



**Origin Energy's  
Proposed Price Path for Standing  
Contract Gas Customers in South  
Australia: 2011-12 to 2013-14**

**Public Submission to the  
Essential Services Commission of South Australia - November 2010**

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## Executive Summary

For the purposes of section 34A(4a)(d)(ii) of the *Gas Act 1997* (the Act), Origin Energy (Origin) has submitted a proposal to the Essential Services Commission of South Australia (ESCOSA) for the determination of prices for the sale and supply of natural gas to standing contract gas residential and small business customers in South Australia.

Origin made a confidential submission on 5 November 2010 and this public submission contains the relevant information, excluding some confidential or commercially sensitive data, to enable stakeholders to review the Origin proposal. Although specific figures have been removed from this public submission, Origin has provided detailed explanation of the inputs and influences upon which Origin's price path proposal have been based to allow stakeholders to make valuable contributions to the consultation process.

Origin has applied for a three year price path determination from 2011-12 to 2013-14, the minimum period of a determination under section 34A (4a), for small customers (annual consumption of less than 1 terajoule per year, as defined in the *Gas Regulations 1997*).

In developing this proposal, Origin has considered the factors ESCOSA must take account of in making its determination to balance the interest of consumers and the industry. These are encapsulated in the primary objective under section 6 of the *Essential Services Commission Act 2002* (ESC Act):

*“protection of the long term interests of South Australian consumers with respect to the price, quality of and reliability of essential services”.*

Other considerations that ESCOSA has recognised as deriving from this primary objective include the promotion of competitive markets, providing for an appropriate return to the regulated entity and ensuring there are sufficient incentives for investment in consumers' long term requirements.

The form of ESCOSA's current three year determination on gas prices for standing contract customers (2008-09 to 2010-11) consists of the following steps:

1. Setting an average retailer revenue (\$/gigajoule) for residential and small business standing contract customers for each year of the price path;
2. Allowing a direct pass through of the non-controllable costs (largely network cost) each year; and
3. Approving each year:
  - a set of retailer tariffs that recover the approved average retailer revenue in total, and
  - a set of standing contract prices that are built up from the retailer tariffs and the non-controllable costs for that year.

In setting the average retailer revenue in the 2008 Determination (Step 1 above), ESCOSA established a three year cost path for Origin's controllable costs. These controllable costs included the wholesale costs of gas and transmission and retail operating costs. ESCOSA also included an allowance for retail margin of 13 per cent on these controllable costs.

Origin supports the continuation of this approach for the next three year price path period. The current submission is therefore concerned with establishing the average retailer revenue for residential and small business standing contract customers required to recover the forecast controllable costs and return an acceptable commercial margin on these costs.

The retail tariffs for a particular customer segment and pricing zone will be calculated by Origin to ensure compliance with the average revenue control. The retailer tariffs and standing contract prices for 2011-12 will be submitted for approval by ESCOSA as consistent with its Final Determination.

### Average Retailer Revenue

The starting point for Origin's submission on average retailer revenue is the customer number and demand forecast for residential and small business customers for each year of the period

(2011-12 - 2013-14). Although there has been a steady and consistent decline of customers on standing contracts over the last three years, churn rates have been lower than previously forecast.

Based on the new demand forecasts and the forecast cost inputs in this submission, Origin proposes two average retailer revenue price paths for the residential and small business standing contract customers respectively as set out in Table A.1.

**Table A.1: Proposed Real Changes in Average Retailer Revenue (\$Dec 2011)**

	Residential		Small Business	
	\$/GJ	(%)	(\$/GJ)	(%)
2010-11	13.02		7.42	
2011-12	14.45	11.0%	\$7.58	2.2%
2012-13	14.61	1.1%	\$7.68	1.3%
2013-14	16.03	9.7%	\$9.10	18.6%

The proposed percentage increase in average revenue in 2011-12 is relative to the approved retail revenue component as part of the retail tariffs submitted to ESCOSA in May 2010.

These current tariffs are used as the starting point because of the changes to the composition of the standing contract customer base which in turn impacts on the average retailer revenue under the approved 2010-11 tariffs. As the forecasts in this submission are derived from the revised standing contract population, it is the adjusted revenue that provides the appropriate base for calculating future revenue requirements.

The key drivers of the percentage increases in the average revenue requirement shown in Table A.1 relate to:

- an increase in the retail costs component in 2011-12 due to the inclusion of customer acquisition costs as part of total retail costs. This has a significant impact on residential retail revenue in 2011-12; and
- a forecast increases in wholesale gas costs from 1 January 2014 as a result of legacy contracts coming to an end and an increasing reliance on coal seam gas from Queensland. This is increasing the required retailer revenue for 2013-14.

The changes in cost components are summarised below.

## Cost of Gas

Origin is not forecasting any real change to the wellhead cost of gas for the first two years of the period.

Origin will be increasingly reliant on coal seam gas (CSG) from Queensland from 1 January 2014 onwards. As a result, Origin is forecasting an increase in wellhead gas cost in 2013-14 reflecting industry expectations of gas prices moving to export price parity from that point.

Origin has also increased the cost of peak gas (MDQ) relative to the allowance made by ESCOSA for 2010-11, the final year of the current price determination. The increase is predominantly being driven by a real increase in the wellhead MDQ price as Origin believes the allowed wellhead MDQ costs for 2010-11 were below reasonable market costs. However, the increase is also impacted by Origin's use of load factors that are more commensurate with its gas portfolio. The adjustment to load factors has also had an impact on forecast transmission costs over the period.

Although the previous allowance for swing gas is now obsolete, Origin has made a minor allowance over the forecast period to recognise the wholesale balancing risks under the current short term trading market (STTM).

## Retail Costs

Origin submits that total retail costs should include both retail operating costs and customer acquisition costs as a retailer should be able to recover at least the minimum costs that it incurs in obtaining, retaining and servicing its customers.

ESCOSA's previous approach of including acquisition costs as part of the retail margin has not provided an adequate coverage of costs and has thus lead to competition stalling in the South Australian gas market. Retail costs need to be set based on a prudent, new entrant retailer to encourage competition and thus greater price offerings to customers.

Origin's proposal for retail costs is for ESCOSA to use the proposed South Australia electricity benchmark cost of \$115 (\$2010) per customer and to continue to adjust this forward using a CPI percent approach to account for increasing labour costs.

In this submission, Origin has also included an assessment of REES costs but only for the six month period from 1 July 2011-30 December 2011. ESCOSA has already approved costs until 30 June 2011 and these costs are currently included in standing contract retail prices. It was agreed as part of that process that any outstanding amounts would be considered as part of Origin price path proposal for 2011-12.

## Retail Margin

The final cost input to the proposed average gas price is the retail margin on controllable costs. Origin proposes that a retail margin of 14.6 percent on controllable costs is appropriate for a gas retailer in South Australia.

Origin believes that based on the ongoing obligation for prepayment of network charges to Envestra and taking into account the additional risks faced by gas retailers, a target retailer margin of 14.6 percent is comparable to the retail margins approved for gas retailers in other jurisdictions. Note that this is at the lower end of the range approved for gas retailers in New South Wales.

However, Origin is proposing the maintenance of the current 13 per cent margin in 2011-12 transitioning to the cost reflective margin of 14.6 percent in 2012-13 and 2013-14. Origin believes this approach is appropriate given the impact that the inclusion of customer acquisition costs in total retail cost will have on standard contract tariffs in the first year of this Determination.

Origin would acknowledge that the 13 percent retail margin proposed to continue in 2011-12 is not comparable to that allowed in the 2008 Determination as it previously included some allowance for customer value or acquisition cost within the retail margin. In this submission, Origin proposes customer acquisition costs be considered as part of retail costs.

For 2011-12, the retail margin sought by Origin translates to an average annual return of less than \$36 per residential customer and \$141 per small business customer. With such low margins, particularly in the residential market, it takes only a minor forecast error to put the commercial viability of gas supply to standing contract customers at risk.

## Tariff Changes

Given the proposed increases in average retailer revenue set out in Table A.1 above, and assuming that non-controllable costs remain constant in real terms, standing contract prices would be expected to increase as set out in Table A.2 (subject to any actual changes in non-controllable costs).

**Table A.2: Forecast Real Increases in Standing Contract Prices**

	2011-12	2012-13	2013-14
Residential	5.2%	0.6%	4.9%
SME	1.0%	0.6%	8.6%

Residential customers are expected to see real increases in their standing contract prices of the order of 5 percent in 2011-12 and 2013-14 with prices remaining relatively stable in real terms in 2012-13.

The inclusion of customer acquisition costs within retail cost has a smaller impact on small business customers and consequently, these customers see little real change in their standing contract prices until 2013-14 when the impact of increasing wellhead gas costs is marked.

## Indicative Customer Impacts

Indicative customer impacts for 2011-12, based on the expected standing contract increases highlighted in Table A.2, are set out in Table A.3.

At this stage, Origin is not proposing significant restructuring of the retailer tariff component so customers will see similar price changes however, if there is substantial restructuring of network charges, these will flow directly through in the standing contract prices.

Subject to unexpected changes in non-controllable costs, average residential customers will see increases of around \$8 per bill while the average small business will be paying an additional \$22 a quarter.

**Table A.3: Indicative Customer Bill Impacts for 2011-12**

Average Annual Consumption		Residential	SME
Low consumption	(\$/qtr)	\$4.96	\$3.33
Medium consumption	(\$/qtr)	\$8.14	\$22.62
High consumption	(\$/qtr)	\$17.70	\$104.06

# 1 Introduction

Origin Energy (Origin) supplies natural gas, electricity and liquid petroleum gas (LPG) to more than 3 million business and residential customers in Australia, New Zealand and the Pacific. Origin is a participant in most segments of the energy supply chain including exploration and production, power generation and energy retailing and trading.

Origin's interest in the gas market in South Australia is focused on gas retailing with some interests in gas production. However, in addition to its gas retail business, Origin is an active participant in the electricity retail market in South Australian and has also invested in a number of generators in that state including being joint owner of the Osborne generation station (180MW) and full ownership of Ladbroke (80MW) and Quarantine (210MW) generation stations.

## 1.1 Price path proposal

For the purposes of section 34A(4a)(d)(ii) of the *Gas Act 1997* (the Act), Origin requests ESCOSA determine the average retail revenue component of the South Australian standing contract prices for the sale and supply of natural gas in accordance with this price path submission.

The Origin price path submission was provided to ESCOSA in a confidential submission on the 5 November 2010 and this public submission is essentially the same document, however, certain information has been omitted because of its confidential or commercially sensitive nature. Origin has provided detailed explanation of the inputs on which Origin's price path submission have been based within this submission to allow stakeholders to understand the reasons for Origin's proposal.

Origin requests that ESCOSA continue with its current approach of adopting separate average retailer revenue controls, applied on a \$/GJ basis, for each of the residential and small business (SME) customer categories. The period of the determination requested is three years, from 1 July 2011 to 30 June 2014 and is in respect of small customers (annual consumption of less than 1 terajoule per year, as defined in the *Gas Regulations 1997*).

The average retailer revenue components for each year in the current determination period were set by ESCOSA in June 2008 with effect from 1 July 2008<sup>1</sup>, and were designed to apply up to 30 June 2011. Subsequently, ESCOSA approved the 2008-09 standing contract prices that were based on delivering the allowed average retailer revenue and a pass through of the approved network charges and other non-controllable costs. The standing contract price for the remaining years of the price path consisted of tariffs that recovered the approved retailer tariff component for that financial year plus the relevant published network charges, and other regulated market charges, for that particular year.

As set out in section 1.2 below, Origin proposes to continue this approach in the next determination period. Proposed changes in average retailer average revenue will therefore be based on forecast changes in controllable costs and retail margin and applied to the retail component of the current retail tariffs.

Origin notes that its actual costs for 2010-11 may vary to the previous allowance for 2010-11 and as a consequence the movement in average revenue in 2011-12 is based on the retail component of the current 2010-11 standing contract tariffs.

In this proposal, Origin has not specifically analysed the variations between the 2010-11 actual costs and the costs approved in the 2008 Determination and therefore does not propose to include any retrospective adjustment for these variations.

Please note that all prices and costs quoted in this submission are exclusive of GST.

## 1.2 Approach to developing the price path proposal

This submission was prepared with regard to the objectives of gas industry regulation, as set out in the Act, together with the objectives set for ESCOSA under the *Essential Services*

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<sup>1</sup> ESCOSA, *Gas Standing Contract Price Path, Final Inquiry Report and Final Price Determination*, June 2008.

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*Commission Act 2002* and the factors that ESCOSA is required to consider in making a price determination under that Act.

Origin has sought to protect the long term interests of South Australian consumers by proposing a price path that reflects the underlying costs of selling and supplying gas to small customers given a competitive wholesale market for gas. The proposal results in outcomes that are fair and reasonable at an individual customer level while preserving the viability of supply to small customers in the face of growing demand for gas across the whole south-eastern gas market driven by both electricity generation and the potential export of liquefied natural gas (LNG). These trends are expected to continue through the determination, along with the increasing interdependence of gas markets, creating a great deal of uncertainty about future gas costs particularly out to 2013-14.

The proposed average revenue price path specifically applies to Origin's mass market standing contract customers. Origin's view is, however, that retail costs do not differ significantly between gas and electricity mass market customers and thus a similar cost allowance should be set for both fuels.

It is important to note that the number of customers on gas standing contracts has rapidly declined since the commencement of FRC. However churn rates in South Australia over the last three years are less than forecast in the current determination and this has influenced Origin's approach to the forecasts of gas customer numbers and gas consumption for the next regulatory period.

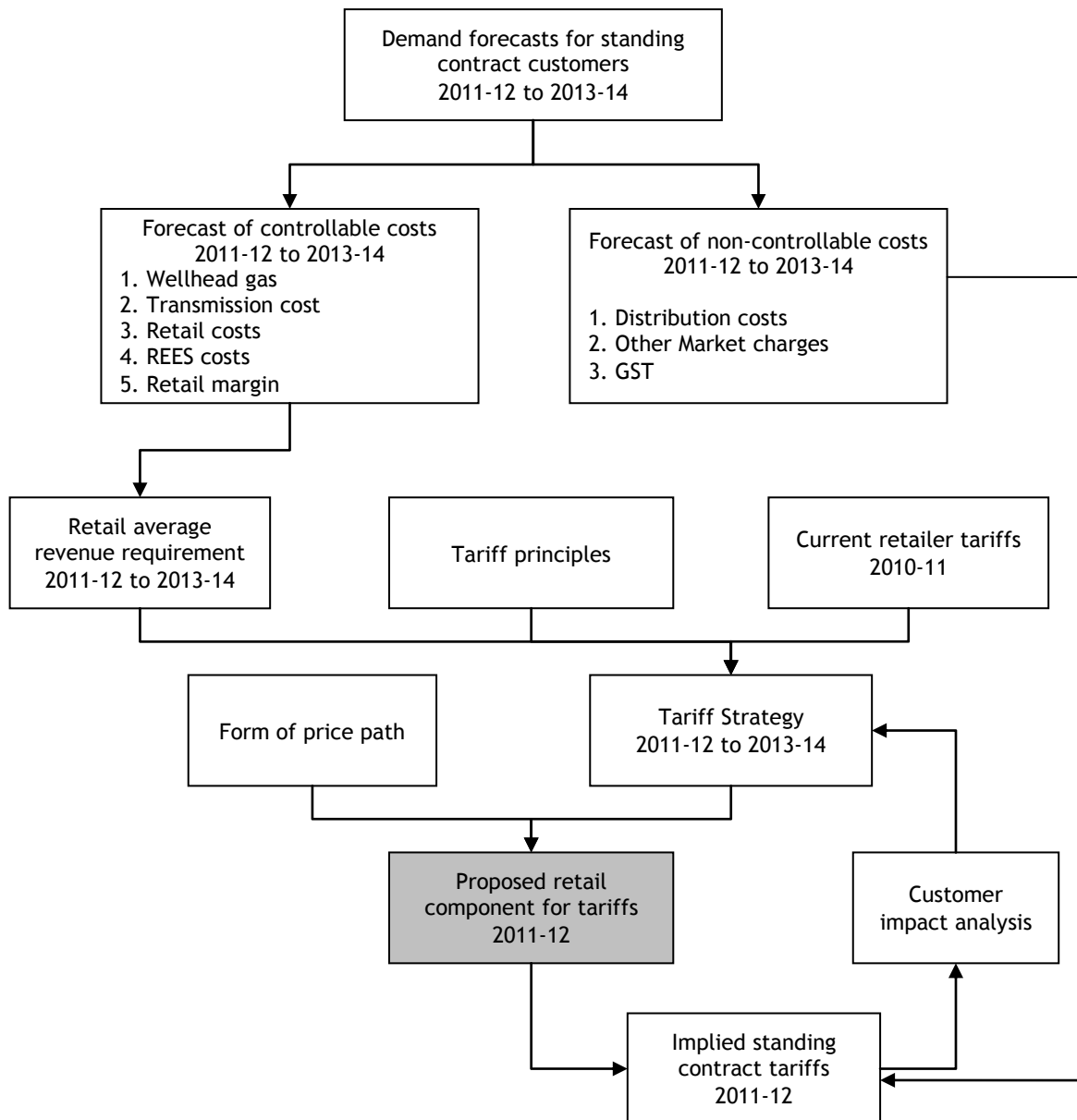
It also highlights the difficulty facing all parties in imposing a three year price path based around an average retailer revenue approach. Nevertheless, for the purposes of this submission, Origin has constructed a proposed price path as set out in Figure 1.1.

The price path includes:

- Demand forecasts: Separate demand forecasts are built up for each customer segment and geographical region. For each of these segments the demand forecast is a function of both forecast customer numbers and forecast average gas consumption;
- Cost building-block approach: The forecast standing contract customer numbers and demand for 2011-12 to 2013-14 are used to forecast all controllable cost components that form part of the retailer tariff including wellhead gas prices, transmission charges, retail costs, REES costs and retail margin on controllable costs;
- Average revenue requirement: The controllable cost elements and customer and demand forecasts are then used to calculate the associated retailer revenue and average revenue per gigajoule requirement for each year;
- Tariff strategy: To recover the average revenue requirement defined by the building block methodology, a tariff strategy is formulated to guide the setting of retailer tariffs given relevant tariff principles (such as cost reflectivity) and the design of the current 2010-11 tariffs;
- Form of the price path: The price path takes account of the distinction between controllable and non-controllable costs, and also specifies the instrument of control, conditions for re-opening and pass-through conditions; and
- Proposed price path: The proposed price path combines the form for the price path with the tariff strategy necessary to achieve the average retailer revenue requirement within acceptable customer impact limits.



Figure 1.1: Origin Approach to developing the proposed price path



In this submission, Origin has only calculated the percentage change in the average retailer revenue path needed to recover controllable costs including retail margin. Retailer tariffs for 2011-12 will be proposed during this consultation process but retail tariffs for final years of the period will be calculated on the basis of the final determination and submitted for approval to ESCOSA in May of each relevant year.

### 1.3 Risk Analysis

There are inherent risks in setting retail prices for a three year period because the regulatory framework requires assumptions to be made regarding future gas costs, transmission costs, changes to retail costs and appropriate returns. These risks are greatest for a standard retailer who is required to supply small customers on a regulated tariff with revenue constrained by the level of the regulated tariff.

As identified by IPART<sup>2</sup>, risks can be allocated based on the following criteria:

<sup>2</sup> IPART, *Review of Regulated Retail Tariffs and Charges for Electricity 2010-13, Draft Report and Draft Determination*, December 2009, p44

- *Systematic risks* - these arise from retailers' exposure to overall economic conditions (ie. small customers demand falls in line with slower economic growth). Allowances to cover these risks are usually covered in the retail margin; and
- *Non-systematic risks* - these risks are outside the economic environment and are related to unforeseen events such as change in weather patterns, capacity of networks or regulatory requirements (ie. national reform, energy efficiency schemes). These costs are generally included directly in the cost of gas or retail cost component or are mitigated in the regulatory framework through specific cost pass-through mechanisms.

In Table 1.1, Origin has categorised identifiable risks and indicated whether the risks have been included as part of the calculation of cost of gas, retail costs, retail margin or whether Origin will rely on the cost pass-through mechanism to mitigate these risks. This itemisation has been done to ensure that all risks are covered through the determination in a transparent manner.

**Table 1.1: Allocation of Risks**

Risk	Description	Comments	Allocation
<ul style="list-style-type: none"> <li>• Variation of the load profile or maximum daily quantities of standing contract customers</li> </ul>	<ul style="list-style-type: none"> <li>• Actual load profile or maximum daily quantity is different to that assumed in setting the regulated retail tariffs</li> </ul>	<ul style="list-style-type: none"> <li>• Systematic risks due to changes in economic conditions.</li> <li>• Non-systematic risks due to changes in weather patterns, technology or capacity.</li> </ul>	<ul style="list-style-type: none"> <li>• Allocated systematic risk through retail margin.</li> <li>• Allocate non-systematic risks associated with estimating MDQ in cost of gas.</li> </ul>
<ul style="list-style-type: none"> <li>• Variations in cost of gas contract price</li> </ul>	<ul style="list-style-type: none"> <li>• Higher than forecast gas contract price</li> </ul>	<ul style="list-style-type: none"> <li>• Non-systematic risk due to changes in capacity and price.</li> </ul>	<ul style="list-style-type: none"> <li>• Non-systematic risk through cost pass through event.</li> </ul>
<ul style="list-style-type: none"> <li>• STTM cost assumptions</li> </ul>	<ul style="list-style-type: none"> <li>• Volatility of prices and deviation penalties</li> </ul>	<ul style="list-style-type: none"> <li>• Mainly non-systematic risks due to changes in demand</li> </ul>	<ul style="list-style-type: none"> <li>• Non-systematic risk through cost of gas allowance.</li> </ul>
<ul style="list-style-type: none"> <li>• Material increase in customer defaults and bad debts</li> </ul>	<ul style="list-style-type: none"> <li>• Significant change in bad debt and default rate among standard customers</li> </ul>	<ul style="list-style-type: none"> <li>• Systematic risk due to changes in economic conditions.</li> <li>• Non-systematic risk due to changes in gas prices and regulatory changes.</li> </ul>	<ul style="list-style-type: none"> <li>• Systematic risk to retailers in setting retail margin.</li> <li>• Normal business risks of bad debt allocated to retail operating costs.</li> </ul>
<ul style="list-style-type: none"> <li>• Market Costs (ie. AEMO)</li> </ul>	<ul style="list-style-type: none"> <li>• Market operating costs from third parties</li> </ul>	<ul style="list-style-type: none"> <li>• Non-systematic risk due to changes in market operating rules.</li> </ul>	<ul style="list-style-type: none"> <li>• Non-controllable cost. Risk will be treated as a direct cost pass through (along with network charges).</li> </ul>
<ul style="list-style-type: none"> <li>• Prepayment of Envestra charges</li> </ul>	<ul style="list-style-type: none"> <li>• Prepayment of Envestra charges in advance</li> </ul>	<ul style="list-style-type: none"> <li>• Systematic risk due to demand variations.</li> </ul>	<ul style="list-style-type: none"> <li>• Systematic risk allocated through retail margin.</li> </ul>
<ul style="list-style-type: none"> <li>• Network Adjustment</li> </ul>	<ul style="list-style-type: none"> <li>• Network charges incurred regardless of whether customer is at site</li> </ul>	<ul style="list-style-type: none"> <li>• Systematic risk due to variations in consumption.</li> </ul>	<ul style="list-style-type: none"> <li>• Systematic risk allocated through retail margin.</li> </ul>
<ul style="list-style-type: none"> <li>• Change in price of carbon</li> </ul>	<ul style="list-style-type: none"> <li>• Introduction of CPRS or carbon tax</li> </ul>	<ul style="list-style-type: none"> <li>• Non-systematic risk due to regulatory development.</li> </ul>	<ul style="list-style-type: none"> <li>• Cost pass through event.</li> </ul>
<ul style="list-style-type: none"> <li>• Energy efficiency schemes</li> </ul>	<ul style="list-style-type: none"> <li>• Introduction or change in green energy schemes</li> </ul>	<ul style="list-style-type: none"> <li>• Non-systematic risk due to market, policy and regulatory developments</li> </ul>	<ul style="list-style-type: none"> <li>• Cost pass through event.</li> </ul>

Risk	Description	Comments	Allocation
<ul style="list-style-type: none"> <li>Change to customer numbers</li> </ul>	<ul style="list-style-type: none"> <li>Customer churn to market contracts is higher than expected.</li> </ul>	<ul style="list-style-type: none"> <li>Non-systematic risk due to changes in prices or market operating environment.</li> </ul>	<ul style="list-style-type: none"> <li>Non-systematic risk included in retail operating costs.</li> </ul>
<ul style="list-style-type: none"> <li>Changes in regulation, legislation or taxation</li> </ul>	<ul style="list-style-type: none"> <li>Government imposed changes in regulatory environment that were unanticipated at the time of making the determination</li> </ul>	<ul style="list-style-type: none"> <li>Non-systematic risk due to unforeseen regulatory or taxation change event.</li> </ul>	<ul style="list-style-type: none"> <li>Cost pass through event.</li> </ul>
<ul style="list-style-type: none"> <li>General Business risks</li> </ul>	<ul style="list-style-type: none"> <li>Economic risks (unexpected changes in interest rates), credit risk, operational risk (ie. equipment failure, fraud)</li> </ul>	<ul style="list-style-type: none"> <li>Mainly a systematic risk due to changes in economic conditions.</li> </ul>	<ul style="list-style-type: none"> <li>Systematic risks addressed through retail margin.</li> </ul>

#### 1.4 Organisation of the price path submission

The structure of this submission addresses the approach of Figure 1.1 including:

- a background on Origin Energy, the South Australian gas market and the sale and supply of gas to standing and default contracts;
- a discussion of the appropriate form of the price path;
- demand forecasts for standing contract customers over the period;
- an item by item justification of controllable costs;
- an identification of non-controllable cost items and likely movements;
- a summary of Origin's retailer revenue requirement; and
- a discussion of Origin's tariff strategy.

#### 1.5 Confidentiality

Origin has lodged two versions of its price path submission with ESCOSA, this public version and a confidential version. Origin is working with ESCOSA to ensure the protection of all confidential information in accordance with the legislations and Origin's obligations to our various counterparties under our commercial contracts.

Nonetheless, Origin is sympathetic to the views of public stakeholders regarding the difficulty of commenting on pricing proposals with sparse detail. To address this problem, in the public version of the submission, Origin has sought to explain qualitatively, where it cannot do so quantitatively for reasons of commercial confidentiality, how the various components of the proposed price path are forecast.

## 2 The South Australian gas market

### 2.1 Natural gas in South Australia

The South Australian Gas Company (SAGASCO) was incorporated in 1861, over 140 years ago. For the first 100 of those years, SAGASCO distributed coal gas to Adelaide and its surrounding villages, to a steadily expanding domestic, commercial and industrial customer base. SAGASCO commenced distribution of LP gas, a by-product from the local petroleum refining industry, and by the mid-1960s the transition from coal to gas was largely complete. This coincided with the discovery of natural gas in the Cooper/Eromanga Basin.

Figure 2.1: Current gas sources, transmission networks and major delivery points



Note. Mount Gambier is now connected directly to the SEA Gas pipeline.

Although SAGASCO entered a supply and purchase agreement with the Cooper Basin Producers in 1966, it was the subsequent growth in demand for natural gas for electricity generation that made the development of the gas fields and the construction of the Moomba to Adelaide pipeline economically viable. Electricity generation accounted for around 47 per cent of gas use in the State in 2007-08 however this percentage would be substantially greater in 2010-11 with ABARE forecasting it to grow to 60 per cent by 2029-30.

The first natural gas was supplied to Adelaide in November 1969 and during the 1970s it became the major source of energy for South Australian industries. Wider distribution of natural gas to regional centres developed during the following two decades.

In addition to the Cooper Basin, South Australia also has access to natural gas from the on shore and off shore gas fields in Western Victoria including Minerva, Yolla, Thylacine and Geographe fields. While these provide additional supplies to South Australia, they also demonstrate the increasing integration of the gas market (along with the Cooper Basin hub), a factor that provides for greater competition between sellers but also between buyers.

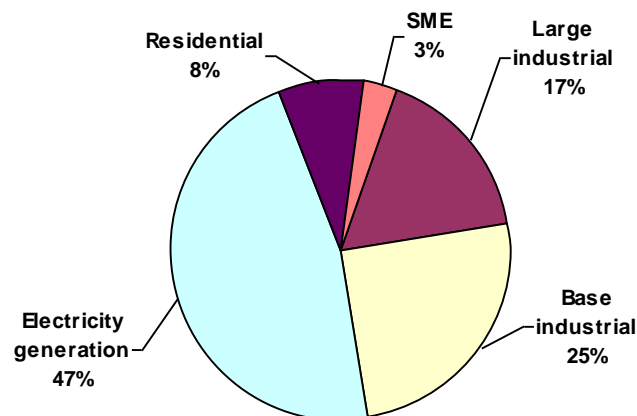
In mid 2009, Epic commissioned their QSN Link. The QSN Link is an extension of Epic's South West Queensland Pipeline (SWQP) and has been designed to physically transport up to 250TJ/d when fully compressed, operating at pressures up to 15.3MPa. The pipeline will transport gas from the Wallumbilla Gas Hub through the SWQP to connect with the Moomba to Adelaide Pipeline System and the Moomba to Sydney Pipeline.

The capacity of the SWQP, following the first stage expansion, is equivalent to 40 per cent of the peak Adelaide demand. At the end of 2009, Epic Energy signed a long term Gas Transmission Agreement with Origin Energy to underpin the proposed Stage 3 looping expansion of the entire 935km SWQP (including the QSN Link). The project involves the construction of a new pipeline adjacent to the existing SWQP as well as further compression at the inlet of the SWQP at Wallumbilla. The expanded SWQP capacity would be increased to approximately 380TJ/d.

### 2.1.1 Gas consumption and maximum daily demand

As is shown in Figure 2.2, electricity generation and industrial businesses (ie. mining, manufacturing and construction) are the dominant users of natural gas in South Australia. Residential and small business users have not typically been large consumers of gas in South Australia. ABARE data further forecasts that gas consumption will continue to grow on a similar proportional basis for the next 20 years with the greatest increases in gas consumption in the electricity generation sector.

**Figure 2.2: Composition of South Australian natural gas consumption**



Source: ABARE 2008, Australian Energy: National and State Projections to 2029-30.

In assessing gas costs for standing contract customers, it is important to understand not only their annual gas requirements but the profile of their demand during the year. In particular, both wholesale gas costs and transmission costs contain a significant component that relate to capacity requirements - the amount that can be delivered on a peak demand day.

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 (load factor).

These concepts are particularly important in considering the costs associated with supply to residential and small business customers as these customers generally have a more peaky demand profile but also require firm supply. For instance, during winter when demand by

residential customers on a cold day may be very high, it is generally larger industrial customers who will have their supply constrained if there is a shortage of gas in the market.

## 2.2 Short Term Trading Market

An additional element to the gas wholesale market is the introduction of the short term trading market (STTM) which officially became operational in South Australia on 1 September 2010. The introduction of this market has significantly increased the costs and complexity of operating in the market and managing a gas portfolio more generally. For example, Origin as the incumbent retailer with an obligation to supply all small customers, faces new risks and costs of supply (such as deviations penalties) from operating in this infant market.

AEMO's role in the STTM is to settle the market, publish forecasts of prices and quantities, sets daily gas prices, debits and credits accounts of STTM Users and shippers and collects payments.

As part of AEMO's settlement process, AEMO debits deviation payments from STTM Users if the amount of gas consumed is greater than that nominated by the STTM User. This deviation charge is higher than the ex ante price to encourage Users to more accurately schedule. A deviation penalty can also be incurred by a STTM User if the amount consumed is less than that forecast by the STTM User, however, the deviation charge in this circumstance is lower than the ex ante price.

These deviation penalties are particularly problematic for a retailer such as Origin with a large mass market load and limited control over demand.

## 2.3 Retail Competition in South Australia

An important consideration in setting standard gas prices in South Australia is assessing the level of competition in the small customer gas segment. Competition in the gas market infers that prices are reflective of costs and customers benefit through greater price offerings and discounts. Origin believes that the need to consider the level of competition in setting prices is encapsulated in the primary objective of section 6 of ESC Act where it states that the Commission needs to take into account:

*“the long term interests of South Australian consumers with respect to the price, quality of and reliability of essential services”.*

The latest competition review found that while there was intense competition in the gas market when it first opened, it has slowed in recent years. Market transfers peaked around 27 per cent in December 2004, with it stalling in 2007 leading to a market transfer rate of only around 12 per cent in June 2009<sup>3</sup>. Further, the review found that competition in the gas market is directly related to the electricity market. That is, if the level of market activity is high in the electricity market, the level of activity in the gas market is relatively high. No retailers were actively seeking stand alone gas customers.

Origin believes that this is largely due to the fact that the reward: risk ratio (ie. retail margin) for a gas customer is not appealing. Retailers are apprehensive to sign up gas customers to stand alone market contracts as the benefits of obtaining these customers is either negligible or quickly eroded if an error is made in the market (ie. billing). It is important to note that retailers typically use standing tariffs as the reference price for market contracts. If these prices are not reflective of costs nor provide some reward to the retailer in obtaining the customer, competition is likely to continue to stall.

This is further supported by the 2008 Australian Energy Market Commission (AEMC) Competition Review of the South Australian energy market that found that while there was a steady conversion of standing contract gas customers to market contracts, the retail margin was seen to be unattractive and competition would only increase if there was sufficient margin to account for changes in input costs<sup>4</sup>.

Origin would also point to the advances made to regulated retail pricing of electricity in South Australia, namely ESCOSA's introduction of a relative price movement (RPM)

<sup>3</sup> ACIL Tasman, *Competition in South Australia's Retail Energy Markets - Report on interviews with participants*, June 2010, p24

<sup>4</sup> AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia*, First Final Report, September 2008.

methodology from 2011. Origin is supportive of this methodological change but believes the South Australian gas market is not showing the necessary level of product choice to justify proposing it for this period. However, Origin believes that ESCOSA should be setting prices on a competitive basis with the view that gas retail prices will be de-regulated at the end of the next three year pricing period.

To achieve this, an appropriate price path needs to be set and Origin's views on the costs and risks of operating in the gas market are set out in the following sections.

### 3 Standing contract gas customers

Since 28 July 2004, all South Australian natural gas customers have been able to choose their gas retailer. However, the South Australian Government has provided small customers (annual consumption less than 1 TJ) with the safety net of regulated prices and if requested by a small customer, Origin has the obligation to sell and supply gas to any such customer on the regulated price. The number of small customers on the regulated price has been falling as customers continue to enter into market contracts with Origin or other gas retailers.

It should be noted that Origin is the only gas entity to whom the obligation to supply on a standing contract basis applies and, moreover, the standing contract price can only be varied via a price determination by ESCOSA.

#### 3.1 Regulation of standing contract prices

The current standing contract prices were set by ESCOSA and are designed to apply up to 30 June 2011. From 1 July 2011, new standing contract prices must be determined.

ESCOSA has chosen to do this in the previous determination by setting the average retailer revenue by market segment (residential and small business customers) for three years, the minimum period allowed under the current statutory framework. ESCOSA has allowed Origin to set the individual retailer tariffs for each segment and gas supply region consistent with the average revenue target. The approved standing contract prices are then simply the sum of the approved retailer tariffs and the network charges and other non-controllable costs.

##### 3.1.1 *What guides the assessment of an 'appropriate price'*

At a high level, there are three points of reference for ESCOSA: the objects of the Gas Act; the objectives set for ESCOSA under the Essential Services Commission Act 2002; and, under the same ESC Act, the generic list of factors that ESCOSA is required to have regard to when making a price determination.

Origin has considered the objectives of these Acts and believes that the objectives, as set out in ESCOSA's Final Report on Gas Standing Contract Prices in 2008, provide a reasonable basis for setting gas prices in the new determination period from 1 July 2011.

The focus is on protecting the long term interests of gas consumers by establishing a price path consistent with the costs of supplying standing contract customers, promoting competition, providing for an appropriate return to the regulated entity and ensuring there are sufficient incentives for investment in consumers' long term requirements.<sup>5</sup>

Once the retailer revenue has been determined, the network and other non-controllable costs are treated as a simple pass-through; only the retailer tariffs are subject to the price control formula. Origin expects this approach to continue in the new determination, and for the new determination to be limited to the minimum period of three years.

#### 3.2 Nature of the service and service standards

Standing contract prices relate to the sale and supply of gas by Origin to small customers under the standing contract terms and conditions. ESCOSA has set these terms and conditions under the *Energy Retail Code* (Code) which also establishes a number of service standards on the relevant retailer.

Meeting these service standards, together with complying with the various rules set out in the Code is a factor that must be recognised in the assessment of retail operating costs. Moreover, the jurisdictional nature of these rules means that potential synergies across Origin's total customer base are somewhat limited until the establishment of the National Energy Consumer Framework (NECF) under the national reform process.

Origin proposes that any potential cost impacts due to changes in regulatory requirements, such as NECF, would be recovered via a cost pass-through application (section 5.4).

<sup>5</sup> ESCOSA, *Gas Standing Contract Price Path, Final Inquiry Report and Final Price Determination*, June 2008, pA11-12.



### **3.3 Charges not covered by the price path**

There are a number of other fees and charges relating to the supply of gas which may also appear on the customer's bills and these additional charges include both distribution charges that are passed-through as excluded services and various retail fees.

These fees include (but are not limited to):

- special meter reading charges;
- disconnection/reconnection charges;
- account establishment fees;
- dishonoured cheque fees;
- late payment fees; and
- credit card payment fees.

## 4 Demand forecasts

The cost of supplying standing contract customers varies between the small customer segments (residential and small business) and to some degree, across pricing zones and as a consequence, Origin has separate retail tariffs across these groups.

As a result, in order to estimate the average retailer revenue requirement for the period 2011-12 to 2013-14, Origin has produced ten separate forecasts – one for each combination of customer segment and pricing zone.

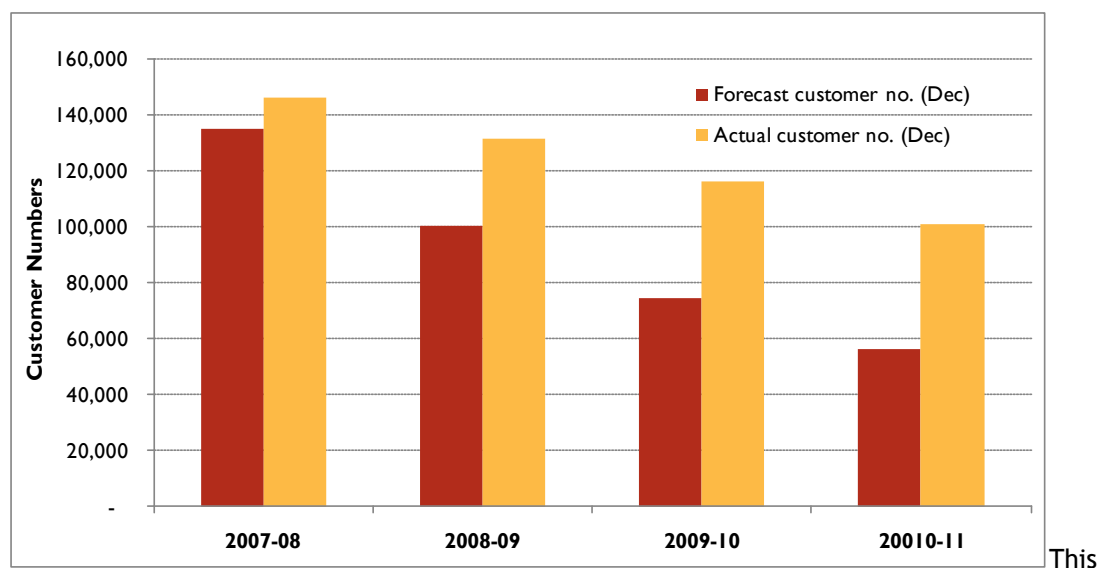
Each of these demand forecasts includes an estimate of the average customer numbers to be billed each year, total gas consumption by tariff block (reflecting the seasonal profile of consumption) and the average annual consumption per customer.

As an initial step, Origin performed an analysis of actual gas billing data for the last three years (2007-08 to 2009-10) which demonstrated that:

- usage patterns have been reasonably stable over this time, particularly with respect to the important parameters of average consumption, allocation between regions and allocation of consumption to the consumption blocks; and
- there has been a steady and consistent decline of customers on standing contracts over the last three years.

Origin notes that the decline in customers on standing contracts is lower than in previous years and consequently, much less than was forecast by Origin in the previous determination. Figure 4.1 highlights that the actual numbers of standing contract customers over the period has been much greater than was forecast in 2008.

**Figure 4.1: Forecast v Actual Standing Contract Customers, 2007-08 to 2010-11**



This variation was caused by the number of residential customers remaining on gas standing contracts over the last three years and Origin believes this is explained by the reduced competition in the South Australian energy markets generally and more specifically, the limited margins available for gas customers. The implied market transfer rates for South Australia are discussed further in section 4.3.

## 4.1 Historical Customer Numbers and Consumption

In this Determination, Origin has used a methodology for estimating customer numbers and consumption that varies to the methodology used in 2008. Origin has been able to extract volumes from actual billing information for all bills covering consumption between 1 July 2007 and 30 June 2010.

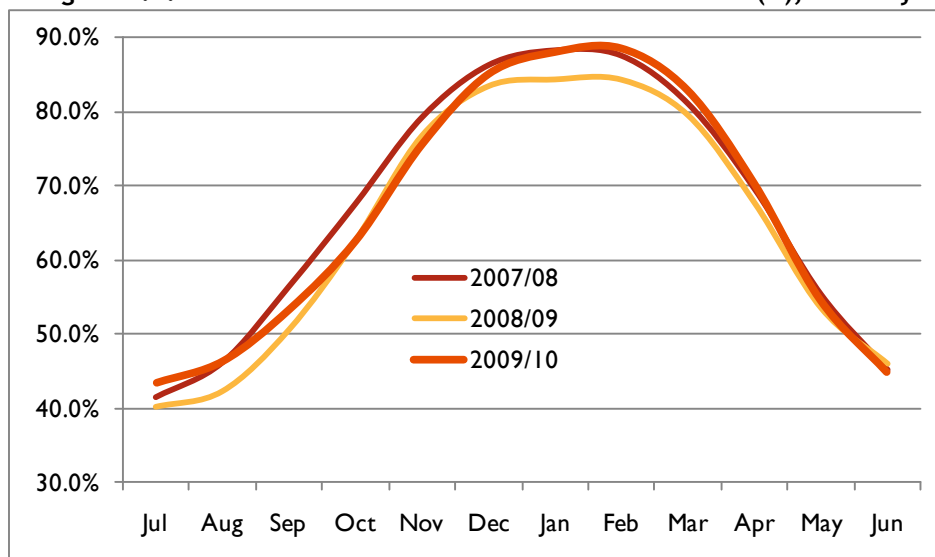
An analysis of historical customer numbers and consumption for both residential and small business customers highlights that:

- there appears to be a consistent downward trend in customer numbers;
- average consumption has been reasonably stable over the period; and
- the consumption between tariff blocks is also stable. This was found to be the case across all regions.

Origin also conducted a detailed analysis of the relative consumption allocation on a month to month basis to ensure that consumption patterns had not changed markedly. Figure 4.2 shows the percentage allocation of residential tariff block 1 of monthly consumption for the Adelaide region. Clearly, although there is some movement between years, the allocations from 2007-08 to 2009-10 follow much the same shape.

Consequently, Origin has used percentages from 2009-10 as the basis for allocating forecast total consumption into respective tariff blocks.

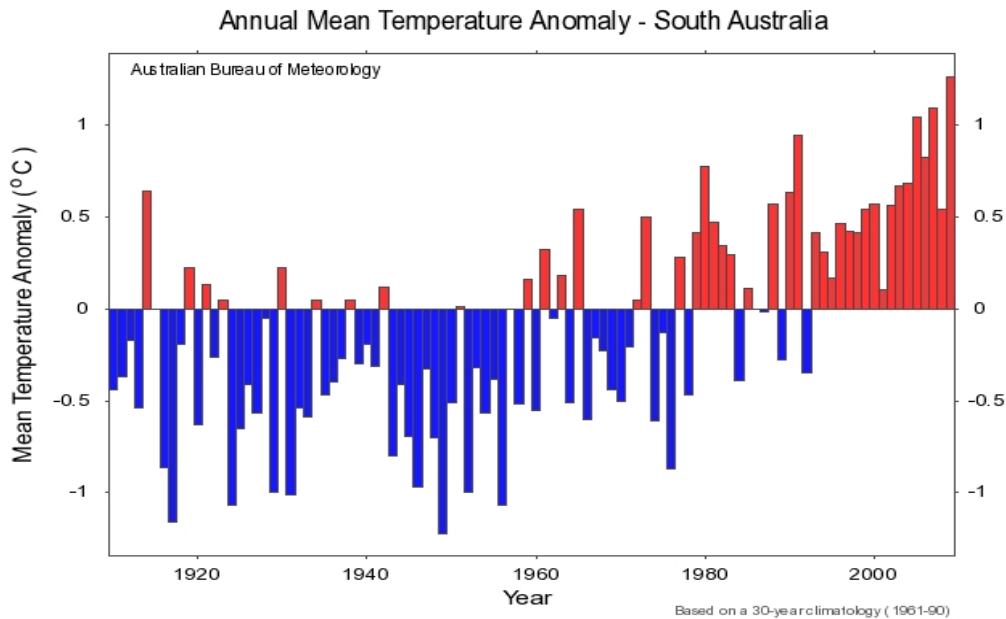
**Figure 4.2: Adelaide Residential Tariff Block 1 Allocation (%), monthly**



The allocation between customer numbers and regions for both the residential and small business segments also have remained stable so Origin has used the proportions derived from 2009-10 as the basis for allocating the forecast customers into respective regions.

Origin did find that the residential average consumption/customer in 2009-10 was slightly lower than in previous years, probably due to slightly higher average temperatures during 2009. Figure 4.3 was obtained from the Australian Bureau of Meteorology and illustrates the historical annual mean temperature anomaly. The last three anomalies (2009, 2008 and 2007) appear to coincide with the variations in average consumption during that time.

Consequently, Origin has used the 2008-09 average consumption figures for residential and SME customers respectively in its forecast rather than the lower 2009-10 numbers.

**Figure 4.3: Annual Mean Temperature Anomaly - South Australia**

## 4.2 Forecasts

In order to produce the basic customer number forecast for each segment, Origin determined a trend line which best describes the change in monthly billed counts.

The forecasts produced by these trend equations form the foundation for the volume forecasts as the estimated average consumption per customer in each region and each segment are then used with the customer number forecasts to forecast total consumption for each region from 2011-12 to 2013-14.

The resulting demand forecasts for each customer segment and pricing zone for each year have been provided to ESCOSA as Confidential Information.

## 4.3 Market transfer rates

Although there has been a steady and consistent decline of customers on standing contracts in South Australia over the last three years, market transfers<sup>6</sup> have been relatively low in South Australia in comparison to other Australian states. Origin's data suggests that annualised market transfers for South Australian mass market gas customers was around 24.6 per cent in 2004-05, has been falling since 2007 with market transfers around 10.8 per cent in 2009-10.

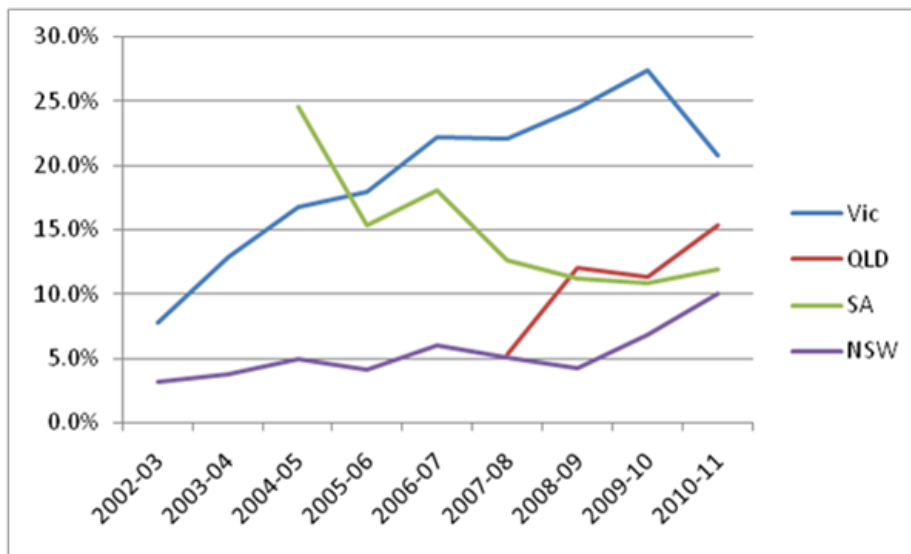
In contrast, market transfer rates in Victoria peaked last financial year at around 27.4 per cent and although they have slightly fallen in the recent months, market transfers are still sitting at a healthy 20.8 per cent in this financial year. Given these significant transfer rates, it was found that competition was effective in Victoria and prices have been de-regulated. This means that there is sufficient investment return for retailers to compete for customers and offer them a favourable market offer.

In recent years, IPART has also recognised that in order for there to be competition in the New South Wales gas market, regulated prices need to reflect costs. This has led to IPART raising regulated tariffs and approving a retail margin that more reflects the corresponding risks compared with their previous determinations and with the actual margins under their determination (which was significantly less than the forecast margin due to previous failure to recognise actual retail market risks).

These increases in tariffs have partially restored the position and may have had some influence on the recent increase in competition in New South Wales. Origin believes that to increase competition in the retail gas market in South Australia, prices need to reflect the costs and risks of operating in such a market.

<sup>6</sup> The above relate only to market transfers. This is where a customer moves from one retailer to another retailer. They do not include customers that have moved from a standard contract to a market contract with Origin.

Figure 4.4: Natural Gas Annualised Mass Market Churn Rates



## 5 Form of the price path

Origin proposes a continuation of the current form of the price path.

### 5.1 Scope of control

Origin proposes that the price control apply only to controllable costs with non-controllable costs treated as a direct pass through into standing contract prices. As with current practice, gas transmission costs are to be classified as controllable costs because they are contracts negotiated by the retailer with the relevant transmission company and prices may not (for a variety of reasons) reflect any prices determined under a pipeline access arrangement<sup>7</sup>.

In relation to non-controllable costs, Origin would highlight that the administrative arrangements for the price control need to ensure that Origin continues to be able to pass-through Envestra's distribution charges based on actual rather than forecast network tariffs.

In this submission Origin has also treated AEMO direct market charges as non-controllable costs and therefore they are not included in the average retailer revenue proposal which is based on controllable costs only.

### 5.2 Instrument of control

Origin has requested that ESCOSA determine average retailer revenue price controls for residential and SME customers separately. These agreed price control formulae will then form the basis of Origin's retail tariffs to apply to residential and SME customers at the regional level - a total of 10 tariff sets. While tariffs will vary between the regions, in aggregate, the revenue from the tariffs will be consistent with the two average retailer revenue control formulae.

The standing contract price for a particular customer segment and pricing zone would then be defined as the sum of the relevant retailer tariff, Envestra's network tariff and miscellaneous non-controllable costs including AEMO charges.

### 5.3 Period of price path

Under the Act, the minimum period for the price path is three years and Origin proposes that the price path for standing contract prices be limited to the minimum of three years from 1 July 2011 to 30 June 2014.

Origin believes ESCOSA should be setting prices with the view that prices will be de-regulated at the end of this pricing determination. To achieve this, an appropriate price path needs to be set. Retaining retail price regulation in an environment where retailers are facing increasing costs is likely to adversely affect the ability for retailers to provide price offerings to customers.

### 5.4 Conditions for re-opening

Under the Gas Act, a re-opening of the price path is a non-trivial exercise. Recent amendments to s34A(4A)(f) allows ESCOSA to re-open the price path if it is satisfied that special circumstances (ie. indirect cost) exist and to reset the X-factor within the existing price path for the remainder of the price path period.

Origin understands that ESCOSA would conduct a full inquiry in the event of a re-opening application.

Origin has designed its price path proposal to minimise the requirement for re-opening, the price path approach in South Australia.

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<sup>7</sup> The SEA Gas pipeline is not a covered pipeline and therefore transmission charges are negotiated with the pipeline owner on a commercial basis. The MAPS pipeline has previously been the subject of an Access Arrangement however, an approved Access Arrangement does not displace historical contracts, such as Origin's long standing transmission contracts.

## 5.5 Pass through items

In the 2008 Determination, ESCOSA defined relevant pass through events as:

- change in taxes events;
- regulatory reset events; and
- Ministerial Direction events.

Origin believes that these cost pass through categories are too narrow and do not encapsulate all the potential events that could occur over a three year period. This is especially true with the myriad of market reforms that are currently occurring at a national level. For example, there are discussions regarding a national energy efficiency scheme, the introduction of a carbon tax, changes to the cost of gas given potential demand for LNG and the move to a national consumer protection framework.

To cover these potential events, Origin proposes that the Determination has a pass through provision without a specified definition of events. This would reduce the risks of unforeseen future costs and the need for a re-opening of the Determination using the special circumstances provisions.

The onus would lie on Origin, as the standing contract retailer, to assess the impact of any unforeseen event and then apply for a cost pass through event if deemed it significant. Of course, ESCOSA would then assess whether any application was warranted and would make its decision on the actual pass-through required.

Furthermore, Origin does not believe that a materiality threshold is necessary as the time and cost to Origin of submitting and gaining approval from ESCOSA for a pass-through event provides its own materiality threshold. A threshold is also difficult to define to consider the ongoing and cumulative cost of potential pass-through events rather than a single year's costs.

Origin would highlight that IPART has taken this approach to cost pass through events in relation to gas. It has an unconstrained approach in that the gas retailers' *Voluntary Transitional Pricing Arrangements* sets out a process to make an application (ie. must provide justification statement, cost justifications and time periods for application) but does not impose any limit on the actual events that may give rise to a cost pass through event<sup>8</sup>. Origin believes a similar approach should be taken in this Determination.

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<sup>8</sup> Clause 4.9 of Origin's Voluntary Transitional Pricing Arrangements sets out a list of examples of events that may give rise to a pass through event, but the list is not exhaustive.

## 6 Controllable costs

### 6.1 Load factors

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 for the small business customer market segments. For the residential customer segment, for instance, the peak daily demand is around three times their average daily demand. For the small business customer segment the peak demand is around twice their average daily demand.

The load factors required for the price path are related to the regulatory requirement to meet 1 in 25 year peak demand. These load factors are important in allocating capacity related costs associated with both wellhead and transmission costs.

This in turn means that the total costs for gas and for transmission are different for residential and small business customers. Origin has submitted the same load factors as in its previous submission.

### 6.2 Cost of Gas Supply

Origin determines its forecast gas supply charges based on the portfolio of supply contracts required to ensure:

- sufficient availability of gas to meet the annual forecast demand of Origin's South Australian gas customers; and
- the level of supply security set out in the various regulatory instruments and in the standard terms and conditions of supply.

In developing a portfolio of supply contracts to ensure firm (non-interruptible) supply for small customers, Origin adopts the industry benchmark of a 1 in 25 peak day demand. This is the same supply security standard as the planning criteria used by Envestra for sizing gas distribution network pipelines in South Australia and is also consistent with Origin's obligations under its retail licence to supply gas to small customers.

As a result, Origin's supply portfolio can be viewed as being made up of a variety of physical, financial and swap contracts to supply base load and peak load demand.

The wholesale gas supply is purchased by Origin and other market participants as two distinct products;

- base load supply that is referred to in this submission as Wellhead cost; and
- peak load supply that is referred to in this submission as Wellhead MDQ Supply.

The base load supply contracts are characterised by a flat daily supply of gas with negligible tolerance between the maximum and minimum daily quantity. These contracts are characterised by a maximum daily volume, a yearly maximum volume and a yearly minimum volume. Gas that is not taken up to the contract minimum volume constraint must be paid for and is either forfeited or banked and taken in ensuing years at additional cost.

The peak load supply contracts are required to augment the base load contracts during days of high demand to allow the gas retailer to maintain supply and comply with regulatory requirements. Peak load contracts or instruments are characterised by a maximum daily volume and a fixed yearly capacity payment. Retailers such as Origin with significant mass market loads are obliged to provide for the capacity to meet this forecast demand, in advance, based on forward projections of an extreme year rather than actual peak demand.

The introduction of the Short Term Trading Market into the Adelaide Hub exposes retailers to the price volatility risk associated with an active spot market. A mass market retailer must comply with prudent risk strategies to manage their exposures to extreme demand conditions and stress tests associated with supply outages. These include obtaining physical or financial hedges to meet peak demand.

In the South Australian wholesale market, with potentially significant pipeline imbalance penalties, and despite the advent of the STTM, this type of approach is even more important.



The details of Origin's approach to both annual supply and peak day supplies have been provided to ESCOSA in its Confidential Submission and are summarised below. The approach has been developed from and is consistent with:

- complying with our regulatory and legal obligations as the standing contract retailer in South Australia;
- satisfying the requirements of the South Australian wholesale market as required by the Australian Energy Market Operator (AEMO); and
- a prudent retailer acting in accordance with appropriate commercial risk management policies to limit exposure in the market.

The approach adopted by Origin and outlined above is much the same as that used in the previous tariff determination.

### *6.2.1 Wellhead cost - annual contract quantity (ACQ)*

Origin supplies its South Australian customers through a diverse portfolio of gas supply contracts. This portfolio includes gas originating from the Cooper/Eromanga Basin and from interstate gas fields.

The wellhead price incorporated into 2008 Determination was also based on the weighted average costs of a portfolio of base load supply arrangements required by Origin to ensure supply security through the period.

This methodology, which is continued in the current revenue proposal, involves dividing the total gas purchase cost for the entire customer demand by the total yearly volume sold to all of Origin's customer groups. This approach allows South Australian mass market customers to benefit from the economies of scale and scope arising from Origin's total demand base and its purchasing and negotiating synergies.

This methodology also ensures that all small customers receive the same wellhead price irrespective of their geographic location or whether they are supplied from the Cooper Basin, Victorian or Queensland gas fields.

The wellhead price approved for the current period was predominantly based on known contract prices but also on price assumptions for:

- contract replacements, required due to roll off of legacy contracts; and
- the contract price reviews associated with longer term contracts. Origin highlights here that longer term gas supply contracts generally have periodic, market linked, price review clauses.

Over the last three years, wholesale wellhead gas prices have increased at a rate commensurate with Origin's forecast in the previous price path submission. A number of LNG projects proposals have already been put forward to liquefy natural gas and export LNG from Queensland. The federal government has provided conditional environmental approvals for Gladstone Liquefied Natural Gas (GLNG) and BG Group's Queensland Curtis LNG with BG Group recently committing to commence building the plant immediately. Both projects have forecast to commence Gladstone based exports of LNG from 2014. Origin expects an increase in wellhead gas cost in 2013-14 due to gas prices moving to export LNG netback price parity from that time.

### *6.2.2 Wellhead MDQ Cost*

The supply of wellhead MDQ required over the price path period is based on the total portfolio of contracts required to ensure an appropriate level of security for non-interruptible customers, namely a 1 in 25 peak day demand.

The total MDQ commodity cost is allocated to customer segments based on their contribution to the peak day demand (similar to the contribution to transmission costs). This is represented by the load factor for each market segment, that is, the ratio of the segment peak day demand to the average daily demand of the segment.

The higher load factor for the residential market means that this segment contributes to a higher proportion of Origin's wellhead MDQ requirements than to Origin's ACQ requirements (although it is still in absolute terms a lower amount than other larger customer segments)

The market price of MDQ has continued to increase over the course of the current price path period reflecting changes in the South Australian gas and electricity supply market and competing demands from interstate buyers. In particular, Origin's view on future MDQ prices is based on the following factors which will impact on future MDQ costs:

- reduced flexibility in base gas supply contracts including reduced flexibility in daily deliverability compared to annual deliverability;
- the increase in gas fired generation units in Queensland, South Australia and Victoria has compounded these trends as generators compete for limited intraday balancing and other short term gas supplies.
- overall gas demand volatility and peakiness increases as well as reduced flexibility with respect to contractual linepack rights on the key transmission pipelines; and
- the cost of disposal of non peak/ excess gas on the STTM, Victorian gas market and non peak generation pool.

### 6.2.3 Short Term Trading Market Cost

A risk component was included in the 2008 Determination based on the operational costs of delivering gas to Cavan on a daily basis to cover Origin's swing gas position.

This Swing Gas risk cost has become redundant with the advent of the STTM. However, there are specific market fees and additional risks associated with the operation of the STTM. Origin has included an allowance in the gas costs to account for the additional market volatility risks associated with imbalance, deviation and contingency gas.

The actual fees and charges applied by AEMO for the STTM will be passed through as non-controllable costs.

### 6.2.4 Transmission Costs

The transmission system in South Australia is made up of two major transmission systems (MAPS and SEA Gas), and a number of laterals that transport gas to regional centres. In addition, a small transmission pipeline currently takes gas from the SEA Gas Pipeline to Mt Gambier, following the depletion of the Katnook gas field.

Origin's analysis of transmission costs separates the costing and cost allocation for the main transmission pipelines of MAPS and SEA Gas on the one hand with the costing and cost allocation of the lateral pipelines that take gas to its four regional centres.

Gas transmission costs for the main pipelines (MAPS and SEA Gas) have been built up on the basis of the total portfolio of Origin's transmission capacity requirements to provide the appropriate level of security of supply for the various market segments. The mass market supply load factor and peak day requirements are again based on the 1 in 25 peak day forecast for this segment. Origin approach to contracting transmission is based on achieving the lowest delivered cost given its portfolio of contracts and previous investments in supply capability to South Australia.

Origin's approach to determining the transmission cost of the small customer segment is similar to the calculation of MDQ wellhead requirements. That is, the total (MAPS + SEA Gas) transmission portfolio cost is calculated using:

- the forecast of the volume of gas to be supplied from MAPS and SEA Gas for the total portfolio of customers;
- calculating a volume weighted average cost of the portfolio based on the fixed cost component of the various charges. Origin has used its contracted positions on the respective pipelines to determine the weighted average;
- adding any average variable charges; and
- including the additional costs for lateral pipelines to the regional areas of Riverland, Whyalla and Mt Gambier.

Under this approach, the main transmission pipeline costs (\$/GJ) will be the same across all regions but will vary between market segments based on their different load factors.

Although the portfolio pricing approach means that the main pipeline costs are effectively postage stamped, regional centres do incur additional costs for transmission pipeline laterals. These additional costs add little to Origin's overall transmission costs and therefore the average revenue requirement (as 96 per cent of the mass market gas load is in Adelaide).

However, they do have the potential to significantly affect specific retailer tariffs, a matter which must be carefully considered in terms of the impact on particular regional areas and the rebalancing constraints generally.

The lateral transmission costs are fixed costs that are allocated to the relevant geographical areas and to market segments within each area on an MDQ basis. A cost per GJ is calculated by dividing the total cost for an area and segment by the annual demand for that same customer segment. Origin has separately forecast the lateral costs for supplying customers in Whyalla, Mt Gambier and the Riverland.

### 6.2.5 Summary of Gas Costs

The total cost of gas supply for each year is calculated by the addition of the prices associated with wellhead gas, wellhead MDQ, STTM and transmission costs both main and lateral.

While Origin has forecast average real transmission costs that are predominantly unchanged over the period, it has forecast real increases in the cost of gas for residential and SME customers in 2011-12 and 2013-14. In 2011-12, this real increase is being driven by Origin's current forecasts of MDQ while the change in 2013-14 is solely due to a forecast increase in wellhead cost or ACQ.

The following table summarises gas supply costs, including wellhead and transmission across the price path period, averaged across all South Australian regions and market segments.

**Table 6.1: Forecast Gas Supply Costs (\$Dec 2011)**

		2011-12	2012-13	2013-14
Residential	(\$/GJ)	7.01	7.05	8.29
SME	(\$/GJ)	5.90	5.90	7.14

## 6.3 Retail Costs

For this proposal, Origin has considered the relevant retail costs to be that of a prudent new entrant retailer and has defined retail costs to include:

- (i) Retailer Operating Costs (ROC) - these are costs associated with call centres, billing, revenue collection and credit systems, IT systems, regulatory compliance and corporate overheads; and
- (ii) Customer Acquisition Costs (CAC) - these costs are related to acquiring new customers, retaining existing customers and transferring existing non-market customers onto market contracts. These costs include marketing, advertising, sales overheads, door to door agent costs and telesales.

These are the costs that are incurred by retailers in obtaining, retaining and providing services to its customer base. Determining retail cost based on a prudent, new entrant retailer will encourage a greater level of competition in the South Australian gas market and is in the long-term best interest of customers.

In this submission, Origin has also included an assessment of REES costs for a six month period from 1 July 2011 to 30 December 2011 to be treated as a separate retail cost item. ESCOSA has already approved costs until 30 June 2011 and it was agreed that any outstanding amounts not recovered would be considered as part of this price determination<sup>9</sup>.

<sup>9</sup> ESCOSA, Origin Energy's REES Cost Pass through application made by Origin Energy, Reasons for Decision, 30 June 2009, p6

### 6.3.1 *Origin's Approach*

Origin's approach to determining prudent retail costs is basing the costs on a new entrant retailer and carrying out a benchmarking exercise of recent and relevant Regulatory decisions. A benchmarking approach highlights and demonstrates what other Regulators have deemed to be efficient retail costs of other retailers in similar markets.

As noted above, Origin's definition of retail costs differs to that provided for in the 2008 Determination as Origin does not agree with the previous approach used to allocate customer acquisition costs. ESCOSA took the view that customer acquisition costs should form part of the retail margin as the activities are of an investment nature which pays returns over time.<sup>10</sup>

Origin strongly opposes this approach being adopted in the next pricing determination. Including CAC as part of the retail margin has not provided an adequate coverage of costs and to improve competition, it should form part of the total retail cost. A retailer should be able to recover at least the minimum costs that it incurs in obtaining, retaining and servicing new customers. If the retail cost component is set below a prudent retailer's cost to serve, competition stalls and customers are not offered price benefits or discounts. This is to the detriment of customers and as the recent review of competition in South Australia showed, retailers are currently not active in the gas market as the risk of a billing error erodes any benefit of obtaining the customer<sup>11</sup>.

As ESCOSA is aware, the method of regulating electricity prices in South Australia is such that retail costs include both ROC and CAC<sup>12</sup>. Origin believes there should be no difference between the treatment of electricity and gas in this respect. Accordingly, Origin has included both retailer operating cost and acquisition costs in its' retail cost estimates.

Other issues ESCOSA should be cognisant of when reviewing the retail cost benchmarks include:

- labour or wage costs are an important direct and indirect component of retail costs (including fixed costs). Labour costs are increasing at rates well above CPI; and
- the introduction of REES Scheme has had a significant impact on retail costs including increased costs from greater regulatory and compliance obligations, manual processes, market data integrity issues, re-engineering of processes, and increased demand on call centres.

Origin's retail cost proposal has taken these impacts into account with REES costs being separately calculated in section 6.3.3 and considered as a distinct retail cost subcategory.

### 6.3.2 *Retail Costs - Benchmark of other jurisdictions*

There are a number of energy retailers with similar operations to Origin and to a lesser extent, size, operating across jurisdictions and fuel sources. Given this, benchmarking exercises give a good indication of what other Regulators have deemed as prudent retail costs for retailers of similar size.

It is noted that it can be difficult to compare jurisdictional pricing decisions due to the different methodologies and parameters used by Regulators in approving the retail costs. Origin has attempted to highlight the basis on which each of these costs have been determined and escalated decisions to December 2010 using actual CPI's. A summary of retail cost benchmarks is outlined below in Table 6.2.

<sup>10</sup> ESCOSA, *2008 Gas Standing Contract Price Path Inquiry Final Inquiry Report and Final Price Determination*, June 2008, pA-100.

<sup>11</sup> ACIL Tasman, *Competition in South Australia's Retail Energy Markets - Report on interviews with participants*, June 2010, p20.

<sup>12</sup> ESCOSA, *2010 Review of Retail Electricity Standing Contract Price Path- Draft Inquiry Report and Draft Price Determination*, September 2010, pA-96.

Table 6.2: Benchmark of Retail Costs<sup>13</sup>

Jurisdiction/ Fuel	Date of Regulatory Decision	Retail Cost (\$Dec 2010)
New South Wales (Gas)	IPART, June 2010	\$120.40*
Victoria (Gas)	CRA, November 2007	\$107.70
South Australia (Electricity)	ESCOSA, September 2010	\$115
NSW (Electricity)	IPART, March 2010	\$112.9-116.99
Queensland (Electricity)	QCA, May 2010	\$126.41
ACT (Electricity)	ICRC, April 2010	\$104.90
Victoria (Electricity)	CRA, November 2007	\$136.28

\*Note: This is the higher end of IPART range of retail costs. Lower estimates excluded customer acquisition costs.

It should be noted that Queensland, New South Wales and South Australian electricity Regulators have accepted customer acquisition and retention cost as part of retail costs for their regulated tariff decisions. IPART has also included customer acquisition costs as part of retail costs for Standard Gas Retailers.

Victorian tariffs are de-regulated, however previous regulated pricing decisions in Victoria included customer acquisition costs as part of retail costs for both electricity and gas.

Some important points to note from these above decisions include:

- New South Wales (gas) - IPART considered a retail cost (including CAC) of \$120.40 as an appropriate cost recovery amount of a Standard Gas Retailer. In determining this cost, IPART was required to consider the effective development of competition and reduce small customer's reliance on regulated tariffs<sup>14</sup>. IPART used a combination of benchmarking and bottom up cost approach to determine the appropriate costs;
- South Australia (electricity) - ESCOSA has proposed a retail cost (including CAC) of \$115 per customer (Dec \$2010). A combination of benchmarking and analysis of reported costs was used to determine the appropriate retail cost;
- New South Wales (electricity) - IPART allowed a real retail operating cost allowance of \$109.80 per customer in 2009-10 escalating to \$113.70 in 2012-13. IPART's terms of reference specifically states that they should:  
*"include customer acquisition costs in the allowance, to ensure that regulated retail tariffs are set at a level that encourages competition."*<sup>15</sup>;
- Queensland (electricity) - the QCA approved retail costs of \$126.41 per customer in 2010-11 which includes the costs of customer acquisitions and transfers in the Queensland electricity market. Although this framework relies on an index so the actual retail cost is not verified, it is important to recognise the inclusion and quantum of the CAC allowances ; and
- Victoria (electricity and gas) - gas and electricity prices are deregulated in Victoria. The most recent study conducted in Victoria was by CRA Consulting in November 2007. CRA concluded that the same retailer operating cost should be used for both electricity and gas as the complexities of each fuel balances out<sup>16</sup>.

The above costs do not include any allowance for REES costs. REES costs are unique to the South Australian energy market and should be considered as a separate pass through item.

<sup>13</sup> ICRC, *Retail Prices for non-contestable Electricity Customers 2010-12*, April 2010, p36, IPART, *Review of Regulated Retail Tariffs and Charges for Electricity 2010-13, Final Report*, March 2010, p16, QCA, *Benchmark Retail Cost Index 2009-10, Final Decision*, May 2010, p45; CRA, *Impact on prices and profit margins on energy retail competition in Victoria - Final Report*, November 2007, p37-39; IPART, *Final Report: Review of regulated tariffs and charges for gas 2010-2013*, June 2010, p111

<sup>14</sup> IPART, *Final Report: Review of regulated tariffs and charges for gas 2010-2013*, June 2010, p11

<sup>15</sup> IPART, *Review of regulated tariffs and charges for electricity 2010-13, Final Report*, March 2010, p24.

<sup>16</sup> CRA, *Impact of prices and profit margins on energy retail competition in Victoria*, November 2007, p40.

ESCOSA has taken this approach with AGL SA for the 2011 Draft Electricity Retail Pricing Determination.

### 6.3.3 REES Costs

The REES Scheme was introduced by the South Australian Government on 1 January 2009 for a three year period with an option to extend for a further three year period. The scheme requires obliged energy retailers to undertake mandatory energy efficiency activities and energy audits for households in South Australia to assist consumers in becoming more efficient in the way that they use energy. Under the REES, Origin is prescribed as an obliged energy retailer for both its electricity and gas licence. The South Australian Minister for Energy has the responsibility for setting the overall targets for the activities and retailers are subject to yearly penalties if the targets are not met.

REES costs for 2009-10 and 2010-11, as they apply to standing contract gas customers, have been approved by ESCOSA through a separate cost-pass through application. Gas tariffs for these years have been accordingly adjusted to take into account these costs<sup>17</sup>. ESCOSA agreed that any future costs for the period 1 July 2011 - 30 December 2011 should be considered as part of the this current price review<sup>18</sup>.

Origin's REES costs for the six-month period in 2011 relate to:

- REES Compliance Costs - these are the costs that have been incurred on an on-going basis as a result of the introduction of the REES; and
- Third Party Costs in relation to prescribed REES activities including the cost of conducting detailed energy audits to priority group households.

The proportion of Origin's REES costs that apply to standing contract gas customers for the six-month period has been provided to ESCOSA on a confidential basis.

It needs to be recognised that the future of REES Scheme beyond 2011 is uncertain. There have been recent discussions at a Commonwealth Government level that all state based energy efficiency schemes should be transitioned to a national scheme<sup>19</sup> as well as discussions at a State level that a modified REES energy efficiency scheme will continue post 2011. If further details of the scheme are known prior to the finalisation of this pricing determination then Origin will include forecast costs for 2012 in the 2011-12 prices. If details are not known, Origin proposes that any new costs associated with an energy efficiency scheme would be treated as a cost pass through event.

### 6.3.4 Proposed Retail Cost Benchmark

Origin's view is that retail costs do not differ significantly between gas and electricity mass market customers and a similar retail cost allowance should be set for both fuels. Although gas customer bases are generally smaller than electricity, the regulatory, operational and market requirements for gas remain distinct in many areas from that of electricity. This is especially true with the variations in market rules at the wholesale level in gas and the introduction of the STTM - this pushing up the relative retail operating costs for gas.

Origin's proposal for retail costs is for ESCOSA to use the current South Australia electricity cost benchmark of \$115 per customer for 2010, excluding the REES compliance costs. Origin further proposes this amount continue to be adjusted forward using an actual CPI per cent approach to account for increasing labour costs and the impact of customer churn.

Origin also requires ESCOSA to continue the approach of separately assessing general retail costs and the explicit REES costs. Origin believes it is inappropriate for ESCOSA to roll-in REES costs with general retail costs at this time given the explicit requirements of the scheme and the ongoing uncertainties of energy efficiency costs post December 2011.

<sup>17</sup> ESCOSA, *Origin Energy's REES Cost Pass through application made by Origin Energy, Reasons for Decision*, 30 June 2009, p5

<sup>18</sup> *ibid*, p5-6.

<sup>19</sup> In October 2010, the Commonwealth Government released a "*Report of the Prime Minister's Task Group on Energy Efficiency*" that recommends the abolishing of state based energy efficiency schemes and the move towards a national energy efficiency scheme. It is understood that Commonwealth Government is considering this recommendation.

## 6.4 Retail Margin

The retail margin is designed to cover the retailer for its risk-weighted investment. That is, to cover a return on capital, depreciation, amortization and taxes. Origin believes the margin needs to be set to encourage business efficiencies, new entrants, less of a reliance on regulated prices and thus competition in the gas market. An insufficient retail margin can cause financial pressure with the exit of current retailers and the deterrent of new retailers entering the market.

The AEMC's Review of Competition in South Australia found that retail margins are unattractive and are at or below the bottom of the range required to enter a new market, especially in regional areas<sup>20</sup>. This discourages new entrants and competition in the gas market. The AEMC noted that margins need to be sufficient to attract competition.

For the next pricing determination, Origin believes that ESCOSA needs to set an appropriate retail margin taking into account that:

- all business risks are being suitably covered;
- satisfactory returns are provided to shareholders; and
- any forecast error resulting in reduced retail margins.

It should be noted that recent regulated pricing determinations have concluded that the retail margin for gas should be set higher than that allowed for electricity. This is based on there being greater risks associated with being a gas retailer. Risks include those related to the higher fixed cost nature of gas retailing, variations in demand, greater working capital requirements and the fact that annual gas expenditure per customer is typically lower than electricity<sup>21</sup>.

Origin believes that it is imperative that ESCOSA considers these issues and in particular the fact that the controllable cost base on which the margin is applied for gas has reduced over time. If the same retail margin percentage methodology is applied to both electricity and gas controllable costs in South Australia, the relative dollar gross margin per customer is considerably greater for an electricity customer than a gas customer. The recent competition review noted that retailers are apprehensive to enter the gas market as the dollar margin can be eroded quickly if there is an error in servicing a customer.<sup>22</sup>

Origin submits that the margin allowance should be relative to the controllable cost base. Given these risks and the characteristics of the South Australian gas market, a higher margin is required for gas retailing in comparison to electricity to encourage any form of price competition.

### 6.4.1 Retail Margin Benchmarks

As previously highlighted, a retail margin should reflect the risks faced by retailers in operating in the relevant market. Recent pricing determinations in New South Wales (gas) and South Australia (electricity) provide some commentary on the appropriate retail margins and the fact that the retail margin in gas should be higher than that allowed in the electricity industry. This is based on the greater risks that gas retailers face in recovering costs across a smaller customer base.

As noted in recent benchmark studies, it can be difficult to compare retail margin in each of the jurisdictions as they have been determined on different bases. While ESCOSA bases retail margin on controllable costs, other jurisdictional regulators base retail margin on a percentage of sales revenue. A summary of comparable recent regulatory decisions with regards to retail margin are set out in Table 6.3 below.

<sup>20</sup> AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia, First Final Report*, September 2008, pxiii.

<sup>21</sup> IPART, *Review of Regulated retail tariffs and charges for gas 2010-2013*, Final Report, p31; LECG, *Review of the South Australian electricity standing contract retail operating cost and retail operating margin - Report to ESCOSA*, August 2010, p40.

<sup>22</sup> ACIL Tasman, *Competition in South Australia's Retail Energy Markets - Report on interviews with participants*, June 2010, p20

Table 6.3: Benchmark of Retail Operating Margins<sup>23</sup>

State	Decision	Period	Retail Margin (%controllable costs)	Retail Margin (% sales revenue)
NSW Electricity	IPART	2010-13	10.8	5.4
ACT Electricity	ICRC	2010-12	10.8	5.4
QLD Electricity	QCA	2010-11	10.0	5.0
SA Electricity	ESCOSA	2011-13	10.0	5.0
NSW Gas	IPART	2010-13	14.6-16.6	7.3-8.3

IPART's recent regulated gas pricing decision is most relevant to the next pricing determination in the South Australian gas market. IPART engaged SFG to assist them in determining an appropriate retail margin for the gas market in New South Wales. SFG used three different methodologies for estimating retail margin, with IPART determining that a combination of ranges using SFG's expected returns approach and benchmarking approach were most relevant. SFG estimated the following ranges for the two approaches<sup>24</sup>:

- expected returns approach - 7.5 to 9.1 per cent of sales revenue; and
- benchmarking approach - 7.2 to 7.6 per cent of sales revenue.

IPART concluded in its final decision that a reasonable range for retail margin for a gas standard retailer was 7.3 to 8.3 per cent of sales revenue. Comparing this with ESCOSA's methodology of retail margin, it is equivalent to approximately 14.6 to 16.6 per cent of controllable costs.

It is important to note that ESCOSA's 2008 Determination of a 13 per cent retail margin is not comparable to the benchmarks of other jurisdictions. This is as a result of ESCOSA including an investment return for customer acquisitions as part of the retail margin. Other jurisdictional regulators have captured customer acquisitions costs under retail costs and not retail margin. This highlights that the previous approved 13 per cent retail margin is well below the New South Wales gas benchmark range.

#### 6.4.2 Proposed Retail Margin

Origin believes that a retail margin of 14.6 per cent of controllable costs would be an appropriate margin that reflects the risks of operating in the South Australian gas market. This is at the lower range of that approved for New South Wales gas retailers, but higher than comparable electricity allowances.

Origin recognises the impact that the change in methodology to include customer acquisition costs within retail cost has on standard tariffs in 2011-12. Therefore, Origin is proposing that the current margin of 13 per cent be adopted in 2011-12 with a transition to a cost reflective margin of 14.6 per cent in years 2 and 3 of the price path.

There are a number of reasons for the proposal for a 14.6 per cent margin that are set out in the confidential submission including the significant risk of forecast error, particularly during a period of rapid change in both the retail and wholesale gas market, and the requirement for prepayment of network charges that are imposed on Origin and other gas retailers by the network operator, Envestra.

It should be noted that even with a retail margin of 13 percent in 2011-12, the gross margin for a South Australian gas retailer is still below that of New South Wales gas retailers for both residential and small business customers. The use of gross margins is a means to compare and verify costs across jurisdictions given the different handling of many of the variables in retail cost and retail margin number in each of the jurisdictions.

Origin has determined the gross margins for residential customers in each of the jurisdictions based on the dollar margin of average retail revenue plus retail costs. The results of this

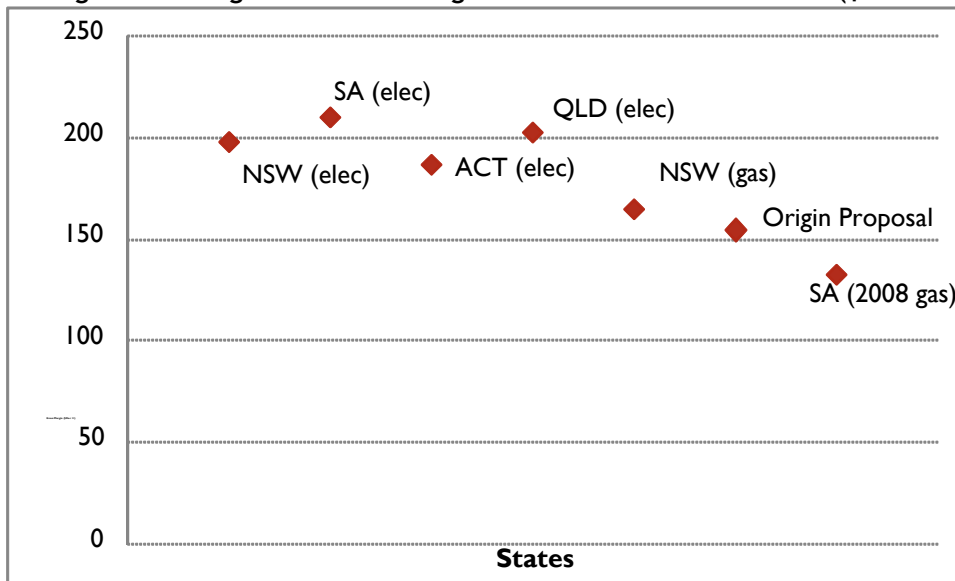
<sup>23</sup> ICRC, *Retail Prices for non-contestable Electricity Customers 2010-12*, April 2010, p39, IPART, *Review of Regulated Retail Tariffs and Charges for Electricity 2010-13*, Final Report, March 2010, p128-137, QCA, *Benchmark Retail Cost Index 2009-10, Final Decision*, May 2010, p44-45; IPART, *Final Report: Review of regulated tariffs and charges for gas 2010-2013*, June 2010, p34-37.

<sup>24</sup> IPART, *Review of Regulated retail tariffs and charges for gas 2010-2013*, Final Report, p33-34.



analysis, a comparison of gross margins in the various states for both electricity and gas regulated businesses are shown in Figure 6.1.

**Figure 6.1: Regulated Gross Margins for Residential Customers (\$Dec 2011)**



Source: Origin Energy

These results clearly show that even with Origin's proposal for a retail cost increase to allow for appropriate customer acquisition costs, the gross margin for South Australian residential gas customers remains at the lower end of the range provided by other regulated jurisdictions.

In this context, it should be noted that the regulatory risks of setting a retail margin are asymmetrical - while lower margins will have a direct impact on market competitiveness, if the approved margins are above commercial requirements they will have little impact with competition removing the opportunity for any additional returns.

## 7 Non-controllable costs

### 7.1 Distribution Charges

Under its Access Arrangement, Envestra charges Origin for provision of reference services to small customers. These charges relate to:

- domestic haulage reference services (relevant to Origin's residential customers);
- commercial haulage reference services (relevant to Origin's small business customers); and
- ancillary reference services (inlet disconnection, reconnection and special meter reading services).

For the calculation of standing contract prices, the major cost input is the haulage reference services provided by Envestra. Under the form of price path proposed in section 5, these Envestra charges would be a direct pass through.

Envestra's 2010-11 charges for these services are set out in Table 7.1. For modelling purposes, non-controllable costs have been assumed to remain constant in real terms from these levels.

**Table 7.1: Envestra reference service tariffs, 2010-11**

Reference service		Charge, GST exclusive
Domestic haulage reference service		
Daily charge	(\$/day)	0.310
First 49.3 MJ	(c/MJ)	1.125
Additional MJ	(c/MJ)	0.520
Commercial haulage reference service		
Daily charge	(\$/day)	0.620
First 9,86.3 MJ	(c/MJ)	0.880
Next 4,274 MJ	(c/MJ)	0.472
Next 11,178 MJ	(c/MJ)	0.206
Additional MJ	(c/MJ)	0.086
Inlet disconnection service	(\$)	61.00
Inlet reconnection service	(\$)	61.00
Special meter reading service	(\$)	9.00

Source: Envestra SA Tariff Schedule, 1 July 2010-30June2011.

For the calculation of standing contract prices, the major cost input is the haulage reference services provided by Envestra. Under the form of price path proposed in section 5, these Envestra charges would be a direct pass through.

### 7.2 Other Market Charges

The South Australian gas market functions and operations were transferred from REMCo to AEMO on 1 October 2009. AEMO levies a charge on market participants to cover the costs of its operations. The fees are separated into a number of different categories including (not exhaustive):

- *Short Term Trading Market (STTM)* - on 1 September 2010, STTM became operational in South Australia. AEMO is the market operator and levies fees on participants to cover their costs incurred in operating the market;
- *Gas Advocacy Panel* - from 1 July 2010, AEMO is required to collect funds to recover the costs of the Gas Consumer Advocacy Panel. These costs are a direct pass-

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through to the Consumer Advocacy Panel. The 2010-11 tariff is based on a set rate of cents per meter per month<sup>25</sup>;

- *Gas Statement of Opportunities (GSOO)* - from 1 July 2010, costs associated with the development of the GSOO are to be recovered from gas retailers in South Australia. The 2010-11 tariff is based on a set rate of cents per meter per month<sup>26</sup>;
- *South Australia Gas FRC* - these are ongoing charges associated with the introduction of FRC. It is understood that retailers are charged based on a dollar per MIRN basis per month; and
- *Annual Service Fee* - This is charged based on a dollar per participant per year basis.

The actual fees and charges will be passed through to customers based on the amounts set by AEMO.

### **7.3 GST**

All prices and costs quoted in this submission are exclusive of GST. GST will be passed through on all relevant cost items.

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<sup>25</sup> Australian Energy Market Operator (AEMO), *AEMO Budget 2010-11*, June 2010, p11.

<sup>26</sup> *Ibid*, p11

## 8 Revenue requirement

Based on the controllable and non-controllable costs discussed in sections 6 and 7, the resulting revenue requirement for each of the small customer segments (comprising residential and small business customers with annual consumption of less than 1 terajoule) are set out in Table 8.1.

**Table 8.1: Revenue requirement - 2011-12 to 2013-14**

		2010-11	2011-12	2012-13	2013-14
<b>Residential Retail Cost</b>	<b>(\$/GJ)</b>	<b>13.02</b>	<b>14.45</b>	<b>14.61</b>	<b>16.03</b>
Change	(%)		11.0%	1.1%	9.7%
<b>SME Retail Cost</b>	<b>(\$/GJ)</b>	<b>7.42</b>	<b>7.58</b>	<b>7.68</b>	<b>9.10</b>
Change	(%)		2.2%	1.3%	18.6%

## 9 Retail gas tariffs

In considering the history of price changes, it is important to understand that Origin has five pricing zones<sup>27</sup> and charges different prices to residential and small business (less than 1 TJ) customers in each of those zones. Geographic and customer type distinctions are important in determining the retailer tariffs in each region because of underlying differences in the associated costs of supply.

Over the last three years, Origin has used the price control mechanism to adjust retailer tariffs to more cost reflective levels. However, Origin has retained an implicit cross-subsidy between various regional areas because of the portfolio approach to assessing gas costs and major pipeline transmission costs. Thus, regional retailer tariff differences reflect the impact of specific lateral transmission pipeline costs rather than differences in the sources of gas supply.

Within the constraint of the average retailer revenue controls, Origin has moved progressively towards establishing cost reflective standing contract prices across South Australian residential and small business gas customers.

Nevertheless, over the last three years Origin has not sort full cost-recovery at the level of each gas supply region as this may have significant impacts on consumers in a number of specific gas supply specific regions outside Adelaide.

Origin proposes to continue this approach of balancing cost-reflective principles in setting the retailer tariffs with consideration given to the customer impacts in specific areas, and will therefore progressively unwind cross-subsidies through the next determination period.

Other important pricing principles that will be incorporated into the final retailer tariffs once the average retailer revenue is determined include the recovery of fixed costs through fixed revenue charges, wherever this can be done without significant impacts on customers.

It should be noted that much of the structure of standing contract prices which customers see (and which includes network charges etc) reflects the structure of the network charges as these account for some 50 per cent of total costs in the standing contract. The structure of these network charges is separately agreed between ESCOSA and Envestra in accordance with the approved network Access Arrangement.

### 9.1 Implied customer impact

The customer impacts associated with indicative standing contract prices are shown in but further adjustments will be required for actual CPI and for the actual network charges.

**Table 9.1: Indicative customer bill impact, 2011-12**

Average Annual Consumption		Residential	SME
Low consumption	(\$/qtr)	\$4.96	\$3.33
Medium consumption	(\$/qtr)	\$8.14	\$22.62
High consumption	(\$/qtr)	\$17.70	\$104.06

<sup>27</sup> The pricing zones are: Adelaide and Peterborough; Mt Gambier; Port Pirie; Riverland and Murray Bridge; and Whyalla.