REVIEW OF GAS STANDING CONTRACT PRICES 2011/12 - 2013/14

ISSUES PAPER

November 2010

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REQUEST FOR SUBMISSIONS

The Essential Services Commission of SA (the Commission) invites written submissions from interested parties in relation to the issues raised in this paper. Written comments should be provided by **17 December 2010**. It is highly desirable for an electronic copy of the submission to accompany any written submission.

It is Commission policy to make all submissions publicly available via its website (www.escosa.sa.gov.au), except where a submission either wholly or partly contains confidential or commercially sensitive information provided on a confidential basis and appropriate prior notice has been given.

The Commission may also exercise its discretion not to exhibit any submission based on their length or content (for example containing material that is defamatory, offensive or in breach of any law).

Responses to this paper should be directed to:

Review of Gas Standing Contract Prices: Issues Paper

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Public Information about the Commission's activities

Information about the role and activities of the Commission, including copies of latest reports and submissions, can be found on the Commission's website at www.escosa.sa.gov.au.

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GLOSSARY OF TERMS

ACCC	Australian Competition and Consumer Commission
ACQ	Annual Contract Quantity
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
CARC	Customer Acquisition and Retention Cost
THE COMMISSION	The Essential Services Commission of South Australia
CPI	Consumer Price Index
ESC ACT	Essential Services Commission Act 2002
FRC	Full Retail Contestability
GAS ACT	Gas Act 1997
GJ	Gigajoule (10^9 J)
IPART	Independent Pricing & Regulatory Tribunal (NSW)
LNG	Liquefied Natural Gas
MAPS	Moomba to Adelaide Pipeline System
MDQ	Maximum Daily Quantity
MJ	Megajoule ((10^6 J)
ORIGIN ENERGY	Origin Energy Retail Ltd.
REES	Residential Energy Efficiency Scheme
ROC	Retail Operating Cost
RPM	Retail Price Methodology
SA	South Australia
SEA	South East Australian (pipeline)
SESA	South East South Australian (pipeline)
SME	Small and Medium Enterprise
STTM	Short Term Trading Market
TJ	Terajoule (10^{12} J)

1 INTRODUCTION

1.1 Background

Full retail contestability (FRC) commenced in the South Australian gas market on 28 July 2004, allowing all customers to enter into a market contract with a retailer of their choice. Since that time, competition in the gas retail market has developed and, as at 30 June 2010, 70% of small[1] gas customers had switched to a market contract.

For those small customers that have not entered into a market contract, the *Gas Act 1997* provides a measure of protection via the standing contract provisions. Under these provisions, the gas standing contract retailer, Origin Energy Retail Ltd. ("Origin Energy") must offer to supply gas to small customers under a regulated ("standing") contract. The task of fixing standing contract prices in South Australia lies with the Essential Services Commission of South Australia ("the Commission").

The Commission has broad powers to make a price determination regulating prices, conditions relating to prices and price fixing factors which apply to those standing contracts. Such a price determination is of binding effect for a period of at least three years from 1 July 2011.

Unless special circumstances are determined by the Commission to exist, the Commission may only make a gas standing contract price determination if it 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 price put forward.

While the provision of such a statement is a condition precedent to the Commission being empowered to make a price determination, in making a price determination the Commission is not assessing or passing judgment on the merits or otherwise of the submission. Instead, the Commission is undertaking an independent price-fixing process; necessarily informed 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.

On 5 November 2010, the Commission received such a submission from Origin Energy. A public version of this submission is available from the Commission's website.[2]

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1 Those customers with annual gas consumption less than 1TJ.

2 Refer: http://www.escosa.sa.gov.au/library/PUBLIC%20SUBMISSION%20-%20Origin%20SA%20Gas%20Retail%20Price%20Path.pdf

1.2 *Inquiry into the fixing of gas standing contract prices*

Before making a price determination, the Commission is required to undertake an Inquiry under the *Essential Services Commission Act 2002* ("the ESC Act") into the question of the appropriate price to be fixed as the gas standing contract price.

This paper is the initial document in the Commission's Inquiry into the appropriate price to be fixed as the gas standing contract price from 1 July 2011.

This paper relates to the price fixing functions of the Commission with respect to the standing contract, rather than the terms and conditions of that contract.

The purpose of this paper is to seek comments on relevant issues, to guide and inform the Commission's preparation of a Draft Inquiry Report and Draft Price Determination, to be released in March 2011.

Ultimately, the Commission must make a determination on the appropriate form of regulation and price control for Origin Energy in meeting its standing contract obligations in South Australia for the period 1 July 2011 to 30 June 2014. In doing so, the Commission will be informed by representations and submissions made by stakeholders and interested parties, the advice of specialist consultants, and work undertaken by the Commission's own staff.

This approach is similar to the approach used by the Commission in its two previous Inquiries into gas standing contract prices.[3]

1.3 *Process and consultation*

The Commission invites comment on the Origin Energy submission, on the various issues raised in this Issues Paper, and on any other matters that stakeholders consider relevant to this Inquiry.

Comments on the Origin Energy submission and this Issues Paper should be provided to the Commission by 17 December 2010. Following its consideration of those submissions, the Commission will prepare a Draft Inquiry Report & Draft Price Determination, which is expected to be released in March 2011. Following further public consultation, the Commission will release its Final Inquiry Report & Price Determination by June 2011. An indicative timetable for the Inquiry is set out below.

Details on how to make submissions are provided on the opening page of this Issues Paper.

[3] Documents relating to the Commission's 2005 and 2008 Inquiry into gas standing contract prices are available on the Commission's website: http://www.escosa.sa.gov.au/projects/129/2005-gas-standing-contract-price-path-inquiry.aspx and http://www.escosa.sa.gov.au/projects/43/2008-gas-standing-contract-price-path-inquiry.aspx.

Timetable	
Action	By
Receive Origin Energy Proposal	5 November 2010
Release Issues Paper & Origin Energy Proposal	19 November 2010
1st round stakeholder submissions due	17 December 2010
Release Draft Report & Determination	End March 2011
2nd round stakeholder submissions due	End April 2011
Release Final Report & Determination	June 2011
Determination takes effect	1 July 2011

2 OBJECTIVES OF THE REVIEW

2.1 Objectives of the Commission

The Commission is a statutory body, with its powers and functions limited to those granted to it by Parliament through the ESC Act.

Section 5 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" – the *Gas Act 1997* ("Gas Act") has been declared for this purpose.

When the Commission is undertaking a function within its overall responsibilities, it must have regard to specific objectives as set out in legislation. Section 6(1) of the ESC Act sets out the core set of objectives to which the Commission must have regard:

6 (1) In performing the Commission's 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; and*
> >
> > *(ii) prevent misuse of monopoly or market power; and*
> >
> > *(iii) facilitate entry into relevant markets; and*
> >
> > *(iv) promote economic efficiency; and*
> >
> > *(v) ensure consumers benefit from competition and efficiency; and*
> >
> > *(vi) facilitate maintenance of the financial viability of regulated industries and the incentive for long term investment; and*
> >
> > *(vii) promote consistency in regulation with other jurisdictions.*

In addition to these objectives, as the Commission is making a price determination under Part 3 of the ESC Act, it must also, under Section 25(4), 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;*
>
> *(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;*
>
> *(h) any other factors that the Commission considers relevant.*

Finally, section 25(5) of the ESC Act requires the Commission, in making a price determination, to ensure that wherever possible the benefits of regulation outweigh the costs and that the decision it makes clearly articulates any trade-off between costs and service standards.[4]

[4] It is to be noted that sections 25(3), (4) and (5) are expressed to be "subject to" the provisions of the Gas Act, such that to the extent a consideration of the "order" of factors is required, it is clear that the ESC Act section 6 factors are paramount, followed by any factors specified in the Gas Act and the matters specified in sections 25(3), (4) and (5) are final considerations. It is for this reason that the Commission does not have the full range of price regulatory options in section 25(3) available to it in this case – the Gas Act (section 34A) requires the Commission to "fix" a price.

3 PREVIOUS INQUIRIES

The Commission has undertaken two Inquiries into gas standing contract prices, the first established a price path that applied from 1 July 2005 to 30 June 2008 and the second set a further three year price path commencing 1 July 2008.[5] Prior to the Commission's first Price Determination, the Minister for Energy was responsible for setting gas standing contract prices in SA.

In its previous Inquiries, the Commission has employed a cost-based "building block" approach to reviewing gas standing contract prices, whereby it has determined the prudent costs that should be incurred by a gas retailer in meeting the obligations of the standing contract retailer in South Australia. The Commission has focused on the prudent costs that were within the control of the standing contract retailer, namely:

(i) Wholesale cost of gas purchases;

(ii) Transmission charges by pipeline operators;

(iii) Retailer operating costs; and

(iv) Retail margin.

Gas distribution charges also form part of the gas standing contract price, but these charges are not within the control of Origin Energy and are separately regulated. Therefore, the Commission treated these charges as a cost pass-through to standing contract customers.

In its previous Inquiry, the Commission determined that the following costs represented a realistic estimate of efficient charges for the three-year period of the price path commencing 1 July 2008 (Table 3.1).

[5] Publications relating to the Commission's previous Inquiries can be found at http://www.escosa.sa.gov.au/gas-overview/pricing-access/retail-pricing.aspx.

Table 3.1 - Summary of the Commission's decisions on retailer controllable costs 2008/09 – 2010/11 (GST exclusive in December 2011[6] prices)

COST COMPONENT	CUSTOMER TYPE	2008/09	2009/10	2010/11
Cost of Gas ($/GJ)	Residential	4.78	4.79	4.87
	Small Business	4.41	4.42	4.51
Transmission Costs ($/GJ) (weighted average of 5 regions)	Residential	1.83	1.83	1.84
	Small Business	1.32	1.32	1.32
Retail Operating Costs ($/customer p.a.) (inclusive of FRC costs)	All	109.65	97.13	97.13

The Commission also determined that the retail margin should be set at a fixed percentage (13%) of the total of these controllable costs.

Having determined these controllable costs, the Commission calculated the aggregate annual revenues during the price path period that would be required to recover these costs. The Commission determined that it would utilise a CPI-X form of regulation, applying an average revenue control, which would cap the amount of revenue per GJ sold on an annual basis. The 2008/09 average revenue control allowed the standing contract retailer to earn a maximum of $10.65/GJ for residential standing contract customers and $6.02/GJ for Small and Medium Enterprise (SME) standing contract customers.[7] These amounts were allowed to increase during each subsequent year of the price path period by CPI + X (with an X-factor for residential customers of 1.0% and 0.8% for SMEs).

In addition to this primary control, the Commission determined that a secondary control should exist to limit the extent to which any individual gas standing contract tariff can increase each year. This "rebalancing control" was set such that the charge at any level of annual consumption for each "retailer tariff" could not increase by more than CPI + 3% for residential customers and SME customers each year.

The Commission acknowledged the potential for unforeseen events to occur during the price path period, which could see the standing contract retailer incur materially different costs to those forecast and for which standing contract prices should be adjusted as a consequence. The Commission determined that it would allow for the pass-through to consumers of any material changes in costs arising from the following events:

- a change in taxes event;
- a regulatory reset event; and

6 Under the Commission's 9-month lag convention, March CPI is used as a proxy for December CPI. Therefore, in escalating the Commission's previous cost benchmarks from December 2008 prices, it has used the actual change in CPI from March 2008 to March 2010, and has applied an additional 2.5% forecast inflation to bring prices to December 2011 levels. This approach is consistent with that used by Origin Energy in its price path proposal.

7 Expressed in December 2011 prices

- a Ministerial Directions event.[8]

Outside of those events, the Commission determined it appropriate to rely on the provisions of the Gas Act relating to “special circumstances” as the appropriate means of dealing with circumstances where Origin Energy’s costs significantly increase or decrease due to events beyond Origin Energy’s control.

8 The definitions of these events can be found in the Commission’s 2008 Gas Standing Contract Price Determination (http://www.escosa.sa.gov.au/library/080624-GasStandingContractPrice_2008-FinalDetermination-PartAB.pdf).

4 MARKET DEVELOPMENTS

4.1 *Gas retail market developments*

While the gas standing contract price has a direct impact on only 30% of small customers, it plays an important role in the development of competition within the small customer market. Similar to the electricity standing contract price, it operates as a benchmark, against which market offers are compared.

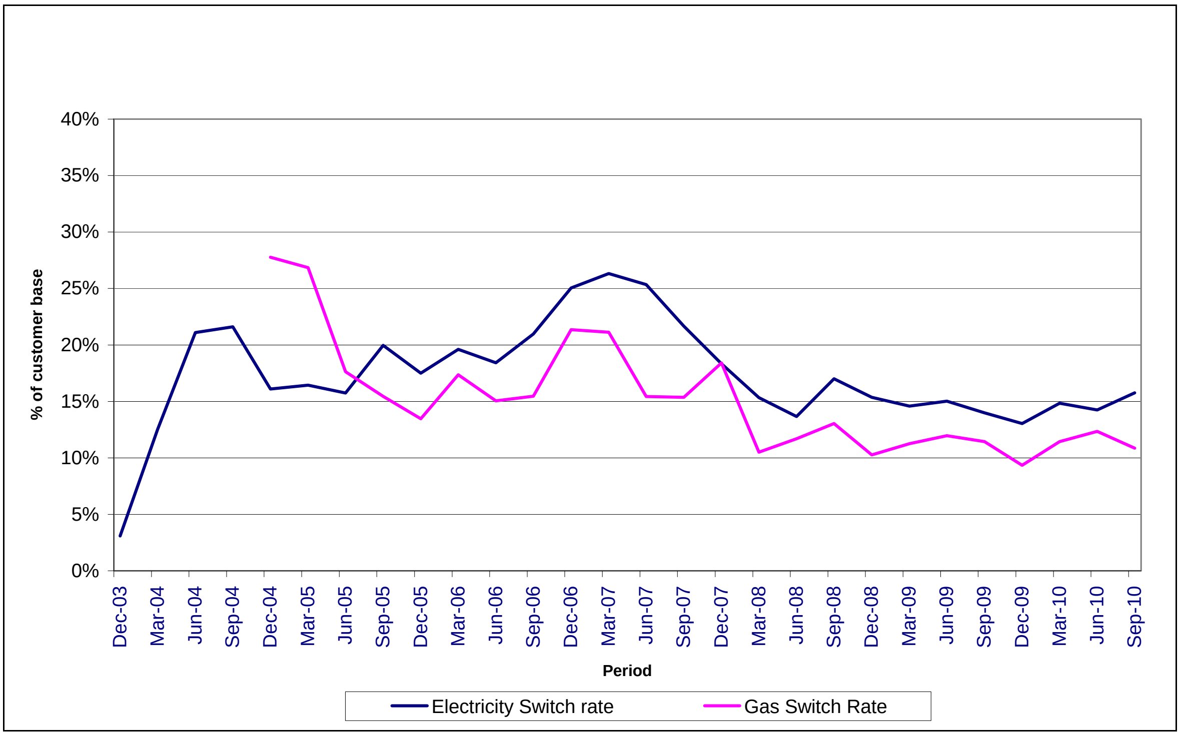
The sections below describe the state of the gas retail market in South Australia and report key indicators of gas retail competition since the commencement of FRC.

4.1.1 Customer Switching

As shown in Figure 4.1, shortly after the commencement of gas FRC in July 2004, there was an initial period of high rates of customer switching. Since late 2004, there has been a steady decline in the rate of customer switching, to a level of around 11% (annualised) in the September quarter 2010.

Further, it can be observed from Figure 4.1 that there is a close relationship between the level of electricity and gas transfers in South Australia. This is due to the fact that those retailers participating in the South Australian small customer gas also participate in the electricity retail market, and often offer gas market contracts as a complementary product to electricity market contracts. Therefore, the level of activity in the small customer retail electricity market significantly influences the level of activity in the small customer gas retail market.

Figure 4.1: Small Customer Market Switching Rate (Annualised from quarterly data)



Source: AEMO

4.1.2 Number of Gas Retailers

As at 30 June 2010, there were 10 retailers licensed to sell gas in South Australia, 9 of which were also licensed to sell electricity (refer Table 4.1). As has been the case over a number of years, only 4 of those licensed gas retailers (AGL SA, Origin Energy, TRUenergy and Simply Energy) are selling to small gas customers in South Australia. Of those 4 retailers, only Origin Energy is actively offering gas market contracts to small customers in regional South Australia.

Table 4.1: Retailers licensed to operate in the South Australian energy supply industry (as at 30 June 2010)

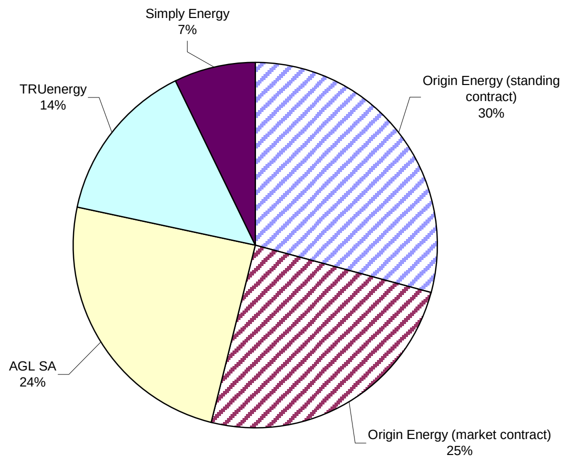
Retailer	Electricity		Gas	
	Currently Licensed	Selling to Small Customers	Currently Licensed	Selling to Small Customers
AGL SA	✓	✓	✓	✓
AGL Sales (Qld Electricity)	✓	×	×	×
Aurora Energy	✓	✓	×	×
Australian Power & Gas	✓	×	✓	×
Cogent Energy	✓	×	×	×
Country Energy	✓	✓	×	×
Diamond Energy	✓	×	×	×
Dodo Power & Gas	✓	×	✓	×
EnergyAustralia	✓	×	✓	×
Ergon Energy	×	×	×	×
ERM Power Retail	✓	×	×	×
Flinders Power	✓	×	×	×
International Power (Retail)	×	×	×	×
Jackgreen International	×	×	×	×
Momentum Energy	✓	✓	✓	×
Origin Energy	✓	✓	✓	✓
Powerdirect	✓	✓	×	×
Red Energy	✓	✓	×	×
Sanctuary Energy	✓	×	×	×
Santos Direct	×	×	✓	×
Simply Energy	✓	✓	✓	✓
Lumo Energy	✓	✓	✓	×
Sun Retail	×	×	×	×
Terra Gas Trader	×	×	×	×
TRUenergy	✓	✓	✓	✓
Current Total	21	10	10	4

4.1.3 Market Shares

As at 30 June 2010, Origin Energy continued to hold the largest share of the small customer gas retail market in South Australia, with a total of 55% of small customers (30% on standing contracts and 25% on market contracts). The second largest market share is held by AGL SA (Figure 4.2).[9]

9 As at 30 June 2010, the total number of small customers in the South Australian gas market is around 386,000, of which 378,000 are residential customers and 8,000 are SME customers.

Figure 4.2: Market share in the South Australia gas retail market (as at 30 June 2010)



Source: Energy Industry Guideline No. 2

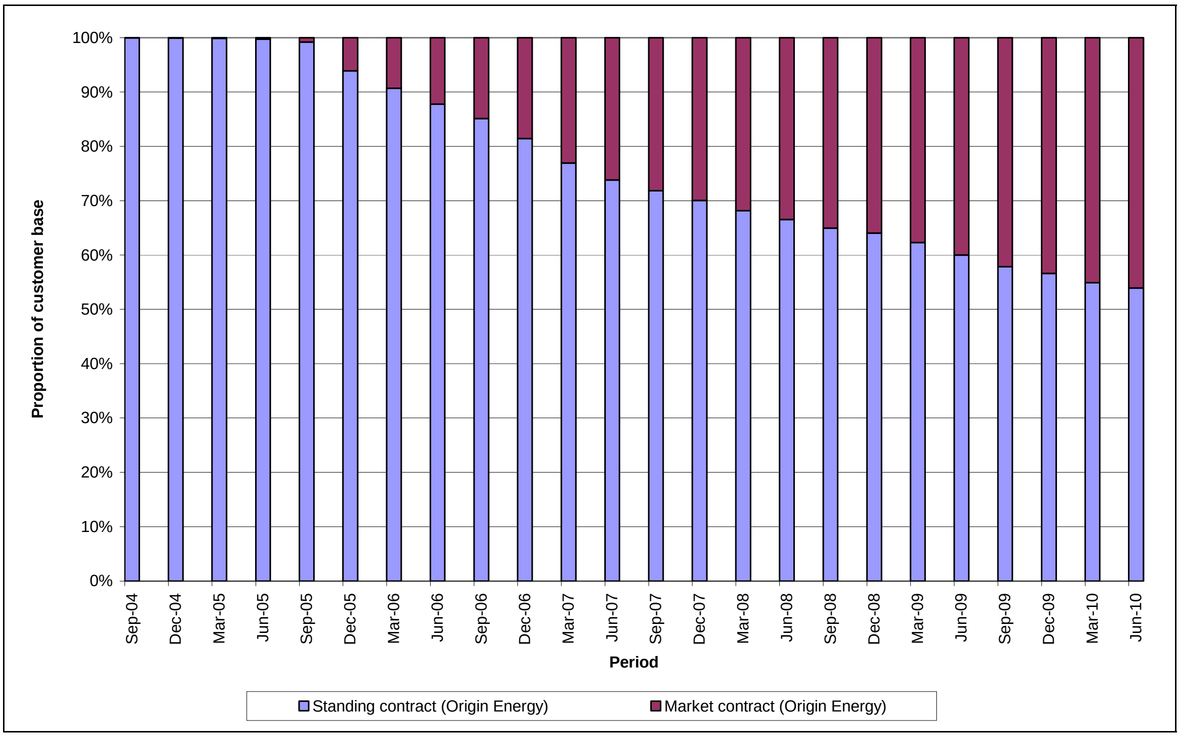
Broadly speaking, the movement of customers from a standing contract to a market contract will typically be driven by the interaction of the following factors:

- the level of active marketing being undertaken by gas retailers in SA;
- the extent to which customers are empowered (e.g. effectively exercising their right to switch gas retailers in response to changing market conditions); and
- price and non-price offers (e.g. available discounts and degree of innovation of gas contracts).

Figure 4-3 illustrates the trend in the number of Origin Energy small customers on a gas standing contract since September 2004. It can be observed that the rate of switching from the gas standing contract has slowed in recent years, relative to the rate experienced prior to mid-2007. This decline in the rate of reduction of the standing contract customer base is consistent with data published by AEMO (refer Figure 4.1 above).[10]

[10] AEMO's data includes all transfer occurring in the South Australian gas market, capturing both initial transfers to market contracts and subsequent transfers as a result of customers either changing gas retailers, or customers changing physical locations. It does not, however, capture small customer transfer from an Origin Energy's gas standing contract to an Origin Energy's market contract.

Figure 4-3: Proportion of Origin Energy customer base on gas standing contracts



Source: Energy Industry Guideline No. 2

4.1.4 Retailer Survey

To build on previous work that has assessed the effectiveness of retail competition in the South Australian energy market, the Commission engaged ACIL Tasman in April 2010 to conduct interviews with market participants, with the aim of canvassing views on the level of competitiveness, and to identify any common factors being experienced that are having an impact on the level of competition in the South Australian retail energy market.[11]

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

11 ACIL Tasman (2010), *Competition in South Australia's Retail Energy markets – Report on Interviews with Participants*, June 2010.

4.1.5 Review of energy retail competition in SA

In 2008, the Australian Energy Market Commission (AEMC) undertook a comprehensive review of the effectiveness of energy retail competition in South Australia, and provided recommendations to the South Australian Government on the continuation of energy retail price regulation.[12]

The AEMC review concluded that the both the electricity and gas retail markets were effectively competitive. However, the AEMC found that retail competition was more intense in the electricity market than the gas market, noting that:

- There is little retail gas competition in regional areas of South Australia, due to the inability of retailers to access firm transmission haulage services on the Moomba to Adelaide Pipeline System (MAPS) laterals and competitively priced haulage services on the South East South Australian (SESA) Pipeline.
- The fixed cost nature of selling and supplying gas and, in addition, the small number of customers residing in regional areas has limited the economic viability of retailing gas in these regions.
- South Australian small gas customers have low annual gas consumption relative to other jurisdictions, which leads to a low dollar value of the margins per customer. New entrant retailers in the gas market were competing generally through dual fuel marketing strategies, where an additional margin can be earned by signing customers to gas as well as electricity, for an incremental increase in the acquisition cost.

Notwithstanding the limitations identified by the AEMC on competition in the retail gas market, the AEMC recommended that the South Australian Government remove both electricity and gas retail price controls, and introduce a price monitoring regime.

That conclusion was, as is necessarily the case in any assessment of competition, based on the best evidence available at that time and must be considered in that light. As competition is, of its nature, a dynamic process, it is to be expected that certain indicators of competition (eg. market shares, switching rates, price discounting and retailer entry and exit) will change over time as the market evolves. As noted by the AEMC, it is important to take a forward-looking view of competition and have regard to wide-ranging evidence, rather than a few certain indicators, in assessing the effectiveness of the competitive market.

In a letter to the AEMC in April 2009, the South Australian Energy Minister subsequently rejected the AEMC's advice in relation to the form of regulation which

[12] AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia, First Final* Report, September 2008, available from the AEMC's website at: http://www.aemc.gov.au/Media/docs/First%20Final%20Report%20-%20Main%20Body-add1d023-cb5b-43d8-a011-208e9d359b28-0.pdf

it considered should be applied for the future, noting that: "... *It is currently the Government's intention to retain price regulation for both the electricity and gas markets in South Australia."*[13]

Accordingly, the Commission must continue to fix standing contract prices as required under the Electricity and Gas Acts.

4.2 Gas retail prices

The price path for the July 2008 to June 2011 period sets an average revenue control, which allows for some rebalancing within and across standing contract tariffs. This means that price movements need not be uniform between the different parts of a tariff.

Table 4.2 below sets out the retail component (i.e. excluding Envestra's gas network charges) of the residential standing contract tariff movements that have resulted from pricing decisions determined from 1 July 2003 to 30 June 2010 in both nominal and real terms.

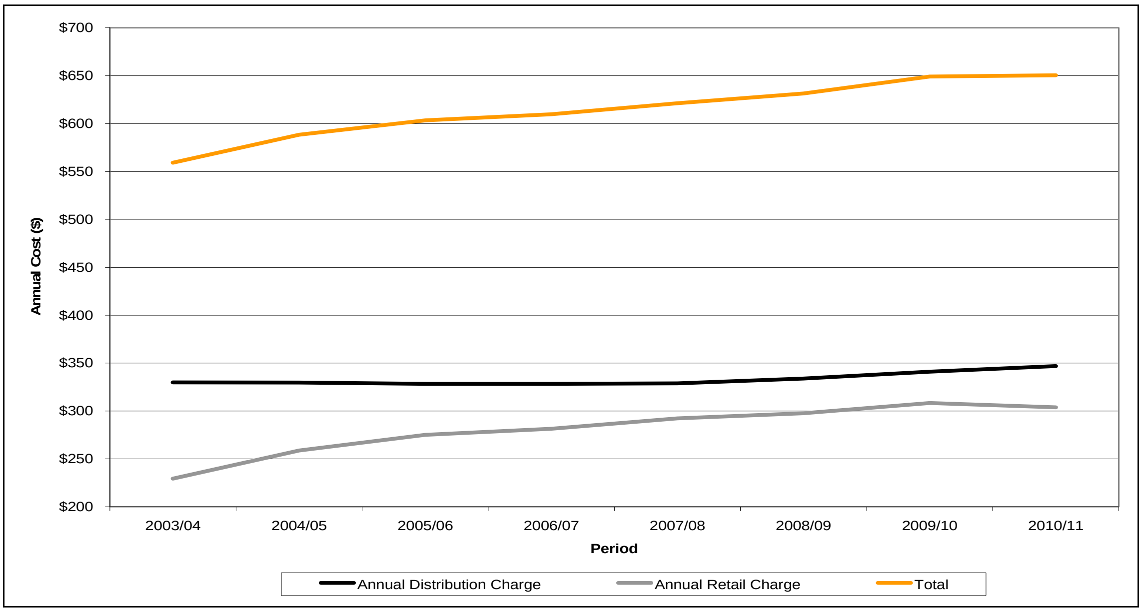
Table 4.2: Residential gas retail tariffs

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Origin Energy Retail Residential Tariffs (GST Exclusive, $ 2010)								
Supply Charge $/QTR	6.93	13.58	17.21	18.35	19.07	19.41	22.50	21.31
First 4500 MJ (c/MJ)	0.87	0.88	0.89	0.89	0.93	0.94	0.93	0.92
Additional MJ (c/MJ)	0.75	0.76	0.77	0.79	0.82	0.83	0.85	0.88
Origin Energy Retail Residential Tariffs (GST Exclusive, $ Nominal)								
Supply Charge $/QTR	5.73	11.44	14.84	16.30	17.35	18.41	21.87	21.31
First 4500 MJ (c/MJ)	0.72	0.74	0.77	0.79	0.84	0.90	0.90	0.92
Additional MJ (c/MJ)	0.62	0.64	0.67	0.70	0.74	0.79	0.83	0.88

Since 2003/04, there has been an increase in the typical real residential annual gas bill of around 16%, which equates to a real increase of around $71. Figure 4-4 below shows how changes to the standing contract price have affected a typical annual residential bill (consumption of 24,000 MJ) for the period 2003/04 to 2010/11. These price trends are expressed in real dollars.

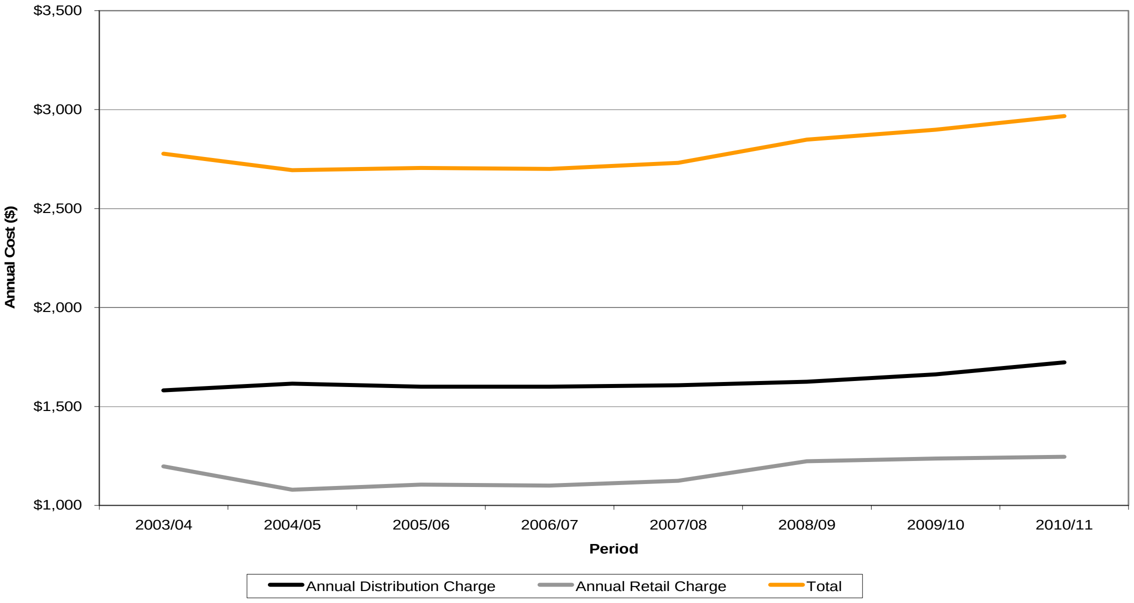
[13] Correspondence, South Australian Minister for Energy to the Australian Energy Market Commission, 6 April 2009, available from the AEMC website at http://www.aemc.gov.au/Media/docs/Minister%20for%20Energy%27s%20Response-f1e594e0-a706-42f2-8259-43ef8a49a807-0.pdf. Based on the full context of the letter, the reference to "price regulation" in this quote is taken to be a reference to "price fixing" (as opposed to price monitoring, which is also price regulation, although of a more light-handed nature).

Figure 4-4: Typical Standing Contract Annual Residential Bill (24,000 MJ per year, GST exclusive - $Mar 2010)



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 170,000 MJ over the same period (2003/04 to 2010/11) in Figure 4-5 below. Over this period, such a small business customer would have experienced a real price increase of approximately 7%, or around $190.

Figure 4-5: Typical Standing Contract Annual Small Business Bill (170,000 MJ per year, GST exclusive - $Mar 2010)



5 METHODOLOGY FOR FIXING PRICES

In August 2010, the Commission finalised its review of the methodology for setting electricity and gas standing contract prices.[14] The review examined the ongoing effectiveness of the current "building block" approach to setting standing contract prices, and the extent to which alternative approaches may better achieve the Commission's objectives in light of current circumstances.

The Commission found that there is a need to consider changes to the existing approach to setting electricity standing contract prices, for two reasons:

- there is currently significant volatility in the wholesale electricity market, which is expected to continue in the medium-term, due largely to uncertainties over carbon pricing and the development of other climate change policies. This uncertainty and volatility makes the Commission's task of forecasting wholesale energy costs for at least 3 years under a traditional cost "building block" approach extremely difficult; and
- The electricity retail market in South Australia has developed significantly since the introduction of Full Retail Competition in 2003. The Australian Energy Market Commission (AEMC) 2008 review of energy retail competition in SA found the electricity and gas retail markets to be effectively competitive, with greater competition existing in the electricity retail market than the gas retail market.[15]

Following extensive consultation with relevant stakeholders, the Commission determined that the best methodology for fixing electricity standing contract prices is to implement a hybrid cost-based and index-based approach. The Commission's preferred approach, called the Relative Price Movement (RPM) approach, includes the following major elements:

- Prices to apply at the commencement of the price path period will be determined by examining costs over the first year through the usual building block approach. This will ensure that the starting price is cost reflective.
- Annual movements in standing contract prices during the price path period will then be determined with reference to movements in market contract prices in SA. The Commission will calculate a price index (RPM index), measuring the change in weighted average market contract prices. This percentage change will then determine the allowed change in standing contract prices.
- Changes in the standing contract price resulting from the RPM index calculation will be bound by a floor and cap, to provide some certainty over the extent to which

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14 All papers relating to the Commission's methodology review are available on the Commission's website at http://www.escosa.sa.gov.au/projects/78/energy-standing-contract-price-methodology-review.aspx.

15 Australian Energy Market Commission, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia: First Final Report*, 19 September 2008 (available at http://www.aemc.gov.au/Market-Reviews/Completed/Review-of-the-Effectiveness-of-Competition-in-Electricity-and-Gas-Retail-Markets-in-South-Australia.html).

prices will move over the price path period. Should the RPM index calculation breach the floor or cap, prices will be fixed at the floor or cap. If there are sufficient grounds to allow standing contract prices to move beyond the floor or cap, the Commission may undertake a "special circumstances" review to consider whether or not such a move is justified.

During consultation with stakeholders, the Commission received broad support for the application of the proposed RPM approach to electricity standing contract prices. The Commission has decided to implement the RPM approach, which will commence under the next electricity standing contract price path, which begins on 1 January 2011.

In relation to the gas market, the Commission found that there is evidence to suggest that, relative to the electricity market, gas wholesale prices exhibit less medium-term volatility and that there is a lesser degree of retail competition in the gas market. For these reasons, it concluded that there appears to be less of a need to depart from the current cost-based approach to setting regulated gas retail prices than regulated electricity retail prices. However, the Commission remained open to further consideration on the appropriate approach for setting gas standing contract prices prior to commencing this current Inquiry into such prices.

The Commission has not received any submissions supporting the implementation of an RPM approach for gas standing contract prices. The Origin Energy pricing submission has argued for the continuation of the current building-blocks approach to price fixing, suggesting that "the South Australian gas market is not showing the necessary level of product choice to justify proposing [the RPM methodology] for this period".[16]

The Commission is therefore proposing to undertake its Inquiry into gas standing contract prices to apply from 1 July 2011, on the basis of conducting a traditional cost-based approach. Stakeholders are invited to comment on this proposal.

[16] Refer http://www.escosa.sa.gov.au/library/PUBLIC%20SUBMISSION%20-%20Origin%20SA%20Gas%20Retail%20Price%20Path.pdf.

6 ORIGIN ENERGY SUBMISSION

6.1 Form of price control

Origin Energy has proposed a form of price control that is similar to that implemented in the two previous price paths. It has proposed a 3-year price path, where the price control is applied only to Origin Energy's "controllable costs". Consistent with previous price determinations, Origin Energy has submitted that distribution charges, AEMO market charges and GST should be treated as non-controllable costs and passed through directly to gas standing contract prices.

6.1.1 Average revenue control

Origin Energy has also proposed the continuation of an average revenue form of control, which would limit the amount of revenue per GJ sold to standing contract customers. Consistent with the Commission's past price determinations, Origin Energy has proposed separate average revenue controls to apply to residential and small business customers. Applying separate average revenue controls reduces the ability for Origin Energy to undertake tariff rebalancing between the two customer groups.

6.1.2 Rebalancing control

The Commission has historically implemented a secondary control, which limits the extent to which individual charges can increase for any customer of any level of consumption. The "rebalancing control" is designed to avoid price shocks that may arise from tariff rebalancing undertaken by the retailer. The Commission notes that Origin Energy has not proposed the continuation of a rebalancing control in its price submission.

6.1.3 Pass through items

Origin Energy has proposed that the Price Determination contain pass-through provisions which allow for any material change in costs to be passed through to standing contract customers, upon application by Origin Energy to the Commission. It has suggested that the pass through provisions should be sufficiently broad, to accommodate any significant event that may have a material cost impact, rather than defining a list of pass through events. Origin Energy has used the pass-through provisions of the IPART Voluntary Transitional Pricing Arrangements as an example of a broad approach that should be adopted. It has argued that such an approach would reduce the risk of unforeseen future costs and the need for a re-opening of the Price Determination using the Commission's powers under the "special circumstances" provision of the Gas Act.

Comments are invited on the form of price control, including pass through provisions, proposed by Origin Energy.

6.2 Customer Numbers and Demand Forecast

Estimating the number of customers on a gas standing contract and their respective consumption profile by segment at any time over the regulatory period is a difficult task as it requires various assumptions to be made. In addition to the factors that could influence churn (refer Section 4.1), there are also a number of other factors such as government policies and weather events that could influence consumption levels.

The forecast level of demand for gas, both in terms of average demand and peak demand, is a critical input into the Commission's Price Determination as it impacts on the amount of base load gas and peak gas that is required for supply to standing contract customers.

Origin Energy has projected gas standing contract customer numbers and consumption by segments over the 3-year regulatory period based on the following approach:

- Extracting monthly billing information for small customers on a gas standing contract with a consumption profile that was less or equal than 1 TJ per annum between the period 1 July 2007 and 30 June 2010. The data was then classified into the appropriate business segments, regions and determining the respective tariffs blocks;
- Identifying historical relationships between both the volume and tariff blocks and, customer numbers and regions;
- Calculating an average consumption per customer by customer segment based on the billing information extracted;
- Using linear trends that best described the number of aggregate monthly billed counts to forecast customer numbers expected to be billed on a gas standing contract over the 3-year regulatory period;
- Multiplying the customer number forecasts by the estimated average consumption per customer to estimate the total volume of gas demand at an aggregated residential and commercial level; and
- Allocating the consumption forecasts into respective regions and tariff blocks using the observed historical relationships.

Further details and modelling of Origin Energy's proposed customer number and consumption forecasts have been provided to the Commission for assessment on a confidential basis.

6.3 Cost of Wholesale Gas

Key features of the South Australian wholesale gas market are summarised below:

CONTRACT TERM	Gas is typically purchased on long-term contracts of up to 20 years in duration.
SPOT MARKET	A Short-Term Trading Market (STTM) has recently been established to provide for a spot market for gas delivered into metropolitan Adelaide.
MARKET PRICES	Gas contract prices are generally strictly confidential. There are no public benchmarks highlighting an appropriate "market price" for gas.
CONTRACT FLEXIBILITY	Gas contracts allow for different delivery volumes on different days, and to some extent different years. Depending on the exact nature of the contract, therefore, the average price of gas to a Retailer is generally less sensitive to demand than in electricity where there is a relatively strong correlation between price and demand.
HAULAGE	Entry and exit from the gas market is complicated by the need to secure firm haulage rights to ship gas from a particular supply location to the market (essentially Adelaide[17]).

The absence of an open and transparent gas market, together with the complexities of hauling gas from various locations, makes it difficult to determine what wholesale gas purchases a "prudent" retailer should make.

The Origin Energy proposed cost of gas is divided into three categories:

- Base load supply, or Annual Contract Quantity (ACQ);
- Peak load supply, or Maximum Daily Quantity (MDQ); and
- Short-Term Trading Market (STTM) costs.

Origin Energy has proposed an ACQ cost for 2011/12 and 2012/13 that is in line with the Commission's current ACQ benchmark for 2010/11. However, it has proposed a significant increase in ACQ costs in 2013/14, reflecting its expectation that wholesale gas prices will move to export Liquefied Natural Gas (LNG) netback price parity from 1 January 2014.[18]

Origin Energy has also proposed a significant increase in MDQ costs, which it proposes to apply from the commencement of the price path. Origin Energy claims that the increase is driven by the following factors:

- reduced flexibility in gas supply contracts has increased the need for peak contracts;
- Overall gas demand volatility and peakiness has increased, driven by increased gas-fired generation in Queensland, South Australia and Victoria;
- Reduced flexibility in linepack rights under the Moomba to Adelaide Pipeline System (MAPS) Access Arrangement and limited flexibility on the SEA Gas pipeline has led to further reductions in the flexibility of Origin Energy peak supply portfolio; and

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17 More than 95% of the gas is supplied to Adelaide.

18 LNG netback price parity is the delivered price of LNG less the costs of liquefaction and shipping.

- The cost of disposal of non-peak/excess gas on the STTM, Victorian gas market and non-peak generation pool.

While Origin Energy notes that Swing Gas costs have become redundant given the commencement of the STTM, it claims that the new spot market arrangements create additional market volatility risks associated with imbalance, deviation and contingency gas. STTM costs, while much less significant than ACG and MDQ costs, are therefore proposed to increase above the swing gas costs incorporated into the previous price path determination.

Noting that the detailed cost information proposed by Origin Energy remains confidential, the Commission nevertheless invites comment on the cost drivers being put forward by Origin Energy, which it suggests will lead to a significant increase in wholesale gas costs over the next 3-year price path period.

6.4 Transmission costs

The 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 Moomba to Adelaide Pipeline System (MAPS) and SEA Gas pipeline, 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. While reference charges for a gas transmission pipeline may be set under an access arrangement approved by the ACCC, a retailer can negotiate different price outcomes by managing its suppliers and load.

The Commission notes that both the MAPS and SEA Gas pipelines are unregulated. Therefore, there are no regulated reference prices for these pipelines, with prices being determined through commercial negotiation.

Origin Energy has proposed an increase in total transmission costs for MAPS and SEA Gas in 2011/12 due to a higher load factor attributed by Origin Energy to residential and small business customers.[19] In the following two years of the price path, Origin Energy forecasts these main pipeline costs to decrease in real terms.

Costs associated with haulage through lateral pipelines to Whyalla, Riverland and Mt Gambier are calculated separately by Origin Energy and allocated specifically to each relevant region. Origin Energy has submitted increased Mt Gambier lateral pipeline costs

[19] The load factor describes the relationship between peak and average demand. The higher the load factor, the peakier the load requirement, and the greater the transmission pipeline capacity that is needed to meet peak demand.

on the basis that EPIC pipeline costs have increased. It has also submitted that the Riverland lateral costs be increased above the current benchmark set by the Commission.

The Commission invites comments on the key drivers of transmission cost changes identified by Origin Energy.

6.5 Retail operating costs

Retailer operating costs (ROC) are an important component of gas tariffs.

There are several different ways that an appropriate ROC allowance could be determined. These include setting ROC based on assessing an entity's submitted (or claimed) costs, utilising external benchmarks, or a combination of both approaches.

Benchmarking requires that the benchmarks from different jurisdictions are comparable. This requires some consistency in the definition of ROC and similarities in operating and regulatory environments. The absence of such similarities can raise questions over the reliability of the benchmarks.

Under an actual cost approach, a number of judgements must be made as to whether or not the submitted actual costs are justified, whether they are ongoing, and how they are allocated to different business segments and customer types. The allocation of operating costs to SA gas standing contract customers incurred by a business that operates across multiple jurisdictions in both electricity and gas can be a complex exercise, requiring numerous assumptions.

Recognising that deficiencies exist in either of the approaches, the Commission has previously determined gas ROC using a combination of both.

Origin Energy's proposal on ROC of $117.87[20] per customer (excluding REES) is based on the Commission's draft determination for the Retail Electricity Standing Contract Price Path[21], published in September 2010. It has proposed that this allowance remains flat across the three year price path, increasing only in line with CPI.

The Commission's draft determination for the electricity standing contract price path was set based principally on benchmarking with other jurisdictions, with reference to the actual costs of the standing contract retailer used as a sense-check of the proposed allowances.

Origin Energy has submitted that this forms an appropriate benchmark as retail costs do not differ significantly between the gas and electricity small customer market. Origin Energy has not put forward any actual cost information to support its proposal.

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20 $Dec11 prices ($115.00 @ $Dec10 prices)

21 This document can be found on the ESCOSA website at - http://www.escosa.sa.gov.au/library/100906-ElectricityStandingContractPriceDraftDecision-PartA-StatementOfReasons.pdf

Stakeholders are invited to comment on the appropriate approach to determining ROC allowances for a standing contract retail gas entity.

6.5.1 Customer Acquisition & Retention Costs (CARC)

The draft determination for the Retail Electricity Standing Contract Price Path was set based on the relevant costs of a prudent new entrant retailer in meeting the responsibilities of the standing contract supply to small customers. As such, it included within ROC an allowance for CARC, being the costs of both acquiring and retaining customers. Origin Energy argues that setting standing contract costs on this basis will encourage a greater level of competition in the gas market and is in the long term interest of consumers.

As identified in Section 4.1.1, recent slowing of activity levels in the gas retail market has mirrored that in the electricity retail market. There has been no gas-only marketing activity to date beyond energy retailers with licences for both gas and electricity seeking to leverage off their electricity customer base by offering gas contracts to existing customers. Indeed, there is no significant population of gas-only (i.e. non-electricity users) customers to target and marketing activities have been limited to either electricity only or dual-fuel offers.

Given that the market has developed in this way, there may be a case for considering the acquisition of gas customers to be a by-product of the acquisition of electricity customers. In this case, a CARC allowance based on only the marginal cost of acquiring a gas customer could be set.

In its 2008 gas standing contract determination, the Commission took the view that any CARC costs were part of the retail margin, considering the activities as an investment which pays returns over time. Subsequent regulatory decisions for energy in other jurisdictions have typically made allowance for CARC costs as part of ROC rather than retail margin.

Is there a case for setting an allowance based on treating CARC in gas as an incremental cost to CARC in electricity?

Is it appropriate to address any CARC allowance as part of ROC or Retail Margin?

6.5.2 Residential Energy Efficiency Scheme (REES)

The REES scheme was introduced by the South Australian Government on 1 January 2009, and obliges retailers to undertake energy efficiency activities and energy audits, to assist consumers in becoming more energy efficient. It represents a new component in the ROC allowance, although Origin Energy has been allowed to pass through REES costs to gas standing contract prices since 1 July 2009.

The scheme is set to continue through to the end of 2014, although targets beyond the end of 2011 are yet to be established, as are the list of energy efficiency activities to be included in the scheme. Further to this, the Commonwealth Government may seek to introduce a national energy efficiency scheme, replacing the state schemes that currently operate, including REES.

There is evidence that a saturation point is near to being reached for some of the cheaper energy efficiency activities, necessitating a focus towards more expensive activities in future years.

Origin Energy has provided a confidential submission to the Commission setting out its proposed REES costs to apply to standing contract customers for the second half of 2011. Thereafter, it proposes that energy efficiency costs be treated as a pass-through, given the uncertainty that exists over future schemes, activities, and targets.

In its determination of the electricity standing contract prices to apply from 1 January 2011, the Commission intends to set an allowance for REES for the first six months of 2011. REES costs thereafter will be adjusted using an RPM methodology (see chapter 5), which it proposes not to introduce for the gas standing contract.

Is it appropriate to set a firm allowance for REES costs across the three year period, given the material uncertainty over future schemes, activities, and targets or should the uncertainty after the end of 2011 be addressed via a pass-through event for the remainder of the price path?

6.6 Retail margin

The retail margin is the increment above a retailer's actual costs to cover return on capital, depreciation, amortisation, taxes and profit. It is intended to compensate and reward retailers for their investment in the business and the risks they assume in order to provide retail services.

The retail margin is not only important for maintaining the financial viability of the standing contract retailer, but it is also important for the development of competition in the gas retail market. In developing an appropriate retail margin, the Commission is seeking to strike a balance between the need to attract investment into the South Australian gas retail market, while ensuring that gas standing contract customers are not funding an excessive return to the gas standing contract retailer.

Similar to retail operating costs, retail margins can be determined through benchmarking against other regulatory decisions, through an assessment of the actual costs that comprise the retail margin, or through a combination of these two approaches. The

Commission considered both benchmarking and a build up of actual costs in its previous Inquiry.

Origin Energy's proposal provides for maintaining the margin allowance at 13% on controllable costs in 2011/12, then increasing the margin to 14.6% for 2012/13 and 2013/14. This is principally linked to the continuation of prepayment of distribution charges, the risk of forecast error and its impact given the low dollar margin per customer, and the decline in the proportion of retailer tariffs to total standing contract prices (whereby a greater margin on controllable costs is needed to achieve the same margin on total sales).

It should be noted however that the retail margin for the current price path included an allowance for CARC, which Origin Energy is now proposing to include in ROC. Maintenance of retail margin at 13% would therefore represent and increase over the current price path.

Further to the discussion in section 6.5.1 on the treatment of gas as an incremental activity to the marketing of electricity, it may be appropriate to consider the retail margin on a total energy (dual fuel) basis. Such an approach may be more reflective of how the market in South Australia has developed.

Comments are sought on Origin Energy's proposal for an increased retail margin.

Is there a case for considering a retail margin across both electricity and gas (dual fuel) rather than continuing to treat gas as a stand-alone product?

6.7 Non-Controllable Costs

Non-controllable costs comprise two elements:

- Distribution Charges – charges levied by Envestra for provision of reference services relating to domestic haulage, commercial haulage, and ancillary reference services (disconnections, reconnections, special meter reads).
- Other Market Charges – charges set and collected by AEMO for the provision of various gas market functions and operations (e.g. operating the Short Term Trading Market, running the Gas Advocacy Panel).

Origin Energy proposes that these charges should continue to be a direct pass through into standing contract prices.

6.8 Customer Impact

The Origin Energy proposal has calculated a set of implied tariffs based on a set of principles that reflect forecasts of controllable and non-controllable costs put forward in its proposal. Origin Energy's proposed price path and the associated customer impacts for 2011/12 are set out in Table 6.1 and Table 6.2 respectively.

Table 6.1: Origin Energy's proposed real increases in gas standing contract prices

	2011/12	2012/13	2013/14
RESIDENTIAL	5.2%	0.6%	4.9%
SME	1.0%	0.6%	8.6%

Source: Origin Energy's pricing proposal

Table 6.2: Origin Energy's forecasts – indicative customer bill impacts for 2011/12

		RESIDENTIAL	SME
LOW CONSUMPTION	($/qtr)	$4.96	$3.33
MEDIUM CONSUMPTION	($/qtr)	$8.14	$22.62
HIGH CONSUMPTION	($/qtr)	$17.70	$104.06

Source: Origin Energy's pricing proposal

The Commission notes that the set of implied tariffs proposed by Origin Energy and the associated customer impacts are indicative, and are provided solely for the purpose to serve as a guide to facilitate discussions during the Inquiry's public consultation process.

7 NEXT STEPS

The Commission has set out a provisional timetable for the Inquiry in Section 1.3 of this Issues Paper.

The timetable indicates that the Commission is seeking comment on the issues raised in the paper by 17 December 2010.

This Issues Paper provides the first opportunity for stakeholders to have an input into the process. The Commission encourages stakeholders to comment on the issues identified throughout the paper and those in the Origin Energy submission.

From November 2010 to February 2010, the Commission will undertake a number of studies with the assistance of consultants to give it a more detailed understanding of the cost components of the standing contracts price.

The Commission will use the information it receives from stakeholder submissions, Origin Energy and consultants to prepare a Draft Inquiry Report and Draft Price Determination for release to stakeholders in March 2011.

Stakeholders will be given an opportunity to comment on the Draft Inquiry Report and Draft Price Determination. Submissions will be required by late April 2011.

The Final Inquiry Report and Price Determination will be released in June 2011, to enable the Price Determination to take effect from 1 July 2011.