AGL Energy Sales & Marketing Limited
AGL Centre
111 Pacific Highway North Sydney
PO Box 944
North Sydney NSW 2059

Telephone: 02 9922 8212
Facsimile: 02 9922 8477

25 March 2002

Dr T G Parry
Chairman
Independent Pricing and Regulatory Tribunal
PO Box Q290, QVB Post Office
SYDNEY NSW 1230

Dear Dr Parry,

Regulated Retail Tariffs

Energy Sales and Marketing (AGL) appreciates the opportunity to comment on the Terms of Reference of the mid year review of the Independent Pricing and Regulatory Tribunal's (Tribunal's) determination of *Regulated Retail Prices for Electricity to 2004*.

AGL considers that the level of regulated retail prices do not provide sufficient scope for second tier retailers to effectively compete in all segments of the NSW electricity market. AGL is of the view that the default prices do not adequately take into account the costs and risks in purchasing energy, the level of operating costs experienced by retailers including customer acquisition costs and are based on a low retail margin.

The potential for concerns to adversely impact competition were raised by AGL in our submission to Tribunal 's determination of Regulated Retail Prices for Electricity to 2004

AGL believes that a number of aspects of the Tribunal's determination require further consideration if the Tribunal is to met the Government's objective of "promoting competition in the retail market for electricity". Specific comments on costs used to derive the retail component of the target levels of the regulated retail tariffs follow:

Operating Costs excluding FRC costs ($35-$55)

Operating costs range of $35 to $55 is not sufficient to cover efficient operating costs of second tier retailers.

The Tribunal recognised the difficulty in setting a range given fluctuations in costs over time as provided by the standard retail suppliers.

Regulated prices if based on the most efficient of practices for each aspect of retail operations will increase the difficulties for second tier retailers to compete in the NSW market except in a few targeted segments. The potential effect is to reduce the numbers likely to receive competitive offers to a significantly smaller percentage of the total market.

The Tribunal has also noted the arbitrary nature of any cost allocation between networks and retailers. This may only further exacerbate the problems faced by second tier should any implicit cross subsidies exist between standard retailers and their network businesses.

AGL considers that the cost of acquiring customers has not been adequately addressed in the Tribunals determination. The impact of the regulatory framework (for example, extending time to process customer transfers) and the limited business to business arrangements in place have resulted in higher than expected costs. The payback period on acquisition costs acts as a barrier to entry for second tier retailers.

AGL does not accept that all marketing costs should be excluded from the regulated prices. In particular the benefits associated with strengthening brand recognition spread across all customers. In its submission to the then Office of the Regulator General AGL stated that

> *To illustrate our point we draw the comparison between the position of two franchise customers prior to FRC, and their positions in the new contestable market. One of the customers takes no action upon the introduction of FRC while the other enters into a contract for one year. The second customer has a very similar relationship with their retailer to the relationship they had prior to FRC – in that they are unable to enter into a new arrangement with another retailer. The first customer now has a very different relationship – in that they may take their business elsewhere. The first customer effectively holds an option over their future energy purchase arrangements and their retailer must take account of that. From the retailer's point of view, the cost to serve the first customer is increased both by the need to retain the customer and by its need to provide for the possibility that the customer may transfer.*

By not including sufficient allowance for acquisition costs in the regulated price, AGL is constrained in its ability to compete with incumbent retailers for a significant portion of customers.

Recovery of FRC Costs

AGL notes that the Tribunal will be reviewing FRC related costs as part of the mid term review. The $5 per customer allowed for in the regulated tariff is not sufficient for the recovery of these costs. AGL is attempting to compete with the regulated tariff that does not include sufficient allowance for efficient FRC costs (excluding marketing costs).

FRC Costs are significantly higher than $5 per customer. Significant portions of these costs are back end costs associated with processing the customer transfer and billing of customers. While it is anticipated that these costs will fall as churn levels increase further investment is required to automate these processes to industry standards (having common agreed B2B protocols will permit this work to commence).

It should be noted that the FRC costs for second tier retailers have the potential to be higher. For example, there is no sharing of systems with network businesses.

Net Margin of 1.5% to 2.5%

AGL believes that an allowance of 1.5% to 2.5% net margin is insufficient and will exclude competitors from competing with the standard retailer suppliers. AGL notes the position taken by the Tribunal in its final report on Regulated Retail Prices for Electricity to 2004.

> *The Tribunal believes that creating additional margin in regulated tariffs is not desirable from an economic efficiency or equity perspective and none has been built into the net profit margin. If the target level of the regulated retail tariff is set at the efficient level, then economically-efficient retail suppliers can compete – either by providing a value-added service to the customer at an appropriate price, or by being more efficient than the standard retail supplier.*

The retail margin should also be considered in the context of the risks associated with retailing activities. Specifically:

- the level low of the net margin is justified on the basis that the trading risk is mitigated by the ETEF. However, no second tier retailer has access to the ETEF. Therefore, implicit in the Tribunal's decision is that it expects second tier retailers to compete in the NSW small customer market for the same low net margins that the standard retailer suppliers are entitled to, noting that they face significantly more risks.

.

- competing with the standard retail suppliers by providing value added services is not a solution to this problem. Increasing value-added services increases costs, which in turn is paid for out of the additional margin generated by the service.

- the level of 1.5% to 2.5% does not adequately cover the risk of bad debt and other risks associated with FRC (other than trading risk).

The setting of an appropriate retail margin ought to be undertaken taking into account the potential for efficiency gains in incumbent businesses and the level of risk for energy purchases. Low operating costs, potentially as a result of cost recovery for some activities through distribution operations means that the second tier retailers will have limited opportunity to compete.

Limits on price increases applying to transitional tariffs

AGL supports the use of price paths of the regulated tariff to the target levels in order to minimise price shocks to customers. However, AGL is concerned that the pace of the path in the determination is such that it precludes it from competing in all but a limited group of customers on profitable tariffs.

In Summary

The levels of the regulated retail prices set by the Tribunal are too low for the reasons set out in this submission. The Tribunal has set a price it believes is reasonable based on the conditions faced by the standard retail supplier including purchasing through the ETEF, economies of scale, no marketing costs and no acquisition costs.

These costs set the best price and second tier retailers have difficulty competing as they:

1. Do not have access to the ETEF (and therefore higher risk energy purchases).
2. Have differing degrees of access to economies of scale in the NSW electricity market.
3. Incur marketing costs to attract new customers.
4. Are confronted with high acquisition costs to finalise customer churns.

AGL considers that the Tribunal has set the regulated price at a level that makes it difficult for an efficient second tier to effectively compete in the electricity market..

If you wish to discuss the specifics of the above matters, please contact Mark Bowden, Manager Retail Electricity Regulation, on 03) 9201 7066. or email mbowden@agl.com.au.

Yours sincerely,

Sandy Canale
General Manager Customer Services