2008 GAS STANDING CONTRACT PRICE PATH INQUIRY

FINAL INQUIRY REPORT & FINAL PRICE DETERMINATION

June 2008

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GLOSSARY OF TERMS

ACG	Allen Consulting Group	**REMCo**	Retail Energy Market Company Ltd
ACQ	Annual Contract Quantity	**RMA**	Retail Market Administrator
AEMC	Australian Energy Market Commission	**ROC**	Retail Operating Cost
AER	Australian Energy Regulator	**SA**	South Australia
AGL SA	AGL South Australia Pty Ltd	**SEAGas**	South East Australia Gas Pty Ltd
CAC	Customer Acquisition Costs	**SME**	Small Medium Enterprises
Commission	Essential Services Commission of South Australia	**SUG**	System Use Gas
CPI	Consumer Price Index	**TJ**	Terajoule
CSM	Coal Seam Methane	**TUOS**	Transmission Use of System
DD	Degree Day	**UGS**	Underground Storage
EBITDA	Earnings before Interest, Tax, Depreciation and Amortisation		
ESC Act	Essential Services Commission Act 2002		
FRC	Full Retail Competition		
Gas Act	Gas Act 1997		
GJ	Gigajoule		
GST	Goods and Services Tax		
HDD	Heating Degree Day		
ICRC	Independent Competition and Regulatory Commission, ACT		
IPART	Independent Pricing and Regulatory Tribunal, NSW		
MAPS	Moomba to Adelaide Pipeline System		
MDQ	Maximum Daily Quantity		
MIRN	Metering Installation Registration Number		
MJ	Megajoule		
MMA	McLennan Magasanik Associates		
MRET	Mandatory Renewable Energy Target		
NEM	National Electricity Market		
NERA	NERA Economic Consulting		
NGASA	Natural Gas Authority of SA		
NSL	Net System Load		
Origin Energy	Origin Energy Retail Ltd		
P.A	Per annum		
QCA	Queensland Competition Authority		
REES	Residential Energy Efficiency Scheme		

EXECUTIVE SUMMARY

This report presents the final conclusions of the Commission's Inquiry into gas standing contract prices for the three-year period 1 July 2008 to 30 June 2011. Accompanying this Final Inquiry Report is a Final Price Determination, which is the legal instrument that gives effect to the Commission's price decision.

In this price-setting process, the Commission is only considering the retailer component of gas standing contract prices. In addition to this component, standing contract prices include Envestra distribution charges and REMCo retail market administration charges, both of which are regulated separately by the Commission. The retailer component of tariffs accounts for just under half of a total bill for a small customer. It is noted that less than half of all small gas customers now use the standing contract for sale and supply of gas as the majority have moved to market contracts.

In order to set the retailer component of tariffs at an appropriate level, the Commission has examined the various costs that a prudent standing contract retailer faces:

- wholesale gas costs – that is, the cost of purchasing gas from gas producers;
- transmission costs – the cost of transporting gas via transmission pipelines to the gas distribution networks;
- retail operating costs –the cost of running a retail operation; and
- retail margin – which covers other retail costs such as working capital, depreciation and a return on assets.

Having considered a proposal put forward by Origin Energy, submissions from interested parties and expert reports it has commissioned, the Commission's final decision is to set a gas standing contract price path lower than that proposed by Origin Energy. The final decision on the maximum average retailer revenue in 2008/09 (expressed in $Dec 08) is $11.81/GJ for residential customers and $6.76/GJ for small business customers.

Retail Component of Gas Standing Contract Price
Origin Energy proposed price path vs. Commission's final price path

	1 Jul 08	1 Jul 09	1 Jul 10
Residential Customers			
Origin Energy Proposal	8.6%	CPI + 1.6%	CPI + 2.2%
Commission's final price path	8.25%	CPI+1%	CPI+1%
Small business customers			
Origin Energy Proposal	17.25%	CPI + 0.7%	CPI + 1.6%
Commission's final price path	15.0%	CPI+0.8%	CPI+0.8%

The Commission's final decision to increase gas standing contract prices on 1 July 2008 will add approximately $15 to an average annual residential bill (around 3% of the total annual bill). Annual price changes thereafter will be lower than this initial price increase, in real terms.

The initial price rise largely reflects increases in wholesale gas supply costs and an increased retail margin to reflect arrangements for payment of distribution charges in SA, which has working capital implications for the standing contract retailer.

However, the price rise is below the amount proposed by Origin Energy, driven largely by the Commission's decision on peak demand, which impacts on the costs of purchasing peak gas and transmission services, along with its decision on retail operation costs, particularly in relation to the amounts still to be recovered by Origin Energy for capital costs relating to the introduction of Full Retail Contestability (FRC).

PART A
- FINAL INQUIRY REPORT -

1 INTRODUCTION

Under the provisions of section 34A of the *Gas Act 1997* (Gas Act), Origin Energy Retail Ltd (Origin Energy) is required, as a declared standing contract retailer, to offer to sell and supply gas to any small gas customer (that is, persons using less than 1 terajoule (TJ) of gas per annum[1]), whether a residential or a business customer, on request. [2]

Origin Energy's offer to sell and supply under a standing contract must be on the terms and conditions as specified by the Essential Services Commission of South Australia (the Commission) under Part C of the Energy Retail Code[3] and at the price fixed by the Commission under the Gas Act.[4]

This Final Price Determination and Final Inquiry Report deals with the second of those matters, the appropriate price for the Commission to fix for the sale and supply of natural gas by Origin Energy under standing contracts for the period 1 July 2008 to 30 June 2011.[5]

The price fixing process is not, of course, at large; the Commission is required to proceed in accordance with the legislative requirements as specified by both the Gas Act and the relevant provisions of the Commission's empowering statute, the *Essential Services Commission Act 2002* (the ESC Act).

In summary, those Acts require that the price fixing process may generally[6] only commence once the Commission has received a submission from Origin Energy, stating the price it proposes the Commission fix as the standing contract price together with a justification for the proposed price.[7] Following receipt of such a submission, the Commission is required to conduct an Inquiry (under Part 7 of the ESC Act) into the appropriate price to be fixed. In doing so, it is required to have regard to a large number of matters as specified by both the Gas Act and the ESC Act. The outcomes of the Inquiry thereafter form the inputs into the price which is ultimately fixed by the Commission using its price determination powers under Part 3 of the ESC Act.

The prices thereby fixed are binding on Origin Energy for a period of three years. Importantly, in fixing prices for the purposes of the legislative scheme, the Commission is

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1 Regulation 8E Gas Regulations 1997

2 Origin Energy was proclaimed to be the standing contract retailer, under section 34A(5) of the Gas Act, in the South Australian Government Gazette, 23 September 2004, p3692.

3 Refer Energy Retail Code (ERC/01) , available from the Commission's website at http://www.escosa.sa.gov.au/webdata/resources/files/040227-C-EnergyRetailCodeFinal.pdf

4 Refer generally, section 34A of the Gas Act, available at http://www.legislation.sa.gov.au/LZ/C/A/GAS%20ACT%201997/CURRENT/1997.24.UN.RTF.

5 The fixing of a price for the sale of other types of gas by Origin Energy (eg. bottled or reticulated LPG) is not the subject of this Inquiry.

6 The price-fixing process may be foreshortened in particular instances where the Commission deems that "special circumstances" exist, refer section 34A(4a)(d) of the Gas Act.

7 Section 34A(4a)(d)(ii) Gas Act.

not required to specify each price for each individual tariff or tariff component across the entire period, but rather may undertake its task by specifying initial tariffs and components and providing a mechanism for changes to those tariffs across the period. In that way the actual price fixed at any given time is readily ascertainable, yet at the same time, the price control regime contains sufficient flexibility to reflect changing market conditions.

This is the second price determination made by the Commission to apply to Origin Energy. The first price determination applied for the period July 2005 – June 2008.[8]

On 19 November 2007, the Commission received a submission from Origin Energy for the period July 2008 – June 2011. A public version of this submission is available on the Commission's website.[9] As such, the price fixing process commenced upon receipt of the Origin Energy submission.

The remainder of this chapter sets out an overview of the important structural and operational features of the South Australian gas supply industry and describes, in greater detail, the specific workings of the legislative requirements of the ESC and Gas Acts in the context of the gas standing contract price determination.

1.1 Overview of Gas Supply Industry

The South Australian gas industry comprises participants in the production, transmission, distribution and retailing sectors. These sectors take natural gas from the point of extraction (the well head) to the point of consumption (the burner tip).

The Commission licenses participants in the distribution and retailing sectors in accordance with the Gas Act.

The gas industry structure in South Australia (SA) is discussed below.

1.1.1 Production

Natural gas in SA is extracted from the Cooper Basin in the far north of the state. Natural gas supplied to SA is also extracted from interstate fields such as the Otway and Bass gas basins off the coast of Victoria and indirectly (via swaps) from coal seam gas fields in Queensland.

1.1.2 Transmission

Gas is transported from the production fields to the city gate (where the distribution system takes over) by means of transmission pipelines. These transmission pipelines transport large volumes of natural gas under high pressure.

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8 Documents relating to the 2005/06 – 2007/08 Gas Standing Contract Price Determination are available on the Commission's website at http://www.escosa.sa.gov.au/site/page.cfm?u=134&c=440.

9 Origin Energy Retail Ltd, *Proposed Price Path for Standing Contract Prices for Supply and Sale of Natural Gas: 2008/09 to 2010/11 – South Australia: Public Submission*, November 2007 (refer http://www.escosa.sa.gov.au/webdata/resources/files/071122-OriginEnergySAGasRetailPricePathSubmission-Public.pdf)

In SA, there are two major transmission pipelines:

- the Moomba–Adelaide pipeline system (MAPS), which transports gas from the Cooper Basin to Adelaide; and
- the South East Australia Gas Pty Ltd pipeline (SEAGas), which transports gas from the Otway and Bass basins to Adelaide.

These transmission pipelines also have lateral connections that supply regional areas such as Port Pirie.

In addition, there is a 70km pipeline from the Katnook processing plant to Mt Gambier and Snuggery.

Both the MAPS and South-East (Katnook) pipelines are owned and operated by Epic Energy. The SEA Gas pipeline is owned and operated by the members of the SEA Gas partnership: International Power, APA Group and TRUenergy.

1.1.3 Distribution

Once the gas is transported by the transmission pipeline to a gate station, it feeds into the distribution pipe network.[10] The distribution pipe network transports the gas to residential houses, offices, hospitals, factories and other businesses.

Once the gas is in the distribution network it is transported at lower pressures and in smaller volumes than along the transmission pipeline. The transmission-connected natural gas distribution network in SA is owned by Envestra Ltd.

The distribution network owned by Envestra is a regulated monopoly. The access regime which applies to the distribution network is administered by the Commission. This regime includes the approval, by the Commission, of reference tariffs for the services provided by Envestra.[11] A reference tariff operates as a benchmark tariff for a specific service, in effect giving a potential access seeker a right of access to the specific service at the reference tariff, and giving Envestra the right to levy that reference tariff for the service.

Any matters relating to safety and reliability of the distribution network are dealt with by Envestra.

[10] Gate stations link transmission pipelines and distribution pipelines.

[11] Documents relating to the Access Arrangement applicable to Envestra are available from the Commission's website (refer http://www.escosa.sa.gov.au/site/page.cfm?u=135). It is noted that this regulatory responsibility will pass to the Australian Energy Regulator when a new National Gas Law takes effect, possibly in July 2008.

1.1.4 Retail

Retailers sell and supply natural gas to "end user" customers.

Unlike electricity retailers which buy electricity through the National Electricity Market (NEM), gas retailers in SA operate under a "contract carriage market" where they must have contractual arrangements in place for purchase (with gas producers such as Santos), transmission (with Epic or SEAGas) and distribution (with Envestra) of gas. The wholesale gas price and terms and conditions of supply are governed by these agreements.

1.1.5 Retail gas prices

On 28 July 2004, full retail competition (FRC) was introduced into the South Australian gas market. Prior to that date, while other retailers were legally entitled to compete, there were insufficient market systems in place to permit those other retailers to do so on a large scale (other than to very large customers). Since July 2004, gas retailers in addition to Origin Energy have been able to compete to sell and supply gas to all customers and increasing levels of competition have been observed in the market.[12]

As competition continues to evolve, the State Government has provided for the regulation of gas retail prices to protect vulnerable customers and ensure small consumers have access to a basic standard of service at a reasonable price. In virtually every energy market where competition has been developed in the retail sector (including the South Australian retail electricity market), regulatory or government control of prices is intended to apply for a period of time until the competitive market is functioning properly.

Under current national processes agreed to by Commonwealth, State and Territory governments, the state of competition in gas retail markets is being reviewed by the Australian Energy Market Commission (AEMC) on a jurisdiction-by-jurisdiction basis. The reviews conducted are, in part, intended to provide advice to relevant Ministers as to whether or not price controls, such as those provided for standing contracts under the Gas Act, should continue.

The AEMC commenced such a review for SA in March 2008, with final recommendations to be made by December 2008.[13] Until such time as action is taken by the State Government on any recommendation as to the state of the competitive market and the appropriate future course of regulatory pricing intervention, if any, the current pricing controls will continue to apply.

[12] Discussion on the state of gas retail competition in SA is contained in Chapter 2 of this report.

[13] Information on the review of effectiveness of competition in the gas and electricity retail markets in South Australia being conducted by the AEMC is available from the AEMC website (refer http://www.aemc.gov.au/electricity.php?r=20080115.175820).

That said, it is important to understand that there are no price controls established in respect of retail gas prices outside of the standing contract prices. The prices charged under all retail gas contracts other than the standing contract (known as "market contracts" and which may be offered by any retailer including Origin Energy) are unregulated.

1.1.6 Wholesale gas market

To achieve effective competition in the retail market as described above, the development and introduction of rules ("market rules") and systems was required in the wholesale gas market. These market rules and systems facilitate the allocation of gas on transmission pipelines between competing retailers, and ensure that each retailer matches supply with its demand (or pays a penalty for imbalance between supply and demand).

An independent market administrator (Retail Energy Market Company Ltd – REMCo) is responsible for overseeing the market, including the development and administration of the market rules, and the management of data flows and customer transfers. REMCo is licensed by the Commission under the Gas Act as the gas market administrator for SA.[14]

In its main role of administrator of the retail market rules, REMCo is responsible for developing and managing key processes in a contestable market, including:

- delivery point registration, discovery and transfer (i.e. customer transfer);
- data exchange between market participants;
- the balancing, apportionment and reconciliation of gas injections into the network;
- rule changes and administration; and
- a dispute mechanism.

Retailers are responsible for contracting with gas producers for the total gas supply for their requirements. However, given the uncertainty of customers' actual demands, there will always be imbalances between a retailer's purchases and sales: this requires a balancing service to match actual supply and demand for every retailer on a daily basis. In SA, given that there are two major transmission pipelines through which gas is supplied, these imbalances occur on both an inter and an intra pipeline basis.

As part of its balancing service, REMCo allocates gas to retailers using Net System Load (NSL) profiling. REMCo also operates an inter-pipeline Swing Service to ensure physical balancing between the two main pipelines MAPS and SEAGas.

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[14] Refer www.remco.net.au

Under this Swing Service arrangement, the retailers lodge 'bids' to buy and sell gas on the respective MAPS and SEAGas pipelines. REMCo settles the swing market daily based on the volume of gas required for balancing between the pipelines, the bid buy and sell prices and the actual cause of the imbalance itself.

Physical imbalances between parties on one pipeline (that is, on an intra-pipeline basis, for example, between users of the MAPS pipeline) must also be settled but this is done on the basis of private commercial arrangements between the pipeline parties rather than the Swing Service operated by REMCo.

REMCo's operational charges are primarily applied to the gas retailers on a customer connection basis (there are also small joining and annual membership fees payable). The charge is currently offset by an annual Government payment to Envestra equal to the REMCo charge.

REMCo charges are regulated by the Commission pursuant to section 33(1)(c) of the Gas Act. The current REMCo price determination, which took effect from 28 July 2004 and will apply until 30 June 2009, sets out the maximum charges that REMCo can recover from market participants as a Retail Market Administrator (RMA) in SA.[15]

1.1.7 Annual consumption

As shown in Figure 1.1, gas fired electricity generators and industrial businesses remain the dominant users of natural gas in SA, forecast to account for 47% and 42% of annual consumption in 2007/08 respectively. Residential and small business customers have historically not been large consumers of gas in SA. Australian Bureau of Agricultural and Resource Economics data for national and state projections to 2029-30 forecast that gas consumptions will continue to grow on a similar proportional basis for the next 20 years, with the biggest increase in gas consumption in the electricity generation sector.[16]

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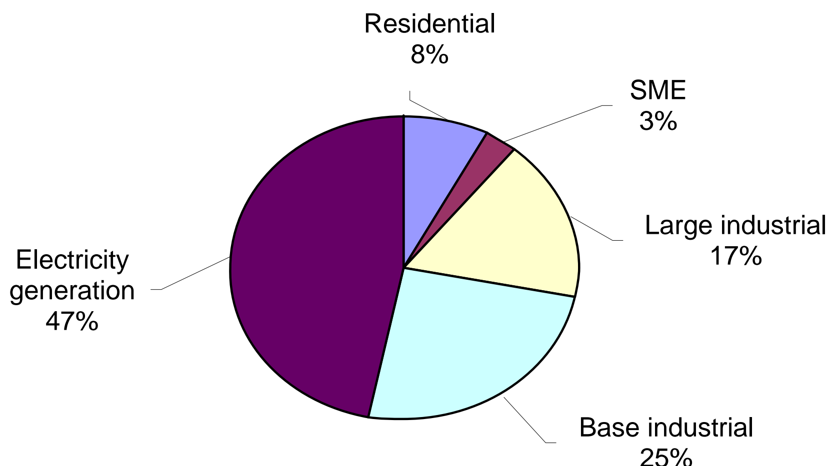
[15] The Commission's Retail Market Administrator price determination is available on the Commission's website at http://www.escosa.sa.gov.au/webdata/resources/files/040629-R-GasFinalPriceDetermin.pdf.

[16] For more information, see: Australian Bureau of Agricultural and Resource Economics 2007, *Australian Energy – National and State Projections to 2029-30*, December 2007, which can be accessed at: www.abareconomics.com.

Figure 1.1: Forecast composition of SA natural gas annual demand, 2007-08



Source: Origin Energy forecasts based on a total demand of 38.2PJ for 2007-08. Note 'SME' includes small business customers up to 10 TJ per year.[17]

1.1.8 Maximum daily consumption

The annual demand forecasts determine the overall volume of gas that must be purchased by Origin Energy, other retailers and certain large users for the year. As with electricity supply, it is maximum demand rather than average demand that determines the required scale of production, transmission and distribution facilities, and hence maximum demand has some influence on the delivered cost of gas.

The contribution of different market segments to maximum demand is different from the contribution of different market segments to annual demand.

In the gas industry, this peak capacity requirement is generally expressed in terms of maximum daily quantity (MDQ) and the relationship between this peak day requirement and the average daily requirement is known as the "load factor".

Load factors used by Origin Energy in planning peak demand for each market have been provided to the Commission on a confidential basis.

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[17] Origin Energy Retail Ltd, Proposed Price Path for Standing Contract Prices for Supply & Sale of Natural Gas: 2008/09 to 2010/11 South Australia: Public Submission, November 2007, page 10.

1.2 Nature of the price determination

Under the terms of section 34A of the Gas Act, the provision of Origin Energy's submission is a condition precedent to the Commission being empowered to make a price determination.

This means that, while the Commission in making price determinations generally is not simply assessing or passing judgement on the merits or otherwise of the submission, in the case of the Gas Standing Contract Price Determination, the submission of Origin Energy must be, and has been, afforded a significant weight by the Commission.

It does not follow, however, that the Commission's Gas Standing Contract Price Determination is merely an approval or rejection of that submission. The Commission is still required to undertake an independent price-fixing process, necessarily informed to a large extent by the content of the submission, but also informed by other evidence gathered by the Commission, including stakeholder submissions, expert advice and advice from Commission staff.

1.3 Legislative Framework

Part 3 of the ESC Act concerns price regulation. Section 25(1) states that the Commission may make determinations regulating prices, conditions relating to prices and price-fixing factors for goods and services in a regulated industry. However, section 25(2) states that the Commission may only make a price determination if authorised to do so by a relevant industry Act or by regulation under the ESC Act. Section 25(3) of the ESC Act provides that the Commission may make a price determination that regulates prices, conditions relating to prices or price-fixing factors in a regulated industry in any manner the Commission considers appropriate, including:

(a) fixing a price or the rate of increase or decrease in a price;

(b) fixing a maximum price or maximum rate of increase or minimum rate of decrease in a maximum price;

(c) fixing an average price for specified goods or services or an average rate of increase or decrease in an average price;

(d) specifying pricing policies or principles;

(e) specifying an amount determined by reference to a general price index, the cost of production, a rate of return on assets employed or any other specified factor;

(f) specifying an amount determined by reference to quantity, location, period or other specified factor relevant to the supply of goods or services;

(g) fixing a maximum average revenue, or maximum rate of increase or minimum rate of decrease in maximum average revenue, in relation to specified goods or services;

(h) monitoring the price levels of specified goods and services.

Section 6A of the Gas Act states that the Commission has (in addition to the Commission's functions and powers under the ESC Act), the licensing, price regulation and other functions and powers conferred by the Gas Act and any other functions and powers conferred by regulation under the Gas Act. More specifically, section 33(1)(a) of

the Gas Act states that the Commission may make a determination under the ESC Act regulating prices and price-fixing factors for the sale and supply of gas to small customers or customers of a prescribed class. This provides the authorisation required by section 25(2) of the ESC Act.

1.4 Factors to consider in making the Final Price Determination

Section 25(4) of the ESC Act states that, in making a price determination, the Commission must have regard to the following (subject to the provisions of the Gas Act[18])

1.4.1 Factors specified in Part 2 of the ESC Act

Section 5(1) of the ESC Act sets out the particular functions of the Commission.

Section 5(1)(a) specifies that one such function is to "regulate prices and perform licensing and other functions under relevant industry regulation Acts".[19]

Section 6(1) sets out the objectives or factors to which the Commission must have regard in performance of its section 5 functions. Thus, in performing its functions, the Commission must:

(a) have as its primary objective protection of the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services; and

(b) at the same time, have regard to the need to:

(i) promote competitive and fair market conduct;

(ii) prevent misuse of monopoly or market power;

(iii) facilitate entry into relevant markets;

(iv) promote economic efficiency;

(v) ensure consumers benefit from competition and efficiency;

(vi) facilitate maintenance of the financial viability of regulated industries and incentive for long term investment; and

(vii) promote consistency in regulation with other jurisdictions.

1.4.2 Factors specified in Part 3 of the ESC Act

Section 25(4) of the ESC Act states that in making a price determination, the Commission must, in addition to the general factors set out in section 6, have regard to:

(a) the particular circumstances of the regulated industry and the goods and services for which the determination is being made;

(b) the costs of making, producing or supplying the goods or services;

(c) the costs of complying with laws or regulatory requirements;

(d) the return on assets in the regulated industry;

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[18] Section 25(6) ESC Act

[19] In the ESC Act, *relevant industry regulation Act* means another Act by which a regulated industry is declared for the purpose of the ESC Act, and includes regulations under that other Act.

(e) *any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries;*

(f) *the financial implications of the determination;*

(g) *any factors specified by a relevant industry regulation Act or by regulation under the ESC Act; and*

(h) *any other factor that the Commission considers relevant.*

Section 25(5) also states that, in making a price determination under the Act, the Commission must ensure that:

(a) *wherever possible, the costs of regulation do not exceed the benefits; and*

(b) *the decision takes into account and clearly articulates any trade-off between costs and service standards.*

1.4.3 Factors specified in the Gas Act

Section 25(6) of the ESC Act requires that the factors set out in section 25(3), (4) & (5), and hence also the section 6(1) factors, have effect in relation to a regulated industry subject to the provisions of the relevant industry regulation Act for that industry (in this case, the Gas Act).

Section 3 of the Gas Act states that its objects are:

(a) *to promote efficiency and competition in the gas supply industry;*

(b) *to promote the establishment and maintenance of a safe and efficient system of gas distribution and supply;*

(c) *to establish and enforce proper standards of safety, reliability and quality in the gas supply industry;*

(d) *to establish and enforce proper safety and technical standards for gas installations and appliances; and*

(e) *to protect the interests of consumers of gas.*

In addition, section 33(2) of the Gas Act provides that the Minister may, by notice published in the Gazette, direct the Commission about certain matters in relation to the making of price determinations under the Gas Act. No Ministerial directions have been notified to the Commission in respect of its current consideration of the gas standing contract price.

Accordingly, there are multiple factors to which the Commission is required to have regard in making a price determination.

However, the Commission has a clear primary objective as set out in Section 6(1)(a) of the ESC Act, which is the protection of the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services. It must at the same time have regard to the other factors set out in Part 3 of the ESC Act, remembering that all of these ESC Act factors are subject to the provisions of the Gas Act.

1.4.4 Other factors

Finally, section 25(4)(h) of the ESC Act states that the Commission can also have regard to any other factors that the Commission considers relevant.

1.5 Establishing a Retail Gas Price Path

Section 34A of the Gas Act provides a scheme under which the Commission will exercise its power to make a determination regulating prices, conditions relating to prices and price-fixing factors for the sale and supply of gas to small customers.[20] In particular, section 34A(4a) provides that:

> *The following provisions apply in relation to the fixing by the Commission of a standing contract price for an entity and class of customers for the purposes of this section:*
>
> *(a) the Commission may fix the price by a determination of a kind referred to in section 33(1)(a);*
>
> *(b) a determination must provide for the expiry of the determination at the end of a period of not less than 3 years specified in the determination;*
>
> *(c) a determination may provide for prices that vary at specified times according to a formula specified in the determination;*
>
> *(d) unless the Commission determines that special circumstances exist—*
>
> *(i) a determination may not be made to take effect before the expiry date of the last preceding determination made by the Commission in accordance with this subsection;*
>
> *(ii) a determination may only be made if the entity has made a submission to the Commission stating the price that the entity proposes be fixed by the Commission as the entity's standing contract price, and the entity's justification for the price, not less than 6 months and not more than 9 months before the making of the determination;*
>
> *(iii) the Commission must, before making a determination, have conducted an inquiry under Part 7 of the Essential Services Commission Act 2002 into the question of the appropriate price to be fixed as the standing contract price;*
>
> *(e) a submission under paragraph (d) must comply with any requirements as to the form and content of such submissions imposed by the Commission by written notice served on the entity.*

As indicated previously, Origin Energy made a submission to the Commission in November 2007 in accordance with section 34A(4a)(d)(ii).

Section 34A(6) of the Gas Act sets out the meaning of the gas standing contract price. It states that the:

> *standing contract price, in relation to a gas entity and a customer, means—*
>
> *(a) until 1 July 2005—the price last fixed by the Minister under Schedule 2 for the sale and supply of gas to a class of customers to which the customer belongs;*
>
> *(b) on and from 1 July 2005—*
>
> *(i) the price fixed by the Commission in accordance with subsection (4a) as the entity's standing contract price for a class of customers to which the customer belongs; or*
>
> *(ii) if there is no price for the time being fixed by the Commission as the entity's standing contract price in accordance with subsection (4a), the price fixed under this Act as at 31 December 2002 for the sale and supply of gas to a class of customers to which the customer belongs.*

[20] Section 33(1) Gas Act

1.6 Approach adopted by the Commission

In applying the above framework, the Commission has followed a systematic approach in determining the values of key inputs for the retail price path. Specifically, as set out in the following Chapters, it has:

- independently checked Origin Energy's customer, peak demand and consumption data;
- assessed the estimated wholesale gas costs and transmission charges and the allocation between customer groups, to determine the appropriate charge to small customers;
- reviewed and set appropriate allowances for retail operating costs and retail margin; and
- considered how to manage risks and uncertainties associated with setting a 3-year price path.

In considering each of the components of the standing contract price, the Commission has had regard to all of the factors specified by law, and particularly the need to:

- protect consumers' long-term interests with regard to the price, quality and reliability of gas supply;
- ensure Origin Energy's reasonable costs are recovered;
- facilitate maintenance of the financial viability of the gas industry;
- promote economic efficiency and ongoing investment in the gas industry; and
- encourage competition and prevent abuse of monopoly power.

In applying these factors, the Commission has sought to achieve the lowest possible price for small customers consistent with allowing Origin Energy to recover all of its reasonable costs incurred in meeting its standing contract obligations.

The Commission has also been mindful of the need to ensure that competition in the gas retail market can continue to develop. The Commission's consideration of this matter is described in Chapter 2.

1.7 Process

Prior to making a price determination, the Commission is required to conduct an Inquiry under Part 7 of the ESC Act into the question of the appropriate price to be fixed as the standing contract price.[21]

[21] See Gas Act, section 34A(4a)(d)(iii).

This Inquiry commenced with the release of the Origin Energy price path proposal and accompanying Issues Paper in November 2007.[22] The Issues Paper stated that the feedback received would guide and inform the Commission in preparing a draft Inquiry Report.

The following five parties made submissions to the Issues Paper:[23]

- AGL South Australia Pty Ltd (AGL SA);
- Simply Energy;
- Minister for Energy;
- Origin Energy; and
- TRUenergy

Following consideration of submissions, consultant reports and other analysis, in April 2008 the Commission released a Draft Inquiry Report, and accompanying Draft Price Determination, presenting the Commission's draft conclusions on the gas standing contract prices that should apply for the period 1 July 2008 to 30 June 2011.[24]

The Commission invited comment by way of submissions on the Draft Inquiry Report and Draft Price Determination.

The following five parties made submissions to the Draft Inquiry Report.

- AGL South Australia Pty Ltd (AGL SA);
- Simply Energy;
- Minister for Energy;
- Origin Energy;
- TRUenergy

The Commission appreciates the contributions made by these stakeholders to the Inquiry process. The Commission has given the submissions received careful consideration in reaching its final views on the appropriate gas standing contract prices to apply from 1 July 2008 to 30 June 2011. The Commission's final findings of the Inquiry, and the statement of reasons for the final price determination, are reflected within this document.

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22 Essential Services Commission of SA, *Review of Gas Standing Contract Prices 2008/09-2010/11: Issues Paper*, November 2007 (refer http://www.escosa.sa.gov.au/webdata/resources/files/071122-GasPricePath_IssuesPaper.pdf)

23 All of these submissions, along with submissions to the Commission's Draft Inquiry Report and Draft Price Determination, are available on the Commission's website refer: http://www.escosa.sa.gov.au/site/page.cfm?u=259&t=submissionsXList&xlistId=57.

24 The Draft Inquiry Report and Draft Price Determination is available on the Commission's website at : http://www.escosa.sa.gov.au/site/page.cfm?u=259&c=2537.

2 STATE OF THE RETAIL MARKET

2.1 Gas retail market developments

While the Commission establishes the price path in accordance with legislative criteria, the standing contract prices themselves exist in a competitive retail market and can have an effect on that market. Indeed, to this point the standing contract price has operated as a standard or benchmark price in the market, against which market offers are placed. Therefore, the level of standing contract prices is likely to have implications for the retail market.

This Chapter describes the state of competition in the retail gas market in SA and reports key indicators of gas retail market development over the period since FRC commenced. The information herein is derived from that which the Commission collects in monitoring the development of the energy retail market (both electricity and gas) in SA, to establish the status of competition in the market and to provide further insights into actions that the Commission might take to enhance retail market competition. However, it is not meant to be a full assessment of the effectiveness of competition in the gas retail market; as noted previously, the AEMC is currently undertaking such an analysis.

2.1.1 Number of retailers

As at 31 March 2008, there were ten retailers licensed to sell gas in SA, nine of which were also licensed to sell electricity (refer Table 2.1). Currently, only four of these gas retailers (Origin Energy, AGL SA, TRUenergy and Simply Energy) are making offers to small customers (consistent with 2005). Some retailers have been targeting particular market segments (e.g. dual fuel rather than gas only, residential rather than non-residential). Some retailers are also not offering market contracts in regional areas of SA (as discussed in section 2.2)

Table 2.1: Licensed gas retailers in SA

Retailer	Electricity		Gas		
	Licensed	Selling to Small Customers	Licensed	Date of Licence Issue	Selling to Small Customers
AGL SA	✓	✓	✓	22 March 2001	✓
Australian Power & Gas	✓	×	✓	22 November 2007	×
Country Energy	✓	✓	✓	30 April 2008	×
Dodo Power & Gas	✓	×	✓	9 January 2008	×
EnergyAustralia[25]	×	×	✓	29 February 2008	×
Jackgreen International	✓	✓	✓	20 September 2006	×
Momentum Energy	✓	✓	✓	28 June 2007	×
Origin Energy	✓	✓	✓	16 September 1998	✓
Santos Direct	×	×	✓	1 August 2006	×
Simply Energy[26]	✓	✓	✓	15 June 2005	✓
South Australia Electricity	✓	✓	✓	21 September 2005	×
TRUenergy	✓	✓	✓	1 April 1998	✓
Total	10	8	12		4

2.1.2 Customer Switching

The Commission's 2005 Inquiry into gas standing contract prices was undertaken at a time when FRC had just commenced, and the majority of small customers in SA were still taking gas supply under the standing contract.

Since that time, retail competition has advanced, so that now less than half of all small customers in SA take supply from Origin Energy under the standing contract. There were approximately 5,600 customer transfers per month in 2006/07 as customers took up the lower rates offered by market contracts; up 21% from 2005/06 (Origin Energy reports an average residential churn rate of 26% per annum through 2005/06 and 2006/07). 60% of small customers have moved to market contracts and the rate of switching has been steady. However, the latest

[25] EnergyAustralia, a State-owned corporation under the *Energy Services Corporation Act 1995 (NSW)*, previously held gas and electricity retail licences in South Australia, both in its own name and in partnership with International Power. EnergyAustralia was first issued with an electricity retail licence on 11 October 1999 which it then surrendered on 30 June 2000. It was then issued with an electricity retail licence on 3 April 2003, which it surrendered on 1 November 2006, and a gas retail licence on 30 March 2004, which it surrendered on 1 February 2006. EnergyAustralia was issued with new electricity and gas retail licences on 29 February 2008.

[26] Energy Australia Pty Ltd and International Power Pty Ltd were trading as the EA-IPR Retail Partnership (Simply Energy). In August 2007, International Power acquired Energy Australia's 50% share in the EA-IPR Retail Partnership. The EA-IPR Partnership is now trading as Simply Energy.

quarterly figures indicate that churn rates are falling. At this stage, the reason for the decline is difficult to determine. It is unclear if this represents a one-off 'correction' or simply a natural rate of decline following vigorous historical churn rates.

Table 2.2 shows the proportion of small gas customers (subdivided into residential and small/medium enterprise (SME) categories) that remained on standing contracts with Origin Energy at the end of each year from December 2004.

Table 2.2: Percentage of customers on the standing contract

DATE	DEC 2004	DEC 2005	DEC 2006	DEC 2007	MAR 2008
RESIDENTIAL	90.1%	69.6%	51.7%	40.0%	38.3%
SME	97.3%	92.0%	89.1%	84.1%	83.3%

The take-up of market contracts has been significantly greater amongst residential than non-residential small customers.

In the residential sector, customer switching appears to be greatest in the Adelaide and Mt. Gambier regions, slightly lower in Port Pirie and Whyalla, and non-existent in the Riverland (where gas standing contract customer numbers are increasing rather than decreasing due to an increase in the overall customer base). Table 2.3 summarises the switching rates by region.

Table 2.3: Standing contract customer annual net churn rates by region

		ADELAIDE	MT GAMBIER	PORT PIRIE	WHYALLA	RIVERLAND	TOTAL
2005	RESIDENTIAL	-23.5%	-5.5%	-9.2%	-7.5%	-5.0%	-22.8%
	SME	-3.6%	0.2%	-1.5%	-4.4%	0.0%	-3.4%
2006	RESIDENTIAL	-26.4%	-18.3%	-17.0%	-13.1%	34.4%	-25.9%
	SME	-1.5%	-0.6%	-1.5%	0.0%	8.8%	-1.4%
2007	RESIDENTIAL	-27.1%	-23.4%	-18.6%	-16.2%	42.9%	-26.7%
	SME	-2.3%	-1.9%	-1.5%	1.8%	11.1%	-2.2%

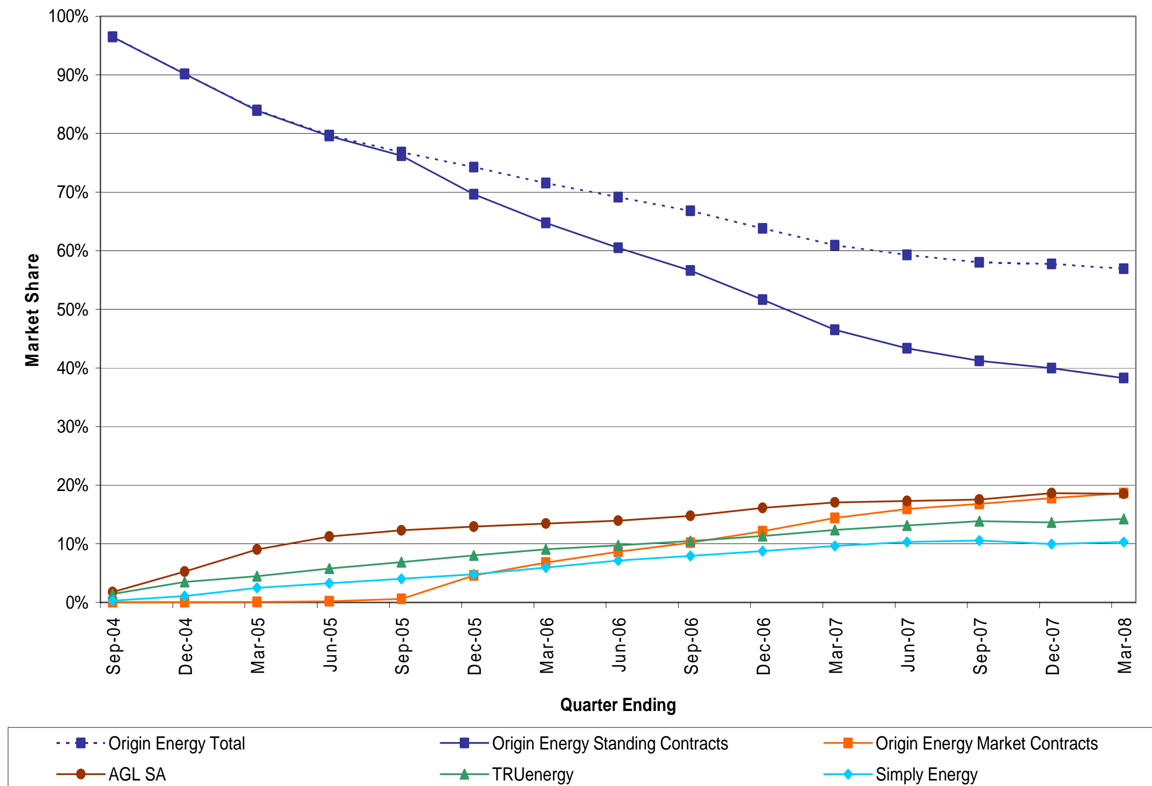
Source: Origin Energy

As at March 2008, Origin Energy's total market share by customer numbers was about 58% (38% standing contract, 20% market contract).[27] AGL SA, TRUenergy and Simply Energy had a market share of 18%, 14% and 10% of total customer numbers respectively.

Figure 2.1 shows trends in market share for various retailers of residential customers since the last quarter of 2004 based on data supplied by retailers.

[27] The market shares reported includes small and large customers.

Figure 2.1: Retail market shares – Residential Gas Customers



2.1.3 Consumer awareness and participation

The Commission has undertaken surveys of consumer awareness of electricity and gas retail market issues in 2004 and 2006.[28] These have shown a high level of consumer awareness about the existence of retail competition in the gas market and have suggested that consumers are generally confident regarding the processes for entering into market contracts.

The survey results indicated that for those residential customers that had chosen to switch retailer, price was the dominant reason (60-65%) for this decision. An overwhelming majority of customers that had switched retailer found the transfer process to be easy. For those residential customers that had not switched retailer, the majority indicated that the reason for this decision was satisfaction with their current retailer.

[28] For a detailed summary of the results of these surveys, refer section 3 of the Commission's March 2006 statistical report available from www.escosa.sa.gov.au/site/page.cfm?u=105&c=46.

2.1.4 Gas retail prices

Standing Contract Prices

The proposed price path for the July 2008 to June 2011 period sets an average revenue control. Actual tariff movements are subject to this control, but there is scope for some rebalancing within and across tariffs, which means that movements need not be uniform between the different parts of a tariff.

Table 2.4 sets out the retail part (i.e. excluding network charges) of the residential standing contract tariff movements that have resulted from pricing decisions from 1 July 2003 to 30 June 2008 in both nominal and real terms. Prices from July 2005 were those resulting from the Commission's 2005 three year price path determination for Origin Energy. Prior to July 2005, retailer tariffs were established by the Minister for Energy.

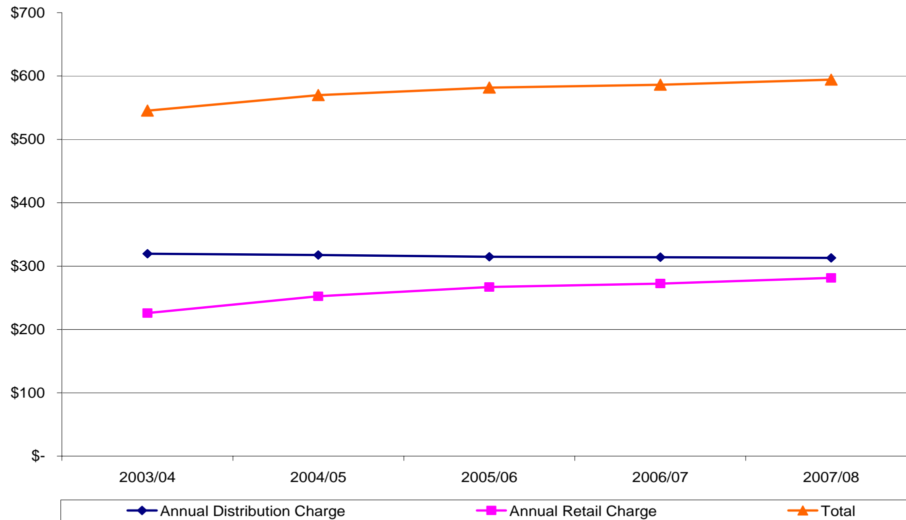
Table 2.4: Residential gas retail regulated tariffs

	2003/04	2004/05	2005/06	2006/07	2007/08
Origin Energy Retail Residential Tariffs (GST Exclusive, $ Nominal)					
Supply Charge $/QTR	5.73	11.44	14.84	16.30	17.35
First 4500 MJ (c/MJ)	0.72	0.74	0.77	0.79	0.84
Additional MJ (c/MJ)	0.62	0.64	0.67	0.70	0.74

Since 2003/04, there has been an increase in the typical real[29] residential annual gas bill of 9%, which equates to a real increase of around $48. It is worth noting that a large proportion (7%) of this increase occurred prior to the 2005 price path determination. Figure 2.2 shows how changes to the standing contract price have affected a residential customer with annual gas consumption of 22 GJ for the period 2003/04 to 2007/08. These price trends are expressed in real dollars, removing the effect of inflation.

[29] That is, removing the impact of inflation.

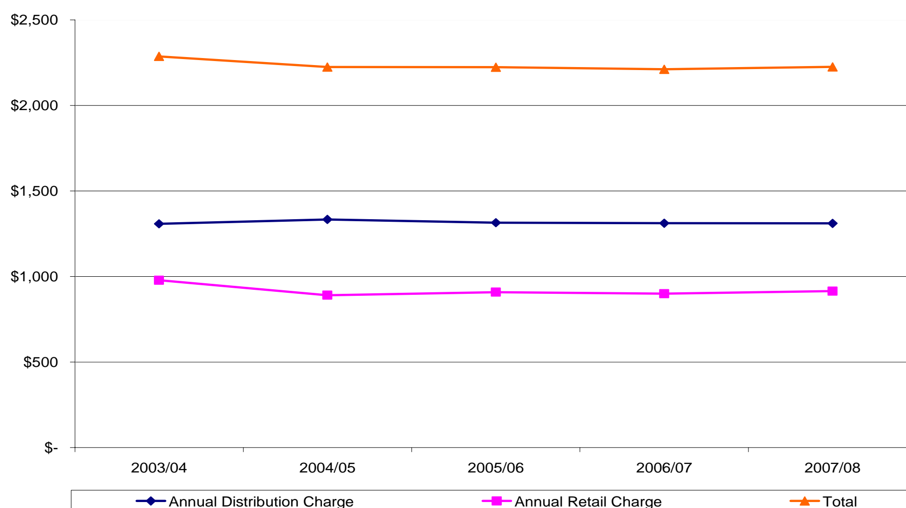
Figure 2.2: Typical Standing Contract Annual Residential Bill (22 GJ per year, GST exclusive - $Dec 08)



It is noted that the proportion of the total residential bill attributable to the retailer charges has risen from 40% in 2003/04 to about 48% in 2007/08, with distribution charges remaining approximately constant in real terms over this period.

Given the diverse nature of business, the use of averages for SME consumption is less meaningful than for residential consumption. However, this information is provided for a small business customer with annual consumption of 156 GJ over the same period (2003/04 to 2007/08) in Figure 2.3. Over this period, such a small business customer would have experienced a real price decrease of approximately 3%, or around $74.

Figure 2.3: Typical Standing Contract Annual Small Business Bill (156 GJ per year, GST exclusive - $ Dec'08)



Market Contract Prices

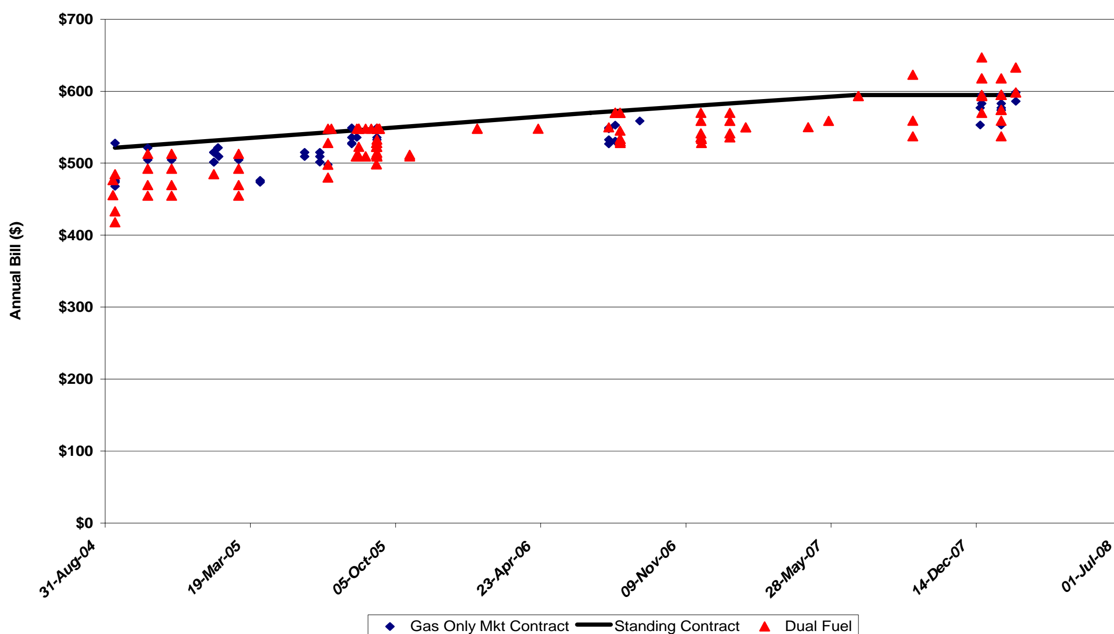
Market Contract Prices are not regulated, and are set by the market, although they are generally set with reference to standing contract (regulated) prices. For example, many market contract discounts are offered as a percentage reduction from the regulated price.

The Commission's web-based Estimator service currently indicates that savings of up to 7.60%[30] are available against the standing contract in the Adelaide Metropolitan area. As market contracts continue to offer lower rates than the standing contract, customers remaining on the standing contract can ameliorate the effects of any change in the price path by moving to a market contract.

In comparison to electricity, market contracts in gas are offered by relatively fewer retailers. Currently only three retailers offer gas only market contracts in the Adelaide Metropolitan area (as opposed to eight retailers in electricity), and just one retailer in the other regions.

Figure 2.4 shows the annual bill for a residential gas customer using 22GJ per annum, based on a sample of market offers as presented to the Commission for use in the Estimator.

Figure 2.4: Annual Bill for a Residential Customer (22 GJ per year, GST exclusive)



30 The terms and conditions for this offer includes a 3 year contract, with penalty for early termination.

Figure 2.4 demonstrates that, historically, most offers have been at or below the regulated price. However, in recent times, the number of offers above the regulated price has been increasing.

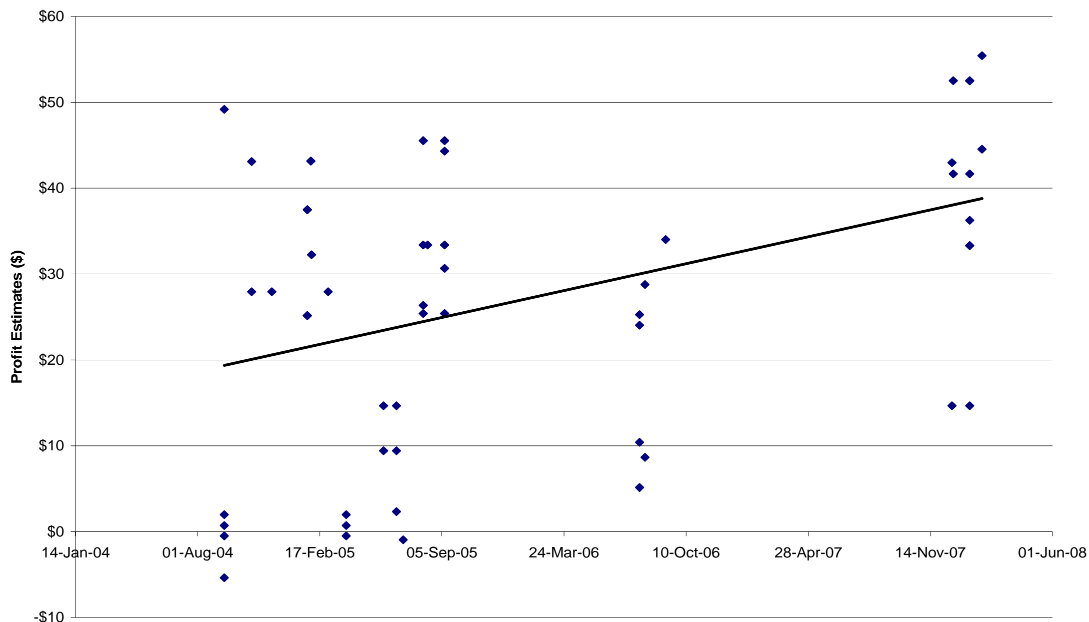
It also demonstrates a greater level of activity in the "dual fuel" offering, compared to offerings in the gas only product.

Profitability

The level of profits earned by retailers provides some guidance as to the state of competition in the market. However, determining profitability necessarily requires an estimation of costs. Determining this estimate is very difficult because it requires a number of assumptions to be made and the estimate is very sensitive to the assumptions made. Nevertheless, a broad estimate as to the level of profitability can provide useful insight. The Commission has therefore attempted to make such an estimate in order to better understand the state of the retail gas market in SA.

The Commission undertook some analysis of the profitability from market offers that have been made to date.[31] The analysis shows that the amounts earned in profit from a residential customer with average consumption of around 22 GJ, is generally between $20 to $50 per year.

Figure 2.5: Annual Estimates of profit earned from a residential gas customer (22 GJ per year)



[31] Based on a sample of market contract prices used in the 'Estimator'.

In contrast, a residential electricity customer with average usage of about 5 MWh typically contributes around $100 towards the profitability of a retailer (although the profit margins, expressed in percentage terms, are similar in gas and electricity).

The low profit earned from the average residential gas user, is mainly due to the relatively lower annual gas bill amounts, compared to the average electricity annual bills of about $1,100. This is mainly due to the low average annual gas usage in SA (about 22 GJ, compared to around 60 GJ in Victoria).

However, when gas is sold together with electricity, so that some of the costs of acquiring gas and electricity customers are shared, acquiring a gas customer becomes a greater value proposition. This is a possible explanation of greater activity in Dual Fuel[32] offers, compared to gas only offers.

2.2 Effectiveness of retail market competition in SA

In early 2007, the Commission engaged NERA Economic Consulting (NERA) to conduct a study on the effectiveness of competition in the SA electricity and gas retail markets. Among other things, the study concluded that the gas retail market was "*well on the way to becoming effectively competitive, albeit with some limited areas of exception*".[33]

One such area of exception is the SME market, where churn rates continue to be very low. The NERA study suggested that limited direct marketing by retailers to SME customers, along with an apparent unwillingness of small business customers to search proactively for information regarding market offers, may explain this outcome.[34]

NERA also observed that competition was still lacking in areas outside of metropolitan Adelaide.[35] It suggested that the most likely barrier to competition in regional areas was the ability for new entrant retailers to obtain transmission pipeline capacity for pipeline laterals running off the MAPS. It understood that much of this capacity is contracted by the standing contract retailer, Origin Energy.

The observation that gas retail competition is limited in regional areas appears contrary to the churn rates being reported by Origin Energy in most regional areas, at least in the residential sector, as set out in Table 2.3. Origin Energy has confirmed that these reported churn rates[36] almost exclusively relate to switching from the standing contract to an Origin Energy market contract (as opposed to a market contract with another retailer). Therefore,

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32 Here the term "Dual Fuel" is broadly meant as a product that is available only if the customer signs up for both gas and electricity at the same time with the same retailer.

33 NERA Economic Consulting, *Review of the Effectiveness of Energy Retail Market Competition in South Australia: Phase 2 Report for ESCOSA*, June 2007, page 87 (available at www.escosa.sa.gov.au/webdata/resources/files/070614-R-Phase2ReviewERMC.pdf).

34 *Ibid*, p ii.

35 *Ibid*, p. 87-88.

36 Email from Origin Energy to the Commission dated 27 February 2008.

the reported churn is not indicative of strong competition in this case, and the NERA conclusion is not necessarily at odds with the data.

The Commission's analysis shows that there are very few service providers that provide gas only products in SA, and there is no indication that the number of suppliers will increase in the near future. However, there is a greater level of activity in the dual fuel market, where gas is sold along with electricity to a customer.

As noted previously, a review of the effectiveness of energy retail competition in SA, conducted by the AEMC, commenced in March 2008. This review will be completed after the Commission has concluded its Inquiry into gas standing contract prices. The Commission notes that the AEMC has finalised its review into energy retail competition in Victoria and has concluded that competition is sufficient to justify the phasing out of retail price regulation.[37]

The Commission notes that it is obliged by the Gas Act to fix gas standing contract prices for at least a further three years from 1 July 2008. If no price is fixed, the standing contract price which will apply at 1 July 2008 is the price set by the Minister for Energy as at 31 December 2002.[38] There is no other mechanism by which gas standing contract prices may be set.

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37 Publications relating to the AEMC review are available on the AEMC website at www.aemc.gov.au.

38 Gas Act, S.34A(6)(b)(ii)

3 THE ORIGIN ENERGY SUBMISSION

In its November 2007 submission, Origin Energy proposed real increases in the retail component of gas standing contract prices across the three-year price path period. The most significant increase was proposed to take effect on 1 July 2008, with smaller price increases projected in 2009/10 and 2010/11.

The Origin Energy proposed price path was based on a building block approach, utilising an average revenue form of regulation whereby separate caps on revenue per GJ sold are imposed in relation to residential and SME customers. The cost building blocks were based on forward-looking estimates of the retailer's controllable costs (wholesale gas supply costs, transmission costs, retail operating costs and a retail margin).

Origin Energy has developed revenue forecasts that are designed to recover its proposed controllable costs, and has translated this into a maximum average revenue control. Retailer revenue is to be recovered via retailer tariffs, which comprise approximately half of the total gas standing contract price (gas distribution charges making up the other half). Origin Energy's proposed increases in the average retailer revenue allowance for residential and SME gas standing contract customers are reproduced in Table 3.1. The 2008/09 proposed increases are expressed in nominal terms, and incorporates a forecast inflation in prices from 2007/08 to 2008/09 of 4.24%. Percentage changes in subsequent years are expressed in real terms (above inflation).

Table 3.1: Origin Energy proposed price path ($Dec 08)

	RESIDENTIAL CUSTOMERS		SME	
	AVERAGE REVENUE ($/GJ)	% CHANGE	AVERAGE REVENUE ($/GJ)	% CHANGE
2008/09	$11.85	8.6%	$6.89	17.25%
2009/10	$12.04	1.6%	$6.94	0.7%
2010/11	$12.30	2.2%	$7.05	1.6%

Origin Energy has estimated the impact of the proposed increases in retailer tariffs on the total standing contract price, as set out in Table 3.2.[39]

Table 3.2: Forecast impact of Origin Energy proposal on total standing contract prices

	RESIDENTIAL CUSTOMERS	SME
	% CHANGE ABOVE CPI	% CHANGE ABOVE CPI
1 July 2008	4.6%	6.6%
1 July 2009	0.9%	0.5%
1 July 2010	1.2%	0.9%

39 These estimated price increases do not incorporate any changes in REMCo charges.

All costs presented in the Origin Energy submission are expressed in dollars of 31 December 2008. Origin Energy has applied a forecast inflation of 3% in converting costs from December 2007 dollars to December 2008 dollars. To enable comparisons against the Origin Energy submission, the Commission has also undertaken its assessment of costs using the same price assumptions. In developing the final price path, the Commission has replaced the assumed inflation for the year ending 31 March 2008 with the actual inflation, as measured by the annual change in CPI (all groups, weighted average of eight capital cities).[40]

The Commission notes that Origin Energy's proposed real increase in average revenue on 1 July 2008 has been calculated with reference to an "adjusted" 2007/08 retailer average revenue, rather than the actual amount approved by the Commission under the current gas standing contract price determination. The adjusted figure takes into account latest estimates of consumption and customer numbers for 2007/08, whereas the Commission's approved average revenue amount is based on forecasts made prior to 2007/08. When compared to the actual approved average revenue allowances for 2007/08, the proposed real increase in average revenue on 1 July 2008 is approximately 6% for residential customers and approximately 14% for SME customers, as opposed to the 9% (residential) and 15% (SME) increases quoted by Origin Energy following its "adjustments".

Origin Energy has provided detailed information to the Commission on a confidential basis regarding its proposed changes in controllable costs. In summary, Origin Energy has described some of the key drivers of these increased costs as:

- *increases to wellhead gas costs including MDQ driven by new contract prices and the rapidly changing supply/demand balance in the south-eastern gas market;*
- *increases to retail operating costs and the extension of the FRC capital cost recovery period, in both instances reflecting the high churn rates;*
- *increases in the retail margin in recognition of the ongoing working capital impacts of the unique gas network payment arrangements and of the substantial wholesale risks and forecast error risks; and*
- *the under-recovery of costs in 2007/08, which together with the demand forecast errors in 2007/08, drive additional adjustments to the average revenue requirement in 2008/09.* [41]

The Commission has received a number of detailed submissions from Origin Energy during this Inquiry on these issues, and other issues relevant to the determination of standing contract prices. Many of these submissions were provided to the Commission on a confidential basis. The Commission's consideration of these submissions is set out in subsequent chapters of this report.

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[40] Consistent with the current gas standing contract price determination, the Commission has adopted a 9-month lag convention, whereby the annual change in the March to March CPI forms a proxy for the annual change in the following December to December CPI.

[41] Origin Energy Retail Ltd., *Proposed Price Path for Standing Contract Prices for Supply and Sale of Natural Gas 2008/09 – 2010/11: Public Submission*, p3.

4 KEY ASSUMPTIONS REGARDING CUSTOMERS

In undertaking this Inquiry the Commission has investigated and reached conclusions on a number of key assumptions concerning standing contract customers that have a significant impact on standing contract prices. The assumptions cover:

- customer numbers – used to derive forecast consumption and is a key driver of retail operating costs;
- customer consumption – a driver of wholesale gas costs and transmission costs and forms the control variable for the average revenue control; and
- load factor – which affects Origin Energy's peak gas requirements (MDQ) and transmission capacity requirements.

4.1 Origin Energy Proposal

The Origin Energy Proposal projects standing contract customer numbers and customer consumption over three years from 1 July 2008 based on the following approach:

- Origin Energy has determined historical standing contract customer churn rates based on customer numbers by segment and region as at 30 June 2005, 30 June 2006 and 30 June 2007. Customers have been counted if they are listed as "active" in Origin Energy's billing system and have been billed in the last 120 days. The churn rates reflect the loss of standing contract customers to second tier retailers and to Origin Energy market contracts, as well as incorporating the impact of new customer connections;
- The average annual churn rate over this period has been used to derive forecast standing contract customer numbers from 30 June 2008 to 30 June 2011. This approach assumes that current churn rates will continue during the price path period;
- Origin Energy has estimated the average consumption per customer by tariff bands by analysing actual billed data in 2005/06 and 2006/07 for standing contract customers. Origin Energy assumes that this estimated average consumption will remain constant over the price path period; and
- Origin Energy has determined a consumption forecast by multiplying the forecast customer numbers by the "average" consumption per customer to derive the total annual consumption for the financial year.

Origin Energy also proposes to use the same load factors (the ratio of peak to average demand) for residential and SME customers as was proposed in its 2005 price path submission.

Details of the Origin Energy customer numbers, consumption and load factor forecasts have been provided to the Commission on a confidential basis. The Commission has also obtained independent expert advice from McLennan Magasanik Associates (MMA), which

was asked to provide the Commission with its own forecasts of standing contract customers, consumption levels and load factors for the 2008/09 to 2010/11 period. This advice, along with the Origin Energy proposal, has been considered by the Commission in developing its own view on these matters. Details of the Origin Energy proposal and MMA advice have not been published by the Commission for confidentiality reasons, and the Commission's assessment of this information, as discussed in the following sections, has therefore been summarised.

4.2 Customer Numbers

The Commission has reviewed the Origin Energy methodology for forecasting customer numbers, particularly in respect of its assumption that historical churn rates will continue into the next price path period.

Origin Energy in its submission to the 2005 review, forecast a decline in churn rates for both residential and SME customers on standing contracts during the 2005/06 – 2007/08 price path period. The Commission accepted that churn rates were likely to be relatively high during the formative stages of FRC, but would reduce slowly over time as the market matured.

However, the current churn rates for gas standing contract customers have exceeded these forecasts and, at the time Origin Energy submitted its proposal, had shown no signs of trending down over time. Origin Energy therefore determined its forecast of standing contract customers for the following price path period based on continuation of the average churn rate for 2005/06 and 2006/07.

The Commission has reviewed historical gas switching data, collected under Energy Industry Guideline No. 2[42], which indicates that the churn rates for both residential and SME customers from the standing contract to market contracts have remained broadly steady over the current price path period. However, the latest quarterly figures indicate that churn rates have fallen. As discussed in Chapter 2, it is difficult to determine, at this stage, whether or not this represents a one-off 'correction' or if it is indicative of longer term trends.

The Commission notes that MMA's assessment of customer numbers also suggests that current churn rates are not likely to decline over the next three years. It has recommended that the Commission adopt churn forecasts that are broadly consistent with those proposed by Origin Energy, although it has suggested that the increasing churn rates in regional areas are likely to increase until they reach the Adelaide level, rather than staying flat as proposed by Origin Energy.

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[42] Energy Industry Guideline No 2: Energy Regulatory Information - Energy Retail Code Retailer (refer http://www.escosa.sa.gov.au/webdata/resources/files/051214-D-FinalRevisedEnergyRetailerGuideline2.pdf).

Noting that MMA has developed customer number forecasts that are generally in line with those forecast by Origin Energy, the Commission has accepted Origin Energy's proposed customer number forecasts in the Final Price Determination.

4.3 Customer Consumption

Estimating the consumption of standing contract customers over the three year price path period is again a difficult task, as it requires the Commission to forecast the average level of consumption for residential and small business customers.

Origin Energy's annual customer consumption forecasts were based on the analysis of quarterly (or monthly) billing data where the relevant bills were issued to customers on the standing contract. For example, if a customer moved to a market contract during the year, only those bills that were issued while the customer was on a standing contract were included in the analysis. Each relevant bill is then analysed to allocate consumption to the tariff bands to capture the historical average consumption per customer and percentage of consumption for each of the tariff bands from which a total annual volume for a financial year can be forecast.

The Commission has compared the historical average consumption figures presented in the Origin Energy price path proposal with the quarterly gas consumption and customer number data collected on a non-regional basis from all retailers under Energy Industry Guideline No. 2, including Origin Energy. For the purposes of Energy Industry Guideline 2 the following definitions apply:

- customer numbers means the number of customers billed during the relevant regulatory period with customers defined in terms of active metering installation registration number (MIRN).
- sales means the quantity of gas (GJ) billed to customers during the relevant period (e.g. quarterly).

These definitions are consistent with those that underpin the consumption and customer numbers being reported by Origin Energy in its price path proposal.

Comparison of the data being reported by Origin Energy under its price path proposal, and that being reported separately to the Commission under Energy Industry Guideline No. 2, reveals significant differences in both residential and SME historical average consumption, with the Energy Industry Guideline 2 data showing much lower average consumption than the price path proposal. The Commission considers that this discrepancy cannot be explained by any differences in methodology used to report each data set, since both are based on consistent definitions. The Commission has pursued this matter with Origin Energy, but has not been able to determine the cause of the discrepancy. The Commission has asked MMA to independently review both sets of data, and MMA has concluded that the average consumption figures presented in the price path proposal from Origin Energy appear overstated.

The Commission has also analysed historical consumption data provided by Envestra and REMCo, as a further check against the Origin Energy figures. This information also indicates a level of average consumption that is significantly below that reported in the Origin Energy price path proposal, even accounting for some differences in methodologies used to report the data.

The Commission notes that, under an average revenue form of regulation, forecast average consumption is a critical input. The impact of using an overstated average consumption forecast is that the average revenue allowance (in $/GJ) will be lower than would otherwise be the case, and that an understated average consumption forecast will lead to a higher average revenue allowance than would otherwise be the case. Therefore, the relatively high average consumption figures that underpin the Origin Energy proposal do not favour Origin Energy in determining an average revenue outcome. The figures are not supported by other available evidence, including information presented by Origin Energy under Energy Industry Guideline No. 2.

On the face of it, there does not appear to be any reason why these two data sets from Origin Energy should not reconcile. The Commission remains concerned with the inconsistency of the consumption data with other data provided by Origin Energy, and it finds it difficult to accept that the average consumption forecasts are reasonable, having regard to other relevant information.

For the purpose of the Draft Price Determination, the Commission determined an average consumption forecast based on the continuation of historical average consumption being reported under Energy Industry Guideline No. 2 in 2005/06 and 2006/07. As this historical data is not disaggregated by region, the Commission prorated the average consumption to each region based on figures provided under the Origin Energy price path proposal.

The Commission received one submission, from Origin Energy, in relation to the Draft Inquiry Report's customer consumption forecast. The submission argued that Envestra's analysis, derived for the purposes of its network determination, did not take into account differences between standing contracts and market contracts, nor did it take into account the effect of churn rate on standing contract customer's consumption patterns.

Given these differences, Origin Energy argued that the forecasting methodology used in its proposal provides the most robust assessment of consumption as it is linked to individual bills where these bills applied to standing contract customers.

Nevertheless, for the purposes of this Price Determination, Origin Energy has accepted the Commission's consumption forecasts.[43] The Commission has therefore, for the purpose of the Final Price Determination, continued to adopt the use of the consumption

[43] Origin Energy Retail Ltd, *Response to ESCOSA on Draft Inquiry Report and Draft Price Determination – South Australia: Public Submission*, April 2008 (refer http://www.escosa.sa.gov.au/webdata/resources/files/080502-OriginGasDraftDetermination-Submission.pdf)

forecasts for the 2008/09 to 2010/11 period as proposed in the Draft Inquiry Report and Draft Price Determination.

4.4 Load Profile

Load factors are used to determine gas demand and therefore gas supply requirements to meet peak day demand and are established separately for the residential and SME customer market segments.

Origin Energy's peak demand forecasts have been derived on a design criteria based on a '1 in 25 years' peak day. That is, the system will be able to (at least) meet demands for gas during a '1 in 25 years' peak demand day. Origin Energy's submission indicates that the peak daily demand is around three times the average daily demand for the residential market. For the SME market, the peak demand is around twice the average daily demand.

The proposal assumes that a constant load factor for residential and SME markets will exist over the price path period, such that there is no change in cost differential between the two market segments. The proposed load factors are identical to those proposed by Origin Energy in its 2005 price path proposal, which were based on regression analysis of customer billing data to determine customer base load and heating degree-day (HDD) sensitivity coefficients[44], and derivation of a 1 in 25 year peak day weather, and application of this value to the regression formula to derive the corresponding peak day consumption and load factor.

It is understood that the derivation of the residential and SME load factors forecast by Origin Energy was based on ten years of weather data from Kent Town weather station, using a 12.67 HDD sensitivity coefficient.

In developing its own set of load factor forecasts for consideration by the Commission, MMA tested its own regression model against that used by Origin Energy. It also investigated the derivation of the 1 in 25 year peak day HDDs based on Kent Town weather station data, as well as data from the Airport weather station, in which 31 years and 48 years of data are available from the respective sources. MMA's analysis investigated the derivation of the 1 in 25 year peak day HDDs from larger samples than used by Origin Energy by constructing two separate series, one based on sampling the annual peaks from all days in the week and the second based on sampling the peaks only from weekdays. MMA noted that because system peaks do not occur at weekends when industrial load is reduced, counting peak weather at weekends will therefore exaggerate the capacity requirement for residential and SME customers.

MMA concluded that, while the Origin Energy regression model is reasonable, based on its own analysis, there is no evidence to support the 1 in 25 year peak HDD estimate

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[44] HDD is a measure of the weather sensitivity of gas demand. Daily HDDs are defined as HDD = 18°C– T when T<18°C, and HDD = 0 when T≥18°C, where T is the average daily temperate in degrees Celsius. Use of this parameter assumes that average temperature has a linear effect on gas use when it is below 18°C and no effect when it is at or above 18°C.

proposed by Origin Energy. It concluded that its load factors for the residential and SME markets, which are lower than those proposed by Origin Energy, represent the best estimates.

Having reviewed Origin Energy and MMA's methodologies for determining customer load factors, the Commission's Draft Inquiry Report and Draft Price Determination concluded that the best estimate of load factors was based on the Origin Energy regression model, combined with the MMA estimate of 1 in 25 year peak HDDs derived from weekday only data. These values are confidential and cannot be disclosed, but were incorporated into the Commission's draft price path calculations.

The Commission received one submission, from Origin Energy, in relation to the Draft Inquiry Report's load profile forecast. Origin Energy provided the Commission with confidential information in support of its own load factor forecasts, and identified four aspects of the MMA load profile forecast methodology that it argued contained errors and inconsistencies.

Firstly, Origin Energy noted that MMA used its own HDD data in conjunction with Origin Energy's degree day (DD) coefficients in its load profile analysis. The submission argued this mismatch of data application would result in a reduced load profile determination, as HDD values are less than DD values.

Secondly, Origin Energy argued that MMA's analysis, which is based on a 30 year sample of weather data to estimate the 1 in 25 year peak day degree days, was too long as it incorporated greenhouse effects. Origin Energy claimed that a shorter 10 year sample weather data was more appropriate, as it is able to minimise the impact of greenhouse effect on the data sample.

Thirdly, Origin Energy argued that MMA's exclusion of weekends from the analysis had no fundamental basis as it reduced the data population and peak DD. While the submission accepted the validity of MMA's assumption when applied to Origin Energy's total customer base, given the reduced demand for gas from SME and industrial customers over weekends, Origin Energy argued that this assumption cannot be similarly applied to residential customers as there is no evidence that residential demand is reduced on weekends. Origin Energy argues that the correct approach is to use a peak day analysis based on "all days" with reference to the peak demand of residential customers only.

Lastly, Origin Energy observed that when the Commission's Draft Decision load factors were tested against actual 2006/07 consumption volumes, it resulted in an estimate of average peak demand that was lower than the actual average peak demand. In contrast, Origin Energy argued that its own load factors resulted in more reasonable outcomes. It therefore suggested that the load factors forecast by Origin Energy have greater predictive power, as they produced MDQ requirements that closely match the actual MDQ requirements on the highest actual peak demand day in 2006/07.

4.4.1 HDD versus DD

Having further reviewed Origin Energy's submissions and MMA's advice, the Commission agrees with Origin Energy that there was a definitional difference underpinning the MMA HDD calculations compared to the Origin Energy calculations (relating to the periods over which maximum and minimum temperatures are measured). The Commission has accepted Origin Energy's definition of DD, which has led to an increase in the estimate of the 1 in 25 year peak degree days relative to those allowed for under the Draft Inquiry Report and Draft Price Determination.

4.4.2 Length of data series

The Commission has considered Origin Energy's arguments for estimating the 1 in 25 year peak day using ten years of data rather than MMA's 31 years of data and has concluded that the MMA approach is more reasonable for two reasons.

Firstly, the Commission considers Origin Energy's ten year series to be insufficient in measuring the impact on gas demand of a 1 in 25 year event. A 31 year series is considered to be more reasonable for the purposes of estimating an extreme value.

Secondly, the Commission rejects Origin Energy's arguments that a shorter, ten year series minimises the impact of the greenhouse effect on the data sample. Origin Energy has suggested that there has been a declining trend in annual degree days, although it has not demonstrated any such trend in relation to 1 in 25 year peak days. If such a trend existed, the Commission would expect the estimated 1 in 25 year peak day to have a higher value based on a longer series of data relative to a more recent series, which does not appear to be the case based on the MMA and Origin Energy estimates.

4.4.3 "Weekday" versus "all day" data

Origin Energy has submitted that it is inappropriate to exclude weekend data when estimating peak degree days. It suggests that such an approach, which is based on estimating the Origin Energy system peak, will impose a cross-subsidy between Origin Energy's large customers and its small customers. It suggests that the Commission should estimate load factors with reference to the peak demand of small residential and SME customers only.

Origin Energy has argued that the Commission should not assume that the standing contract retailer has any large customers, as it is setting a price purely for the supply of gas to residential and SME customers. It is suggesting that the standing contract price should be set based on the stand-alone costs of supplying standing contract customers.

The Commission has previously described its approach to setting standing contract prices as one that involves assessing the costs of a retailer with standing contract obligations, not necessarily a stand-alone standing contract retailer or one that just supplies small customers. In setting a price for the competitive market, it is therefore reasonable to have regard to the costs and benefits arising from retailing to market contract customers (large and small).

In its consideration of MDQ and transmission costs (for which load factors have an impact), the Commission has sought to determine the contribution that residential and SME standing contract customers should make to total MDQ and transmission costs which, in turn, depend on the system peak rather than the non-coincident peak of each customer group. The customer load factors influence the allocation of these costs to the various customer groups, with the Commission accepting that residential customers should pay a contribution that is reflective of its peakier demand. This approach does not impose any cross-subsidy between large and small customers, as argued by Origin Energy, assuming that the allocations based on load factors are reasonable.

The Commission therefore supports the determination of load factors having regard to total system gas demand, which validates the use of weekday data.

4.4.4 Load Factor Final Decision

The Commission has, for the purpose of the Final Determination, adopted load factors that are greater than those provided for under the Draft Inquiry Report and Draft Price Determination as a result of accepting Origin Energy's degree day definition. However, the Commission has concluded that, in all other respects, the methodology for estimating load factors as recommended by MMA and adopted by the Commission in the Draft Inquiry Report should be retained. The Commission notes that these revised load factors are therefore still lower than those that Origin Energy has proposed.

Again, given the confidential nature of these load factors forecast, the Commission is unable to publicly release them; the forecast values have, however, been incorporated within the Commission's final price path calculations.

5 FORM OF PRICE CONTROL

The Commission's Price Determination must specify the form of price control to apply to gas standing contract prices. In particular, it must state the manner in which prices can be adjusted during the price path period. The form of price control is designed to provide the standing contract retailer with an incentive to structure prices efficiently. It also seeks to strike an appropriate balance between providing price certainty, while also having sufficient flexibility to deal with unforeseen events.

Importantly, gas standing contract prices are set to reflect forward-looking efficient costs, rather than the actual costs incurred by the standing contract retailer during the price path period. While actual costs incurred can provide a guide to future costs, ultimately prices are set independently of actual costs in order to provide the retailer with an incentive to outperform the cost benchmarks and thus retain the benefit of such performance.

5.1 Regulation of Controllable Costs

The Commission's assessment of forward-looking costs is limited to only those costs that are within the control of the standing contract retailer. There is no real benefit in including non-controllable costs within the cost building blocks as the retailer is not able to directly influence whether or nor its actual costs will be less than or greater than the benchmarks set.

The building block components are:

- ▲ Cost of wholesale gas;
- ▲ Transmission costs;
- ▲ Retail operating costs; and
- ▲ Retail margin.

The summation of these costs form the basis for deriving the retailer tariffs.

5.2 Treatment of Non-Controllable Costs

The remaining costs that are not within the retailer's control, but which form part of the total gas standing contract price are:

- ▲ Distribution charges;
- ▲ REMCo charges; and
- ▲ GST.

Distribution charges levied by Envestra are regulated separately under an Access Arrangement that has been approved pursuant to the *Gas Pipelines Access (South Australia) Act 1997*.[45]

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[45] The approved Access Arrangement is available from the Commission's website at http://www.escosa.sa.gov.au/site/page.cfm?u=263#e393.

REMCo charges are also regulated separately by the Commission.[46] The Commission notes that, in the 2005 gas standing contract price determination, REMCo charges were treated as a non-controllable cost but were incorporated into retailer tariffs (taking into account a government subsidy of these charges) on the basis that these charges were known at the time of the determination. However, there is greater uncertainty over the level of REMCo charges during the next price path period, as a result of proposed gas market reforms. As it is not possible to forecast future charges given these reforms, the Commission believes that these charges are best dealt with outside the retailer tariffs as a direct pass through to consumers (less any future government subsidy). This is consistent with the Origin Energy proposal, which did not incorporate any REMCo charges into its proposed retailer tariffs.

The three non-controllable costs (distribution charges, REMCo charges and GST) are added to the retailer tariffs to derive the total gas standing contract price. In effect, the non-controllable costs are directly passed through to standing contract customers.

Origin Energy also levies a number of other fees and charges (eg. late payment fees). These other fees are not the subject of this price determination and are regulated separately under the Energy Retail Code.[47]

5.3 Price Path Period

The Gas Act requires the Commission to set a gas standing contract price path for at least a three year period. Origin Energy has proposed that the Commission set the minimum price path period, ie. three years.

The Commission considers this proposal to be appropriate, particularly in light of the inherent difficulty in forecasting retailer costs over the longer term, and given the AEMC's current review of competition in the SA electricity and gas retail markets, which is expected to provide recommendations to the State Government about future regulation of gas standing contract prices. Given these factors, the Commission sees no reason to set a price path period longer than three years.

The Commission notes the submission made by AGL Energy to the Commission's Issues Paper, which suggested that a mechanism be established to allow the removal of retail price controls prior to the end of the three-year price path, should the AEMC make a recommendation for the removal of gas retail price regulation in SA. In response to this suggestion, the Commission reiterates that it is legislatively required to make a price determination of not less than three years, and it is therefore not open to the Commission to make a determination that is capable of expiring before 30 June 2011.

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[46] Information on the Commission's current REMCo price determination is available at http://www.escosa.sa.gov.au/site/page.cfm?u=134&c=286.

[47] The Commission's Energy Retail Code is available at http://www.escosa.sa.gov.au/webdata/resources/files/040227-C-EnergyRetailCodeFinal.pdf.

5.4 Price Control Formulae

There are currently two elements to the control of the gas standing contract retailer tariffs, a control on the maximum average revenue that Origin Energy can earn from residential and SME standing contract customers, and a control on the extent to which retailer tariffs can be rebalanced from year to year.

5.4.1 Average Revenue Control

Origin Energy proposed a continuation of the current control variable, whereby the forecast average revenue ($ per GJ sold) from residential and SME gas standing contract customers is capped during the first year of the price path period, and is allowed to change in subsequent years of the price path period by (1+CPI)*(1-X). The CPI increase is based on the annual (March to March) change in the Consumer Price Index, All Groups Index Number (weighted average of eight capital cities) published by the Australian Bureau of Statistics. The X-factor represents the rate at which the maximum average revenue is allowed to change from year to year, such that the expected present value of revenue over the price path period allows the standing contract retailer to recover the forecast present value of its efficient controllable costs over the period.

The Commission's previous decision to adopt an average revenue control, with GJ as the control variable, recognised that the quantity of gas sold is a significant cost driver of the standing contract retailer, and by using GJ sold it allowed revenues to change in line with costs. While there may be additional cost drivers (eg. peak demand or the number of standing contract customers), the Commission adopted a single control variable (GJ) to reduce complexity.

The current average revenue control applies separately to residential and SME customers. The Commission's decision to establish separate controls for these customer groups reflected a concern that, under a combined control, there would be a strong incentive for Origin Energy to propose low sales forecasts for customers with a relatively high average revenue allowance (residential customers) and high forecast sales for customers with a relatively low average revenue allowance (SME customers) as part of its annual tariff submission, which could lead to the over-recovery of the average revenue. While a factor that corrects for forecast and actual sales may alleviate this problem, such a mechanism is administratively complex and impractical in a three-year price path. Therefore, separate controls were established for the two customer groups.

Origin Energy proposed to continue with separate residential and SME average revenue controls, although it has suggested that its annual tariff submissions should establish a forecast of average revenue based on the forecast volumes specified in the Commission's price determination, rather than Origin Energy providing revised forecasts prior to each year as is currently the case.

The Commission received few comments on the proposed form of regulation in submissions to the Issues Paper, although it notes that AGL Energy has suggested that the Commission adopt a weighted average price cap on the retail costs component of tariffs.

At this point, the Commission does not consider there to be any significant reason to depart from an average revenue form of regulation, particularly since the Commission has no reason to believe that it is resulting in any perverse outcomes, and because it is now well established and understood by relevant stakeholders. The Commission therefore accepts Origin Energy's proposal to continue with an average revenue control ($/GJ), applied separately to residential and SME customers.

In relation to Origin Energy's proposal to base annual forecasts of average revenue on the Commission's forecast volumes determined as part of the current Inquiry, the Commission notes that a primary objective of the average revenue form of regulation is to ensure that revenues (and prices) are closely aligned to efficient costs. In this respect, as expectations of forecast sales change, for example due to revised forecasts of churn, the average revenue control is intended to allow the amount of recoverable revenue to adjust in line with the expected change in costs. Under Origin Energy's suggested approach, revenues will not be able to adjust to revised forecasts of sales as the forecasts are locked in for the three-year price path period. Effectively, this approach more closely represents a revenue cap form of regulation than an average revenue control.

Origin Energy has not provided any justification for its proposed approach. Without such justification, the Commission is inclined to retain the current approach of forecasting average revenue based on revised sales forecasts each year, for the reasons set out above.

5.4.2 Rebalancing Control

Under an average revenue form of regulation, the standing contract retailer has some flexibility to change the relativities between tariff groups and tariff components, while still complying with the average revenue control. This rebalancing of tariffs allows the retailer to move prices to cost reflective levels. Obtaining cost reflectivity is important in a contestable market, since non-cost reflective pricing may lead to some customers being prone to "cherry-picking" by other retailers.

However, there is the potential for some customers to experience significant price shocks if tariff rebalancing is undertaken rapidly. Therefore, it is common for a secondary price control to exist which limits the extent to which tariffs can be rebalanced in any one year.

The current gas standing contract price determination incorporates a rebalancing control, whereby the annual increase in each retailer tariff must increase the charge at any level of consumption by no more than CPI+7% for residential customers, and CPI+5% for SME customers. The rebalancing control does not apply to any rebalancing between residential and SME customers, since there are separate average revenue controls for these customers. Rather, it controls the extent to which tariff components (eg. supply charge) can increase within any tariff category, and the extent to which there can be any rebalancing between geographic regions.

Origin Energy proposed no rebalancing control as part of its price path submission, stating that only small changes were required within and between tariff categories to achieve cost reflectivity. However, it suggested that it will wait until the quantum of the tariffs is known before finalising its position on this matter. In the event that the Commission does impose a rebalancing control, Origin Energy suggested that the Commission adopt one that is imposed above the CPI-X primary control.[48]

Submissions to the Commission's Issues Paper made the following comments in relation to tariff rebalancing:

- The Minister for Energy commented that tariff rebalancing has the potential to significantly impact low consumption standing contract customers, and he requested that the Commission rigorously test the Origin Energy proposal for no rebalancing controls;
- AGL Energy did not support the retention of rebalancing controls, arguing that they may inadvertently result in cross-subsidies. It suggested that, if retained, the controls should be applied to the retail component of tariffs only.

Submissions to the Commission's Draft Inquiry Report and Draft Price Determination raised the following comments on the Commission's draft proposal to adopt a rebalancing control of CPI+3% for both residential and SME customers:

- Origin Energy confirmed that it intended to undertake only limited rebalancing during the price path period, and acknowledged that the Commission's proposed rebalancing controls would be sufficient to achieve its objectives;
- Origin Energy reiterated its position that the rebalancing control should be based on an "average increase plus X%" rather than CPI+X%, to allow for greater flexibility for tariff reform;
- AGL SA again argued that there should be no rebalancing control but that, should the Commission impose one, the current controls of CPI+7% for residential customers and CPI+5% for SME customers should be retained.

48 Such a control would take the form of CPI(1-X)(1+Y), where Y is the allowed rebalancing control.

While Origin Energy has stated that further, though small, rebalancing is still required, it has not provided the Commission with the analysis to support this statement. In the absence of this analysis, the Commission is unable to conclude whether or not any further significant rebalancing will be undertaken by Origin Energy. It notes that, even if no further rebalancing is required, any rebalancing controls will not affect the operation of the price path. If limited rebalancing is required, then the controls will allow for such rebalancing while still providing some protection to customers that may otherwise be exposed to substantial increases in price as a result. Therefore, the Commission's view is that there is little, if any, downside in retaining the rebalancing controls. These controls would continue to apply to the retail component of tariffs only.

In relation to Origin Energy's suggestion that the rebalancing control should apply as a percentage increase above the X factor under the average revenue control, the Commission notes that such an approach is not compatible with the current form of rebalancing control, which is based on limiting the degree to which a customer's retailer charge can increase at any level of consumption. This form of control cannot simply be added to the X factor as the two controls apply to different parameters and are expressed in different terms.

The Commission has no reason to believe that there are deficiencies in the current approach, whereby the control limits the degree to which a customer's retailer charge can increase at any level of consumption. This approach is not as restrictive as one that limits the extent to which any tariff component can increase, and still provides an effective control on prices for customers at all consumption levels.

The Commission's Final Decision is that the rebalancing controls should be set such that the charge under each retailer tariff at any level of consumption does not increase annually by more than CPI+3%, for both residential and SME customers. The Commission considers that this rebalancing control provides sufficient flexibility for Origin Energy to move towards cost reflectivity in its tariff structure and provides customers with some protection over future price changes.

5.5 Pass-through Events

A pass-through mechanism allows (or requires) the retailer to add (or subtract) the cost impact of particular events to its tariffs. Pass-through events are typically limited to events beyond the control of the retailer, in order to maintain appropriate incentives to manage costs. Pass through amounts are based on the difference between the costs incurred by the retailer as a result of the particular event, relative to the costs that would have been incurred by the retailer but for the occurrence of that event. A pass through can reduce some of the risk that a retailer faces, although it does create some forward price uncertainty given that prices may need to move at any time. For this reason pass-throughs are usually limited in number and nature.

In general, the Commission has allowed for cost pass-throughs under a price determination on the basis that the following criteria are met:

- The event should be able to be clearly defined (ie. there should be little ambiguity about whether or not the event has occurred);
- The event should be outside the control of the retailer;
- The event should impact directly on the retailer (eg. an obligation or additional cost should be placed directly on the business); and
- The impact of the event on the retailer's costs should be capable of being measured accurately.

In addition to these criteria, the Commission has also previously provided for pass-through events where the event was known and the costs were within the control of the business, but where there was significant doubt about the timing of the event or the cost impact of the event.

While the exact nature and timing of any pass through event is typically uncertain, there is a requirement to define, up-front, the type of event that will be allowed. There are currently four types of events that can trigger a pass-through under the 2005-2008 Gas Standing Contract Price Determination:

- Change in taxes event – a change in tax that results in Origin Energy incurring materially higher or lower costs in supplying standing contract customers;
- Regulatory reset event – which relates to a material change in the obligations imposed under section 34A of the Gas Act for Origin Energy to offer to retail gas to small customers, as a result of which Origin Energy would incur materially higher or lower costs in providing standing contracts than it would have incurred but for that event;
- Transmission cost event - which means the entry by Origin Energy into a contract or contracts for the haulage of gas through the MAPS as a result of which Origin Energy incurs materially higher or lower costs in providing standing contracts than it would have incurred but for that event; and
- Ministerial directions event – which relates to the issuing of directions under section 37 of the Gas Act by the Minister for Energy in relation to supply interruptions and gas rationing events.

In establishing these pass-through arrangements, the Commission acknowledged in its previous Inquiry that section 34A of the Gas Act itself provides a mechanism for the price path to be reopened under "special circumstances". The intent of Parliament in providing a means for dealing with certain extraordinary events might suggest that the inclusion of pass-through event allowances within the Price Determination is unnecessary. However, the Commission concluded that there may be certain events that were of such a nature as

to be amenable to a pass-through treatment rather than reliance on the "special circumstances" provisions enacted by Parliament. It considered that the "special circumstances" provision should generally be applied only for events of such a magnitude as to disturb the basis of an existing price determination by such an extent as to require a new determination to be made. This provision is discussed further in the following section.

Origin Energy proposes that the current set of pass through items be retained. In its submission to the Commission's Draft Price Determination and Draft Inquiry Report, Origin Energy also suggested that the Commission allow for the pass-through of costs if there is a material forecast error in the setting of controllable cost benchmarks. As an example, Origin Energy has argued that the MDQ cost forecasts established during the previous Inquiry were significantly below the actual price of MDQ incurred by Origin Energy over the current period and that it has been unable to recover this shortfall as there is no pass-through event to deal with this situation, and it could not be addressed appropriately under the "special circumstances" provisions of the Gas Act.

The Commission has decided that it is not appropriate to address forecast risk through a pass-through mechanism. The Commission's reasons for this decision are discussed in section 5.6.1.

The Commission believes that it is appropriate for the existing set of pass-through events to continue, except for the transmission costs event, which was included in the previous determination to specifically reflect the fact that the existing MAPS access arrangement was due to expire on 1 January 2006, and there was some uncertainty regarding the new MAPS charges that Origin Energy would face.

Coverage of the MAPS was revoked by the Minister for Energy in September 2007. Access to the MAPS is now subject to commercial negotiation between the pipeline operator and prospective users. There appears no reason to continue with the current pass-through arrangements for MAPS as these charges should be treated in a manner that is consistent with SEAGas pipeline charges, which are unregulated.

In relation to the "regulatory reset" event, the Commission proposes to broaden the definition of this type of event to include the introduction of any carbon trading scheme which imposes direct obligations upon the standing contract retailer such that it incurs materially higher (or lower) costs in relation to its standing contract obligations. The likelihood of such a scheme being introduced appears to be firming (albeit that the form and content of such a scheme remains unknown) and the Commission acknowledges that there may be some, possibly significant, effect on wholesale gas prices were such a scheme to be introduced. Therefore, to the extent that a carbon trading scheme, or any other scheme that is intended to achieve similar environmental outcomes, imposes direct obligations on the standing contract retailer which materially increases (or decreases) its costs, then the Commission believes that a pass through arrangement is appropriate. The Commission has provided for such a pass through event in its 2008-2010 Electricity

Standing Contract Price Determination and an identical provision has been included in this Gas Standing Contract Price Determination.

The Commission notes the potential for a carbon trading (or similar) scheme to have an indirect impact on the cost of meeting standing contract obligations, for example, by increasing the demand for wholesale gas. Such indirect impacts do not fall within the criteria for a cost pass-through, as they are not as a direct result of an obligation being placed on the standing contract retailer. Nevertheless, should wholesale gas prices increase substantially as a result of such a scheme, or similar schemes, it may be reasonable, if appropriate evidence can be provided by the standing contract retailer, to allow full or part recovery of the financial costs by the standing contract retailer.

The "special circumstances" provisions of section 34B of the Gas Act provide the appropriate vehicle for addressing the indirect impact on costs from the introduction of a carbon trading scheme. The "special circumstances" provision is discussed in more detail in section 5.6.

The Commission's Final Decision is that the events for which a pass-through may be sought are:

- Change in taxes event;
- Regulatory reset event; and
- Ministerial directions event.

5.6 Reopening Events

The "special circumstances" provision of the Gas Act provides the ability for a gas standing contract price determination to be reopened if considered appropriate. The Commission expects that, if an unexpected event occurs which can be shown to have a material impact on the credibility of the price path determination, a review would be initiated pursuant to the "special circumstances" provision of the Gas Act, to determine if the event was unable to be predicted, planned for or reasonably insured against. The review would also determine the extent to which the event had a material impact on Origin Energy's prudent costs, such that the price path set in the price determination was no longer credible.

Origin Energy's submission to the Draft Inquiry Report and Draft Price Determination requested that the Commission give explicit recognition that the "special circumstance" provision could be used to address events arising from national and jurisdictional responses to climate change (including an expanded Mandatory Renewable Energy Target (MRET) scheme, emissions trading scheme, Residential Energy Efficiency Scheme (REES)[49] and solar PV scheme).

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[49] This scheme was announced by the State Government in February 2008, and is scheduled to commence from January 2009 (refer www.dtei.sa.gov.au/energy).

As discussed previously, the Commission has sought to address the cost impact of such schemes through the "regulatory reset" pass-through event, where the schemes impose a direct obligation on the standing contract retailer and materially impact on the cost of providing standing contract services.

Where the schemes impose a cost that is not as a result of a direct obligation on the standing contract retailer, but rather through indirect means (for example in raising – or lowering - the cost of inputs that are necessary for the delivery of standing contract services), then there is the ability for Origin Energy to approach the Commission under the "special circumstances" provision of the Gas Act, to seek approval for the price path to be reopened. In this situation, Origin Energy would need to demonstrate to the satisfaction of the Commission that the event has had a material impact on its costs, and be able to quantify what that impact is.

The Origin Energy proposal also identified a number of other risks that it considered to be material, for which the Commission's price determination should take into account, either through the allowed cost of gas benchmarks, the allowed retail margin, or through the Commission's pass-through provisions. Two of the most significant types of risk that were identified by Origin Energy were forecasting risk and production plant stability risk.

5.6.1 Forecasting risk

Origin Energy claimed that it is exposed to significant forecasting risk, where there is the potential for forecast costs allowed under the price path to be materially different to actual costs. It argued that it is not possible to forecast cost inputs three years ahead with any precision and referred to the Commission's previous price determination, which it suggested significantly underestimated the increase in costs that were faced by the standing contract retailer. Origin Energy argued that the reopening provisions are an onerous and costly means of amending such an error. It proposed that the Commission have regard to this risk in establishing the allowed retail margin.

The Commission acknowledges the difficulty in forecasting volumes and costs in establishing a three-year price path, particularly in a dynamic market such as the energy retail market. However, the fact that prices are based on forecast rather than actual costs is an inherent feature of CPI-X regulation and the Commission is cautious about generally allowing for the pass-through of actual costs unless the particular circumstances warrant it.

The Commission agrees that, in some circumstances, it is appropriate to allow for the pass-through of costs associated with forecast error, to the extent that it is driven by an event that was unforeseen and outside the control of the standing contract retailer. This could be achieved either through the "special circumstances" provision of the Gas Act or through the Commission's approved pass-through event allowances.

The Commission has already defined the events for which a pass-through application can be made, on the basis that the event leads to materially higher or lower costs in providing standing contract services. For other unforeseen events that may also give rise to actual costs being significantly different to forecast costs, any application for pass-through is to be dealt with through the "special circumstances" provision. This scheme is expressly provided for under the Gas Act.

5.6.2 Risks associated with production plant stability

Origin Energy argued that if there is a major operational failure, such as a production plant failure, it will be likely to incur significantly higher costs in supplying standing contract customers. It suggested that, whereas previously supply failure was addressed through demand side management implemented via Ministerial direction, the current market requires Origin Energy to maintain supply, which increases the price risk of spot gas purchases.

Origin Energy has proposed that this risk be addressed through a $0.03/GJ risk allowance in swing gas costs or, in the alternative, that the Commission provide for a pass-through mechanism to address any "large and unusual" costs incurred above the $0.02/GJ swing gas margin. These swing gas costs are discussed in Chapter 6.

The Commission notes that any consideration of costs associated with production plant failure must have regard to the question of whether or not the event was outside the control of the retailer. This may not be a straightforward question, given that the standing contract retailer is expected to enter into arrangements to maintain security of supply and that the costs of such contingencies may already be incorporated elsewhere in the wholesale cost of gas allowance.

The Commission believes that the "special circumstances" provision is the intended means of addressing unforeseen events that are considered to be material and extraordinary in nature. In the Commission's view, a major production plant failure, which has a "large and unusual" impact on costs, is exactly the type of event that Parliament intended to be captured under the "special circumstances" provision.

As discussed in Chapter 6, Origin Energy has not adequately established the costs that are associated with managing the risks of production plant failure. As a result, the Commission cannot determine an allowance for such risks in its cost of gas benchmarks. Instead, the Commission considers that these risks are better dealt with through the "special circumstances" provision of the Gas Act, which will provide Origin Energy the opportunity to address the financial impact of any such event, if or when it occurs.

5.7 Tariff Approvals

The Commission has determined the initial set of standing contract retailer tariffs to apply in 2008/09 as part of the Final Gas Standing Contract Price Determination. Prior to the commencement of 2009/10 and 2010/11, Origin Energy will be required to submit to the Commission information on the forecast number of standing contract customers and total consumption for each standing contract tariff for the respective years, and demonstrate that:

- for each of the two customer categories (residential and SME), total revenue (from the "retailer tariff" component of the standing contract tariffs, exclusive of any pass-through amounts), divided by total consumption is less than or equal to the average retailer revenue permitted for that customer category during the relevant year of the price path. The permitted average retailer revenue control in each year is calculated by reference to the average retailer revenue control fixed for the previous year multiplied by CPI;
- the charge at any level of annual consumption for each "retailer tariff" is no more than CPI + 3% for residential and SME customers above the charge applying at that time;
- the approved Origin Energy retailer tariffs will be summed with the approved Envestra gas distribution tariffs for each standing contract tariff category, to form the total gas standing contract tariffs to apply from 1 July each year; and
- Origin Energy will then be required to publish the final standing contract tariffs (GST exclusive and inclusive) before 30 June each year.

This price control system, with its associated retailer tariff rebalancing controls, is set out in Part B of this Final Inquiry Report and Final Price Determination.

5.8 Provision for New Tariffs

After 1 July 2008, Origin Energy will be entitled to seek to introduce new tariffs and close existing tariffs, subject to the Commission's approval. The revenue outcomes from any new or closed tariffs must be such that the average retailer revenue controls set in this Price Determination are not breached by the tariff's introduction or closure, and customers' allocation to the new tariff must be protected by the retailer tariff rebalancing control relative to the previous tariff to which they were assigned.

6 WHOLESALE GAS COSTS

Approximately one-third of total controllable costs of the standing contract gas retailer relate to the costs of purchasing wholesale gas from gas producers. In SA, the majority of natural gas has been sourced from the Cooper Basin and this is expected to continue over the next price path period. However, increasing volumes are being supplied from interstate sources, such as the Otway and Bass gas basins in Victoria, and Coal Seam Methane (CSM) from Queensland.

As discussed in Chapter 1, the SA gas market operates under a “contract carriage” model, whereby retailers contract directly with gas producers, transmission pipeline operators and distribution network operators for the supply of gas to end users. These contracts are generally confidential, which limits the ability of the Commission to make public comment specifically on the terms, conditions and prices associated with Origin Energy’s gas supply contracts. The Commission has reviewed these contracts as part of this Inquiry process, however, much of the data relied upon by the Commission has been summarised to preserve confidentiality.

There are three components to wholesale gas costs:

1. The wellhead price for the Annual Contract Quantity (ACQ), which relates to the base load gas supply contracts, representing the majority of wholesale gas costs. These contracts generally specify the volume of gas to be supplied (ACQ), the level of flexibility around this contracted amount (defined by the supply load factor, which is the Maximum Daily Quantity (MDQ) available under each contract divided by the daily contract quantity), and the take-or-pay level. ACQ contracts generally offer limited flexibility to meet variations in customer demand and therefore cannot be relied upon to supply during times of peak demand.

2. The wellhead price for MDQ, which is the cost of purchasing gas that is required above the normal ACQ limit. The need to ensure secure gas supply under different peak demand scenarios is an important factor in the determination of MDQ costs.

3. The cost of swing gas, which relates specifically to the cost of retaining the option to purchase additional gas through the SEAGas Pipeline, to cover Origin Energy’s imbalance position between MAPS and SEAGas.

6.1 2005 Inquiry Findings

In its 2005 Inquiry, the Commission concluded that wholesale gas costs to be incurred by the Gas standing contract retailer would be expected to increase over the 2005/06 – 2007/08 regulatory period, although the Commission determined that the increase was not as significant as that forecast by Origin Energy. The Commission’s findings in relation to each wholesale gas component is summarised as follows.

6.1.1 2005 Inquiry - Annual Contract Quantity

The Commission accepted the Origin Energy proposed methodology for forecasting total ACQ costs (in relation to all Origin Energy customers in SA) and dividing by total annual volumes of gas sold. This approach ensured that standing contract customers were not allocated with high cost contracts, leaving low cost contracts to be allocated to the contestable market.

The Commission agreed with Origin Energy that, as existing contracts with gas producers at Cooper Basin and in South-West Queensland expired and were replaced with other contracts, ACQ costs were likely to rise in real terms. In particular, the expiry of the Natural Gas Authority of South Australia (NGASA) contract, entered into in 1995, was expected to have a significant impact on future ACQ costs.

The Commission also accepted that gas from Minerva and Thylacine/Geographe off the Victorian coast, would form an increasing component of Origin Energy's total ACQ requirement during the price path period. The Commission concluded that a forecast 4% increase in price of Thylacine gas in 2007/08 was reasonable given trends in Victorian gas prices.

6.1.2 2005 Inquiry - Maximum Daily Quantity

Origin Energy had proposed that MDQ costs be calculated based on meeting peak demand under a 1 in 25 year peak day scenario. Origin Energy proposed that this MDQ cost be allocated to residential and SME standing contract customers based on their respective contributions to peak demand, as measured by their load factors. Under Origin Energy's approach, power generation customers would not be allocated any MDQ costs on the basis that their gas supply was fully interruptible (and hedged) in winter.

While the Commission accepted the proposed 1 in 25 year peak day scenario, it considered that there was a strong argument for allocating some MDQ costs to generation customers. The Commission disagreed with Origin Energy that the price of MDQ would increase in the final year of the price path period, stating that competition for the supply of MDQ should keep prices constant in real terms.

The Commission considered the previous decision of the Minister for Energy on allowed MDQ costs and the benchmark storage cost at the time, and assumed that this ratio should stay approximately constant over time. This approach, combined with an assumption that the price of storage would stay constant in real terms, formed the basis of the Commission's allowed MDQ costs.

6.1.3 2005 Inquiry - Swing Gas

The Commission accepted the Origin Energy proposal for a separate swing gas cost component of $0.02/GJ as being prudent, given the requirements arising from the introduction of new wholesale market arrangements which came into effect from the commencement of FRC in July 2004.

The Commission's allowed wholesale gas costs for the 2005/06 – 2007/08 price path period are summarised in Table 6.1.

Table 6.1: Commission's decision on allowed wholesale gas costs 2005/06 – 2007/08: $/GJ (GST exclusive in $Dec 08)

	RESIDENTIAL			SME		
	2005/06	2006/07	2007/08	2005/06	2006/07	2007/08
ACQ	3.45	3.48	3.53	3.45	3.48	3.53
MDQ	0.41	0.48	0.48	0.14	0.18	0.18
Swing Gas	0.02	0.02	0.02	0.02	0.02	0.02
Total	3.88	3.99	4.03	3.61	3.68	3.72

6.2 Origin Energy Proposal

Origin Energy has adopted the same approach in developing its proposed wholesale gas costs as was used in its 2005/06 – 2007/08 price path submission. It has proposed increases in gas supply costs of 4% to 6% per annum compared to the 2007/08 allowance provided for under the Commission's previous Price Determination.

6.2.1 Annual Contract Quantity costs

In relation to ACQ costs, Origin Energy argued that competition for gas supplies has increased during the current price path period, creating upward pressure on the price of both new gas contracts and to many existing contracts that are subject to price reviews.

The proposed real increases in allowed ACQ costs are larger in the first year (2008/09) than in subsequent years on the basis that its claimed ACQ costs are currently higher than that provided for under the current price path. This is a contributing factor to Origin Energy's proposed larger increase in average retailer revenue in 2008/09 relative to subsequent years.

6.2.2 Maximum Daily Quantity costs

Origin Energy proposed that gas standing contract customers be charged for MDQ according to the following methodology:

- calculate a load factor MDQ for residential and SME standing contract customers (the Origin Energy methodology for calculating load factors was discussed in Chapter 4).
- subtract from this the peak load available from ACQ contracts. Origin Energy assumed a lower supply load factor relative to that proposed in previous reviews implying that baseload gas contracts are providing less flexibility to meet variations in customer demand.
- the difference between 1 in 25 year peak demand and the supply load factor is calculated to be the additional MDQ required by the standing contract customers.
- multiply this by a cost per MDQ from storage. Origin Energy has based this cost on the price of storage at the TRUenergy owned Underground Storage (UGS) facility in Victoria, plus a charge for the UGS lateral pipeline.
- a stand-alone approach is taken for standing contract customers, meaning that the 1 in 25 year planning MDQ is assumed to be contracted and no diversity of demand across the customer base is allowed for and no benefit attributed to usage by other Origin Energy customers (eg electricity generators using available MDQ) and interaction with other states (eg contracted UGS used for Victoria as well as SA).

6.2.3 Swing Gas costs

Origin Energy proposed a swing gas cost of $0.05/GJ, which is greater than the $0.02/GJ provided for in the Commission's previous price determination. It argued that the previous allowance was:

> *"based on the formative operations of the REMCo market. The market has been operating for several years and Origin considers that the cost to the market of Swing Gas is now established at $0.05/GJ."*[50]

Origin Energy further explained that the proposed swing gas cost:

> *also incorporates a $0.03/GJ risk allowance reflecting the risk of major operational failure such as production plant failure and the costs that would then flow through to Origin in association with the balancing/swing gas requirements.*
>
> *In our view, the additional $0.03 is a reasonable estimation of this risk "insurance", given this is a three year determination. In the alternative, Origin has requested that the tariff determination process provide a facility for pass through provision for large and unusual costs incurred above the provision of a $0.02/GJ swing gas risk margin.*[51]

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[50] Origin Energy, *Proposed price path for standing contract prices for supply and sale of natural gas: 2008-09 to 2010/11*, p38.

[51] Origin Energy, *Supplementary information requests following Origin Energy, ESCOSA & MMA meeting of 30 January 2008*, provided 14 February 2008, pages 3 and 4.

Origin Energy's proposed wholesale gas costs for the 2008/09 – 2010/11 period are summarised in Table 6.2.

Table 6.2. Origin Energy proposed wholesale gas costs 2008/09 – 2010/11:$/GJ (GST exclusive in $Dec 08)

	RESIDENTIAL			SME		
	2008/09	2009/10	2010/11	2008/09	2009/10	2010/11
Cost of Gas	4.72	4.74	4.81	4.21	4.22	4.30

6.3 Summary of Draft Decision

The Commission's Draft Decision on wholesale gas costs is summarised in Table 6.3

Table 6.3. Draft Decision on wholesale gas costs 2008/9 – 2010/11: $/GJ (GST exclusive in $Dec 08)

	RESIDENTIAL			SME		
	2008/09	**2009/10**	**2010/11**	**2008/09**	**2009/10**	**2010/11**
ACQ	3.78	3.79	3.81	3.78	3.79	3.81
MDQ	0.55	0.55	0.55	0.25	0.25	0.25
Swing Gas	0.02	0.02	0.02	0.02	0.02	0.02
Total Cost of Gas	**4.35**	**4.36**	**4.38**	**4.05**	**4.06**	**4.08**

6.4 Submissions

Submissions to the Commission's Draft Decision raised the following issues:

- In relation to the Commission's decision to accept Origin Energy's proposed ACQ costs, other than its 2010/11 costs, TRUenergy argued that the Commission should acknowledge the greater regulatory risk of under-estimating costs in 2010/11 and should allow for some additional costs in this year.
- Simply Energy argued that the Commission's draft decision on wholesale gas costs was too low, and was below the actual costs incurred by Simply Energy in retailing to SA gas customers. It suggested that the major discrepancy arose from swing gas costs.
- Origin Energy argued that, on the basis that the Commission did not accept the forecast 2010/11 ACQ costs, it should provide for a "wellhead price review" pass through event.
- Origin Energy also commented on the Commission's draft decision to share the UGS lateral costs between all Origin Energy customers, and to allocate it to ACQ

costs, on the basis that its purpose was to provide security of supply. Origin Energy argued that these costs should be considered MDQ costs rather than ACQ costs.

6.5 Commission Consideration

In forming its view on appropriate allowances for wholesale gas costs, the Commission has taken into account the following information:

- The Origin Energy proposal and subsequent information and submissions provided by Origin Energy in support of its proposal;
- Independent advice from the Commission's expert consultant, MMA;
- Submissions from other stakeholders to the Commission's Issues Paper and Draft Price Determination and Draft Inquiry Report.

The Commission's final conclusions on ACQ costs, MDQ costs and swing gas costs are discussed in the following sections.

6.5.1 Annual Contract Quantity costs

The Commission has considered the advice of MMA on Origin Energy's proposed ACQ costs, which is based on MMA's analysis of Origin Energy's proposed gas volumes and prices relating to each gas supply source.

While the detailed analysis of the proposed costs by supply source is confidential, MMA has recommended ACQ costs for 2008/09 and 2009/10 that are similar to those proposed by Origin Energy.

MMA has recommended a smaller increase in ACQ costs in 2010/11 compared to the increase being sought by Origin Energy. This difference arises largely from assumptions regarding the future cost of gas from Thylacine, which is expected to be the second largest source of gas supply to Origin Energy customers in SA over the coming price path period.

Origin Energy has not used an actual price for Thylacine gas in its proposal, arguing that the sale from Thylacine is an internal sale and a proxy must, therefore, be used. Instead it has used a proxy price – a Victorian gas price forecast.

MMA has raised various concerns with the use of the Victorian gas price forecast as a proxy for the price of Thylacine gas. These concerns include:

- While Origin Energy purchases some gas from Thylacine under an internal sale, it also purchases Thylacine gas from other companies. MMA suggests that this would appear to set a good arms-length benchmark for the price at which the Thylacine gas is currently sold.
- Origin Energy has assumed price increases from 2010, although this is not consistent with the contract data made available to the Commission.

- Whilst Origin Energy has suggested using a Victorian gas price forecast as a proxy for the Thylacine contract, it has not proposed how to account for any differences in load factor or take or pay levels within this construct.

MMA has concluded that, accepting the use of a Victorian price forecast as a proxy for Thylacine gas, the proposed increase in price beyond 2010 is doubtful given uncertainties over future contract expiry and price reviews.

The Commission agrees that there are deficiencies in Origin Energy's use of a Victorian gas price forecast as a benchmark for the price of Thylacine gas. However, the Commission is also mindful that there is upward pressure on wellhead prices, which is likely to continue throughout the price path period . The Commission has therefore reconsidered its draft decision to reject much of the proposed increase in ACQ costs in 2010/11. Acknowledging the potential impact of climate change response measures on gas demand, and the potential for gas prices to increase more generally, the Commission accepts the Origin Energy proposed increase in ACQ costs in 2010/11. The Commission's final decision on ACQ costs is to therefore accept the Origin Energy proposed costs as reasonable.

The Commission's final decision on ACQ costs for 2008/09 – 2010/11 is set out in Table 6.4.

Table 6.4. Final decision on allowed ACQ costs: $/GJ (GST exclusive in $Dec 08)

	2008/09	2009/10	2010/11
Commission decision on ACQ costs	3.78	3.79	3.87

6.5.2 Maximum Daily Quantity costs

As discussed in Chapter 4, the Commission has determined load factors that should be adopted for residential and SME standing contract customers, which are lower than those proposed by Origin Energy, but greater than the Commission's draft decision on load factors.

A "deemed" load factor of supply is subtracted from these customer load factors to calculate the estimated MDQ requirements for the residential and SME segments. The deemed supply load factor proposed by Origin Energy was lower than that assumed in the Commission's 2005 Gas Price Determination, but has been accepted by the Commission for the purposes of calculating MDQ requirements.

In relation to the price of MDQ, the Commission notes that the aggregate MDQ price put forward in Origin Energy's price path proposal is lower on a unit basis than the price that applied at the time of the previous price determination and is

lower than the price range of $140 to $190/GJ MDQ quoted on the TRUenergy website.[52] The benchmark price therefore appears reasonable.

Under the Commission's approved customer load factors and supply load factors, the amount of required MDQ for all Origin Energy customers (up to those with annual consumption of 10 TJ per annum) is approximately the same as the amount of MDQ reserved by Origin Energy from Otway MDQ sources. Therefore, as additional MDQ is not required to serve this market, the use of Origin Energy's MDQ price in determining MDQ requirements for standing contract customers is reasonable.

In addition to the aggregate MDQ cost, Origin Energy included the cost of transporting gas from UGS along a lateral pipeline to the Port Campbell to Adelaide component of the SEAGas pipeline system. This cost was treated by Origin Energy as part of the SEAGas pipeline costs for its 2005 price path proposal.

MMA's report to the Commission closely examined this proposed UGS lateral cost. MMA raised a number of concerns over this cost, noting that it appears significantly higher than that assumed under Origin Energy's previous price path proposal.

MMA also queried whether or not the lateral is in fact required for the supply of MDQ to SA, as there appeared to be other supply configurations available that could avoid the use of the lateral.

In response to this question, Origin Energy stated that:

> *The UGS lateral is required to allow the delivery of UGS to South Australia. Thylacine is delivered into South Australia via the PCI and volume was contracted with SEAGas specifically to allow this. To maintain security of South Australian supply Origin's policy requires that UGS is able to be delivered into South Australia in the event that Thylacine supply is interrupted.*
>
> *Such redundancy, which ensures supply continuity to small customers in South Australia, would not be possible without contracting the WUGS lateral.*[53]

Having regard to advice from MMA, the Commission's Draft Price Determination and Draft Inquiry Report concluded that the lateral was only required for security of supply reasons rather than for MDQ, and that this provided benefits to all of Origin Energy's customers. It therefore reached the draft conclusion that the cost of the lateral should be treated as an ACQ cost and that this cost should be shared between all Origin Energy customers rather than being allocated only to standing contract customers. This resulted in an allowance of $0.025/GJ for the UGS lateral based on MMA's estimated range of allocated costs.

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52 Refer http://www.truenergy.com.au/Production/Iona/index.xhtml.

53 Origin Energy, *Supplementary information requests following Origin Energy, ESCOSA and MMA meeting of 30 January 2008,* provided 14 February 2008, p 3.

Origin Energy's submission to the Draft Price Determination and Draft Inquiry Report argued that the UGS lateral charge should be allocated with regard to customers' 1 in 25 year peak day requirements. It suggested that UGS does not provide ACQ wellhead supply security, but that it does provide security for peak day requirements and should therefore be treated as an MDQ cost rather than an ACQ cost.

In considering this argument, the Commission referred back to Origin Energy's statement that the UGS lateral is contracted to provide for security of supply in the event that supply from Thylacine is interrupted. If this is the purpose of the lateral, then the Commission considered it likely that any such supply interruption need not occur only during a 1 in 25 year peak event. A breakdown in supply could potentially occur during a 1 in 2 winter, or on days of high demand, which could be in summer if there is high electricity generation. It is therefore not apparent that the UGS lateral would only be used during a 1 in 25 year peak day.

The Commission therefore retains the view that it is not reasonable to treat the UGS lateral costs purely as an MDQ cost. However, given that its use is likely to be required at times of high demand, the Commission has allocated some of the costs to ACQ and some of the costs to MDQ. This has led to an allocation of $0.04/GJ for residential standing contract customers and $0.03/GJ for the small business standing contract customers.

This decision, along with the Commission's final decision on customer load factors, results in MDQ costs that are greater than those provided for under the Commission's Draft Price Determination and Draft Inquiry Report. The Commission's final decision on MDQ costs is summarised in Table 6.5.

Table 6.5. Final decision on allowed MDQ costs $/GJ (GST exclusive in $Dec 08)

	2008/09	2009/10	2010/11
Residential MDQ costs	0.62	0.62	0.62
SME MDQ costs	0.28	0.28	0.28

6.5.3 Swing Gas

Origin Energy's proposal included various risks within the scope of the swing gas costs[54]:

- forecasting risk. According to Origin Energy, mass market and Epic System Use Gas (SUG) are the most volatile and difficult to accurately forecast, there is greater risk during winter and there is uncertainty about the accuracy of the REMCo forecasting model

[54] Origin Energy confidential submission to the Commission, *Wholesale Energy Costs Addendum*, January 2008 page 13.

- production plant stability:

> *In a diverse interconnected market there are multiple points of failure, which often fail without the requirement for Government intervention. Previously when gas was supplied solely by Cooper fields outages resulted in FM events and demand side management was implemented via Ministerial direction. In the current market Origin is now required to source spot gas to maintain supply. This reduces the risk of interruption to the large industrial customers but increases the price risk of spot gas purchases to Origin.* [55]

- Victorian ancillary risk costs for imports
- pipeline overrun and imbalance charges.

Origin Energy provided costs related to all imbalance and overrun charges incurred on the SEAGas and MAPS pipelines during the 2006/07 year. According to Origin Energy, on the peak day of that year there was also a shortfall of injection versus nomination of about 4 TJ and this would presumably have included any costs arising from this.

In total the overrun and imbalance costs averaged less than $0.02/GJ. No further swing (or other) costs have been provided as substantiation of the increase in swing cost proposed. Indeed, Origin Energy has stated that it is allocating $0.03/GJ for future "large and unusual costs", associated with a changing market, rather than swing cost itself.

MMA has recommended to the Commission that the inclusion of a swing gas adjustment of $0.02/GJ remains reasonable for imbalance and overrun risk based on the data it has seen. The Commission accepts that this component of the proposed swing gas costs represents prudent and efficient expenditure.

MMA has, however, raised concerns over the additional risk allowance proposed by Origin Energy, suggesting that Origin Energy has not substantiated the quantum of the costs associated with the increased risk. While it agrees with Origin Energy that the evolving market structure is likely to impose greater risks on retailers than in the past, it is unable to assess the reasonableness of the proposed additional $0.03/GJ allowance.

The Commission notes TRUenergy's submission to the Draft Price Determination and Draft Inquiry Report suggesting that the Origin Energy proposed risks should be included within the swing gas price. The Commission has considered the reasonableness of including an additional cost to address the potential for future supply failures within swing gas costs and agrees with MMA that there is significant uncertainty surrounding the estimated cost proposed by Origin Energy. The Commission also notes that some of the risk associated with potential supply failure (and especially for Thylacine in the case of Origin Energy) has been

[55] Origin Energy confidential submission to the Commission, *Wholesale Energy Costs Addendum*, January 2008, page 13.

factored into MDQ prices through the inclusion of costs associated with security of supply through the UGS lateral. Given the lack of information to support the derivation of the $0.03/GJ allowance, the Commission is unable to conclude that this represents efficient expenditure.

The Commission believes that, for the “large and unusual” events that are being contemplated by Origin Energy, the “special circumstances” provision of the Gas Act provides the most suitable means of addressing any increased costs that may result from these events. The Commission has therefore not included any allowance for this proposed risk in its approved swing gas costs.

The Commission notes the view expressed by Simply Energy in its submission to the Draft Price Determination and Draft Inquiry Report that the $0.02/GJ cost estimate of swing gas is inadequate for a second-tier retailer. The Commission also observes the Simply Energy statement that, while its gas cost mix is different to that of Origin Energy’s, its total wholesale gas costs are comparable to Origin Energy’s. Based on this statement, it is not clear to the Commission that there is a material difference in swing gas costs between Origin Energy and other gas retailers. In particular, if Simply Energy has total gas costs that are comparable to Origin Energy’s, then perhaps any differences in swing gas costs may be explained by the manner in which the gas costs are allocated between the relevant cost categories.

Table 6.6: Final decision on allowed Swing Gas costs $/GJ (GST exclusive in $Dec 08)

	2008/09	2009/10	2010/11
Commission decision on Swing Gas costs	0.02	0.02	0.02

6.6 Final Conclusion

The Commission’s final conclusion on the wholesale gas costs to be incorporated into standing contract prices over the 2008/09 to 2010/11 period is set out in Table 6.7. These costs will apply uniformly over the five pricing regions.

Table 6.7. Final Decision on Wholesale Cost of Gas Benchmarks 2008/09 to 2010/11: $/GJ (GST exclusive in $Dec 08)

	RESIDENTIAL			SME		
	2008/09	2009/10	2010/11	2008/09	2009/10	2010/11
ACQ	3.78	3.79	3.87	3.78	3.79	3.87
MDQ	0.62	0.62	0.62	0.28	0.28	0.28
Swing Gas	0.02	0.02	0.02	0.02	0.02	0.02
Total Cost of Gas	**4.42**	**4.43**	**4.51**	**4.08**	**4.09**	**4.17**

7 TRANSMISSION COSTS

The gas transmission cost component of the gas supply chain relates to the pipeline systems used to transport gas from production facilities to the distribution systems that supply metropolitan areas – the MAPS and SEAGas pipelines, together with a number of smaller lateral pipelines that transport gas to regional centres.

In the gas supply industry, gas retailers are able to negotiate transmission charges that vary with the retailer's capacity and load factor characteristics. This is different to the electricity supply industry, where transmission charges are regulated by the Australian Energy Regulator (AER) and are therefore considered to be non-controllable from a retailer's perspective.

While reference charges for a gas transmission pipeline may be set under a regulator approved access arrangement, a retailer can negotiate different price outcomes by managing its suppliers and load.

The Commission notes that both the MAPS and SEAGas pipelines are now unregulated, following the recent decision of the Minister for Energy to revoke coverage of the MAPS under the *Gas Pipelines Access (South Australia) Act 1998*.[56] Therefore, there are no longer any regulated reference prices for these pipelines, with prices being determined through commercial negotiation.

The overall transmission cost will depend on underlying contract prices, changes in the mix of transmission contracts (e.g. the relative volume through MAPS and SEA Gas) and changes in the customer mix itself due to different churn rates.

7.1 2005 Inquiry Findings

In considering prudent transmission costs in the 2005 Inquiry, the Commission focussed its assessment on:

- the prudence of Origin Energy's transmission contracting strategy and the efficiency of the contract prices; and
- the allocation of gas transmission costs to gas standing contract customers (which involved allocating costs between standing contract customers and other customers and then allocating costs within the standing contract customer class).

In its 2005 Final Decision, the Commission accepted Origin Energy's transmission contracting strategy as prudent, including its approach of reserving transmission capacity on the basis of a 1 in 25 year event.

[56] The Minister's decision is available on the National Competition Council website at www.ncc.gov.au.

The Commission noted that is was appropriate for some transmission costs to be allocated to Quarantine Power Station (an Origin Energy related business) as it benefits from using transmission capacity that has been reserved for standing contract gas customers. However, the Commission was unable to determine a robust estimate of these benefits and therefore decided not to include an explicit allowance for benefits of Quarantine.

The Commission also concluded that there was no justification for Origin Energy's proposed real increase in SEAGas costs, and determined that CPI increases over the price path period was a more reasonable assumption.

7.2 Origin Energy Proposal

Origin Energy's proposed transmission costs separately identify the costs for the main transmission pipelines of MAPS and SEAGas, and the costs for the lateral pipelines that supply Whyalla, Riverland and Mt Gambier.

Origin Energy's approach to determining MAPS and SEAGas costs is generally the same as that adopted in its previous price path proposal, whereby:

- Gas transmission costs for the MAPS and SEAGas pipelines have been built up on the basis of the total portfolio of Origin Energy's transmission capacity requirements;
- A capacity weighted average cost of portfolio based on the fixed cost component was determined;
- The average capacity cost was allocated to the standing contract market segment based on its maximum capacity requirement on a 1 in 25 year planning basis. This included the estimated customer load factor of each of the market segments; and
- The average variable charge was added to the transmission charges.

In relation to the lateral pipelines, Origin Energy stated that all costs are fixed. Accordingly, it allocated these costs to the relevant areas and market segments on an MDQ basis. The volume weighted cost was calculated by dividing the total cost for an area and segment by the annual MDQ demand for that market segment.

Origin Energy's proposal argued that its actual transmission costs in 2007/08 were significantly greater than those allowed for under the Commission's 2005 determination. It therefore proposed an initial increase in transmission costs (over those included in the current price path), but allowed for CPI movements thereafter.

Origin Energy's proposed transmission costs for the 2008/09 – 2010/11 period are summarised in Table 7.1.

Table 7.1. Origin Energy proposed transmission costs 2008/09 – 2010/11:$/GJ (GST exclusive in $Dec 08)

	Residential (weighted average of 5 regions)			SME (weighted average of 5 regions)		
	2008/09	2009/10	2010/11	2008/09	2009/10	2010/11
Transmission Costs	2.01	2.03	2.05	1.35	1.36	1.36

7.3 Summary of Draft Decision

The Commission's Draft Decision on transmission costs is summarised in Table 7.2

Table 7.2. Draft Decision on transmission costs 2008/9 – 2010/11: $/GJ (GST exclusive in $Dec 08)

	Residential				
	Adelaide & Peterborough	Port Pirie	Whyalla	Mt Gambier	Riverland & Murray Bridge
Fixed TUOS main & lateral	1.36	1.36	1.98	3.25	3.22
Variable TUOS	0.10	0.10	0.10	0.10	0.10
Transmission cost	1.46	1.46	2.08	3.35	3.32

	SME				
	Adelaide & Peterborough	Port Pirie	Whyalla	Mt Gambier	Riverland & Murray Bridge
Fixed TUOS main & lateral	0.92	0.92	1.34	2.21	2.19
Variable TUOS	0.10	0.10	0.10	0.10	0.10
Transmission cost	1.02	1.02	1.44	2.31	2.29

7.4 Submissions

Submissions to the Commission's Draft Price Determination and Draft Inquiry Report raised the following issues in relation to transmission costs:

- Simply Energy commented that the Draft Decision on transmission costs for the Adelaide residential market was below the transmission costs incurred by Simply Energy in retailing to that market;
- Origin Energy accepted the Draft Decision to remove park costs incurred on the Moomba to Adelaide pipeline as these were considered as representing MDQ costs rather than transmission costs;
- The Commission's draft decision included a reduction in Origin Energy's proposed Riverland lateral costs by approximately 25% on the basis that the proposed increase in costs appeared to reflect the risk of demand reducing in the region, which would impact on the ability of Origin Energy to recover its fixed transmission costs. Origin Energy submitted in response that it has little influence over regional

demand and that the Commission should recognise this risk by allowing for a forecasting error risk margin within the allowed Riverland lateral costs or allowing for the pass though of such risk.

7.5 Commission Consideration

In determining an allowance for transmission costs, the Commission requested MMA to develop its own set of transmission cost forecasts. The Commission considered both the Origin Energy and MMA forecasts, along with relevant submissions, in reaching its final decision on prudent and efficient transmission costs.

The Commission's considerations are discussed in terms of main pipeline costs (MAPS and SEAGas) and lateral costs.

7.5.1 Main Pipeline Costs

Reserved capacity

The main driver of transmission costs is the transmission pipeline capacity required to meet the maximum demand. This pipeline capacity needs to be reserved under contract with the owners of the transmission pipelines. The estimate of the amount of MAPS and SEAGas transmission capacity Origin Energy has allocated to the residential and SME customers is based on a forecast volume of gas consumption and an assumed customer load factor.

The Commission considered forecast consumption and customer load factors in Chapter 4. The Commission's decision on these matters will reduce the overall transmission costs sought by Origin Energy.

Information provided by Origin Energy to the Commission suggested that it proposed to purchase less transmission capacity than the amount that is calculated based on a sum of the MDQ requirements for all of its customer segments. This is likely to be efficient as it takes into consideration the diversity of the forecast peak demand from different segments of the market and also the fact that some of the capacity would be required very infrequently. It may also be influenced by the fact that the individual demands have been calculated based on meeting a 1 in 25 year peak demand. It may be more efficient for Origin Energy to contract for a capacity lower than that required and meet any excess demand, should it occur, through overrun charges.

While it may be efficient for Origin Energy to reserve less transmission capacity than the sum of demand from all customer segments, it proposed to charge both the residential and SME segments their full MDQ requirements on a stand alone basis. This allocation has been made on the premise that peak residential demand is coincident with the winter system wide peak demand. Origin Energy does not propose to pass on any of the benefits of diversity or cost optimisation potential to its residential and SME standing contract customers.

The Commission has previously raised concerns about this allocation methodology, arguing that small customers should share in the benefits received by other customers using infrastructure that has been reserved and paid for by small customers.

However, determining the amount of these benefits is problematic. Advice from MMA to the Commission sought to determine such benefits, but MMA has itself concluded that a number of allocation methodologies could be used, producing different allocation patterns, all of which are likely to be controversial. The Commission has therefore accepted the standalone methodology proposed by Origin Energy.

MAPS transmission costs

Origin Energy's submission indicated that the transmission costs for MAPS were largely fixed and related to the reservation of capacity. Details of the fixed costs proposed by Origin Energy, including information supporting the derivation of these costs, have been provided to the Commission on a confidential basis.

Origin Energy submitted a fixed transmission use of system (TUOS) price for MAPS that is substantially in excess of that provided for under the Commission's previous price determination. Origin Energy indicated that it has recontracted MAPS capacity from 1 January 2006 and the increase is a reflection of the new rates. It also provided information to the Commission indicating that the proposed cost included the cost of a firm park service, used to manage daily variations in supply and demand.

The Commission retains the view that inclusion of the park service costs within the MAPS fixed costs is not reasonable, as it is more appropriately considered an MDQ cost. A benchmark for MDQ costs has been determined by the Commission in Chapter 6 and to include the park service cost within transmission costs would amount to double recovery. Origin Energy accepted this decision in its submission on the Draft Inquiry Report and Draft Price Determination.

MMA has obtained information from industry personnel regarding current reservation charges for MAPS, which appears to be consistent with information from Origin Energy regarding its current contractual MAPS rate.

This information forms the basis of MMA's recommended MAPS fixed and variable cost components, which is less than the amounts sought by Origin Energy. The Commission accepts this recommendation, noting that a significant driver of the reduction relates to the inclusion of costs that have already been provided for under its MDQ decision.

SEAGas transmission costs

In its previous price determination, the transmission price accepted by the Commission for the SEAGas pipeline was $230/GJ MDQ/year (in $Dec 05). This

was based on the SEAGas published offer available at that time and the understanding that the costs included were more than just those of the main line.

There are currently no SEAGas offers or prices publicly available. However, the term sheet available on the SEAGas website[57] specifies that price escalations at 95% of CPI will apply every 1 January. Applying a high proportion of CPI escalation to the SEAGas TUOS price accepted by the Commission in its previous determination would result in a 2008 price that is broadly consistent with the proposed amount submitted by Origin Energy, even after accounting for the removal of the UGS lateral charge.

Origin Energy provided confidential information to the Commission that broke down the SEAGas fixed costs into various components. This information was analysed by MMA, which recommended that the majority of these costs appeared to be reasonable. However, it suggested that there are certain fixed costs that, on the face of it, seem to be double counted. On this basis, the Commission has accepted the MMA recommendation to remove these costs and adopt a SEAGas fixed cost that is approximately 10% lower than that proposed by Origin Energy.

Origin Energy's proposed SEAGas variable charge is consistent with the 2005 Inquiry outcome, and the Commission accepts this charge as being prudent and efficient.

System Use Gas

Origin Energy has proposed a cost of system use gas (SUG) for both the MAPS and SEAGas pipelines. This is based on applying the maximum 2.2% of wellhead volume by the cost of the weighted average of the wellhead gas price. While the proposed cost of SUG is consistent with a wellhead gas price of around $4/GJ, advice from MMA suggests that the assumed 2.2% of wellhead volume as SUG may be excessive.

Origin Energy advised that 2.2% is the maximum contractual SUG for transmission pipelines and that actual SUG will depend on compression, metering errors and gas losses. Origin Energy thus proposed to charge standing contract customers the maximum SUG charge that is allowed under its transmission contracts, not what is actually charged.

While there is limited information regarding current SUG levels in the MAPS and SEAGas pipelines, the actual amount is considered to be in the order of 1%. The Commission believes that a SUG cost based on this amount, rather than the maximum contractual amount, is more appropriate. This has been reflected in the Commission's allowed SUG costs.

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57 Refer www.seagas.com.au

7.5.2 Lateral Pipeline Costs

The Commission notes that, while the costs of lateral pipelines does not add significantly to Origin Energy's overall transmission costs, it does add to specific tariffs that apply to customers located in the regional areas that use these lateral pipelines.

Information provided by Origin Energy to the Commission on the costs of these laterals was analysed by MMA as part of its review of transmission costs. MMA recommended that the proposed lateral costs were reasonable for Whyalla and Mt.Gambier laterals, but did not appear reasonable for the Riverland lateral.

MMA suggested that the Origin Energy proposed increase in the cost of this lateral appeared to be a result of reduced demand (which increases the unit cost of capacity), rather than an increase in price. It concluded that it was not reasonable to accept that there should be an increase in cost to standing contract customers due to an increase in the unit cost of capacity. The Commission agreed with this view and, based on the MMA recommended cost, approved in its Draft Price Determination a reduction in the Riverland lateral cost of approximately 25% relative to that sought by Origin Energy.

The Origin Energy submission to the Draft Price Determination and Draft Inquiry Report argued that it is reasonable to accept its proposed increase in the Riverland lateral cost to reflect uncertainty over future demand. However, Origin Energy also provided additional information to the Commission suggesting that, in reviewing its previous price path proposal, it found an error in the Riverland pipeline cost calculation that led to an under recovery of costs in the previous three years. The details of this error were provided to the Commission on a confidential basis. Part of the proposed increase in the cost of the lateral is due to this error, and part is due to a forecast reduction in MDQ in the region.

Having regard to this information, the Commission accepts the impact of the proposed lateral cost increase due to the error made in Origin Energy's 2005-2008 gas standing contract price path proposal. This has led to some increase in the Riverland lateral costs relative to the costs determined under the Commission's Draft Price Determination and Draft Inquiry Report. However, the Commission does not accept the residual increase due to forecast reduction in demand, as no evidence has been provided to substantiate the forecast demand reduction, nor to demonstrate that it is reasonable for gas standing contract customers to pay for any such reduction.

7.6 Final Conclusion

The transmission costs that have been incorporated into the Commission's Final Price Determination are set out in Table 7.3. These costs are proposed to stay constant in real terms over the price path period.

Table 7.3. Final Decision on annual transmission costs $/GJ (GST exclusive in $Dec 08)

	RESIDENTIAL				
	ADELAIDE & PETERBOROUGH	PORT PIRIE	WHYALLA	MT GAMBIER	RIVERLAND & MURRAY BRIDGE
FIXED TUOS MAIN & LATERAL	1.54	1.54	2.19	3.54	3.95
VARIABLE TUOS	0.10	0.10	0.10	0.10	0.10
TRANSMISSION COST	**1.64**	**1.64**	**2.29**	**3.64**	**4.05**

	SME				
	ADELAIDE & PETERBOROUGH	PORT PIRIE	WHYALLA	MT GAMBIER	RIVERLAND & MURRAY BRIDGE
FIXED TUOS MAIN & LATERAL	1.08	1.08	1.52	2.44	2.72
VARIABLE TUOS	0.10	0.10	0.10	0.10	0.10
TRANSMISSION COST	**1.18**	**1.18**	**1.62**	**2.54**	**2.82**

8 RETAIL OPERATING COSTS

The retail operating cost allowance is associated with the provision of the following retailer functions:

- Customer service;
- Sales and Marketing;
- Billing and Revenue collection;
- Management and support (including corporate functions).

The retail operating cost allowance is intended to cover all operating costs incurred by the retailer, other than in relation to the purchase of energy, in servicing its standing contract customers.

The retail operating cost allowance should represent the costs that an efficient retailer would be expected to incur in meeting the responsibilities of standing contract supply to small gas customers in SA. The allowance is reflective of a notional prudent retailer, rather than Origin Energy specifically. The implications of this approach are discussed more fully in the following sections.

8.1 2005 Inquiry Findings

The Commission's 2005 Inquiry into standing contract prices examined retail operating costs through a combination of benchmarking against retail operating cost allowances granted in other jurisdictions, and by having reference to the actual operating costs incurred by Origin Energy in retailing to small gas and electricity customers.

The Commission reviewed a wide range of gas and electricity regulatory pricing decisions to inform its decision on an appropriate allowance for retail operating costs and concluded that an allowance of $71.40 per customer per year for gas retail operating costs (excluding FRC costs) was appropriate and consistent with the ranges provided for in other regulatory decisions. The Commission also allowed a CPI+2% increase in this allowance throughout the July 2005 – June 2008 period, to accommodate increasing operating costs per customer as the standing contract customer base switched to market contracts. An annual FRC cost allowance of $18.86 per customer was also approved for the 2005-2008 price path period.

Overall, the Commission set a benchmark of $90.26 per customer for 2005/06 to allow Origin Energy to service its gas standing contract customers in SA.

The 2005 Inquiry approved retail operating cost and FRC cost allowance were as shown in Table 8.1.

Table 8.1: Retail operating cost benchmarks 2005/06 to 2007/08
($ per customer in $Dec 05)

	2005/06	2006/07	2007/08
Retail operating costs (excluding FRC costs)	71	73	74
FRC costs	19	19	19
Total	**90**	**92**	**93**

8.2 Origin Energy Proposal

Origin Energy's proposal for the retail operating cost for the current (July 2008 – June 2011) Price Determination is summarised in Table 8.2.

Origin Energy's proposal was not based on a detailed analysis of its current or forecast retail operating costs for South Australian standing contract customers. Rather, Origin Energy proposed that the Commission use the allowance for average retail operating costs (excluding FRC costs) of $80.85 per customer that formed part of the price control for 2007-08 (refer Table 8.2), and for this allowance to increase by CPI+4% per annum through the next price path period.[58]

Table 8.2: Origin Energy Proposed Retail Operating Costs, 2008/09 to 2010/11
$Dec 08 per Customer

	2007/08	2008/09	2009/10	2010/11
Retail operating cost allowance	$80.85	$84.08	$87.45	$90.94
FRC operating cost allowance	$9.03	$9.03	$9.03	$9.03
FRC capital expenditure recovery	$11.49	$8.55	$8.55	$8.55
Total retail operating cost allowance	$101.37	**$101.66**	**$105.03**	**$108.52**

The Commission's 2005 Price Determination allowed for a steady real increase in retail operating costs per customer of CPI+2% per annum over the three year price path period. Origin Energy argued that a higher real increase in the allowance for retail operating costs per customer is required to account for increasing costs and the effect of higher than expected levels of customer churn, leading to a loss of economies of scale. In support of the argument for increasing costs, Origin Energy stated that labour costs are an important direct and indirect component of retail operating costs, and that these costs are increasing at rates well above CPI. However, no further information was provided in Origin Energy's proposal to support this claim.

The separate identification of the FRC operating cost allowance is consistent with the 2004 pricing decision of the Minister for Energy and Origin Energy's 2005 proposal to the Commission. Origin Energy is not seeking any real increase in this allowance for FRC

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58 Or alternatively to add an allowance for customer acquisition costs of $23 per customer to the annual average retail operating cost allowance.

operating costs over the next price path period, and the value attributed to this cost component has not changed in real terms since the Commission's 2005 Determination.

Origin Energy's operating cost proposal included an allowance for the balance of FRC capital costs that Origin Energy was required to incur to facilitate the commencement of FRC in the SA gas market in July 2004. Further, as the churn rate from the standing contract has been higher than was forecast in the 2004 determination of the Minister for Energy and the Commission's 2005 Determination, Origin Energy claimed it has experienced a shortfall in its recovery of this outlay. Origin Energy proposed that the Commission approve an allowance in each year of the next price path period to provide for the full recovery of its initial FRC capital cost outlay.

Under normal circumstances, a return on and of capital expenditure would be recovered through the retail margin. However, Origin Energy's proposal is based on previous gas standing contract price determinations made by the Minister for Energy in 2004 (the 2004 decision) and by the Commission for in 2005 (the 2005 decision). Origin Energy's argues that it was guaranteed the return of this outlay over five years as part of the 2004 decision. That is, Origin Energy argues that the 2004 decision was, in effect, the approval of a pass-through, which would be monitored over time to ensure no outturn over- or under-recovery. However, no documentary evidence has been provided to clearly substantiate this assertion.

8.3 Summary of Draft Decision

The Commission's Draft Decision on retail operating costs is summarised in Table 8.3

Table 8.3. Draft Decision on retail costs 2008/9 – 2010/11: $/GJ (GST exclusive in $Dec 08)

	2008/09	2009/10	2010/11
Retail operating cost allowance	$89.88	$89.88	$89.88
FRC capital expenditure recovery	$11.49	–	–
TOTAL RETAIL OPERATING COST ALLOWANCE	**$101.37**	**$89.88**	**$89.88**

8.4 Submissions

Submissions to the Issues Paper identified the following matters in relation to Origin Energy's proposed retail operating costs:

- AGL Energy argued that an allowance for retail operating costs should be set at a level that includes all costs in attaining, retaining and servicing customers in a competitive market. AGL Energy supported Origin Energy's position that Origin Energy's declining standing contract customer base resulting from increased

competition in the South Australian gas retail market may increase actual operating costs per customer. [59]

- The Minister for Energy provided an alternative view, suggesting the Commission consider whether retail operating costs could be recovered from its total customer base rather than only from standing contract customers. The Minister saw no justification for an increase in retail operating costs, noting that "*Origin [Energy] has failed to meet Energy Retail Code targets with regard to call centre responsiveness*".[60] The Minister did not consider the Commission should allow for any increase in retail operating costs for this reason.

Submissions to the Draft Inquiry Report and Draft Price Determination made the following comments on the Commission's Draft Decision to set the initial cost allowance for retail operating costs, excluding any FRC capital expenditure recovery, at $89.88:

- Origin Energy accepted the Commission's initial allowance, which reflected the initial allowance proposed by Origin Energy, but noted that its starting allowance was part of a complete proposal for retail operating costs. Origin Energy considered that the Commission did not give full recognition to the actual costs incurred by it in supplying South Australian standing contract gas customers.
- TRUenergy claimed that the Commission's Draft Decision would establish the lowest retail operating cost allowance of any Australian jurisdiction. Although noting that the Commission's proposed approach was consistent with that in Victoria and New South Wales, TRUenergy also suggested the Commission adopt Queensland's approach to indexation of the retail operating cost allowance, where the allowance is escalated by an index consisting of 40 per cent consumer price index (CPI) and 60 per cent average weekly earnings.

With respect to the Commission's Draft Decision to approve an FRC capital expenditure allowance of $11.49 for the first year of the price path period only, Origin Energy argued that it received a commitment from the Minister for Energy that the specific FRC costs that it was required to incur would be recoverable. It suggested that even if it were assumed that FRC capital costs were recovered from market and standing contract customers, the Commission's Draft Decision would not allow it to recover all of these costs by the end of 2008/09.

8.5 Commission Consideration

8.5.1 Approach

The Commission's approach in this Inquiry has been to assess an appropriate allowance for retail operating costs having regard to both the future prudent

[59] http://www.escosa.sa.gov.au/webdata/resources/files/071221-AGLGasPricePathIssuesPaper-Submission.pdf

[60] http://www.escosa.sa.gov.au/webdata/resources/files/071221-L-MinisterEnergyGasPricePathIssuesPaper-Submission.pdf: P1.

controllable costs of a notional retailer with the same standing contract obligations as Origin Energy, and to undertake an assessment of Origin Energy's actual operating costs. The Allen Consulting Group (ACG) was engaged by the Commission to assist the Commission with these analyses.

In consultation with ACG, the Commission sought information from Origin Energy on its actual retail operating costs, as well as additional material to substantiate aspects of its proposal. The Commission's analysis was based on the following sources of information:

- the confidential proposal submitted by Origin Energy to the Commission in November 2007;
- additional material provided by Origin Energy in response to the Commission's information request;
- additional material provided by Origin Energy at the Commission's request in support of its submission to the Commission's Draft Decision;
- information obtained by the Commission in connection with its 2005 decision; and
- information obtained from other external sources.

The Commission reviewed Origin Energy's claimed actual operating costs, and considered how Origin Energy's operating expenditure would be expected to change over the regulatory period.

The Commission sought information from Origin Energy relating to the retail costs it incurs in respect of its small customer retail electricity and gas business across Australia. It was not feasible to obtain information separately for Origin Energy's gas business or its gas standing contract business, as Origin Energy advised the Commission that it could not provide cost information at such a detailed level without a significant reliance on assumed cost allocators.

In response to the Commission's request, Origin Energy provided information on its actual 'cost to serve' for 2006/07 and its estimate for 2007/08. The Commission also considered cost to serve information for 2003/04 provided to it by Origin Energy at the time of the 2005 Price Determination.

Depreciation and amortisation were excluded from the Commission's analysis of retail operating costs, since the retail margin is defined as an 'earnings before interest, taxation, depreciation and amortisation' margin, and so includes an allowance for depreciation and amortisation.

Origin Energy was unable to provide cost to serve data that was directly comparable with the reports extracted from its general ledger for the 2005 decision, citing the number of restructures of the business since the data was provided

previously. However Origin Energy did provide the Commission with a high level reconciliation of the cost to serve information for 2006/07 to its published financial results.

There were some differences between cost to serve line items in this reconciliation and other cost to serve information provided, and between the average 2006/07 cost to serve for all small customers implied by data supplied by Origin Energy in response to the information request from the Commission and the amount suggested by a presentation on its 2006/07 financial results. Nevertheless, the information considered by the Commission indicates that at an aggregate level, Origin Energy's cost to serve information is relatively robust.

As noted above, Origin Energy advised the Commission that it could not provide cost information separately for its gas business or its South Australian gas standing contract business. Further, Origin Energy has not suggested, or provided evidence, to the Commission that its cost to serve South Australian standing contract customers is significantly different from that incurred in serving its small gas and electricity customers generally.

The Commission therefore believes it is reasonable to conclude that the cost to serve information provided by Origin Energy is representative of the actual retail operating costs it incurs in serving South Australian gas standing contract customers.

However, given that this has been a necessarily high level analysis, lacking a clear reconciliation of individual components of Origin Energy's actual retail operating cost to audited financial accounts, the Commission also had regard to recent regulated energy price decisions made by other Australian economic regulators, and to advice provided to regulators in relevant consultants' reports in relation to energy retail operating costs and energy retail margins.

Benchmarking retail operating costs is problematic in that the assumptions underpinning regulatory decisions are not always evident or discernible, and are often divergent between decisions. There is also a potential for circularity in regulatory decisions based primarily on benchmarking rather than an examination of the costs incurred by the retailer with standing contract obligations. Where a regulator simply applies or adapts the outcomes of previous decisions, little contemporary information is added to the knowledge base.

Furthermore, there have been very few relevant decisions made in respect of regulated retail prices for gas customers in Australia. Thus it has been common to assume that the retail operating cost (on a per customer basis) for a gas retailer is the same as for an electricity retailer.[61]

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61 For example, National Economic Research Associates (NERA) 2004, New South Wales Energy Retail Costs: A Report for the Independent Pricing and Regulatory Tribunal, February 2004, and Charles River and Associates (CRA) 2007, Impact of prices

When comparing cost allowances for Origin Energy with those of other retailers, it is noted that the usual convention is for the retail operating cost allowance to be established in terms of a dollar allowance per customer. However costs are not necessarily incurred in proportion to customer numbers as implied by the standard simple benchmarks, but rather a proportion of retail operating costs is likely to be fixed, which means that the retail operating cost per customer may change with the number of customers served.

Care must be taken to ensure that the combination of the allowances for retail operating costs covers all of the economic costs that an efficient retailer would be expected to incur, but does not 'double count' costs (that is, provide an allowance for a cost in both the allowance for operating costs and the margin).

Thus the Commission's approach does not seek to determine a retail operating cost allowance based solely on Origin Energy's actual operating costs, as this has the potential to reward inefficiency, and further, there are practical difficulties in identifying the costs associated with standing contract retail operations, given that this constitutes such a small part of Origin Energy's national business. Nor does the Commission's approach rely purely on benchmarking of costs against other regulatory decisions.

There are two elements to determining an appropriate retail operating cost allowance:

- Determining the appropriate level of retail operating cost expenditure at the commencement of the new regulatory period (July 2008); and
- Determining the rate of change that may be expected in Origin Energy's retail operating costs over the three year regulatory period to June 2011, including expected efficiency gains and input cost movements.

Before these elements are considered in detail, it is pertinent to reflect on the relevant aspects of the benchmarking study undertaken by ACG[62] at the request of the Commission.

8.5.2 Benchmarking analysis

There is limited information available about the establishment of retail operating cost and retail margin allowances in Australian gas markets. Moreover, there appears to be less consistency between jurisdictions than there is in electricity markets. The Commission has therefore focussed its attention on the more recent regulatory decisions made under regimes as similar to South Australia's as

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and profit margins on energy retail competition in Victoria, Final Report. Prepared for the Australian Energy Market Commission, 8 November 2007

62 South Australian Gas Standing Contract Prices — Price Path Review and Inquiry: Benchmarking analysis - Report to the Essential Services Commission of South Australia, The Allen Consulting Group, March 2008

possible. This has made it necessary to mainly consider electricity decisions in this benchmarking analysis.

Given that information directly relating to the Victorian 2004-2007 decision on electricity and gas standing offers and deemed contracts is not publicly available, the Victorian benchmarks noted below may be considered somewhat less persuasive. However, CRA's 2007 study of the impact of prices and profit margins on energy retail competition in Victoria for the AEMC does provide a recent estimate of retail operating costs for a gas retailer, which the Commission considers informative.[63]

A summary of recent decisions by, and reports for, other jurisdictional regulators on retail operating costs (and retail margins) is presented in Table 8.4. Allowances relating to customer acquisition costs (CAC) are distinguished from base retail operating costs (ROC) to provide more meaningful comparisons.

Table 8.4: Retail Operating Cost ($ per customer in $Dec 08) and Retail Margin decisions

Decision / Report	Fuel	Base ROC	CAC	Total ROC	Escalation	Margin
QCA: Queensland (Electricity Benchmark Retail Cost Index for 2008 09) - Draft	Elec	$81	$18	$99	40% at CPI 60% at 4.25%	5% sales
IPART: New South Wales (Regulated electricity retail tariffs and charges for small customers 2007 to 2010)	Elec	$74	$37	$111	CPI	5% sales (EBITDA)
ESCOSA: South Australia (2008-10 Retail Electricity Price Path)	Elec	$95	$0	$95	CPI minus 4.1% p.a.	10% controllable costs
Victoria (Electricity and Gas Standing Offers and Deemed Contracts 2004-07) / CRA Report to the Australian Energy Market Commission 2007	Elec	$79	$50	$129	Not explicit	Not informative
	Gas	$79	$24	$103		
ICRC: Australian Capital Territory (2007-08 Electricity Price Determination)	Elec	$97	$0	$97	CPI	4% sales

IPART was required to develop allowances for retail operating costs and retail margins based on the hypothetical retail operating costs and retail margin of a mass market new entrant retailer, so provided an explicit allowance for the cost of

[63] Charles River and Associates (CRA) 2007, Impact of prices and profit margins on energy retail competition in Victoria, Final Report. Prepared for the Australian Energy Market Commission, 8 November 2007 - http://www.aemc.gov.au/

acquiring new customers. IPART noted that the base retail operating cost allowance was lower than that used in other regulatory decisions, but also noted there was limited data in the public domain against which the Standard Retailers' actual costs could be compared. IPART's decision on the retail margin was based on an expected returns analysis and bottom up methodologies. It did not include any allowance for customer acquisition or, equivalently, any return on the stock of customers.[64]

The QCA's draft determination was calculated by commencing with IPART's estimate for 2006/07 and escalating for wages growth and CPI inflation, noting that the IPART decision drew upon actual cost information. In discussing other benchmarks, they argued that little weight should be placed on the cost benchmarks that were established early in the period of energy retail regulation given that they were based on little information. The QCA's retail margin decision was based on the recent decisions of IPART and the Commission.[65]

The Commission's retail operating cost starting point in its 2007 electricity standing contract price determination was arrived at by escalating the then current allowance set under the previous determination, having had regard to an analysis of actual cost information provided by AGL SA and benchmarking against other regulatory decisions. The allowance reduced by 4.1% per annum because the Commission considered it appropriate for AGL SA to share productivity gains with standing contract customers. While no specific allowance was made for customer acquisition and retention costs in retail operating costs, the Commission relied to a significant extent on AGL SA's reported expenditure, and it acknowledged that by escalating from the previous decision, some allowance for customer acquisition costs was included. The Commission's decision on the retail margin was informed by comparable retail margins allowed by other jurisdictional regulators and the analysis of a bottom-up retail margin based on data provided by AGL SA.[66]

In its report to the AEMC on Victorian competition, CRA derived the estimates of retail operating costs in Victoria by benchmarking against other jurisdictions and considering which of the estimates was likely to be most applicable in the Victorian context.[67]

The ICRC decision on retail electricity prices was based on an estimate of the economically efficient cost base of an incumbent electricity retailer providing retail

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64 IPART, Promoting retail competition and investment in the NSW electricity industry: Regulated electricity retail tariffs and charges for small customers 2007 to 2010, 2007, P95-96

65 Charles River and Associates (CRA) 2008, Calculation of the Benchmark Retail Cost Index for 2007-08 and 2008-09, Prepared for the Queensland Competition Authority, 24 January 2008

66 Essential Services Commission of South Australia (ESCOSA) 2007, Final Inquiry Report and Price Determination: 2007 Review of Retail Electricity Price Path.

67 Charles River and Associates (CRA) 2007, Impact of prices and profit margins on energy retail competition in Victoria, Final Report. Prepared for the Australian Energy Market Commission, 8 November 2007

electricity supply services to a regulated customer segment. The ICRC base retail operating cost was developed by the application of a CPI inflation adjustment to the per customer allowance developed in its previous decision, combined with benchmarking against regulatory decisions in other states. The ICRC decided not to allow any explicit recovery of customer acquisition and retention costs in the retail operating cost base. It believed the additional cost would have a negative social impact, and that this social imperative outweighed the need for further reduction of barriers to entry. The ICRC also determined that such costs are likely to be low on a per customer basis and could be argued to be covered by the CPI allowance for retail operating costs.[68]

The Commission notes that under all of the allowances represented in Table 8.4, depreciation and amortisation are not included in retail operating costs and are addressed in the allowed retail margin.

Having regard to the benchmarks presented, and their limitations, the Commission considers that a range of base retail operating cost values, excluding customer acquisition costs, of between $75 and $95 per customer per year is appropriate.

8.5.3 Initial Retail Operating Cost Allowance

While the Commission cannot disclose the details of the actual cost data provided by Origin Energy, the information that Origin Energy has provided on its retail operating costs suggests that its cost of operating its retail business is substantially higher than the allowance Origin Energy has proposed as an allowance in the next regulatory period, and that its historical expenditures were also substantially higher than the allowances provided in previous regulatory periods. The Commission’s benchmarking exercise indicates Origin Energy’s reported cost to serve has also been substantially above the allowances provided in other regulatory decisions.

The Commission’s analysis of Origin Energy’s cost to serve information indicates that it excludes certain non-retail corporate overheads, and to the extent that these represent activities that are necessarily undertaken for the retail business (and are reasonable), then Origin Energy’s actual cost to serve would be higher. These “undistributed” overheads were identified by ACG, and were not incorporated in Origin Energy’s proposal or actual cost information.

On the other hand, Origin Energy’s cost to serve information does include costs associated with customer acquisition activities, and depreciation and amortisation costs, which the Commission believes should be incorporated in the retail margin allowance rather than the allowance for retail operating costs. Origin Energy’s actual cost data were adjusted to remove these costs, both for the purposes of the actual cost and the benchmarking analyses of retail operating costs.

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68 Independent Competition and Regulatory Commission (ICRC) 2007, Final Decision and Price Direction Retail Prices for Non-contestable Electricity Customers, Report 7 of 2007, June 2007

Origin Energy also proposed that the separate allowance for the recovery of FRC operating and capital costs be continued in the next regulatory period (that is, separate to the allowance that is provided for retail operating costs generally, and for capital costs in the retail margin). Origin Energy separately identified the values it proposed for the allowances to be added to the base retail operating cost allowance.

The issue of Origin Energy's recovery of the initial FRC capital cost outlay is dealt with in Section 8.5.4. The issue of whether or not a separate allowance should be maintained in respect of FRC operating costs, and the value of such an allowance, is dealt with below.

The Commission can see no merit in continuing to separately identify the FRC operating cost allowance. Origin Energy has noted that FRC is now part of its normal operating environment, and did not provide the Commission with actual cost data net of FRC costs. Further, the treatment of FRC operating expenditure (that is, whether or not it is aggregated with other retail operating costs) will not be material to Origin Energy's proposed average retailer revenue allowance either way. Therefore the Commission has decided that the allowance for FRC operating expenditure will no longer be treated as a separate allowance, and instead will be considered as part of total retail operating costs.

Having made these adjustments to the historical and estimated cost to serve data provided by Origin Energy, the Commission's analysis shows that the allowances determined in the Commission's 2005 decision for 2006/07, and 2007/08 are very close to or above Origin Energy's claimed actual cost to serve its small gas and electricity customers generally.

Origin Energy has not suggested, or provided evidence, that its cost to serve South Australian standing contract customers is significantly different from that incurred in serving its small gas and electricity customers generally.

Consequently, the Commission has concluded that the cost allowance for base retail operating costs[69] set by the Commission in its 2005 decision for the 2007/08 regulatory year ($89.88 in $Dec 08) is approximately equivalent to Origin Energy's relevant actual cost to serve its South Australian standing contract customers in 2007/08, and is therefore an appropriate starting point for the retail operating cost allowance for the next regulatory period.

That is, given the results of its analysis of the adjusted cost to serve (before customer acquisition costs, depreciation and amortisation, and excluding the "undistributed" overheads identified by ACG) for 2007/08, the Commission has concluded that the amount proposed by Origin Energy for the FRC operating expenditure allowance ($9.03 per annum real) is reasonable when taken together

[69] Including FRC operating, but excluding FRC capital cost recoveries.

with the retail operating cost allowance ($80.85). The aggregate base retail operating cost allowance of $89.88 is well within the appropriate range given by the Commission's benchmarking analysis discussed in Section 8.5.2. The Commission therefore does not agree with the assertion made by TRUenergy that the allowance is below that allowed for in every other Australian jurisdiction.

Origin Energy submitted that the Commission's Draft Decision to determine a retail operating cost allowance of $89.88 did not give full recognition to the actual costs incurred by it in supplying South Australian standing contract gas customers. Its argument appears to be that aggregate South Australian standing contract customer revenue under the current price path has been lower than it anticipated as the level of customer churn away from standing contracts has been higher than it forecast. Consequently, it would require higher prices to achieve its expected aggregate revenue. It follows that, if the level of customer churn away from standing contracts remains at existing levels, the initial standing contract price at the commencement of the new regulatory period (July 2008) should also be higher.

The Commission reiterates that in setting a retail operating cost allowance for South Australian standing contract customers it has been informed in part by the cost incurred by Origin Energy in serving these customers. Origin Energy has not suggested, or provided evidence, to the Commission that its cost to serve South Australian standing contract customers is significantly different from that incurred in serving its small use gas and electricity customers generally. The Commission therefore believes it is reasonable to conclude that the cost to serve information provided by Origin Energy is representative of the actual retail operating costs it incurs in serving South Australian gas standing contract customers.

It is the Commission's Final Decision that the initial cost allowance for retail operating costs, excluding any FRC capital expenditure recovery, will be the aggregate of the current determination retail operating cost allowance for 2007/08 ($80.85) and the amount proposed by Origin Energy for the FRC operating cost allowance ($9.03), or $89.88.

8.5.4 Full Retail Contestability Capital Expenditure as a Component of Retail Operating Costs

As noted in Section 8.5.3, Origin Energy sought the recovery of capital costs associated with the implementation of FRC within the retail operating cost allowance.

Origin Energy claimed that with the greater number of standing contract customers than was forecast leaving the standing contract to take up market contracts, it would not fully recover the value of the capital costs approved in the Minister for Energy's 2004 decision within the five year period approved for its recovery unless a substantial increase in the allowance for this specific cost component was

approved by the Commission. Origin Energy claimed that in order to fully recover the capital expenditure it was required to incur to facilitate the implementation of FRC within this time-frame, the allowance would need to increase dramatically in 2008/09[70].

As a preferable alternative to a very large increase in 2008/09, Origin Energy proposed that the as yet unrecovered capital costs be recovered over the three year period of the next price determination. Origin Energy originally proposed that this option would require an annual FRC capital cost allowance of $8.55 per customer in each of the three years of the next price path period.

However, the Commission questioned the calculation of this value, and Origin Energy subsequently advised the Commission that its proposal for the annual FRC capital cost allowance should be $18.70 per customer per annum. The Commission disagrees with Origin Energy's calculation and believes a better assessment of the amount Origin Energy is seeking to claim (under Origin Energy's stated assumptions) is $17.14 per customer per annum.

Notwithstanding the amount claimed, Origin Energy's proposed treatment of FRC capital expenditure raised some important issues of regulatory principle.

Normally, once a price control has been set, the regulated business bears certain risks over the regulatory period. If the price control is in the form of a price cap, this will include demand risk. Thus, unless there were obviously mitigating circumstances, the Commission would not agree to Origin Energy's proposal, as it would be analogous to retrospectively reopening the price control that applied during the last regulatory period.

However, whether or not it is reasonable for Origin Energy to recover past 'unrecovered' investments depends to some extent on the expectations that were created at the time of the investment and related assurances provided. Origin Energy has stated that, should the Commission approve less than Origin Energy has claimed, "*…Origin will not be recovering the [capital] costs associated with FRC, in conflict with the commitments made by the South Australian government at the commencement of the FRC investment programme*".[71]

Origin Energy has provided the Commission with a copy of a 2004 letter from the Minister for Energy, which it claims provides the "commitment" for the recovery of FRC costs. Having reviewed this letter, and associated documentation surrounding the Minister's approval of Origin Energy's FRC costs, the Commission does not dispute that there would have been a clear expectation at the time of the Minister's decision that the FRC costs would be recoverable. However, the question that is of

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70 2008/09 is the final year of the five year recovery period that was countenanced in the Minister for Energy's 2004 decision, and in the Commission's 2005 decision.

71 Origin Confidential Submission, p45.

relevance to the Commission in this Inquiry is whether or not Origin Energy has recovered these costs.

On this question, the Commission notes that the Minister for Energy has encouraged the Commission to "ensure over-recovery of these costs does not eventuate" and favours "allowing Origin [Energy] to recover these costs from its total customer base rather than have standing contract customers disproportionately paying for these costs".[72]

It is apparent from consultant advice provided to the Minister for Energy in respect of the Minister's 2004 decision, that FRC operating and capital cost allowances were based on the then projected numbers of standing contract customers. The Commission's 2005 decision maintained this aspect of the Minister's decision, with some minor adjustments to reflect changes in actual customer numbers compared with those forecast.

With the benefit of hindsight, it is arguable that customers that have remained on gas standing contracts have benefited least from the introduction of FRC, and that it is therefore unfair that these customers should also bear the full amount of the any 'unrecovered' capital costs. Indeed, it is possible that setting standing contract prices to recover all of the FRC implementation costs has acted to accelerate the churn of customers away from standing contracts to market contracts. The recovery of the full amount of the 'unrecovered' capital costs from standing contract customers would place further pressure on this group.

However, the Commission notes that the scope to allocate these costs other than via the declared retailer was at the time of the Minister for Energy's 2004 decision, and remains, limited by the gas regulatory regime. Further, the scope to allow Origin Energy to recover its FRC investment from either standing contract customers or market customers is limited by the extent to which its competitors also face similar costs and the effectiveness of competition. Allocating all of the costs to standing contract customers does not alleviate the constraint on cost recovery that competition creates.

This is an important consideration, if the retrospective recovery of these costs is to be approved. Origin Energy's proposal assumed that all of the FRC capital costs should have been, and should continue to be, paid for by standing contract customers. This raises two critical and interconnected issues: whether it is true that Origin Energy has only been able to recover these FRC capital costs from standing contract customers in the past; and thus the extent to which these costs actually remain unrecovered.

The extent to which Origin Energy has been constrained to recover these costs only from standing contract customers is difficult to determine with a high degree of

72 http://www.escosa.sa.gov.au/webdata/resources/files/071221-L-MinisterEnergyGasPricePathIssuesPaper-Submission.pdf

confidence, but the Commission believes a reasonable estimate can be discerned from the consideration of Origin Energy's net churn and its market contract pricing behaviour over the years since the beginning of gas FRC.

The standing contract price serves two purposes: as a safety net for vulnerable customers; and also importantly, as a competitive benchmark. That is, the standing contract price is not only relevant to standing contract customers.

In the early period of gas FRC, Origin Energy was faced with a range of strategic decisions. At the extremes of this range, Origin Energy could have decided to offer discounts compared to the standing contract benchmark (in order to move gas standing contract customers to market contracts and thereby limit its net churn to other retailers), or it could have decided not to compete in such a manner, and hope thus to benefit from the higher prices paid by standing contract customers for as long as possible. Therefore, to the extent there is evidence that the FRC capital expenditure allowance was not competed away, that is, not actively used by Origin Energy as an inducement to maintain customers, the Commission believes that the allowance for FRC capital costs must actually be included in Origin Energy's sales to its market customers during this period.

The Commission has estimated that the FRC capital expenditure allowance, contributed approximately 5% to the retailer component of the standing contract price in its 2005 decision. Given that this discussion is limited to the capital expenditure component, which formed approximately half of the total FRC cost allowance approved at that time, the Commission believes unless there is evidence of *at least* this level of marketing (discounting or offering of other inducements) it would indicate that this allowance has been at least partly recovered from Origin Energy's market customers.

Origin Energy has provided the Commission with information about its gas market contracts since the beginning of FRC for the purposes of the Commission's online *Estimator* residential energy price comparison application, and this information indicates that Origin Energy has actually recovered a significant amount of the FRC capital expenditure allowance over this period.[73]

While Origin Energy started to lose some market share from September 2004, it did not start retailing to market customers itself until after September 2005. The initial gas market contract offered by Origin Energy from July 2004 was at a slight *premium* to the standing contract when applied to a typical residential gas customer.[74] This contract was withdrawn in mid-2005, and Origin Energy did not replace it with another residential gas market contract until mid-2006. Since then,

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73 And also, presumably, the operating expenditure allowance. However, as Origin Energy is only proposing the recovery of the capital expenditure component, that is all that is dealt with here.

74 The Commission uses a benchmark of 22GJ per annum as the benchmark for a typical residential gas customer. Significantly larger customers would achieve discounts under the tariffs in this contract.

Origin Energy has consistently offered residential gas market contracts at either no discount to the standing contract, or with a discount of 2% at all levels of consumption. Neither has the gas component of Origin Energy's dual fuel contracts offered since the start of gas FRC included any discount to relevant standing contract prices.

This analysis suggests to the Commission that Origin Energy was actually recovering FRC capital costs from both market contract and standing contract customers during the years since the commencement of FRC. Thus the amount that could be claimed as unrecovered is likely to be significantly less than Origin Energy has claimed in its proposal. Indeed, ACG initially estimated that, if the FRC capital expenditure allowance had also been recovered as part of Origin Energy's market contracts from the commencement of FRC to the end of 2007/08, based on data provided by Origin Energy on its total small customers, Origin Energy's recovery of all FRC capital costs would already be complete, and no further recovery would be required in the next price path period.

Having received further information from Origin Energy, ACG has since advised the Commission that there would be a small amount of 'unrecovered' FRC capital expenditure as at the end of 2007/08 even if it were assumed that the expenditure was recovered from market and standing contract customers. ACG estimated that an increase in the FRC capital allowance to $11.59 in 2008/09, the first year of the price path period, would eliminate any shortfall.

The Commission does not believe that the standing contract price is an effective or appropriate means by which to resolve an issue such as this. However, it is the only option available to the Commission and the Commission must make a decision based on the evidence available and the persuasiveness of the arguments.

The Commission is not convinced by Origin Energy's analysis of the extent of its under-recovery of FRC capital expenditure. Rather, the Commission believes that Origin Energy has recovered a very significant amount of its FRC capital expenditure outlay. The Commission does not believe that its 2005 decision was tantamount to the approval of a pass-through for FRC costs and does not consider it appropriate to effectively reopen its previous decision in order to approve a different amount for the FRC capital expenditure allowance.

It is therefore the Commission's Final Decision to approve an FRC capital expenditure allowance of $11.59 for the first year of the price path period only. That is, this allowance will be additional to the initial retail operating cost allowance for 2008/09, but will not be added to retail operating cost allowance for the subsequent two years of the price path period. This value of $11.59 is consistent with the allowance provided in the Commission's 2005 decision, escalated to December

2008 prices ($11.49) plus an additional amount for the amount of FRC capital expenditure allowance that would otherwise have been 'unrecovered' ($0.10).

8.5.5 Forecast changes in Retail Operating Costs

Origin Energy's proposal sought to escalate the retail operating cost allowance by CPI+4% per annum, an increase from the CPI+2% approved in the Commission's 2005 decision.[75] It is noted that Origin Energy did not seek to escalate FRC operating cost allowance at a rate greater than CPI inflation. In fact, this cost component has remained unchanged in real terms since the Commission's 2005 Price Determination was made.

Origin Energy's proposal suggested that the increase in the rate at which the retail operating cost allowance is escalated is primarily necessary to account for losses of scale economies as standing contract customers are lost to competing retailers. Origin Energy stated that the rate at which customers are 'churning' from standing contracts is greater than it had previously forecast, meaning that per customer costs have also been higher than forecast.

Origin Energy also justified the increase in the annual retail operating cost allowance escalation rate by noting that labour costs have increased at rates well above CPI. However, no further information wass provided in Origin Energy's proposal to support these claims.

Dealing first with Origin Energy's argument for real increases in retail operating costs to account for the loss of scale economies due to churn, the Commission reiterates that its focus in setting a path for the retail operating cost allowance for South Australian standing contract customers is informed in part by changes in the actual cost that is incurred by Origin Energy in serving these customers.

The Commission notes Origin Energy advised that it could not provide cost information separately for its retail operations relating to small electricity and gas customers in South Australia or its gas standing contract business in South Australia. Therefore, the basis for Origin Energy's claim that its costs per standing contract customer in South Australia have increased at a rate greater than provided for in the approved retail operating cost and FRC cost allowance shown in Table 8.1 is unclear.

Instead, as noted in the discussion on the initial retail operating cost allowance, Origin Energy's argument appears to be that aggregate South Australian standing contract customer revenue under the current price path has been lower than it anticipated as the level of customer churn away from standing contracts has been

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[75] Origin Energy also suggests an alternative to escalating the retail operating cost allowance by CPI+4%, would be for the Commission to add a customer acquisition cost of $23 per customer to the annual retail operating cost allowance. This amount represents the total replacement cost divided by the total number of customers.

higher than it forecast. Consequently, it would require higher price increases to achieve its expected level of revenue. It follows that, if the level of customer churn away from standing contracts remains at existing levels, and the initial standing contract price at the commencement of the new regulatory period (July 2008) is set at the current allowance, it would require significant real increases in the allowance to achieve its target revenue outcome. Origin Energy has estimated the increase would be in the order of CPI+10%.

In any event, the Commission considers it more appropriate to include an allowance in the calculation of standing contract prices to cover at least sufficient customer acquisition activity for Origin Energy to maintain its scale, as "*in a high churn environment, loss of scale is not sustainable over the longer term, and a responsible retailer would not run a business in that manner*".[76]

However, given the Commission's continuing preference for determining a retail margin allowance that provides a 'return on' and 'return of' the value of customers (refer Chapter 9), consistency requires that no allowance is provided for acquiring new customers in the retail operating cost allowance. It is for this reason that Origin Energy's actual operating expenditure has been analysed excluding costs clearly attributable to customer acquisition activities.

Origin Energy did not provide the Commission with any material to substantiate its assertion in respect of expected future labour costs. Further, an increase in labour costs would only translate into an increase in Origin Energy's cost to serve to the extent that there was no off-setting labour productivity growth. Relevant to this consideration, the Independent Pricing and Regulatory Tribunal (IPART) recently concluded that it was:

> *…not persuaded that any adjustment [for higher labour costs] should be made to the retail operating cost allowance…[as] expected increases in labour productivity and technology are likely to result in productivity improvements…[and that this] view is supported by historical trends in the Standard Retailers' actual retail operating costs, where higher wages growth has not led to real increases in these costs.* [77]

Consistent with IPART's conclusion, information from Origin Energy shows that the long term trend in the more labour intensive retail operating functions is for a real change in these cost categories of between plus or minus 1%.

There is therefore no basis for concluding, from past trends in Origin Energy's retail operating expenditure, that future increases in labour costs will exceed expected productivity growth and so imply a material increase in Origin Energy's retail

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[76] Charles River Associates 2008, *Calculation of the Benchmark Retail Cost Index for 2007-08 and 2008-09*, Draft Report for the Queensland Competition Authority, January 2008, p.66.

[77] Independent Pricing and Regulatory Tribunal 2007, *Promoting retail competition and investment in the NSW electricity industry Regulated electricity retail tariffs and charges for small customers 2007 to 2010,* Electricity - Final Report and Final Determination, June 2007 p.99.

operating costs per customer. Rather, it appears the key drivers of the increase in Origin Energy's cost to serve have been the substantial increases in its sales and marketing costs, and regulation and strategy costs.[78] Excluding these costs, Origin Energy's cost to serve actually falls in real terms between 2003/04 and 2007/08.

The Commission has concluded that the information provided by Origin Energy does not support a finding that its retail operating costs have, or could reasonably be expected to, increase at a rate of CPI+4% due to changes in input costs.

While the analysis of historical costs is persuasive, the Commission has also had regard to other sources of information regarding future trends in relevant costs. To this end, the Commission's benchmarking analysis shows that, of those regulatory decisions where a price path beyond 2007/08 was determined, none have provided for any real change in retail operating costs beyond 2007/08. Otherwise, there is little guidance from other regulatory decisions for changing retail operating costs over the period.

The Commission notes that public statements by Origin Energy quoted in the press provide another insight into Origin Energy's expected cost to serve. Recent statements about the efficiencies generated by Origin Energy's acquisition of Sun Retail having "*reduce[d] its cost of serving each customer to $53 from $61*",[79] and regarding consolidation initiatives currently being implemented, indicate that potential exists for future cost savings to be shared with customers.

While it is impossible to compare these quoted cost to serve numbers with the information provided by Origin Energy, as they clearly differ substantially, this information implies a significant reduction in Origin Energy's cost to serve. Even ignoring the composition of the cost to serve values quoted, there is an identifiable $8 reduction that can be compared to total "actual" costs as provided by Origin Energy. Compared to the Commission's highest assessed value of Origin Energy's actual costs, this implies a potential material saving.

An important issue for the Commission in assessing future movements in retail operating costs is the extent to which retailer cost reductions being sought should be shared with standing contract customers. The Commission appreciates that, if it were to pass on all of the benefits to standing contract customers, there would be no incentive for Origin Energy to undertake such projects. On the other hand, in a competitive market, the Commission would expect consumers to receive at least a share of the benefits from ongoing efficiencies.

Under the efficient retailer approach, the Commission acknowledges that it must take a broader view on expected changes in retail operating costs than to focus

[78] The information provided by Origin Energy on changes in these two costs categories suggests that much of the change is either due to changes unrelated to costs (for example, instead reflecting changes in allocation policies) or due to increasing customer acquisition activity.

[79] 'King of strategic moves earns investors' respect', Stephen Wisenthal Australian Financial Review, 5/3/2008 p.37

purely on a simplistic analysis of unverifiable efficiencies. Nevertheless, the Commission would expect a prudent retailer to be continually seeking out cost savings and is aware that other energy retailers are implementing such initiatives, including for example, AGL Energy's Project Phoenix. The Commission therefore believes that it is appropriate to take into account a reasonable expectation of future efficiencies in determining a retail operating cost.

Having regard to the above information, and to the retail operating cost glide path set in the Commission's 2007 South Australian electricity standing contract price determination[80], the Commission has reached the conclusion that cost efficiencies and productivity growth can be expected to at least offset any real increases in retail operating costs for each year of the price path period. However, the Commission has not incorporated a percentage reduction over the price path period, reflecting its view that the benefits of the projected cost savings over the price path period should be shared between Origin Energy and standing contract customers. In determining this outcome, the Commission has taken into account:

- the need to provide an adequate incentive for the standing contract retailer to undertake cost saving initiatives, while still ensuring that standing contract customers benefit from such initiatives; and
- uncertainty as to the actual benefits that will be achieved.

The Commission's Final Decision is therefore to provide for the escalation of the initial cost allowance for retail operating costs at CPI for the term of the next price path period.

8.6 Final Conclusion

It is the Commission's decision that:

- the initial cost allowance for retail operating costs will be $89.88 in $Dec08, this allowance being subject to annual escalation by the CPI during the next price path period; and
- an allowance for FRC capital expenditure of $11.59 in $Dec08 will be added to the initial cost allowance for retail operating costs for the first year of the price path period only.

Table 8.5: Final Decision on Retail Operating Costs, 2008/09 to 2010/11
$Dec 08 per Customer

	2008/09	2009/10	2010/11
Retail operating cost allowance	$89.88	$89.88	$89.88
FRC capital expenditure recovery	$11.59	–	–
TOTAL RETAIL OPERATING COST ALLOWANCE	**$101.47**	**$89.88**	**$89.88**

80 Details of the 2007 Electricity Standing Contract Price Path Inquiry are available from the Commission's website (refer http://www.escosa.sa.gov.au/site/page.cfm?u=162&c=2143).

9 RETAIL MARGIN

The retail margin is intended to compensate investors for committing capital to a retail business. In such a business, capital is most likely to be required for working capital (to account for lags in payment), and to fund physical assets (such as information systems). Intangible assets, including for example, acquired customers, may also represent a capital value on which a return is required. For the purpose of this decision, the retail margin includes an allowance for both the return on investment and depreciation/amortisation.

Under the Commission's approach, the retail margin is calculated on an earnings before interest, tax, depreciation and amortisation (EBITDA) basis.

9.1 2005 Inquiry Findings

The Commission determined a retail margin allowance equivalent to 10% of Origin Energy's controllable cost in its 2005 Price Determination.

As part of the Inquiry process, the Commission considered the use of existing Victorian benchmarks, as Victorian retailers share the most similarities to South Australian gas retailers in terms of the status of competition, regulatory arrangements and ownership arrangements. However, after having identified problems associated with the accessibility and collection of data and various key operational differences between South Australian and Victorian gas retailers that would have introduced further complexities to the analysis, the Commission concluded that the electricity retail margin applicable to AGL SA over the 2005-2008 period and the current Origin Energy South Australian gas retail margin allowance were more relevant to be used as benchmarks in its 2005 Price Determination.

Having regard to all submissions and other relevant information, the Commission concluded that a retail margin of 10% of controllable costs was appropriate for Origin Energy. This was the same profit margin allowed by the Commission in its 2005 Electricity Standing Contract Price Determination, and was approximately the same as Origin Energy's 2004/05 profit margin allowance, as set by the Minister for Energy.

The retail margins approved in the Commission's 2005 decision are as shown in Table 9.1.

Table 9.1: Final Decision on Retail Margin 2005/06 to 2007/08 (percentage of total controllable costs)

	2005/06	2006/07	2007/08
Retail Margin	10	10	10

9.2 Origin Energy Proposal

Origin Energy proposed that the Commission provide for a retail margin allowance of 13% on controllable costs for the period July 2008 – June 2011, an increase from the 10% margin on controllable costs approved in the Commission's 2005 decision. For the purpose of the retail margin allowance, controllable costs include the wholesale cost of gas, transmission costs and retail operating costs, but exclude any FRC related cost recovery.

Origin Energy argued that an increase was required because:

- With the low margins available in the residential market, forecast errors (particularly in terms of customer numbers) put the commercial viability of supplying gas to standing contract customers at risk;
- Since Origin Energy's proposal removed REMCo charges from controllable costs, the value of costs to which the percentage margin is applied is lowered; and
- In its 2006 Final Decision for the Envestra Access Arrangement, the Commission did not change the distribution charges prepayment arrangement as it had foreshadowed in the 2005 gas standing contract price determination; which led to a greater working capital requirement than would have otherwise been the case.

9.3 Summary of Draft Decision

The Commission's Draft Decision provided for a retail margin allowance of 12% of controllable costs, having regard to relevant retail margin benchmarks, a "bottom-up" estimate of the retail margin, and taking into account the assumption made under the 2005 gas price path determination that Envestra's prepayment terms for gas distribution charges would be removed, when this did not eventuate (and hence the working capital requirements for Origin Energy are greater than assumed).

9.4 Submissions

Submissions to the Issues Paper identified the following matters in relation to Origin Energy's proposed retail margin allowance:

- AGL Energy supported the 13% retail margin proposed by Origin Energy as it reflected, in AGL's view, reasonable compensation to gas retailers for the investment and risks of providing retail services in the South Australian gas industry. AGL Energy also noted that a full cost recovery from retail tariffs is essential to ensure continual investment in the gas industry and a more competitive retail market.[81]

[81] http://www.escosa.sa.gov.au/webdata/resources/files/071221-AGLGasPricePathIssuesPaper-Submission.pdf

- Simply Energy also supported the retail margin proposed in Origin Energy's submission as it believed it not only allows second tier gas retailers to compete effectively but also provides an adequate return for such retailers to invest in the South Australian gas retail sector.[82]
- The Minister for Energy rejected Origin Energy's view that an increase in retail margins is justified to compensate gas retailers for the costs and risks of operating in the South Australian gas market.[83]

Submissions to the Draft Inquiry Report and Draft Price Determination made the following comments in relation to the Commission's draft decision to allow a retail margin of 12% of controllable costs for each year of the price path period:

- AGL Energy reiterated that while it supported the 13% retail margin originally proposed by Origin Energy, it considered that, at a minimum, a margin of 12.4% should be allowed in the Commission's final decision.
- Origin Energy argued that the customer value used by the Commission to arrive at its 'bottom up' retail margin of 12.4% was not reasonable, and did not accord with the cost of acquiring customers.
- Simply Energy commented that the Commission's Draft Decision ignored the actual cost of acquiring gas customers.
- The Minister for Energy acknowledged that, while his submission to the Issues Paper argued against increasing the retail margin above the current allowance, he saw some justification for the Commission's proposed increase to reflect working capital requirements associated with the payment terms for gas distribution charges.

9.5 Commission Consideration

The Commission has determined a retail margin allowance by considering the margin allowed in its 2005 decision, and any changes that might be required to reflect changing circumstances, having regard to benchmarking against margins allowed in other jurisdictions, and to a bottom-up return on investment analysis of retail margins for the standing contract business. The Commission engaged ACG to assist with these analyses.[84]

A bottom-up approach to estimating an appropriate retail margin involves determining the quantity of capital that is required by the business, and multiplying this by an appropriate cost of capital. Origin Energy's proposed retail margin allowance was not based on a bottom-up calculation of the margin for its retail business. Rather, it proposed that the

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[82] http://www.escosa.sa.gov.au/webdata/resources/files/071221-SimplyEnergyGasPricePathIssuesPaper-Submission.pdf

[83] http://www.escosa.sa.gov.au/webdata/resources/files/071221-L-MinisterEnergyGasPricePathIssuesPaper-Submission.pdf

[84] Details of the ACG Benchmarking Report are available from the Commission's website (refer http://www.escosa.sa.gov.au/webdata/resources/files/080401_ACG_GasBenchmarkingFinal.pdf)

Commission commence with the margin that it provided for AGL SA electricity standing contract customers in SA, and adjust this margin to reflect differences in gas retailing compared to electricity retailing. Nevertheless, the Commission asked Origin Energy to provide a bottom-up estimate of its retail margin, which was considered by the Commission.

9.5.1 Analysis of Origin Energy's proposal

Forecast Risk

Origin Energy's assertion that an increase in the retail margin allowance is required to account for "*commercial risk generated by forecast error [given] the limited value of the retail margin in terms of dollars per customer*" [85] was not quantified in Origin Energy's proposal, nor in the additional information provided in response to the Commission's information request.

The Commission notes that Origin Energy has, in various submissions, referred to certain risks that it believes should either be factored into standing contract prices, or addressed through cost pass-through arrangements. As discussed in Chapter 5, the Commission has taken the view that where any such risk cannot be quantified, it is not possible to include a risk premium in the standing contract price. To the extent that the standing contract retailer's costs materially change during the price path period as a result of an unexpected event (eg. supply source failure), or from an event where the cost impact is not currently known (eg. the introduction of a Residential Energy Efficiency Scheme (REES)), then the event should be considered as either a pass-through event or as a special circumstances" event. The Commission's consideration of how these two schemes can address certain risks is discussed in Chapter 5.

REMCo Market Operation Charges

Origin Energy's assertion in its proposal that the exclusion of charges imposed by REMCo from controllable costs will lower the base to which the percentage margin is applied and result in a lower dollar value for the margin is inconsistent with the Commission's 2005 decision. The Commission's 2005 decision treated REMCo market operation charges as a non controllable cost, and no margin was therefore attributable to this cost. However as these charges were fixed, the Commission was able to include a specific allowance within the overall average retailer revenue allowance for these costs.

As noted in Chapter 5, for the next price path period the Commission intends to treat market operation charges as a pass-through item, to be assessed in the annual tariff adjustment process, and for an appropriate adjustment to be made

[85] Origin Energy Confidential Submission, P46.

to the overall average retailer revenue cap to cover relevant market operation charges. Therefore Origin Energy's proposal in respect of market operation charges will have no impact on the controllable costs and no adjustment to the margin on controllable costs is required.

Envestra Distribution Charge Prepayment

There are two aspects to Origin Energy's proposal. One is that the margin should be different to electricity because of differences in payment terms, and the second is that the margin should be higher than allowed for under the 2005 gas price determination because the assumed removal of the prepayment did not eventuate.

Origin Energy based its proposal for an increase in the retail margin on an analysis of the difference between distribution payment terms for electricity and gas. It did not undertake analysis of the change to the retail margin that may be required to account for the different assumptions about gas distribution payment terms now, as compared to those underpinning the Commission's 2005 decision.

In this section, the Commission considers whether or not the changed assumptions about gas distribution payment terms might warrant a change to the retail margin. In the following section the Commission considers Origin Energy's calculation of its proposed retail margin based on the differences between electricity and gas.

In its 2005 gas standing contract price decision, the Commission assumed that the gas distribution charge prepayment would be removed from the Envestra gas access arrangement.[86] However, in its final decision on access arrangements to SA's gas distribution system, the Commission agreed to Envestra continuing with its previous policy of distribution charges being paid in advance of the service being provided.[87] However, the Commission noted that Envestra's billing policy provided it with a financial advantage compared to other gas distributors. The Commission decided to decrease Envestra's allowed revenue to remove the economic benefit that Envestra receives compared to other gas distributors.

While the prepayment of distribution charges represents a (working capital) benefit to Envestra, it represents a (working capital) cost to retailers such as Origin Energy. The effect of the Commission reducing Envestra's distribution charges to account for its timing benefit, and raising Origin Energy's margin to account for its earlier payment for distribution charges, is approximately cost neutral from the perspective of gas standing contract customers. On this basis,

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86 Essential Services Commission of SA, 2005, *Gas Standing Contract Price Path: Final Inquiry Report and Final Price Determination,*, June 2005, Page A-92.

87 Essential Services Commission of SA, 2006, *Proposed Revisions to the Access Arrangement for the South Australian Gas Distribution System, Final Decision*, June 2006, pp.118-122.

the Commission considers that it is therefore appropriate to take this additional cost into account in its assessment of an appropriate retail margin.

Origin Energy has provided the Commission with an estimate of the additional working capital costs arising from the prepayment arrangements. ACG has recalculated the working capital cost, suggesting that it is approximately $587,000 per annum, which is greater than the cost calculated by Origin Energy. This difference between the two estimates is primarily attributable to the use of the nominal, rather than the real, discount rate.[88] The Commission has examined both the Origin Energy and ACG calculations and has formed its own view on the working capital cost to Origin Energy, as discussed in section 9.5.2.

Assessment of Origin Energy's proposal for the Retail Margin

Origin Energy's proposal referred to the Commission's November 2007 price determination for electricity standing contract prices. In that decision, the Commission formed the view that, based on comparable retail margins allowed by other jurisdictional regulators, a retail margin allowance of 10% of the sum of wholesale electricity costs and retail operating costs was appropriate, noting that this was equivalent to the retail margins of 5% of sales revenue seen in other regulators' decisions.

Origin Energy's approach in establishing its retail margin was to commence with the benchmark of 5% of 'sales revenue'. Origin Energy proposed that the margin be increased to account for the fact that South Australian gas retailers pay distribution charges in advance of the period in which the service is provided rather than in arrears as is the case for electricity distribution charges.

Origin Energy converted this dollar value of the 'additional' margin into a percentage, which it added to the benchmark 5%, thus proposing that the comparable benchmark margin on sales revenue for its standing contract retail gas business in South Australia should be almost 5.7%.

Origin Energy asserted that for electricity standing contract customers, the 10% margin on wholesale electricity and retailer operating costs, or 'controllable costs', was established by dividing the margin on sales revenue by the proportion of a retailer's costs that are controllable (that is, 5% divided by 50%).

Adopting this approach for gas standing contract customers, Origin Energy calculated a retail margin of 13.2% of controllable costs based on the ratio of the percentage margin on sales (that is, 5.7%) divided by the percentage of total costs that are controllable (which it estimated to be 43%).

[88] A nominal weighted average cost of capital is required for the calculation because prices (and hence revenue instalments) are fixed in nominal terms over the year

In assessing whether Origin Energy's calculation of the margin on sales was correct, the Commission agreed with Origin Energy's proposition that *if* the Commission's intention was to provide a certain margin as a percentage of revenue, but the margin was to be applied to a different base (that is, controllable costs) then the margin should be converted correctly for any change in base costs.

Similarly, if the Commission intended to provide a margin on revenue consistent with its electricity decision, but to apply that margin as a percentage of controllable costs, the margin as a percentage of costs needed to be varied to reflect differences in the percentage of those costs compared to total revenue.

However, ACG estimated that retailer controllable costs (excluding costs associated with full retail contestability and the retail margin), are 45.7% in 2008/09 rather than the 43% used by Origin Energy. Based on these inputs and using Origin Energy's approach, ACG calculates that the margin on gas retailer costs would be 12.7%, rather than 13.2% as estimated by Origin Energy.

Notwithstanding this analysis, the Commission does not agree that Origin Energy's proposal for the retail margin is consistent with the Commission's previous decisions. An implicit assumption behind Origin Energy's proposal that the Commission's electricity margin of 5% of sales revenue be adjusted to make it appropriate for a gas retailer, is that the electricity margin is the correct margin for a gas retailer, apart from the factors noted above, and so the application of the adjusted electricity margin would achieve consistency with the Commission's past decisions.

However, the Commission set Origin Energy's current retail margin of 10% of controllable costs by reference to its decision under the 2005-08 Electricity Standing Contract Price Determination, and the retail margin that had been set by the Minister for Energy prior to the Commission's determination.

In making its 2005 decision, the Commission acknowledged that the percentage of controllable costs in retailing gas was lower than in electricity when it noted that a retail margin of 10% of controllable costs "*approximately equals 4% of Origin Energy's sales revenue, which is consistent with the decision made under the 2004-05 Gas Price Determination by the SA Minister for Energy*".[89]

The Commission wishes to remain consistent with the method it adopted in its 2005 decision. Accordingly it does not consider it appropriate to adjust the retail margin to account for differences in controllable costs as between electricity and gas as proposed by Origin Energy.

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89 Essential Services Commission of SA, 2005, *Gas Standing Contract Price Path: Final Inquiry Report and Final Price Determination*, June 2005, Page A-85.

However, as noted above, the Commission does consider it appropriate to adjust the retail margin for the additional working capital cost arising from the change to the Commission's assumptions about gas distribution payment terms since the Commission's 2005 decision.

9.5.2 Commission Approach to the calculation of Retail Margin

ACG has calculated a retail margin that is based on the Commission's 2005 decision (10% of the dollar value of controllable costs) and adjusts this margin to incorporate its estimate of the working capital requirements resulting from the Envestra prepayment arrangements. ACG's calculation produces a margin on controllable costs of 11.8% as shown in Table 9.2.

Table 9.2: ACG Retail Operating Margin Calculation

COMMISSION APPROACH			
Controllable costs (exc. FRC and retail margin)	(1)	$32,392,816	
Margin on controllable costs	(2)	10.0%	$3,239,282
Additional working capital	(3)		$587,331
Adjusted margin	(4)=(2)+(3)		$3,826,613
Margin on controllable costs (exc. FRC, and retail margin)	(5)=(4)/(1)		11.8%

Source: Allen Consulting Group based on information provided by Origin Energy.

The Commission has undertaken its own calculation, which uses an approach that is similar to that employed by ACG, although the Commission has updated the input data used in ACG's calculation to reflect the forecasts of controllable costs for the next regulatory period implied by this final decision. The Commission's calculation of this adjusted average margin is set out in Table 9.3.

Table 9.3: Commission's Retail Operating Margin Calculation

COMMISSION APPROACH	
Controllable costs (exc. FRC, exc. retail margin) (PV over 3 years)	$56.223m
10% Margin on controllable costs (PV over 3 years)	$5.622m
Additional working capital (PV over 3 years)	$1.294m
Adjusted margin (PV over 3 years)	$6.916m
Margin on controllable costs (exc. FRC, inc. retail margin)	12.3%

The Commission's calculation provides a margin on controllable costs of 12.3%.

This approach is consistent with the Commission's approach in its 2005 decision, but is adjusted for the effect of the prepayment of distribution charges. It is next compared with a bottom up calculation of the retail margin, and later with relevant benchmarks from other regulatory decisions.

9.5.3 Bottom up calculation of the Retail Margin

The bottom-up estimate of the retail margin involves determining the quantity of financial capital, which is required to be invested in the business, and multiplying this by an appropriate cost of capital. The key components in this estimate are:

- the value attributed to standing contract customers, where that value is determined by the cost of acquiring a customer (which also requires that, if the value is not nil, retail operating cost allowance does not include an allowance for the cost of acquiring customers);
- the period over which the value of a customer is amortised;
- working capital requirements due to prepayments and payment lags;
- the value of assets; and
- the (weighted average) cost of capital.

In response to the Commission's information request, Origin Energy provided a bottom up estimate of what it considered to be an appropriate retail margin for its standing contract gas business. Origin Energy estimated that an appropriate retail margin would be 9.2% of sales revenue and 22% of controllable costs. These figures are lower than those estimated by Origin Energy for the Commission's previous price determination when a retail margin of 10% of controllable costs was determined.

The following is an assessment of Origin Energy's estimate, and an alternative estimate based on the Commission's preferred assumptions.

Value of Standing Contract customers

The most significant component of Origin Energy's estimate relates to its assumption as to the value to its standing contract customer base, which it estimates to be almost $214 per customer. ACG assessed this estimate, and considers that the approach adopted by Origin Energy is likely to significantly overstate the value of a mass-market gas customer and should not be accepted by the Commission.

Origin Energy's estimate is based on the Commission's 2005-08 electricity standing contract price determination, whereas the most recent estimate of customer acquisition costs was by IPART, based on Frontier Economics' estimate of the cost that would be incurred by a new mass-market entrant retailer in acquiring (electricity) customers.[90]

[90] IPART 2007, *Promoting retail competition and investment in the NSW electricity industry Regulated electricity retail tariffs and charges for small customers 2007 to 2010*, Electricity - Final Report and Final Determination, pp.101-102.

There are a number of reasons to distinguish these decisions from that which might apply to Origin Energy in this Inquiry. First, both relate to electricity customers, while the churn of gas customers occurs largely as part of a dual-fuel offer, with gas generally being offered as the marginal fuel. As a result, the marginal cost of acquiring a gas customer is likely to be very much lower than the cost of acquiring an electricity customer. Further, IPART notes that only a third of its estimate of customer acquisition costs relate to direct costs. [91]

A second reason relates to differences in the comparative 'value' attributed by the market to electricity and gas customers. In its 2005 decision, the Commission argued that the average residential electricity bill was more than double the average residential gas bill, and that it was therefore reasonable to presume that the dollar profit (and hence value) from an electricity standing contract customer was greater than that of a gas standing contract customer.[92]

Consequently, the Commission assumed that the ratio of value per customer to profit per customer was the same between AGL SA's electricity customers and Origin Energy's gas customers. Using the equivalent of IPART's estimate of the one off acquisition cost of an electricity customer of $210.86, and assuming the respective profitability per electricity and gas customer has remained constant, ACG suggests that adopting the Commission's previous approach would result in a value for gas customers of $28.11.

Origin Energy has not suggested, or provided evidence, to the Commission that its cost to serve South Australian standing contract customers is significantly different from that incurred in serving its small gas and electricity customers generally. In addition, standing contract prices are either higher or the same as market contract prices. This implies that the value of gas standing contract customers is at least equal to that of gas customers generally.

There is economic justification for scaling down the value of an electricity customer to arrive at an appropriate value for a gas customer. As the average bill of a gas customer is substantially smaller than for an electricity customer, the present value of net cash flows from a gas customer is likely to be lower than from an electricity customer. For this reason, a rational energy market retailer should not be prepared to invest as much in acquiring a gas customer as it would for an electricity customer.

In response to the Commission's Draft Decision, Origin Energy provided data on the "value" of electricity and/or gas implied by the sale of gas and electricity retail businesses over the past 10 years. This data is summarised in Table 9.4, and

[91] Ibid, pp.101-102.

[92] ESCOSA 2005, Gas Standing Contract Price Path: Final Inquiry Report and Final Price Determination, Page A-93.

indicates that the value attributable to customers by these financial transactions has ranged from $458 to $1,300.

Table 9.4: Origin Energy implied customer values

COMPANY	DATE	E/G/DUAL	CUSTOMERS ('000)	PRICE ($M)	PRICE ($2007 /CUSTOMER)
UEL	2000	E	540	350	752
Powercor	2001	E	580	235	458
Citipower	2002	E	264	177	740
Energy21	1999	G	501	443	1,051
Ikon Gas	1999	Dual	1,100	858	928
Pulse	2002	Dual	1,080	880	900
Sun Retail	2007	E	833	916*	1,100
Powerdirect	2007	E	396	515**	1,300
Sun Gas	2007	G	71	75	1,050
International Power	2007	E	200	142***	710

*Removed $300m attributable to wholesale and LPG.
**Value attributed to Retail business.
*** For half of business.

However, the Commission considers that the most relevant measure is what it costs to organically acquire customers — the sale price of a retail business is likely to reflect a range of expectations about future return. Origin Energy acknowledges this, commenting that sale prices will also reflect the value of other assets, such as gas or electricity contracting positions.

Origin Energy has suggested that its gas customer acquisition costs are around $150 to $175 per customer. No information was presented to support this assertion.

The Commission has concluded that its estimated customer value of $28.11 is reasonable, although it acknowledges that it cannot be treated as a precise estimate given the various assumptions that underpin it. This highlights the limitations of using a bottom-up approach to determining the retail margin, and supports the Commission's approach of only using this analysis as a reasonableness check rather than as a determinant of the margin itself.

Amortisation of customer value

In calculating its annual return of customer value, Origin Energy amortises its assumed customer value over a 20 year period using straight line depreciation.

Customer acquisition activities are in the nature of an investment that pays returns over time, and hence the cost of acquiring a customer (or amortisation of customer value) should be spread over an appropriate period of time.

ACG argues that rather than using straight line depreciation, a more appropriate approach would be to calculate an annuity, using Origin Energy's cost of capital as the discount rate. This would give a fixed (in real terms if the real discount rate in used) annual amortisation amount.

Working Capital Requirements

ACG recommended that, in establishing the bottom-up retail margin, adjustments were required to Origin Energy's approach to calculating the working capital requirement to reduce the average prepayment period of distribution charges and the average payment lag of retail customers.

Return of assets

ACG assessed Origin Energy's depreciation on capital assets as plausible.

Return on assets

Origin Energy used a real pre tax WACC of 8% in its margin calculations. ACG accepted Origin Energy's proposed WACC and used it in its calculations, other than for the calculation of the required return on working capital, where ACG used a nominal WACC.

Alternative Retail Margin

ACG calculated retail margins using a bottom up approach under a variety of assumptions, all using Origin Energy's estimates of budgeted costs for 2007-08. The Commission has reviewed the assumptions underpinning each of these scenarios, and has concluded that the most plausible and informative scenario for this Inquiry incorporates:

- the adjustments to Origin Energy's working capital approach;
- the return on and of gas customer value recovered through an annuity; and
- a gas customer value of $28.11, consistent with the Commission's approach in its 2005 decision.

The estimate of a retail margin allowance using the abovementioned bottom up approach generates a margin on controllable costs of 13.05% and an equivalent margin on sales of 5.63%. The Commission stresses, however, that this calculation depends critically on the assumed customer value, which is itself difficult to determine. For this reason, the Commission has not placed significant

weight on this analysis for the purposes of determining a retail margin, and has treated the outcomes as indicative only.

9.5.4 Benchmarking retail margins

The benchmarking analysis undertaken for the Commission by ACG concludes that there is limited information available about the establishment of retail margin allowances in Australian gas markets.[93]

However, gas retail margin decisions analysed in ACG's benchmarking report are not recent and have been made under very different regulatory regimes to that of South Australia. Consequently, the Commission has only considered the retail margins included in recent electricity regulatory decisions. Table 9.5 summarises the relevant aspects of the more detailed benchmarking information provided in Table 9.5.

Table 9.5: Retail margin allowances in other jurisdictions (% of sales revenue)

DECISION	RETAIL MARGIN
Queensland Competition Authority (2008) [94]	5%
Independent Pricing & Regulatory Tribunal (2007)[95]	5%
Essential Services Commission of South Australia (2007) [96]	Equivalent to 5%
Independent Competition & Regulatory Commission (2007)[97]	4%

Given the lack of truly relevant decisions to this Inquiry, the Commission is not able to place any significant reliance on the outcome of this analysis.

9.6 Final Conclusion

If the Commission were to adopt the approach to setting the retail margin allowance for South Australian gas standing contract customers it used in its 2005 decision, the margin on controllable costs would be 10%. This would be consistent with relevant electricity retail price decisions.

If the Commission were to adopt the approach to setting the retail margin allowance it used in its 2005 decision, but incorporated an allowance for the changed assumptions in

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[93] The Allen Consulting Group, South Australian Gas Standing Contract Prices — Price Path Review and Inquiry: Benchmarking Analysis - Report to the Essential Services Commission of South Australia, March 2008.

[94] Charles River and Associates (CRA) 2008, Calculation of the Benchmark Retail Cost Index for 2007-08 and 2008-09, Prepared for the Queensland Competition Authority, 24 January 2008

[95] Independent Pricing & Regulatory Tribunal, *Promoting retail competition and investment in the NSW electricity industry Regulated electricity retail tariffs and charges for small customers 2007 to 2010: Final Report and Final Determination*, June 2007.

[96] Essential Services Commission of South Australia (ESCOSA) 2007, Final Inquiry Report and Price Determination: 2007 Review of Retail Electricity Price Path.

[97] Independent Competition & Regulatory Commission, *Final decision: Retail prices for non-contestable electricity customers*, June 2007.

respect of payment terms for distribution charges, the margin on controllable costs would be 12.3%.

If the Commission were to adopt the bottom up approach to setting the retail margin allowance that it considers most plausible, the margin on controllable costs would be 13.05%. The Commission, however, reiterates that this estimate is indicative only as it relies on unverified information provided by Origin Energy in support of its retail margin proposal and is dependent on assumptions regarding customer values, which the Commission acknowledges is difficult to estimate.

The Commission considers it appropriate to adjust the retail margin allowance to account for the changed assumptions in respect of payment terms for distribution charges since its 2005 decision. Therefore, the Commission considers that the derived margin under this approach of 12.3%forms a reasonable estimate. However, the Commission acknowledges that the bottom-up analysis supports a retail margin that is greater than this amount, albeit the extent to which it may be greater is somewhat uncertain. The Commission continues to consider that a bottom up margin of 13.05%is a reasonable estimate, and that this supports the 12.3%derived margin. Based on these two approaches, the Commission's final decision is to approve a retail operating margin of 13% of controllable costs for each year of the price path period.

10 SUMMARY OF FINAL DECISION ON RETAILER CONTROLLABLE COSTS

The Commission's Final Decision on the retailer controllable cost components of the gas standing contract price (that is: wholesale gas costs; transmission costs; and retail operating costs) are as follows:

Table 10.1. Final Decision on retailer controllable costs 2008/09 to 2010/11: weighted average of 5 regions (GST exclusive in $Dec 08)

RESIDENTIAL				
		2008/09	2009/10	2010/11
Wellhead	$/GJ	3.78	3.79	3.87
MDQ	$/GJ	0.62	0.62	0.62
Swing gas	$/GJ	0.02	0.02	0.02
COST OF GAS	**$/GJ**	**4.42**	**4.43**	**4.51**
Fixed TUOS main	$/GJ	1.54	1.54	1.54
Fixed TUOS lateral	$/GJ	0.05	0.05	0.06
Variable TUOS	$/GJ	0.10	0.10	0.10
TRANSMISSION COST	**$/GJ**	**1.69**	**1.69**	**1.70**
ROC (ex-FRC)	$/customer	80.85	80.85	80.85
FRC costs	$/customer	20.62	9.03	9.03
RETAIL OPERATING COST	**$/CUSTOMER**	**101.47**	**89.88**	**89.88**

SME				
		2008/09	2009/10	2010/11
Wellhead	$/GJ	3.78	3.79	3.87
MDQ	$/GJ	0.28	0.28	0.28
Swing gas	$/GJ	0.02	0.02	0.02
COST OF GAS	**$/GJ**	**4.08**	**4.09**	**4.17**
Fixed TUOS main	$/GJ	1.08	1.08	1.08
Fixed TUOS lateral	$/GJ	0.04	0.04	0.04
Variable TUOS	$/GJ	0.10	0.10	0.10
TRANSMISSION COST	**$/GJ**	**1.22**	**1.22**	**1.22**
ROC (ex-FRC)	$/customer	80.85	80.85	80.85
FRC costs	$/customer	20.62	9.03	9.03
RETAIL OPERATING COST	**$/CUSTOMER**	**101.47**	**89.88**	**89.88**

In addition to these amounts, the Commission has determined that a retail margin of 13% of these controllable costs is appropriate for the standing contract price.

10.1 Determination of Price Path

Having made its final determination on these building block components, the Commission has calculated separate "notional" annual retailer revenue requirements for the residential and SME segments based on the unit cost allowances for these components and the Commission's forecasts of consumption and customer numbers.

The Commission's Final Decision on the maximum average revenue to apply for each customer segment during 2008/09, and the manner in which this amount changes in subsequent years (determined by the X factor), has been set to ensure that the present value of this "smoothed" revenue stream over the three-year period is equal to the present value of the "notional" revenue requirement derived from the building block components.

The Final Decision on the maximum average retailer revenue in 2008/09 (expressed in $Dec 08) is $11.81/GJ for residential customers and $6.76/GJ for SME customers. These amounts incorporate the actual change in the March 07 to March 08 CPI of 4.24%, whereas the cost components discussed in previous chapters are all based on an assumed 3% inflation for this year. The Commission has removed this forecast inflation when determining the aggregate revenue requirement, rather than updating each cost component. This provides for the ability to compare the Commission's decision with the Origin Energy proposal, without having to adjust for differences in the treatment of inflation.

Under this Final Decision, the 2008/09 maximum average revenue for residential customers will be escalated by CPI+1% on 1 July 2009 and 1 July 2010. The SME maximum average revenue will be escalated by CPI+0.8% on 1 July 2009 and 1 July 2010. Under these price paths, the amount of revenue that is expected to be recovered by Origin Energy from standing contract customers in 2010/11 will align closely with the costs that are expected to be incurred by Origin Energy in retailing to standing contract customers for that year. This is designed to minimise any price shocks on 1 July 2011, at the end of this price path.

Table 10.2. Retail Component of Gas Standing Contract Price
Origin Energy proposed price path vs. Commission's final price path

	1 Jul 08	1 Jul 09	1 Jul 10
Residential Customers			
Origin Energy Proposal	8.6%	CPI + 1.6%	CPI + 2.2%
Commission's final price path	8.25%	CPI + 1%	CPI + 1%
SME customers			
Origin Energy Proposal	17.25%	CPI + 0.7%	CPI + 1.6%
Commission's final price path	15.0%	CPI + 0.8%	CPI + 0.8%

11 CUSTOMER IMPACT

The decisions made by the Commission in the Gas Standing Contract Price Path Inquiry ultimately impact the gas retail tariffs charged by Origin Energy to its standing contract customers.

In this price-setting process, the Commission is only considering the retailer component of gas standing contract prices. In addition to this component, standing contract prices include Envestra distribution charges and REMCo retail market administration charges, both of which are regulated separately by the Commission. The retailer component of tariffs accounts for just under half of a total bill for a small customer.

In order to estimate the approximate effect of this decision on an annual gas bill, the Commission compares below the annual gas bill that a typical standing contract customer would have received in 2007/08 to the bill that would result from the Final Price Determination for 2008/09. The analysis is presented for both residential and SME customers.

The elements of the analysis are:

- ▲ Estimating a standing contract annual bill for both 2007/08 and 2008/09 – for an average residential customer consuming 22 GJ and for an average SME customer consuming 156 GJ of gas annually.
- ▲ The calculations are based on the actual retailer tariffs that applied in 2007/08 and those that will apply from 1 July 2008.
- ▲ All amounts are quoted GST exclusive in nominal terms.

As a result of the Commission's Final Decision, it is expected that a typical residential gas bill in 2008/09 (for a residential customer consuming 22 GJ annually) will increase by approximately $15 (around 3% of the total annual bill).

Table 3.1 below shows the approximate effect on the retailer component of an annual residential gas bill resulting from the Commission's Final Price Determination. It is noted that the retailer component represents around 48% of the total residential bill.

Table 11.1: Annual Residential Gas Bill Comparison

RESIDENTIAL GAS BILL COMPARISON (GST EXCLUSIVE)	2007/08	2008/09
Annual Retail Charge (Nominal $) - Origin Energy	$ 251.16	$ 266.57

Given the diverse nature of SME, the use of averages is less meaningful than for residential consumption. Nevertheless, a similar bill impact analysis is provided for an SME customer over the same period.

It is expected that a typical SME gas bill in 2008/09 (for a SME customer consuming 156 GJ annually) will increase by approximately $127 (around 6% of the total annual bill), as a result of the Commission's final decision.

Table 11.2 below shows the approximate effect on the retailer component of an annual SME gas bill resulting from the Commission's Final Price Determination.

Table 11.2: Annual SME Gas Bill Comparison

SME GAS BILL COMPARISON (GST EXCLUSIVE)	2007/08	2008/09
Annual Retail Charge (Nominal $) - Origin Energy	$ 947.50	$ 1,074.57

The initial price rise in 2008/09 over the three year price path period largely reflects increases in wholesale gas supply costs and an increased retail margin to reflect arrangements for payment of distribution charges in SA, which has working capital implications for the standing contract retailer.

The Commission notes that data collected under Energy Industry Guideline No. 2 in March 2008, indicates that standing contracts are currently used by less than 40% of all small customers in South Australia. Many small customers have moved to market contracts, offered by either the incumbent or another gas retailer, and these have continued to offer lower rates than the standing contracts. Therefore, the bill impacts outlined above apply to fewer than half of the total number of small customers.

As market contracts continue to offer lower rates than the standing contracts, customers remaining on the standing contract can ameliorate the effects of the new price path by moving to a market contract.

PART B

- PRICE DETERMINATION -

PART B –PRICE DETERMINATION

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1 GENERAL

1.1 Authority

1.1.1 This Standing Contract Price Determination is made by the *Commission* under Part 3 of the Essential Services Commission Act 2002 as authorised by sections 34A and 33(1)(a) of the Gas Act 1997.

1.2 Term

1.2.1 Subject to clause 1.2.2, this Standing Contract Price Determination takes effect on the *commencement date* and ceases to have effect on 30 June 2011.

1.2.2 Clause 1.8.1 of this Standing Contract Price Determination comes into effect on the day that this Standing Contract Price Determination is made by the *Commission* in accordance with the requirements of the Essential Services Commission Act 2002.

1.3 Revocation of previous price determinations

1.3.1 Pursuant to section 26(8) of the Essential Services Commission Act 2002, on and from the *commencement date* this Standing Contract Price Determination revokes the Standing Contract Price Determination made by the *Commission* on 28 June 2005.

1.3.2 Nothing in this Standing Contract Price Determination affects, and is not intended to affect, anything done or omitted to be done, or rights or obligations accrued, under any previous Standing Contract Price Determination made by the *Commission*.

1.4 Definitions and interpretation

1.4.1 Words and phrases in italics in this Standing Contract Price Determination are defined in clause 5.1 and the *Price Path Schedule*.

1.4.2 This Standing Contract Price Determination must be interpreted according to the principles in clause 5.2.

1.5 Application of standing contract price determination

1.5.1 This Standing Contract Price Determination applies only in respect of the sale and supply of *natural gas* to *standing contract customers* by the *declared retailer*.

1.5.2 This Standing Contract Price Determination:

(a) regulates the maximum *standing contract prices* which the *declared retailer* can charge *standing contract customers* for the sale and supply of *natural gas* during the *price path period*;

(b) specifies the principles, procedures and formulae which apply to the *declared retailer* during the *price path period* for altering, varying, opening or closing *standing contract prices*; and

(c) provides for the pass through of certain changes in the costs incurred by the *declared retailer* to *standing contract customers*.

1.6 Prices exclude GST

1.6.1 In this Standing Contract Price Determination, unless otherwise specified all references to prices, tariffs or tariff components that are or may be charged are references to those prices, tariffs or tariff components exclusive of *GST*.

1.7 Application of standing contract prices

1.7.1 Once a *standing contract price* has been set under this Standing Contract Price Determination, the *standing contract price*:

(a) cannot be varied except as provided for in this Standing Contract Price Determination; and

(b) continues to apply until the earlier of:

(i) the date (if any) specified in this Standing Contract Price Determination on which the *standing contract price* ceases to apply;

(ii) the date on which this Standing Contract Price Determination ceases to have effect.

1.8 Publication of standing contract prices

1.8.1 Prior to the *commencement date*, the *declared retailer* must publish:

(a) in the *Gazette* and on its website (in a prominent and readily accessible position), the *price list* specified in the *Initial Standing Contract Price Schedule*; and

(b) a notice in a newspaper circulating generally in the State setting out:

(i) the existence of the *standing contract price* and of the *price list* referred to in clause 1.8.1(a);

(ii) a general description of the nature and applicability of the *standing contract prices* set out in the *price list*; and

(iii) advice as to how the *price list* may be accessed.

1.8.2 On and from the *commencement date*, the *declared retailer* must:

(a) at all times maintain on its website (in a prominent and readily accessible position) an accurate and current *price list* setting out:

(i) all *standing contract prices* (*GST* exclusive and inclusive), and the criteria for assignment to each *standing contract price*;

(ii) each relevant *standing contract price component* (*GST* exclusive); and

(b) send (free of charge) a copy of the *price list* referred to in clause 1.8.2(a) to a *standing contract customer* on request;

1.8.3 On and from the *commencement date*, whenever a *standing contract price* is altered in accordance with Chapter 2, Chapter 3 or Chapter 4, or a new *standing contract price* is introduced or a *standing contract price* is closed in accordance with Chapter 3, the *declared retailer* must publish:

(a) in the *Gazette*, and on its website (in a prominent and readily accessible position) a notice setting out:

(i) the relevant altered, new or closed s*tanding contract price* or *standing contract prices* (*GST* exclusive and inclusive), and relevant assignment criteria; and

(ii) each relevant *standing contract price component* (*GST* exclusive).

(b) a notice in a newspaper circulating generally in the State setting out:

(i) the existence of the altered, new or closed *standing contract price* or *standing contract prices*;

(ii) a general description of the nature and applicability of the altered, new or closed *standing contract price* or *standing contract prices*; and

(iii) details of how the *price list* referred to in clause 1.8.2(a) may be accessed,

at least 10 *business days* prior to the commencement of the altered, new or closed *standing contract price* or *standing contract prices*.

1.9 Modification of time periods

1.9.1 If requested in writing by the *declared retailer*, the *Commission* may, by written notice to the *declared retailer*, extend:

(a) the time by which a thing required to be done by the *declared retailer* under this Standing Contract Price Determination must be done; or

(b) the period within which a thing required to be done by the *declared retailer* under this Standing Contract Price Determination must be done.

1.9.2 If the *Commission* makes a request for information for the purposes of making a decision or exercising any of its powers under this Standing Contract Price Determination, any time period within which the *Commission* is required to make a decision, notify any person or exercise any of its powers under this Standing Contract Price Determination:

(a) stops running on the date the request is made; and

(b) starts to run again on the date that the *Commission* notifies the *declared retailer* in writing that the *Commission* is satisfied that the requested information has been provided.

1.9.3 If the *Commission* makes a request for information under clause 1.9.2, it will notify the *declared retailer*:

(a) as soon as practicable after the request for information has been made, of the date the relevant time period stopped running; and

(b) as soon as practicable after the *Commission* has decided that any information received satisfies the request for information, of the date the relevant time period started to run again.

1.10 Reviews of decisions

1.10.1 The *declared retailer* may make an application to the *Commission* for a review of a decision made, or deemed to have been made, by the *Commission* under this Standing Contract Price Determination.

1.10.2 The only grounds for a review under this clause 1.10 are that a decision made, or deemed to have been made, by the *Commission* under this Standing Contract Price Determination:

(a) was not made in accordance with the requirements of this Standing Contract Price Determination;

(b) is unreasonable having regard to all the relevant circumstances; or

(c) is based wholly or partly on an error of fact in a material respect.

1.10.3 An application for a review of a decision must:

(a) be in writing; and

(b) set out the decision made, or deemed to have been made, by the *Commission* under this Standing Contract Price Determination, to which the application relates; and

(c) set out in detail the grounds on which the *declared retailer* seeks review and the decision sought on the review; and

(d) be accompanied by any information that the *declared retailer* considers should be taken into account by the *Commission* in the review; and

(e) be lodged with the *Commission* within 10 *business days* after the decision made, or deemed to have been made, by the *Commission* under this Standing Contract Price Determination, is published.

1.10.4 The *Commission* will not enter into a review of a decision made, or deemed to have been made, by the *Commission* under this Standing Contract Price Determination where it believes that:

(a) the application for review is vexatious; or

(b) the subject matter of the application is trivial, misconceived or lacking in substance.

1.10.5 If an application is made for a review of a decision made, or deemed to have been made, by the *Commission* under this Standing Contract Price Determination, the *Commission*:

(a) will publish a copy of the application on its website; and

(b) may invite submissions on the matter the subject of the review in a manner and within a period specified by the *Commission*.

1.10.6 A review will be decided within 6 weeks of the application being lodged with the *Commission*.

1.10.7 If a review is not decided within that period, the *Commission* will be taken to have confirmed the decision made, or deemed to have been made, by the *Commission* under this Standing Contract Price Determination on the same grounds on which the original decision was made.

1.10.8 After considering the application, the *Commission* may confirm, vary or substitute the decision.

1.10.9 The *Commission* will give the applicant and any other person who provides a submission to the review written notice of the *Commission's* decision under clause 1.10.8 and the reasons for that decision.

1.10.10 A decision of the *Commission* made under clause 1.10.8 may not be the subject of an application for review under this clause 1.10.

1.11 Collection and use of information

1.11.1 Any information required to be provided by the *declared retailer* in accordance with this Standing Contract Price Determination is required by the *Commission* to be provided pursuant to Part 5 of the Essential Services Commission Act 2002.

2 STANDING CONTRACT PRICE

2.1 Maximum standing contract price

2.1.1 The *declared retailer* must not charge a *standing contract customer* a *standing contract price* in respect of a *connection point* which is greater than an amount calculated in accordance with this Chapter 2.

2.2 Initial standing contract prices at the commencement date

2.2.1 The maximum *standing contract price* which the *declared retailer* may charge a *standing contract customer* in respect of a *connection point* at the *commencement date* must be calculated in accordance with the *initial standing contract prices* as set out in the *Initial Standing Contract Price Schedule*.

2.3 Standing contract price components

2.3.1 The *standing contract prices* set under this Standing Contract Price Determination are comprised of the following *standing contract price components*:

(a) the *distribution tariff* charges applicable to each relevant *connection point*;

summed with,

(b) the *REMCo charges* applicable each relevant *connection point*;

summed with,

(c) the *retailer tariff* charges applicable to each relevant *connection point* in accordance with Chapter 2 and Chapter 3, calculated in accordance with the formulae and principles set out in the *Price Path Schedule*;

summed with,

(d) any *pass through amounts* approved by the *Commission* under Chapter 4.

2.4 Pass through of distribution tariffs

2.4.1 The *declared retailer* must, for each relevant *connection point*, pass through to a *standing contract customer* the *distribution tariff* charges applicable to that *connection point* as fixed from time to time.

2.5 Standing contract price assignment

2.5.1 At the *commencement date*, the *declared retailer* must assign each of its *standing contract customers* to a *retailer tariff* and associated *standing contract price* as set

out in the *Initial Standing Contract Price Schedule* in respect of each of the *standing contract customer's connection points* in accordance with the criteria set out the *Initial Standing Contract Price Schedule*.

2.5.2 After the *commencement date*, the *declared retailer* must assign each of its *standing contract customers* to a *retailer tariff* and associated *standing contract price* in respect of each of the *standing contract customer's connection points* in accordance with the criteria set out in the *price list* referred to in clause 1.8.2(a).

2.5.3 In determining which *retailer tariff* and associated *standing contract price* a *standing contract customer* should be assigned to in respect of a *connection point* under clause 2.5.1 or clause 2.5.2, the *declared retailer* must treat *standing contract customers* in similar situations in a similar manner.

2.5.4 Nothing in this clause 2.5 will prevent a *standing contract customer* from exercising its right under clause 6.8 of Part A of the Energy Retail Code to apply to the *declared retailer* for assignment to a different *retailer tariff* and associated *standing contract price*.

2.6 Annual alteration of retailer tariffs

2.6.1 The *declared retailer* must, for each *regulatory period* after the *initial regulatory period*, give the *Commission* a statement for approval in accordance with clause 2.6.2 that:

(a) sets out the *declared retailer's* proposed *retailer tariffs* and *retailer tariff components* for the *regulatory period*; and

(b) demonstrates and explains how the compliance of the proposed *retailer tariffs* and *retailer tariff components* with this Chapter 2 and the relevant principles and formulae set out in the *Price Path Schedule*.

2.6.2 A statement referred to in clause 2.6.1 must be given to the *Commission* at least 35 *business days* but not more than 60 *business days* before the start of the *regulatory period*.

2.6.3 The *Commission* will publish a statement received under clause 2.6.1 on its website within 5 *business* days of receipt of the statement from the *declared retailer*.

2.7 Commission approval

2.7.1 The *Commission* will approve a statement given by the *declared retailer* under clause 2.6.1 if it is satisfied that:

(a) the statement demonstrates the compliance of the proposed *retailer tariffs* or *retailer tariff components* with this Chapter 2 and the relevant principles and formulae in the *Price Path Schedule*; and

(b) all forecasts and estimates included in the statement comply with clause 2.10; and

(c) no *retailer tariff* exceeds the maximum price which may be set for that *retailer tariff* in accordance with this Chapter 2 or the *Price Path Schedule*.

2.7.2 In determining whether or not to approve a statement given by the *declared retailer* under clause 2.6.1, the *Commission* will have regard to whether:

(a) the proposed revenue outcomes are consistent with the *price path formula* set out in the *Price Path Schedule*;

(b) the individual *retailer tariffs* are consistent with the *tariff rebalancing formula* set out in the *Price Path Schedule*; and

(c) the individual *retailer tariff components* are consistent with the requirements of clause 2.3 and clause 2.4.

2.7.3 If the *Commission* approves a statement given by the *declared retailer* under clause 2.6.1, it will:

(a) notify the *declared retailer* of that approval in writing within 20 *business days* of the *Commission* receiving the statement; and

(b) publish a notice on its website advising of the approval of the statement.

2.7.4 If the *Commission* does not approve a statement given by the *declared retailer* under clause 2.6.1, it will

(a) notify the *declared retailer* of that decision and the reasons for that decision in writing within 20 *business days* of the *Commission* receiving the statement; and

(b) publish a notice on its website advising of the non-approval of the statement.

2.7.5 If the *Commission* does not notify the *declared retailer* of the *Commission's* decision regarding a statement given under clause 2.6.1 within 20 *business days* of the *Commission* receiving the statement, the *Commission* is deemed to have approved the statement with effect from the 21st *business day* after the *Commission* receives the statement.

2.8 Replacement statement

2.8.1 If the *Commission* does not approve a statement given by the *declared retailer* under clause 2.6.1, the *Commission* may allow the *declared retailer* to replace the statement within 5 *business days* or such longer time as specified by the *Commission*.

2.8.2 A replacement statement under clause 2.8 will be taken to be a statement given under clause 2.6.1, except that:

(a) clause 2.8 does not apply to the replacement statement; and

(b) the time period in clause 2.7.5 will run from the date the *Commission* receives the replacement statement.

2.9 Required annual alteration

2.9.1 If;

(a) the *declared retailer* does not provide to the *Commission* the statement required under clause 2.6.1 in relation to a *regulatory period*;

(b) or, subject to clause 2.8, the statement required under clause 2.6.1 is provided but not approved by the *Commission*,

then the *Commission* will vary the relevant *retailer tariffs* and *retailer tariff components* for the *regulatory period* in a manner in which the *Commission* could have approved the *retailer tariffs* and *retailer tariff components* if included in a statement given by the *declared retailer* under clause 2.6.1.

2.9.2 The *Commission* will:

(a) notify the *declared retailer* in writing; and

(b) publish a notice on its website,

advising of any *retailer tariffs* or *retailer tariff components* varied by the *Commission* under clause 2.9.1.

2.10 Forecasts and estimates

2.10.1 For the purposes of a statement prepared by the *declared retailer* under this Chapter 2:

(a) forecasts of demand, energy and revenue for a *regulatory period* must be based on the best forecasts available at the time the statement is prepared; and

(b) estimates of demand, energy and revenue for a *regulatory period* must be based on the actual results for that part of the *regulatory period* that are available at the time the statement is prepared and the best forecasts available for the rest of the *regulatory period*.

2.11 Application of annual alterations

2.11.1 The *retailer tariffs* and *retailer tariff components:*

(a) in the statement given by the *declared retailer* under clause 2.6.1 which have been or are deemed to have been approved by the *Commission*; or

(b) varied by the *Commission* under clause 2.9.1,

must apply from the start of the *regulatory period* in which the *retailer tariffs* are to apply.

3 ALTERING, INTRODUCING AND CLOSING STANDING CONTRACT PRICES

3.1 Altering, introducing and closing standing contract prices

3.1.1 For any *regulatory period* after the *initial regulatory period*, the *declared retailer* may seek the *Commission's* approval to:

(a) introduce a new *standing contract price* from the commencement of that *regulatory period* as a result of the introduction of a new *retailer tariff* in accordance with clause 3.2;

(b) close a *standing contract price* from the commencement of that *regulatory period* as a result of the closure of a *retailer tariff* in accordance with clause 3.3.

3.2 New retailer tariffs

3.2.1 The *declared retailer* may introduce a new *retailer tariff* subject to the *Commission's* approval in accordance with clause 3.4.

3.2.2 To seek the *Commission's* approval to introduce a new *retailer tariff* under clause 3.2.1, the *declared retailer* must give the *Commission* a statement at least 60 *business days* before the commencement of the *regulatory period* setting out:

(a) a description of the service to which the new *retailer tariff* is to apply;

(b) details of the comparable *distribution tariff*;

(c) the proposed new *retailer tariff* and criteria for assignment to that *retailer tariff*;

(d) if the new *retailer tariff* is intended to replace an existing *retailer tariff*, details of the relevant existing *retailer tariff*;

(e) the effect of the proposed new *retailer tariff* on *standing contract customers*;

(f) information as to which of the *standing contract customers* that are currently assigned to the relevant existing *retailer tariff* are eligible to be assigned to the new *retailer tariff*;

(g) which classes of *standing contract customers* that are currently assigned to the relevant existing *retailer tariff* the *declared retailer* proposes to assign to the new *retailer tariff*;

(h) how the *declared retailer* proposes to calculate and present the *retailer tariff components* of the new *retailer tariff*, including how the relevant CPI will be calculated for the commencement of the *retailer tariff*;

(i) the revenue outcomes resulting from the introduction of the new *retailer tariff*, which must be consistent with the *average retailer price control* for the *regulatory period* as specified in the *Price Path Schedule*; and

(j) the compliance of the new *retailer tariff* with the principles and formulae specified in Schedule 2.B of the *Price Path Schedule*.

3.2.3 The *Commission* will publish a statement received under clause 3.2.2 on its website within 5 *business* days of receipt of the statement from the *declared retailer*.

3.2.4 If the *Commission* approves, or is deemed to have approved under clause 3.4, the introduction of the new *retailer tariff* in the statement given by the *declared retailer* under clause 3.2.2, the *declared retailer* must ensure that:

(a) all *standing contract customers* who are to be assigned to the new *retailer tariff* are notified of that assignment; and

(b) a notice is published in accordance with the requirements of clause 1.8; and

(c) the new *retailer tariff* only applies to a *standing contract customer* in accordance with the requirements of the Energy Retail Code.

3.3 Closing a standing contract price

3.3.1 The *declared retailer* may close a *retailer tariff* subject to the *Commission's* approval in accordance with clause 3.4.

3.3.2 To seek the *Commission's* approval to close a *retailer tariff* under clause 3.3.1, the *declared retailer* must give the *Commission* a statement at least 60 *business* days before the commencement of the *regulatory period* setting out:

(a) details of the *retailer tariff* which it proposes to close;

(b) the effect of the proposed closure on *standing contract customers*;

(c) the *retailer tariff* to which *standing contract customers* will be eligible to be assigned after the closure of the existing *retailer tariff*;

(d) the revenue outcomes resulting from the closure of the *retailer tariff*, which must be consistent with the *average retailer price control* for the *regulatory period* as specified in the *Price Path Schedule*; and

(e) the compliance of the revenue outcomes referred to in clause 3.3.2(d) with the principles and formulae specified in Schedule 2.B of the *Price Path Schedule*.

3.3.3 The *Commission* will publish a statement received under clause 3.3.2 on its website within 5 *business days* of receipt of the statement from the *declared retailer*.

3.3.4 If the *Commission* approves or is deemed to have approved under clause 3.4 the closure of the *retailer tariff* in the statement given by the *declared retailer* under clause 3.3.2, the *declared retailer* must ensure that:

(a) all *standing contract customers* that are affected by the closure and that are to be assigned to a different *retailer tariff* are notified of that assignment and the date from which that assignment will be effective; and

(b) a notice is published in accordance with the requirements of clause 1.8; and

(c) the different *retailer tariff* to which a *standing contract customer* is assigned under clause 3.3.4(a) only applies to the *standing contract customer* in accordance with the requirements of the Energy Retail Code.

3.4 Commission approval

3.4.1 The *Commission* will approve a statement given under clause 3.2.2 or clause 3.3.2 if it is satisfied that:

(a) the statement demonstrates compliance of the proposed *retailer tariffs* and *retailer tariff components* with the relevant principles and formulae in the *Price Path Schedule*; and

(b) all forecasts and estimates included in the statement comply with clause 3.5; and

(c) no *retailer tariff component* exceeds the maximum price which may be set for that *retailer tariff component* in accordance with Chapter 2; and

(d) no *retailer tariff* exceeds the maximum price which may be set for that *retailer tariff* in accordance with the principles and formulae set out in the *Price Path Schedule*.

3.4.2 If the *Commission* approves a statement given by the *declared retailer* under clause 3.2.2 or clause 3.3.2, it will:

(a) notify the *declared retailer* of that approval in writing within 40 *business days* of the *Commission* receiving the statement; and

(b) publish a notice on its website advising of the approval of the statement.

3.4.3 If the *Commission* does not approve a statement given by the *declared retailer* under clause 3.2.2 or clause 3.3.2, it will

(a) notify the *declared retailer* of that decision and the reasons for that decision in writing within 40 *business days* of the *Commission* receiving the statement; and

(b) publish a notice on its website advising of the non-approval of the statement.

3.4.4 If the *Commission* does not notify the *declared retailer* of the *Commission's* decision regarding a statement given by the *declared retailer* under clause 3.2.2 or clause 3.3.2 within 40 *business days* of the *Commission* receiving the statement, the *Commission* is deemed to have approved the statement with effect from the 41st *business day* after the *Commission* receives the statement.

3.4.5 If the *Commission* does not approve a statement given by the *declared retailer* under clause 3.2.2 or clause 3.3.2, the *Commission* may allow the *declared retailer* to replace the statement within such time as specified by the *Commission*.

3.4.6 A replacement statement under clause 3.4.5 will be taken to be a statement given under clause 3.2.2 or clause 3.3.2, except that:

(a) clause 3.4.5 does not apply to the replacement statement; and

(b) the time period in clause 3.4.4 will run from the date the *Commission* receives the replacement statement.

3.5 Forecasts and estimates

3.5.1 For the purposes of a statement prepared by the *declared retailer* under this Chapter 3:

(a) forecasts of demand, energy and revenue for a *regulatory period* must be based on the best forecasts available at the time the statement is prepared; and

(b) estimates of demand, energy and revenue for a *regulatory period* must be based on the actual results for that part of the *regulatory period* that are available at the time the statement is prepared and the best forecasts available for the rest of the *regulatory period*.

4 REGULATED PASS THROUGH

4.1 Relevant pass through event

4.1.1 A *relevant pass through event* is a:

(a) *change in taxes event*; or

(b) *regulatory reset event*; or

(c) *Ministerial directions event*.

4.2 Application by the declared retailer

4.2.1 If a *relevant pass through event* occurs, the *declared retailer* may seek the *Commission's* approval to pass through a *pass through amount* in relation to the amounts that the *declared retailer* is otherwise permitted to charge as a *retailer tariff* pursuant to Chapter 2.

4.2.2 To seek the *Commission's* approval to pass through a *pass through amount* under clause 4.2.1, the *declared retailer* must give the *Commission* a statement within 60 *business days* of the *relevant pass through event* occurring, specifying:

(a) details of the *relevant pass through event*;

(b) the date the *relevant pass through event* took or takes effect;

(c) the estimated financial effects of the *relevant pass through event* on the provision of *standing contracts* by the *declared retailer*;

(d) the pass through amount the *declared retailer* proposes in relation to the *relevant pass through event*;

(e) the basis on which the *declared retailer* proposes to apply the *pass through amount* to *retailer tariffs*; and

(f) the date from, and period over which, the *declared retailer* proposes to apply the *pass through amount*.

4.2.3 The *Commission* will publish a statement received under clause 4.2.2 on its website within 5 *business* days of receipt of the statement from the *declared retailer*.

4.3 Approval by Commission

4.3.1 If the *Commission* receives a statement under clause 4.2.2 in relation to a *relevant pass through event*, the *Commission* will decide whether the *relevant pass through event* occurred and, if the *Commission* decides the *relevant pass through event* occurred, the *Commission* will:

(a) decide the *pass through amount*;

(b) decide the basis on which the *pass through amount* may be applied to *retailer tariffs*;

(c) decide the date from, and period over which, the *pass through amount* may be applied,

and,

(d) notify the *declared retailer* of those decisions in writing within 30 *business days* of the *Commission* receiving the statement; and

(e) publish a notice on its website advising of the *Commission's* decisions.

4.3.2 If the *Commission* does not approve a statement given by the *declared retailer* under clause 4.2.2, it will

(a) notify the *declared retailer* of that decision and the reasons for that decision in writing within 30 *business days* of the *Commission* receiving the statement; and

(b) publish a notice on its website advising of the non-approval of the statement.

4.3.3 If the *Commission* does not give a notice to the *declared retailer* under clause 4.3.1 or clause 4.3.2 within 30 *business days* of receiving a statement from the *declared retailer* under clause 3.2.2 on the 31st *business day* after receiving the *declared retailer's* statement, the *Commission* is deemed to have notified the *declared retailer* of its decision that the *pass through amount* and the basis on, date from and period over which the *pass through amount* may be applied are as specified in the *declared retailer's* statement.

4.4 Required pass through

4.4.1 If a *relevant pass through event* occurs, and the *declared retailer* does not give the *Commission* a statement under clause 4.2.2 concerning the *relevant pass through event*, the *Commission* may require the *declared retailer* to pass through

a *pass through amount* in relation to the amounts that the *declared retailer* is otherwise permitted to charge as *retailer tariffs* pursuant to Chapter 2.

4.4.2 If the *Commission* decides to require the *declared retailer* to pass through a *pass through amount*, the *Commission* will decide:

(a) the *pass through amount*;

(b) the basis on which the *pass through amount* may be applied to *retailer tariffs*; and

(c) the date from, and period over which, the *pass through amount* must be applied,

and notify the *declared retailer* in writing of the *Commission's* decision and the reasons for the *Commission's* decision.

4.5 Relevant factors

4.5.1 In making a decision under clause 4.3, the *Commission* will take into account the matters and proposals set out in the *declared retailer's* statement.

4.5.2 In making a decision under clause 4.3 or clause 4.4, the *Commission* will seek to ensure that the financial effect on the *declared retailer* associated with the *relevant pass through event* concerned is economically neutral, taking into account:

(a) the numbers of *standing contracts customers* subject to each *retailer tariff*;

(b) the time cost of money for the period over which the *pass through amount* is to be applied;

(c) the basis on and period over which the *pass through amount* is to be applied;

(d) the financial effect on the *declared retailer* associated with the provision of *retail services* directly attributable to the *relevant pass through event* and the time at which the financial effect arises;

(e) any *pass through amount* applied under this Chapter 4 relating to a previous *relevant pass through event* in the same category, which resulted in the *declared retailer* recovering an amount either more or less than the financial effect on the *declared retailer* of that previous *relevant pass through event*;

(f) in relation to a *change in taxes event*:

(i) any change in the way or rate at which another tax is calculated, or the removal or imposition of another tax, which, in the *Commission's* opinion, is complementary to the *change in taxes event* concerned; or

(ii) the effect of any other previous *change in taxes event* that has occurred since the later of the *commencement date* and the last decision made under this Chapter 4 in relation to a *change in taxes event*; and

(g) any other factors the *Commission* considers relevant.

4.6 Application of pass through amount

4.6.1 The *declared retailer* must, after:

(a) receipt or deemed receipt of a notice under clause 4.3, or receipt of a notice under clause 4.4, allowing or requiring the *declared retailer* to pass through a *positive pass through amount*; and

(b) ensuring its *standing contract customers* are notified of:

(i) the *positive pass through amount* which the *Commission* has approved or is deemed to have approved; and

(ii) the circumstances giving rise to the *positive pass through amount*; and

(iii) the basis on, date from and period over which the *positive pass through amount* will be applied to the *standing contract prices*,

apply the *positive pass through amount* on the basis, from the date and over the period specified or deemed to be specified in the notice from the *Commission*.

4.6.2 The *declared retailer* must, after:

(a) receipt or deemed receipt of a notice under clause 4.3, or receipt of a notice under clause 4.4, allowing or requiring the *declared retailer* to pass through a *negative pass through amount*; and

(b) ensuring its *standing contract customers* are notified of:

(i) the *negative pass through amount* which the *Commission* has approved or is deemed to have approved; and

(ii) the circumstances giving rise to the *negative pass through amount*; and

(iii) the basis on, date from and period over which the *negative pass through amount* will be applied to the *standing contract prices*,

apply the *negative pass through amount* on the basis, from the date and over the period specified or deemed to be specified in the notice from the *Commission*.

4.6.3 The effect of any *pass through amount* must be notified to *standing contract customers* in a manner approved by the *Commission*.

4.7 Price path calculations

4.7.1 A *pass through amount* applied by the *declared retailer* under this Chapter 4 will not be:

(a) taken into account in deciding:

(i) the *declared retailer's* revenues, *retailer tariffs* or *retailer tariff components* used in the *Price Path Schedule*; or

(ii) whether the *declared retailer's retailer tariffs* or *retailer tariff components* comply with the principles and formulae in the *Price Path Schedule*, or

(b) subject to the procedures specified in Chapter 2.

5 DEFINITIONS AND INTERPRETATION

5.1 Definitions

In this Standing Contract Price Determination:

"***average retailer price control***" means the maximum amount which the *declared retailer* may earn per gigajoule of gas sold and supplied to *standing contract customers*, as calculated in accordance with clause 5.2.7 and the *Price Path Schedule*.

"***billing cycle***" means the regular recurrent period for which a *standing contract customer* receives a bill from the *declared retailer* in relation to a *standing contract*.

"***business day***" means a day on which banks are open for general banking business in Adelaide, other than a Saturday or a Sunday.

"***change in taxes event***" means:

a) a change in (or change in application or official interpretation of) a *relevant tax* or the way in which a *relevant tax* is calculated;

b) the removal of a *relevant tax*; or

c) the imposition of a *relevant tax*,

applicable only to the Australian gas supply industry to the extent that the change, removal or imposition applies to the provision of *retail services* by the *declared retailer* or services supplied to the *declared retailer* in respect of the provision of *retail services* by the *declared retailer* as a result of which the *declared retailer* would incur materially higher or lower costs in providing *standing contracts* than it would have incurred but for that event.

"***Commission***" means the Essential Services Commission established under the Essential Services Commission Act 2002.

"***commencement date***" means 1 July 2008.

"***connection point***" means the point of connection between a *standing contract customer's* gas installation and the gas distribution network.

"***distribution tariff***" means the tariff for gas distribution services provided by *Envestra* applicable to a *connection point* from time to time as set in accordance with the Access Arrangement approved by the Commission for the purposes of the Gas Pipelines Access (South Australia) Act 1997 or any alternative access agreement in place between *Envestra* and the *declared retailer* (as the case may be).

“***distribution tariff component***” means an individual price element comprising part of a *distribution tariff*.

“***declared retailer***” means the retailer declared under section 34A of the Gas Act 1997 and, as at the *commencement date*, is Origin Energy Retail Ltd (ACN 078 868 425).

“***Envestra***” means Envestra Limited (ACN 078 551 685).

“***Gazette***” means the South Australian Government Gazette.

“***GST***” means the tax imposed under G*ST Law*.

“***GST Law***” has the meaning attributed in the A New Tax System (Goods and Services Tax) Act 1999, and terms related to GST such as “ABN”, “Input Tax Credit”, “Taxable Supply” and “Tax Invoice” have the meaning attributed in the *GST Law*.

“***initial regulatory period***” means the period 1 July 2008 to 30 June 2009.

“***initial average retailer price control***” means the value fixed in Schedule 2.A(a)(ii).

“***initial standing contract prices***” means the *standing contract prices* listed in the *Initial Standing Contract Price Schedule* which the *declared retailer* may charge *standing contract customers* from the *commencement date* until the *standing contract price* is first varied in accordance with Chapter 2.

“***Initial Standing Contract Price Schedule***” means Schedule 1 of this Standing Contract Price Determination.

“liquefied petroleum gas” means a hydrocarbon fluid composed predominantly of one or more of the following hydrocarbons:

a) propane (C_3H_8);

b) propene (propylene) (C_3H_6);

c) butane (C_4H_{10});

d) butene (butylene) (C_4H_8);

“Ministerial directions event” means a direction given by the Minister under section 37 of the Gas Act 1997 to the *declared retailer* as a result of which the *declared retailer* incurs materially higher or lower costs in providing *standing contracts* that it would have incurred by for that event.

“***natural gas***” has the meaning given to that term in AS 4564 and, for the avoidance of doubt, does not include *liquefied petroleum gas*.

“***negative pass through amount***” means, in relation to a *relevant pass through event*:

a) an amount that the *declared retailer* is required to pay its *standing contract customers*; or

b) the extent of the reduction in payments by *standing contract customers* to the *declared retailer*.

“***non-residential customers***” means *standing contract customers* other than *residential customers*.

“pass through amount” means a *positive pass through amount* or a *negative pass through amount*.

“***positive pass through amount***” means, in relation to a *relevant pass through event:*

a) an amount that *standing contract customers* are required to pay the *declared retailer*; or

b) the extent of the increase in payments by *standing contract customers* to the *declared retailer*.

“***price list***” means the *price list* under clause 1.8 and is the “price list” for the purposes of the Standing Contract specified in Part C of the Energy Retail Code made by the *Commission* pursuant to section 28 of the Essential Services Commission Act 2002 as in force from time to time.

“***price path formula***” means the *average retailer price control* formula specified in Schedule 2.A of the *Price Path Schedule*.

“***price path period***” means the period 1 July 2008 to 30 June 2011.

“***Price Path Schedule***” means Schedule 2 of this Standing Contract Price Determination.

“***regulatory period***” means each period of 12 months ending on 30 June during the *price path period*.

“***regulatory reset event***” means:

a) a material change in the obligation imposed under section 34A of the Gas Act 1996 for the *declared retailer* to offer to sell and supply gas to *small customers*; or

b) a decision made by the *Commission*, the Australian Energy Regulator, the Australian Energy Markets Commission, the South Australian Government or the Commonwealth Government after the *commencement date*:

i. imposing a set of minimum standards on the *declared retailer* in respect of the provision of *standing contracts* that are different from the set of minimum standards imposed on the *declared retailer* in respect of the provision of *standing contracts* at the *commencement date*; or

ii. requiring the *declared retailer* to purchase financial products in respect of the sale and supply of gas based on a specified environmental outcome or outcomes; or

iii. requiring the *declared retailer* to participate in a scheme related to a specified environmental or energy efficiency outcome or outcomes,

as a result of which the *declared retailer* would incur materially higher or lower costs in providing *standing contracts* than it would have incurred but for that event.

"***relevant pass through event***" has the meaning given in clause 4.1.

"***relevant tax***" means any tax imposed by or payable directly or indirectly to any Authority of the Commonwealth of Australia or Authority of the State of South Australia, (including a goods and services tax), but excluding any:

a) income tax (or State equivalent income tax), fringe benefits tax or capital gains tax;

b) payroll tax;

c) land tax or any other tax on the ownership or occupancy of premises;

d) customs and import duties;

e) municipal rates, taxes and other charges imposed by local authorities;

f) stamp duty, financial institutions duty, bank accounts debits tax or similar taxes and duties;

g) penalties and interest for late payments relating to any tax; or

h) any tax that replaces any of the taxes referred to in (a) to (h).

"***REMCo charges***" means the charges payable by the *declared retailer*, calculated on a per *connection point* basis across the *declared retailer's* entire customer base, to Retail Energy Market Company Limited (ACN 103 318 556) in respect of Retail Energy Market Company Limited's operations carried out under the authority of its retail market administrator's licence.

"***residential customer***" means a *standing contract customer* whose gas consumption relates to premises used wholly or principally as private residences.

“***retail services***” means the services provided by the *declared retailer* in respect of the provision of *standing contracts* to *small customers*.

“***retailer tariff***” means the tariffs the *declared retailer* may charge a *standing contract customer* at a *connection point* in relation to *retail services* calculated in accordance with Chapter 2.

“***retailer tariff component***” means an individual price element comprising part of a *retailer tariff*.

“***small customer***” has the meaning given to that term in the Gas Act 1997.

“***SME customer***” means a *standing contract customer* other than a *residential customer*.

“***standing contract***” means a contract for the sale and supply of gas entered into by the *declared retailer* and a *small customer* in accordance with section 34A of the Gas Act 1997.

“***standing contract customer***” means a *small customer* who has entered into a *standing contract* with the *declared retailer* in accordance with section 34A of the Gas Act 1997.

“***standing contract price***” means the prices fixed under this Standing Contract Price Determination for the sale and supply of *natural gas* for the purposes of section 34A of the Gas Act 1997.

“***standing contract price component***” means each of the price elements of a *standing contract price* specified in clause 2.3.

“***tariff rebalancing formula***” means the formula specified in Schedule 2.B of the *Price Path Schedule*.

5.2 Principles of Interpretation

Unless the contrary intention appears, these principles of interpretation apply to this Standing Contract Price Determination:

5.2.1 Words denoting persons include corporations, unincorporated associations, firms, governments and governmental agencies.

5.2.2 A reference to a person includes that person's agents, successors and permitted assigns, persons who have control over any assets of a person and receivers, managers, trustees, administrators and liquidators and similar persons appointed over:

(a) a person; or

(b) any assets of a person;

5.2.3 Headings are only included for convenience and do not affect the interpretation of this Standing Contract Price Determination.

5.2.4 A reference to a clause, Chapter, Part or Schedule is to a clause, Chapter or Part of or Schedule to this Standing Contract Price Determination.

5.2.5 A reference to an agreement, document or regulatory instrument is a reference to that agreement, document or regulatory instrument as varied or replaced from time to time and includes any Schedules or attachments to the agreement, document or regulatory instrument.

5.2.6 A reference to legislation or to a provision of the legislation includes a modification or re-enactment of it, a legislative provision substituted for it and a regulation or statutory instrument issued under it.

5.2.7 For the purposes of calculating the *average retailer price control*:

(a) maximum revenue in dollars per gigajoule must be measured to a minimum of two decimal places; and

(b) a consistent approach to rounding must be used in each *regulatory period*.

5.2.8 All *standing contract prices* calculated under this Standing Contract Price Determination must be rounded to the accuracy, in terms of the number of decimal places, required by the *declared retailer's* charging and billing systems.

5.2.9 A *standing contract price* that has been calculated and rounded under the principles in clause 5.2.8 must not be rounded to a different level of accuracy when utilised in calculations made under this Standing Contract Price Determination.

5.2.10 CPI is to be calculated in accordance with clause 2.A(a) of the *Price Path Schedule*.

5.2.11 When a calculation is required under this Standing Contract Price Determination:

(a) *Regulatory period* "*t*" is the *regulatory period* in respect of which the calculation is being made; and

(b) *Regulatory period* "*t-1*" is the *regulatory period* immediately preceding *regulatory period* "*t*".

SCHEDULE 1 INITIAL STANDING CONTRACT PRICE SCHEDULE

The various maximum *standing contract prices* apply according to the geographical region in which a *standing contract customer's connection point* is located and according to whether the *standing contract customer* is a *residential customer* or an *SME customer*.

METROPOLITAN AREA

(Areas of the State of South Australia other than Mt Gambier, Port Pirie, Whyalla, Riverland and Murray Bridge but including Barossa and Peterborough)

These maximum *standing contract prices* are applicable to all meter readings or estimates from 1 July 2008 and are to be applied pro rata to the number of days in the billing period from 1 July 2008. All prices below are maximum per quarter prices.

Residential Customers

For gas sold and supplied from 1 July 2008 to residential customers the following charges, which are exclusive of GST, apply.	
Supply Charge per quarter:	$44.27
Consumption during the quarter:	
for the first 4,500 megajoules:	1.9652 cents for each megajoule
and for each additional megajoule thereafter:	1.2929 cents for each megajoule

SME Customers

For gas sold and supplied from 1 July 2008 to SME customers the following charges, which are exclusive of GST, apply.	
Supply Charge per quarter:	$75.69
Consumption during the quarter:	
for the first 25,000 megajoules:	1.4257 cents for each megajoule
for the next 65,000 megajoules:	1.4096 cents for each megajoule
and for each additional megajoule thereafter:	1.0454 cents for each megajoule

Note these quarterly consumption bands for *SME customers* are to be adjusted proportionately for monthly *billing periods*.

MT GAMBIER

(The areas within Post Code areas 5277; 5280; 5290)

These maximum *standing contract prices* are applicable to all meter readings or estimates from 1 July 2008 and are to be applied pro rata to the number of days in the billing period from 1 July 2008. All prices below are maximum per quarter prices.

Residential Customers

For gas sold and supplied from 1 July 2008 to* residential customers *the following charges, which are exclusive of* GST*, apply.	
Supply Charge per quarter:	$44.27
Consumption during the quarter:	
for the first 4,500 megajoules:	1.9796 cents for each megajoule
and for each additional megajoule thereafter:	1.3010 cents for each megajoule

SME Customers

For gas sold and supplied from 1 July 2008 to SME customers the following charges, which are exclusive of GST, apply.	
Supply Charge per quarter:	$75.69
Consumption during the quarter:	
for the first 25,000 megajoules:	1.4075 cents for each megajoule
for the next 65,000 megajoules:	1.3601 cents for each megajoule
and for each additional megajoule thereafter:	1.0559 cents for each megajoule

Note these quarterly consumption bands for *SME customers* are to be adjusted proportionately for monthly *billing periods*.

PORT PIRIE

(Post Code area 5540)

These maximum *standing contract prices* are applicable to all meter readings or estimates from 1 July 2008 and are to be applied pro rata to the number of days in the billing period from 1 July 2008. All prices below are maximum per quarter prices.

Residential Customers

For gas sold and supplied from 1* July 2008 to residential customers *the following charges, which are exclusive* of GST, *apply.	
Supply Charge per quarter:	$44.27
Consumption during the quarter:	
for the first 4,500 megajoules:	1.9789 cents for each megajoule
and for each additional megajoule thereafter:	1.2957 cents for each megajoule

SME Customers

For gas sold and supplied from 1 July 2008 to *SME customers* the following charges, which are exclusive of *GST*, apply.	
Supply Charge per quarter:	$75.69
Consumption during the quarter:	
for the first 25,000 megajoules:	1.4412 cents for each megajoule
for the next 65,000 megajoules:	1.4182 cents for each megajoule
and for each additional megajoule thereafter:	1.0395 cents for each megajoule

Note these quarterly consumption bands for *SME customers* are to be adjusted proportionately for monthly *billing periods*.

WHYALLA

(The areas within Post Code areas 5600; 5608; 5609)

These maximum *standing contract prices* are applicable to all meter readings or estimates from 1 July 2008 and are to be applied pro rata to the number of days in the billing period from 1 July 2008. All prices below are maximum per quarter prices.

Residential Customers

For gas sold and supplied from 1 July 2008 to residential customers the following charges, which are exclusive of GST, apply.	
Supply Charge per quarter:	$44.27
Consumption during the quarter:	
for the first 4,500 megajoules:	1.9791 cents for each megajoule
and for each additional megajoule thereafter:	1.2974 cents for each megajoule

SME Customers

For gas sold and supplied from 1 July 2008 to SME customers the following charges, which are exclusive of GST, apply.	
Supply Charge per quarter:	$75.69
Consumption during the quarter:	
for the first 25,000 megajoules:	1.4347 cents for each megajoule
for the next 65,000 megajoules:	1.4247 cents for each megajoule
and for each additional megajoule thereafter:	1.0617 cents for each megajoule

Note these quarterly consumption bands for *SME customers* are to be adjusted proportionately for monthly *billing periods*.

RIVERLAND AND MURRAY BRIDGE

(The areas within Post Code areas 5253; 5342; 5343; 5344)

These maximum *standing contract prices* are applicable to all meter readings or estimates from 1 July 2008 and are to be applied pro rata to the number of days in the billing period from 1 July 2008. All prices below are maximum per quarter prices.

Residential Customers

For gas sold and supplied from 1 July 2008 to residential customers the following charges, which are exclusive of GST, apply.	
Supply Charge per quarter:	$44.27
Consumption during the quarter:	
for the first 4,500 megajoules:	1.9689 cents for each megajoule
and for each additional megajoule thereafter:	1.3285 cents for each megajoule

SME Customers

For gas sold and supplied from 1 July 2008 to SME customers the following charges, which are exclusive of GST, apply.	
Supply Charge per quarter:	$64.43
Consumption during the quarter:	
for the first 25,000 megajoules:	1.4720 cents for each megajoule
for the next 65,000 megajoules:	1.3368 cents for each megajoule
and for each additional megajoule thereafter:	0.9228 cents for each megajoule

Note these quarterly consumption bands for *SME customers* are to be adjusted proportionately for monthly *billing periods*.

SCHEDULE 2 PRICE PATH SCHEDULE

2.A Price Path Formula

(a) Obligation for r*esidential customers*

(i) The *standing contract prices* for *residential customers* as at the *commencement date* are set out in the *Initial Standing Contract Price Schedule*.

(ii) The *initial average retailer revenue control* for *residential customers* is $11.81/GJ.

(iii) The *average retailer revenue control* ($/GJ) for *residential customers* (ARC_r) for any *regulatory period t* after the *initial regulatory period* is calculated as follows:

$$ARC_{r_t} = ARC_{r_{t-1}}\left(CPI_t\left(1 + x_r\right)\right)$$

where,

$ARC_{r_{t-1}}$ = for the *regulatory period* 1 July 2009 to 30 June 2010 is the *initial average retailer revenue control* for *residential customers*; and

for any *regulatory period* after 30 June 2010 is the *average retailer revenue control* ($/GJ) fixed for the *regulatory period t-1* for *residential customers*.

CPI_t = *CPI* as defined in clause 2.A(a).

x_r = 1%.

(b) Obligation for *SME customers*

(i) The *standing contract prices* for *SME customers* as at the *commencement date* are set out in the *Initial Standing Contract Price Schedule*.

(ii) The *initial average retailer revenue control* for *SME customers* is $6.76/GJ.

(iii) The *average retailer revenue control* ($/GJ) for *SME customers* (ARC_s) for any *regulatory period t* after the *initial regulatory period* is calculated as follows:

$$ARC_{s_t} = ARC_{s_{t-1}} \left(CPI_t \left(1 + x_s \right) \right)$$

where,

$ARC_{s_{t-1}}$ = for the *regulatory period* 1 July 2009 to 30 June 2010 is the *initial average retailer revenue control*; and

for any *regulatory period* after 30 June 2010 is the *average retailer revenue control* ($/GJ) fixed for the *regulatory period t-1*.

CPI_t = *CPI* as defined in clause 2.A(a).

x_s = 0.8%.

2.B Tariff Rebalancing Formula

(a) Obligation for r*esidential customers*

The *declared retailer* must ensure that the charge to a *residential customer* under each *retailer tariff* at any level of annual consumption in *regulatory period t* is no more than *CPI* + 3% greater than the charge under that *retailer tariff* (or, where the *retailer tariff* has been closed or a new equivalent *retailer tariff* has been introduced under Chapter 3, the most comparable *retailer tariff*) at the same level of annual consumption in *regulatory period t-1*, such that:

$$RTC_t \leq RTC_{t-1} \left(CPI + X \right)$$

where, for the same *retailer tariff*,

RTC_t = the total charges payable by a *residential customer* in *regulatory period t* for any level of annual consumption.

RTC_{t-1} = the total charges payable by a *residential customer* in *regulatory period t-1* for the same level of annual consumption being considered for *regulatory period t*.

CPI = *CPI* as defined in clause 2.A(a).

(b) Obligation for *SME customers*

The *declared retailer* must ensure that the charge to a *SME customer* under each *retailer tariff* at any level of annual consumption in *regulatory period t* is no more than *CPI* + 3% greater than the charge under that

retailer tariff (or, where the *retailer tariff* has been closed or a new equivalent *retailer tariff* has been introduced under Chapter 3, the most comparable *retailer tariff*) at the same level of annual consumption in *regulatory period t-1*, such that:

$$RTC_t \leq RTC_{t-1}(CPI + X)$$

where, for the same *retailer tariff*,

RTC_t = the total charges payable by a *residential customer* in *regulatory period t* for any level of annual consumption.

RTC_{t-1} = the total charges payable by a *SME customer* in *regulatory period t-1* for the same level of annual consumption being considered for *regulatory period t*.

CPI = *CPI* as defined in clause 2.A(a).

2.C CPI

(a) For each *regulatory year t*, *CPI* is calculated as follows:

(i) the Consumer Price Index, All Groups Index Number (weighted average of eight capital cities) published by the Australia Bureau of Statistics for the March Quarter immediately preceding the start of *regulatory year t*;

divided by

(ii) the Consumer Price Index, All Groups Index Number (weighted average of eight capital cities) published by the Australia Bureau of Statistics for the March Quarter immediately preceding the start of *regulatory year t-1*.

(b) For each *regulatory year t-1*, *CPI* is calculated as follows:

(i) the Consumer Price Index, All Groups Index Number (weighted average of eight capital cities) published by the Australia Bureau of Statistics for the March Quarter immediately preceding the start of *regulatory year t-1*;

divided by

(ii) the Consumer Price Index, All Groups Index Number (weighted average of eight capital cities) published by the Australia Bureau of

Statistics for the March Quarter immediately preceding the start of *regulatory year t-2*.