIAC takes the view that as a responsible regulatory agency, IPART should not approve Origin's Energy's proposed price increase for the Albury/Murray Valley supply area based on the information provided by the company. Rather, PIAC recommends that IPART set the price for Standard Contracts in the Albury/Murray Valley area based on gas commodity costs in line with AGL's forecast of gas prices at Longford (plus transportation on the Victorian transmission system to Albury, and separately, to Murray Valley), noting that these gas prices are new entrant prices and still provide considerable margin for existing retailers who are constrained from accessing alternative markets ex Victoria (such as the broader NSW market or Queensland LNG).

PIAC would note here, that the Victorian wholesale spot market over the last year has been averaging between $3.50 and $4.00/GJ and has shown no trend increase over the last year as would be expected if Victorian gas prices were under pressure.[25]

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19 AGL, above n 15, 4.
20 See: http://www.aer.gov.au/sites/default/files/AER%20amended%20decision%20–%20APA%20GasNet%20access%20arrangement%20-%2021%20November%202013_0.pdf
21 IPART, above n 1, 5.
22 AGL, above n 15, 17.
23 Origin Energy, above n 8, 7.
24 AGL, above n 15, 16-19.
25 Australian Energy Market operator, *Report: INT310_v4_PRICE_AND_WITHDRAWALS*, 2014. Available at: www.aemo.com.au/Gas/Market-Data/Victorian-Wholesale-Gas-Market-Data.

Recommendation 4

PIAC recommends that IPART set Standard Contract prices for the Albury/Murray Valley supply area based on gas commodity costs that are no more than $5.59 G/J in 2014/15 and $6.50 in 2015/16.

6. Affordability

6.1 Timing of the price increase

The prices determined by IPART through this review will come into effect on 1 July 2014. Given the size of the increase, PIAC is extremely concerned about the possibility of many consumers experiencing bill shock. The price rise is scheduled to come into effect in the middle of winter – a period of high gas use for many households, particularly those in the Origin Energy's Standard Supply areas.

PIAC understands from its engagement with community welfare organisations that many consumers, especially those experiencing financial hardship, often are not aware of future price rises until they receive their next bill. As a result, many consumers will be using gas for weeks, or even months, unaware that the price they are paying for it has increased significantly.

PIAC recommends that IPART communicate this issue to retailers, and suggest that retailers not fully pass through these price increases until after winter. Data from Core Energy Group in the Origin Energy proposal suggests that domestic gas contracts have been signed to meet all demand for the remainder of the current VPA.[26] As a result, the only increase in costs that retailers would face is from the more modest increases in network costs. 'New entrant' pricing in the middle of the peak demand period magnifies the negative impact on consumers of IPART's decision to focus on competition rather than efficiency.

PIAC also notes that any such move by retailers to 'protect' consumers from a price rise until after winter could be presented extremely positively to consumers, potentially improving the image of those companies in the minds of consumers.

Recommendation 5

PIAC recommends that IPART highlight the danger of bill shock that stems from a significant increase in retail gas prices occurring in the middle of winter.

Recommendation 6

PIAC recommends that gas retailers postpone significant price increases until the end of winter 2014.

6.2 Percentage-based energy rebates

PIAC has previously called for the introduction of percentage-based energy rebates in NSW. Recent research from the Australian Council of Social Services on energy concessions in each Australian jurisdiction found that the best way to assist households struggling with their energy bills is through a proportional rebate.[27] A Deloitte report prepared for the Energy Supply

[26] Origin Energy, above n 8, 6.

[27] ACOSS, *Preventing Shocks and Addressing Energy Poverty*, 2014, 8. Available at: http://www.acoss.org.au/images/uploads/Concessions_paper_2014_FINAL.pdf

Association of Australia similarly recommended that percentage-based concessions would be more effective in assisting vulnerable families with high energy consumption, particularly those in the family formation group.[28] This approach would also assist households to better cope with seasonal variations in their bills.

In addition, PIAC notes that the recent federal Budget tightened eligibility for the Family Tax Benefit. As a result, fewer households will be eligible for the Family Energy Rebate. PIAC takes the view that this presents an opportunity to review NSW energy rebates and intrdocue a percentage-based low-income rebate to assist vulnerable consumers with the increasing cost of essential energy services. PIAC calls on IPART to support this recommendation in its final report for this inquiry.

Recommendation 7

PIAC recommends that IPART recommend that the NSW Government review available energy assistance and introduce a percentage-based rebate for low-income consumers.

7. Conclusion

PIAC takes the view that in light of the significant uncertainty in the domestic gas market, new suppliers are extremely unlikely to enter the small retail market. As a result, PIAC recommends that IPART focus on its objective of protecting consumers from prices that are higher than efficient levels in the short term.

PIAC further argues that the proposed allowances for increases in the wholesale gas price are excessive, given the number of factors that could influence the potential size and timing of the increases. The proposed price path also has the potential to hurt both consumers and the health of the retail gas market and could possibly cause a gas market ‘death spiral’.

PIAC also takes the view that the proposed wholesale cost allowance for Origin Energy Standard Contracts in the Albury/Murray Valley area is unjustifiably high (even given ‘new entrant’ pricing), in light of the constraints that exist on transporting gas from Victoria to NSW and onwards to export terminals in Queensland. In light of the level of detail provided by Origin Energy in support of this proposal, PIAC submits that IPART should not approve the price rises in their entirety. Finally, PIAC is hopeful that retailers may be understanding of the potential for mid-winter price increases to cause significant bill shock and delay the full price rise until later in 2014.

28 Energy Supply Association of Australia, *Improving Energy Concessions and Hardship Payment Policies*, 2014, 4. Available at www.esaa.com.au/Library/PageContentFiles/56ab8d52-6922-4e13-9774a339541d5a86/130320_esaa_Deloitte_report_Improving_energy_concessions_and_hardship_payments_policies.pdf