2011 GAS STANDING CONTRACT PRICE PATH INQUIRY

DRAFT INQUIRY REPORT & DRAFT PRICE DETERMINATION

April 2011

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Request for Submissions

The Essential Services Commission of South Australia (the Commission) invites written submissions from interested parties in relation to the issues raised in this paper. Written comments should be provided by **Monday 9 May 2011**. It is highly desirable for an electronic copy of the submission to accompany any written submission.

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

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

Responses to this paper should be directed to:

2011 Gas Standing Contract Price Path Inquiry: Draft Inquiry Report and Draft Price Determination

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

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GLOSSARY OF TERMS

ACIL TASMAN	ACIL Tasman Pty Ltd
ACQ	Annual Contract Quantity
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AGL SA	AGL South Australia Pty Ltd
CARC	Customer Acquisition & Retention Costs
COGS	Cost Of Goods Sold
COMMISSION	Essential Services Commission of South Australia
CPI	Consumer Price Index
CPRS	Carbon Pollution Reduction Scheme
CSG	Coal Seam Gas
EAT	Earnings After Tax
EBITDA	Earnings before Interest, Tax, Depreciation and Amortisation
ENVESTRA	Envestra Limited
EPIC	Epic Energy
EPP	Export Price Parity
ERC	Energy Retail Code
ESC ACT	Essential Services Commission Act 2002
FRC	Full Retail Competition
GAS ACT	Gas Act 1997
GJ	Gigajoule
GST	Goods and Services Tax
HDD	Heating Degree Day
ICRC	Independent Competition & Regulatory Commission
IPART	Independent Pricing and Regulatory Tribunal, NSW
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
MAPS	Moomba to Adelaide Pipeline System
MDQ	Maximum Daily Quantity
MIRN	Metering Installation Registration Number
MJ	Megajoule
MMA	McLennan Magasanik Associates
NECF	National Energy Customer Framework
NEM	National Electricity Market
NSL	Net System Load
ORIGIN ENERGY	Origin Energy Retail Ltd
QCA	Queensland Competition Authority

QSN	Queensland to South Australia/New South Wales (pipeline)
REES	Residential Energy Efficiency Scheme
REMCo	Retail Energy Market Company Ltd
RET	Renewable Energy Target
ROC	Retail Operating Cost
ROM	Retail Operating Margin
RPM	Relative Price Movement
SAPERE	Sapere Research Group
SA	South Australia
SACOSS	South Australian Council of Social Service
SCP	Standing Contract Price
SEAGas	South East Australia Gas (pipeline)
SESA	South East South Australian (pipeline)
SKM MMA	Sinclair Knight Merz McLennan Magasanik Associates
SME	Small & Medium Enterprises
STTM	Short Term Trading Market
SWQP	South West Queensland Pipeline
SUG	System Use Gas
TJ	Terajoule
TUOS	Transmission Use of System
UGS	Underground Storage
VTPA	Voluntary Transitional Pricing Arrangement

EXECUTIVE SUMMARY

Background

The Essential Services Commission of South Australia (the Commission) is currently undertaking an Inquiry under Part 7 of the Essential Services Commission Act 2002 into the gas standing contract prices to apply from 1 July 2011. Origin Energy is the gas standing contract retailer in South Australia and is required to offer the standing contract to any small customer (consuming less than 1TJ per annum) subject to terms and conditions (including price) regulated by the Commission. Currently, less than 30% of all small customers are standing contract customers. The majority of small gas customers purchase gas through market contracts at an unregulated price.

This report presents the draft conclusions of the Commission's Inquiry. Accompanying this Draft Inquiry Report is a Draft Price Determination, which is the legal instrument that will, once finalised, give effect to the Commission's price determination.

In regulating the gas standing contract price, the Commission is primarily concerned with the retailer's controllable costs, which comprise approximately 45% of a typical residential standing contract bill. In addition to this component, standing contract prices include Envestra's distribution charges and the Australian Energy Market Operator's (AEMO's) retail market administration charges, both of which are separately regulated and are therefore treated as cost pass-through items to standing contract customers.

The context for this Inquiry

An important context to the Commission's Inquiry is the status of competition in the gas retail market in South Australia.

Full Retail Competition (FRC) commenced in the South Australian gas market in July 2004, approximately 18 months after FRC commenced in the electricity market. Since that time, there has been significant new entry into the electricity retail market, and there are currently 9 retailers that compete with the incumbent, AGL South Australia, for electricity customers in South Australia.

Competition in the gas retail market has evolved in a different way to competition in the electricity retail market.

As has been the case since 2005, there are currently 3 retailers (AGL SA, TRUenergy and Simply Energy) that compete with the Standing Contract gas retailer (Origin Energy) for gas customers in South Australia. Each of the gas retailers is a major participant in the electricity retail market, which enables them to exploit the strong synergies between electricity and gas retailing in order to maximise economies of scale and scope, and minimise total costs. The retailers also have a significant presence in the gas-fired generation market, which provides an opportunity for diversification of their gas sales portfolio between generation and other users of gas.

As confirmed through a retailer survey conducted by ACIL Tasman on behalf of the Commission in June 2010, retailers do not see stand-alone gas retailing as being a viable proposition in South Australia as the market is too small, given the relatively low gas usage per customer and the smaller customer base in this state.[1] Instead, competition for small gas customers occurs on a dual fuel basis, with gas considered to be the secondary product to electricity.

The Commission's approach

The nature of the gas retail market in South Australia has important implications for the Commission's role in setting the gas standing contract price.

Consistent with the approach taken in previous standing contract price reviews, the Commission continues to view the role of the gas standing contract price as balancing the need to promote effective retail competition, while also providing a degree of price protection to those customers that continue to purchase gas under the standing contract. While the Commission remains committed to facilitating competition in energy retailing, it will do so in the context of there being two distinct competitive markets – an electricity retail market and a dual-fuel retail market.

In fixing the gas standing contract price, the Commission has sought to determine the costs of an efficient gas retailer, on the basis that a prudent retailer sells both gas and electricity. This approach is different to that proposed by Origin Energy, which is based on establishing a price that would provide for new entry to the gas retail market on a stand-alone basis.

Determining the costs of gas retailing

The Commission's approach has implications for the manner in which it examines Retail Operating Costs (ROC) and the Retail Operating Margin (ROM). The Commission's draft

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[1] ACIL Tasman, *Competition in South Australia's retail energy markets: Report on interviews with participants,* June 2010, pp.39-40 (available on the Commission's website at http://www.escosa.sa.gov.au/library/100624-CompetitivenessRetailMarketReport-ACILTasman-Public.pdf)

finding is that the ROC proposed by Origin Energy is excessive and should be reduced, particularly in terms of the Customer Acquisition and Retention Cost (CARC) component. Origin Energy proposed the same total ROC allowance as the Commission allowed in its Final Determination on Electricity Standing Contract Prices in December 2010, of $117.87 per customer. Whilst Origin Energy's proposal did not split ROC between base-ROC and CARC, the Commission, supported by advice from its consultant, has analysed Origin Energy's proposed ROC based on a split of costs consistent with the previous electricity price determination.

The Commission determined a CARC allowance of $39.46 per customer under its 2010 Electricity Standing Contract Price Determination, which was based on the stand-alone cost of acquiring and retaining electricity customers. There has been no new entry into the gas-only retail market, nor has the Commission seen any evidence of retailers actively marketing gas as a stand-alone product.

Consequently, it is the Commission view that the costs of an efficient retailer in meeting the responsibilities of gas standing contract supply to small customers should be assessed as those of a dual-fuel retailer. Therefore, the Commission has included within ROC an estimate of the incremental CARC, rather than the stand-alone CARC sought by Origin Energy. The Commission has also made a specific adjustment to CARC to take account of the lower rate of customer switching in the gas market, relative to the electricity market. The resultant CARC that is provided for in this Draft Determination is $24.72 per customer.

The Commission has also determined that an efficiency factor should be applied to the remaining components of ROC, to reflect the fact that energy retailers are generally moving towards consolidation of retailing systems, which will enable them to take greater advantage of the economies of scale and scope that are available from having gas and electricity customer bases across various states. As a result, the Commission's base-ROC (excluding CARC), declines from $78.41 per customer in 2011/12 to $75.30 per customer in 2013/04. The Commission has also allowed an additional $2.60 per customer to reflect the costs associated with the Residential Energy Efficiency Scheme (REES), although there is some uncertainty over the costs of this scheme beyond 2011 as a result of the targets and activities being subject to review; there is the possibility of a cost pass-through event during the price path period should Origin Energy be able to demonstrate that the REES costs are materially higher.

On other cost components, the Commission has determined slightly lower wholesale gas costs and transmission costs than those proposed by Origin Energy. The Commission has carefully considered Origin Energy's claim for an increase in wholesale gas costs in

2013/14, to reflect increased LNG exporting from Queensland and a movement in domestic prices towards Export Price Parity (EPP). However, the Commission has found that there is significant uncertainty over the timing and extent of the LNG impact, which creates risk to retailers and consumers of fixing a price for 2013/14 inclusive of an EPP assumption. The Commission's preference is to deal with any transition to EPP through the 2014 gas standing contract price review, to the extent that EPP only becomes an issue from 2014 onwards. If wholesale gas prices were to increase materially during the price path period as a result of EPP, the possibility of re-opening the price determination prior to 1 July 2014 remains.

The Commission's draft determination incorporates wholesale gas costs of approximately $5.00/GJ for residential customers and $4.50/GJ for Small Medium Enterprise (SME) customers (the difference between the two relates to the increased requirement for peak gas for residential customers). These allowances are around 4% and 2% higher than respective 2010/11 benchmarks set for residential and SME customers by the Commission in the 2008 Gas Standing Contract Price Determination. The Commission's decision to accept Origin Energy's proposal to increase the load factors for both customer groups relative to those set in 2008 (reflecting a higher ratio of peak demand to average demand) contributes towards the increased wholesale gas costs.

The Commission's draft determination on transmission costs is marginally lower than that proposed by Origin Energy, as a result of the Commission removing certain costs that it considers to be unjustified or counted in other cost categories. The draft determination sets a residential transmission cost of approximately $1.90/GJ and a SME transmission cost of approximately $1.30/GJ. The difference between the two costs relates to the different load factors for residential and SME customers, which impacts on the amount of transmission capacity that should be allocated to each group.

The Commission has also set a Retail Operating Margin (ROM) for the gas standing contract retailer that is consistent with the margin set in the 2008 Gas Standing Contract Price Determination. Origin Energy's proposal to increase the ROM from 13% of controllable costs in 2011/12 to 14.6% of controllable costs in 2012/13 and 2013/14 was not accepted by the Commission, on the basis that there does not appear to be any justification to depart from the current gas retail margin. The ROM is consistent with that set by the Commission in its electricity standing contract price determination, specifically adjusted to take into account the additional working capital requirements that gas retailers have in South Australia due to the prepayment arrangements that exist under Envestra's gas distribution Access Arrangement. When applied to an increasing controllable cost base, the absolute value of the retail margin increases slightly from that determined previously by the Commission.

The Commission's draft findings on the controllable costs to be reflected in gas standing contract prices are summarised below.

Draft Determination on Retailer Controllable Costs 2011/12 to 2013/14
Weighted average of 5 regions, $/GJ, GST exclusive, $Dec 11

	Draft Determination: Residential				Draft Determination: SME			
	2010/11[2]	2011/12	2012/13	2013/14	2010/11	2011/12	2012/13	2013/14
Cost of Gas	4.87	4.99	4.97	4.97	4.50	4.50	4.48	4.48
Transmission Cost	1.84	1.91	1.88	1.89	1.32	1.31	1.29	1.31
ROC	4.39	5.11	5.04	4.96	0.64	0.72	0.71	0.70
ROM (13%)	1.44	1.56	1.55	1.54	0.84	0.85	0.84	0.84
Total Retail Cost	12.67[3]	13.57	13.44	13.36	7.29	7.38	7.32	7.33

Note, the above table contains some minor rounding errors

Impacts of this Draft Determination

The Commission has converted its draft determination on controllable costs over the 3 year period into a residential and SME price path, expressed as an average revenue ($/GJ). The Draft Determination on the maximum average retailer revenue in 2011/12 (in $Dec11) is $13.48/GJ for residential customers and $7.35/GJ for SME customers, representing a 2.5% increase and a 0.9% decrease in real terms respectively. These amounts incorporate a forecast change in CPI of 2.5% in converting prices from $Dec10 to $Dec11 terms, which will be updated for the Commission's final determination.

2 Benchmarks determined by the Commission for 2010/11 as part of the 2008 Gas Standing Contract Price Determination.

3 Includes a REES pass through of $0.13/GJ

In 2012/13 and 2013/14, the Commission's Draft Determination would see residential and SME prices increasing by CPI only (no real increase).

Retail Component of Gas Standing Contract Price
Origin Energy's proposed price path vs. Commission's draft price path (real price changes)

	1 Jul 11	1 Jul 12	1 Jul 13
Residential Customers			
Origin Energy's Proposal	+9.9%	1.1%	9.7%
Commission's draft price path	+2.5%	0	0
SME customers			
Origin Energy's Proposal	+2.2%	1.3%	18.6%
Commission's draft price path	-0.9%	0	0

The Commission's Draft Determination to increase gas standing contract prices on 1 July 2011 would add approximately $9 to an average annual residential bill (around 1.5%), assuming that the increase is applied uniformly between tariff components.

The Commission invites comment from interested parties on this Draft Inquiry Report and Draft Price Determination. Submissions are due by **9 May 2011**. The Commission will consider submissions, and any further information it gathers in the course of the inquiry, and release a Final Report and Price Determination, incorporating any changes, by early June 2011.

1 INTRODUCTION

Under the provisions of section 34A of the *Gas Act 1997* (Gas Act), Origin Energy Retail Ltd (Origin Energy) is required, as a declared standing contract retailer, to offer to sell and supply gas to any small gas customer (that is, persons using less than 1 terajoule (TJ) of gas per annum[4]), whether a residential or a business customer, on request. [5]

Origin Energy's offer to sell and supply under a standing contract must be on the terms and conditions as specified by the Essential Services Commission of South Australia (the Commission) under Part C of the Energy Retail Code[6] (ERC) and at the price fixed by the Commission under the Gas Act.[7]

This Draft Price Determination and Draft Inquiry Report deals with the second of those matters, the appropriate price for the Commission to fix for the sale and supply of natural gas by Origin Energy, under standing contracts, for the period 1 July 2011 to 30 June 2014.[8]

The Commission is required to proceed in accordance with the legislative requirements as specified by both the Gas Act and the relevant provisions of the Commission's empowering statute, the *Essential Services Commission Act 2002* (the ESC Act).

Those Acts require that the price fixing process may generally[9] only commence once the Commission has received a submission from Origin Energy, stating the price it proposes the Commission fix as the standing contract price (SCP) together with a justification for the proposed price.[10] Following receipt of such a submission, the Commission is required to conduct an Inquiry (under Part 7 of the ESC Act) into the appropriate price to be fixed. In doing so, it is required to have regard to a large number of matters as specified by both the Gas Act and the ESC Act. The outcomes of the Inquiry thereafter form the inputs into the price which is ultimately fixed by the Commission using its price determination powers under Part 3 of the ESC Act.

The prices thereby fixed are binding on Origin Energy for a period of three years. Importantly, in fixing prices for the purposes of the legislative scheme, the Commission is not required to specify each price for each individual tariff or tariff component across the

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4 Regulation 8E Gas Regulations 1997

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

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

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

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

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

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

entire period, but rather may undertake its task by specifying initial tariffs and components and providing a mechanism for changes to those tariffs across the period. In that way the actual price fixed at any given time is readily ascertainable, yet at the same time, the price control regime contains sufficient flexibility to reflect changing market conditions.

The Commission made such a price determination in 2008 to apply to Origin Energy for the period July 2008 – June 2011.[11] The Commission's first such gas price determination covered the period July 2005 – June 2008.[12]

On 5 November 2010, the Commission received a submission from Origin Energy for the period July 2011 – June 2014. A public version of this submission is available on the Commission's website.[13] As such, the price fixing process commenced upon receipt of the Origin Energy submission and this Draft Price Determination and Draft Inquiry Report sets out, for public comment, the Commission's views on the appropriate standing contract prices and the reasons for those views.

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

1.1 Overview of Gas Supply Industry

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

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

The gas industry structure in South Australia is discussed below.

1.1.1 Production

Natural gas in South Australia is extracted from the Cooper Basin in the far north of the state. Natural gas supplied to South Australia is also extracted from interstate fields such as the Otway and Bass gas basins off the coast of Victoria. Coal seam gas (CSG) from Queensland is able to be transported to the southern states through the South West Queensland Pipeline (SWQP) and the recently constructed Queensland to South Australia/New South Wales (QSN) pipeline.

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11 Documents relating to the 2008 Gas Standing Contract Price Determination are available on the Commission's website at http://www.escosa.sa.gov.au/projects/43/2008-gas-standing-contract-price-path-inquiry.aspx

12 Documents relating to the 2005 Gas Standing Contract Price Determination are available on the Commission's website at http://www.escosa.sa.gov.au/projects/129/2005-gas-standing-contract-price-path-inquiry.aspx#stage-list=6

13 Origin Energy Retail Ltd, *Origin Energy's Proposed Price Path for Standing Contract Gas Customers in South Australia: 2011-12 to 2013-14*, November 2010 (refer http://www.escosa.sa.gov.au/projects/160/2010-gas-standing-contract-price-path-inquiry.aspx)

1.1.2 Transmission

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

In South Australia, there are two major transmission pipelines:

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

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

1.1.3 Distribution

Once the gas is transported by the transmission pipeline to a gate station, it feeds into the distribution pipe network.[14] The distribution pipe network transports the gas to residential houses, offices, hospitals, factories and other businesses.

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

The distribution network owned by Envestra is a regulated monopoly. The access regime which applies to the distribution network is currently being reviewed by the Australian Energy Regulator (AER).[15] The Access Arrangement will set out the maximum distribution tariffs that can be charged by Envestra for the five year period commencing 1 July 2011. The Commission will treat the gas distribution tariffs approved by the AER as a cost pass-through to standing contract prices.

1.1.4 Retail

Retailers sell and supply natural gas to “end user” customers.

Unlike electricity retailers which buy electricity through the National Electricity Market (NEM), gas retailers in South Australia operate under a “contract carriage market” where they must have contractual arrangements in place for purchase (with gas producers such as Santos), transmission (with Epic or SEAGas) and

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

[15] Information regarding the AER’s review of Envestra’s South Australian gas Access Arrangement is available at http://www.aer.gov.au/content/index.phtml?itemId=743115.

distribution (with Envestra) of gas. The wholesale gas price and terms and conditions of supply are governed by these agreements.

1.1.5 Retail gas prices

On 28 July 2004, full retail competition (FRC) was introduced into the South Australian gas market. Prior to that date, while retailers other than Origin Energy were legally entitled to compete, there were insufficient market systems in place to permit those other retailers to do so on a large scale (other than to very large customers). Since July 2004, gas retailers in addition to Origin Energy have been able to compete to sell and supply gas to all customers and increasing levels of competition have been observed in the market.[16]

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

1.1.6 AEMC's Review of Energy Retail Competition in South Australia

In 2008, the Australian Energy Market Commission (AEMC) undertook a comprehensive review of the effectiveness of energy retail competition in South Australia, and provided recommendations to the South Australian Government on the continuation of energy retail price regulation.[17]

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

- There is little retail gas competition in regional areas of South Australia, due to the inability of retailers to access firm transmission haulage services on the MAPS laterals and competitively priced haulage services on the SEAGas Pipeline.
- The fixed cost nature of selling and supplying gas and, in addition, the small number of customers residing in regional areas, has limited the economic viability of retailing gas in these regions.

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

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

- South Australian small gas customers have low annual gas consumption relative to other jurisdictions, which leads to a low dollar value of the margins per customer. New entrant retailers in the gas market are competing generally through dual-fuel marketing strategies, where an additional margin can be earned by contracting customers to gas as well as electricity, for an incremental increase in the acquisition cost.

Having determined that effective retail competition exists, the AEMC recommended that the South Australian Government remove both electricity and gas retail price controls, and introduce a price monitoring regime.

In a letter to the AEMC in April 2009, the South Australian Energy Minister subsequently rejected the AEMC's advice, stating that he intended to retain regulation of electricity and gas standing contract prices. The Minister noted that:

> *The public confidence achieved by independent oversight of retail pricing is considered to be especially important at a time of implementing major change, such as will occur with the commencement of the Commonwealth's Carbon Pollution Reduction Scheme (CPRS), expanded Renewable Energy Target (RET) and the current global financial crisis. The existing framework for regulating retail energy prices in South Australia is crucial to safeguarding the interests of the public during this current period of uncertainty. I recognise that the long term viability of retailers is important to deliver safe, reliable and cost effective energy over the longer term.*[18]

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

1.1.7 Wholesale gas market

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

The AEMC is responsible for overseeing the gas market rules, while AEMO administers wholesale market arrangements, including operation of a Short-Term Trading Market (STTM) and management of data flows and customer transfers.

Retailers are responsible for contracting with gas producers for the total gas supply for their requirements. However, given the uncertainty of customers' actual demands, there will always be imbalances between a retailer's purchases and

[18] Correspondence, The Hon. P. Conlon MP, South Australian Minister for Energy, to the AEMC,6 April 2009 available from the AEMC website at http://www.aemc.gov.au/Media/docs/Minister%20for%20Energy%27s%20Response-f1e594e0-a706-42f2-8259-43ef8a49a807-0.pdf.

sales: this requires a balancing service to match actual supply and demand for every retailer on a daily basis. In South Australia, given that there are two major transmission pipelines through which gas is supplied, these imbalances occur on both an inter and an intra pipeline basis.

The STTM, which commenced operation on 1 September 2010, is a wholesale market designed to facilitate gas balancing by allowing for the purchase and sale of gas at market-based prices that are set daily. Prices are set for each "hub" of the market, which comprise Adelaide and Sydney initially, although there is scope to include additional hubs later.

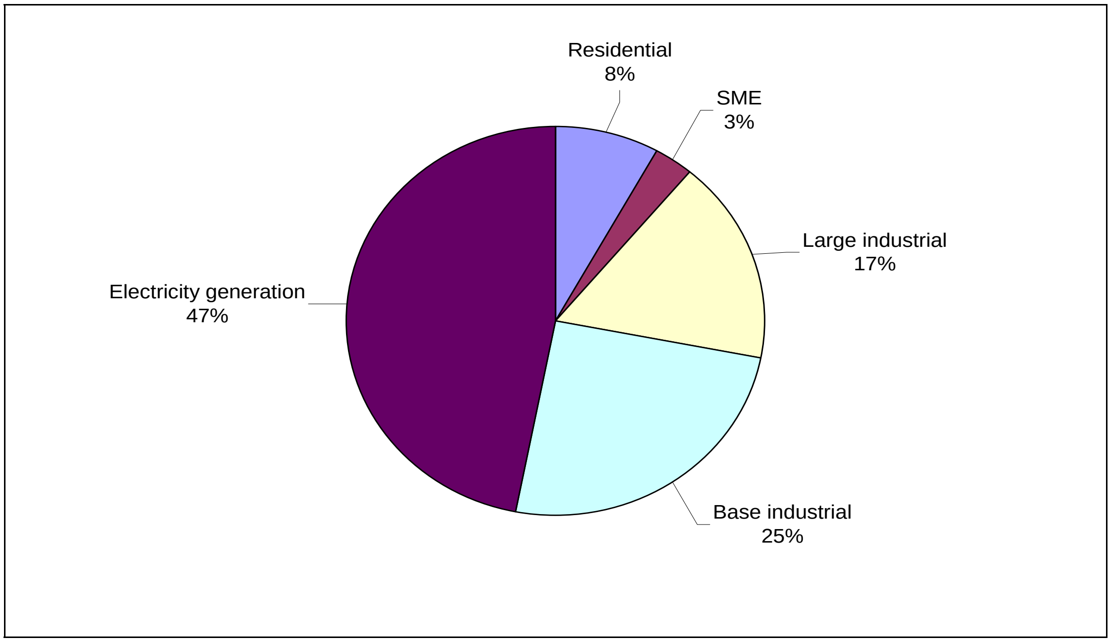
Further discussion on the STTM, and its implications for wholesale gas costs, is contained in Chapter 6 of this Draft Inquiry Report.

1.1.8 Annual consumption

As shown in Figure 1.1, gas fired electricity generators and industrial businesses remain the dominant users of natural gas in South Australia, forecast to account for 47% and 42% of annual consumption, respectively. Residential and small business customers have historically not been large consumers of gas in South Australia. Australian Bureau of Agricultural and Resource Economics data for national and state projections to 2029/30 forecast that gas consumptions will continue to grow on a similar proportional basis for the next 20 years, with the biggest increase in gas consumption in the electricity generation sector.[19]

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

Figure 1.1 - Composition of South Australian natural gas consumption



Source: Origin Energy Retail Ltd, *Proposed Price Path for Standing Contract Prices for Supply & Sale of Natural Gas: 2011/12 to 2013/14 South Australia: Public Submission*, November 2007, page 7.

1.1.9 Maximum daily consumption

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

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

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

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

1.2 Price Determination and Inquiry

In terms of the formal price determination process, the Commission is permitted, but is not required, to prepare a draft price determination under section 25(1) of the ESC Act. The Commission considers it important and appropriate to prepare a draft price determination in order to provide all stakeholders with the opportunity to consider and review the draft outcomes of the price determination process prior to the making of the final price determination.

A draft price determination has therefore been released at the same time as this draft Inquiry Report. To advance both the Inquiry and the price determination process more efficiently, and to better reflect the connection between the Inquiry process and the formal price determination process, the Commission has decided that the draft findings of the Inquiry, which ultimately form the basis of the statement of reasons for the draft price determination, and that statement of reasons, should be reflected within a single document.

The decision to reflect the draft Inquiry findings in this manner permits Origin Energy and other stakeholders to assess, on an individual merits basis, each of the considerations taken into account by the Commission in establishing the various parameters feeding into the draft price determination.

1.3 Nature of the price determination

While the provision of Origin Energy's submission is a condition precedent to the Commission being empowered to make a price determination, the Commission is not, in making the price determination, simply assessing or passing judgment on the merits or otherwise of the submission. Instead, the Commission is undertaking an independent price-fixing process, necessarily informed to a large extent by the content of the submission, but also informed by other evidence gathered by the Commission, including stakeholder submissions, expert advice and advice from Commission staff.

1.4 Legislative Framework

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

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

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

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

(d) *specifying pricing policies or principles;*

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

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

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

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

Section 6A of the Gas Act states that the Commission has (in addition to the Commission's functions and powers under the ESC Act), the licensing, price regulation and other functions and powers conferred by the Gas Act and any other functions and powers conferred by regulation under the Gas Act. More specifically, section 33(1)(a) of the Gas Act states that the Commission may make a determination under the ESC Act regulating prices and price-fixing factors for the sale and supply of gas to small customers or customers of a prescribed class. This provides the authorisation required by section 25(2) of the ESC Act.

1.5 Factors to consider in making the Draft Price Determination

Section 25(4) of the ESC Act states that, in making a price determination, the Commission must have regard to the following factors (subject to the provisions of the Gas Act[20])

1.5.1 Factors specified in Part 2 of the ESC Act

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

Section 5(1)(a) specifies that one such function is to "regulate prices and perform licensing and other functions under relevant industry regulation Acts".[21]

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

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

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

- (i) *promote competitive and fair market conduct;*
- (ii) *prevent misuse of monopoly or market power;*
- (iii) *facilitate entry into relevant markets;*

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[20] Section 25(6) ESC Act

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

(iv) *promote economic efficiency;*

(v) *ensure consumers benefit from competition and efficiency;*

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

(vii) *promote consistency in regulation with other jurisdictions.*

1.5.2 Factors specified in Part 3 of the ESC Act

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

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

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

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

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

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

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

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

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

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

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

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

1.5.3 Factors specified in the Gas Act

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

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

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

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

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

(d) *to establish and enforce proper safety and technical standards for gas installations and appliances; and* *(e) to protect the interests of consumers of gas.*

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

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

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

1.5.4 Other factors

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

1.6 Establishing a Retail Gas Price Path

Section 34A of the Gas Act provides a scheme under which the Commission will exercise its power to make a determination regulating prices, conditions relating to prices and price-fixing factors for the sale and supply of gas to small customers.[22] In particular, section 34A(4a) provides that:

The following provisions apply in relation to the fixing by the Commission of a standing contract price for an entity and class of customers for the purposes of this section:

(a) the Commission may fix the price by a determination of a kind referred to in section 33(1)(a);

(b) a determination must provide for the expiry of the determination at the end of a period of not less than 3 years specified in the determination;

(c) a determination may provide for prices that vary at specified times according to a formula specified in the determination;

(d) unless the Commission determines that special circumstances exist—

(i) a determination may not be made to take effect before the expiry date of the last preceding determination made by the Commission in accordance with this subsection;

(ii) a determination may only be made if the entity has made a submission to the Commission stating the price that the entity proposes be fixed by the Commission as the entity's standing contract price, and the entity's justification for the price, not less than 6 months and not more than 9 months before the making of the determination;

22 Section 33(1) Gas Act

(iii) the Commission must, before making a determination, have conducted an inquiry under Part 7 of the Essential Services Commission Act 2002 into the question of the appropriate price to be fixed as the standing contract price;

(e) a submission under paragraph (d) must comply with any requirements as to the form and content of such submissions imposed by the Commission by written notice served on the entity.

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

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

standing contract price, in relation to a gas entity and a customer, means—

(a) until 1 July 2005—the price last fixed by the Minister under Schedule 2 for the sale and supply of gas to a class of customers to which the customer belongs;

(b) on and from 1 July 2005—

(i) the price fixed by the Commission in accordance with subsection (4a) as the entity's standing contract price for a class of customers to which the customer belongs; or

(ii) if there is no price for the time being fixed by the Commission as the entity's standing contract price in accordance with subsection (4a), the price fixed under this Act as at 31 December 2002 for the sale and supply of gas to a class of customers to which the customer belongs.

1.7 Approach adopted by the Commission

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

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

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

- protect consumers' long-term interests with regard to the price, quality and reliability of gas supply;
- ensure Origin Energy's reasonable costs are recovered;

- facilitate maintenance of the financial viability of the gas industry;
- promote economic efficiency and ongoing investment in the gas industry; and
- encourage competition and prevent abuse of monopoly power.

In applying these factors, the Commission has sought to establish the lowest possible price consistent with:

- the costs that an efficient retailer would be expected to incur in meeting the responsibilities of standing contract supply to small customers in South Australia over the period;
- encouraging active competition among retailers for the benefit of consumers;
- encouraging ongoing, efficient investment to meet consumers' long-term requirements; and
- providing an appropriate return for an efficient declared retailer.

Further discussion on the approach undertaken by the Commission in formulating its draft determination is contained in subsequent chapters.

Much of the detailed analysis conducted by the Commission in this Inquiry relies on information provided by Origin Energy that is commercially sensitive and has been kept confidential. For example, information regarding Origin Energy's contracts with gas producers and pipeline operators has not been disclosed by the Commission on the basis that its release would negatively impact on Origin Energy's commercial position. While the Commission's information gathering powers under the ESC Act are broad, and do not limit the ability of the Commission to collect such confidential information, the Commission has preserved the confidentiality of commercially sensitive information in discussing its reasons for this Draft Determination.

The Commission recognises that such an approach creates difficulties for stakeholders in commenting on the details of the Commission's analysis, given that certain aspects of the analysis have been summarised in this Draft Report. The Commission has sought to strike an appropriate balance between providing sufficient information in this Draft Report to enable stakeholders to understand the basis of the Commission's Draft Determination, while also ensuring that confidential information is not disclosed, to protect Origin Energy's commercial position.

1.8 Process

Prior to making a price determination, the Commission is required to conduct an Inquiry under Part 7 of the ESC Act into the question of the appropriate price to be fixed as the standing contract price.[23]

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

This Inquiry commenced with the release of a public version of the Origin Energy price path proposal and an accompanying Issues Paper in November 2010.[24] The Issues Paper stated that the feedback received would guide and inform the Commission in preparing a draft inquiry report.

The following four parties made submissions to the Issues Paper:[25]

- AGL South Australia Pty Ltd (AGL SA);
- Minister for Energy;
- Origin Energy; and
- South Australian Council of Social Service (SACOSS).

The Commission acknowledges the effort of stakeholders in preparing submissions for this Inquiry.

Following consideration of submissions, consultant reports and other analysis, this Draft Inquiry Report, and the accompanying Draft Price Determination, presents the Commission's draft conclusions on the gas standing contract prices that should apply for the period 1 July 2011 to 30 June 2014.

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[24] Essential Services Commission of South Australia, *Review of Gas Standing Contract Prices 2011/12-2013/14: Issues Paper*, November 2010 (refer http://www.escosa.sa.gov.au/library/101117-GasPricePath2010-IssuesPaper.pdf).

[25] All of these submissions are available on the Commission's website refer: http://www.escosa.sa.gov.au/site/page.cfm?u=259&t=submissionsXList&xlistId=57.

2 2008 GAS STANDING CONTRACT PRICE DETERMINATION

The Commission's 2008 Gas Standing Contract Price Determination considered the retailer component of gas standing contract prices.

In establishing its 2008 Final Determination, the Commission examined the following cost components from the perspective of a prudent standing contract retailer:

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

The Commission's Final Determination on the controllable costs in gas standing contract prices applied from 1 July 2008 to 30 June 2011 are summarised in Table 2.1.

Table 2.1 - Final Determination on retailer controllable costs 2008/09 to 2010/11: weighted average of 5 regions (GST exclusive, $Dec 08)

	Residential			SME		
	2008/09	2009/10	2010/11	2008/09	2009/10	2010/11
Cost of Gas ($/GJ)	4.42	4.43	4.51	4.08	4.09	4.17
Transmission Cost ($/GJ)	1.69	1.69	1.70	1.22	1.22	1.22
ROC ($/customer)	101.47	89.88	89.88	101.47	89.88	89.88

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

The Commission determined a maximum average retailer revenue in 2008/09 (expressed in $Dec08) of $11.81/GJ for residential customers and $6.76/GJ for small business customers.

Table 2.2 provides a summary of the Commission's 2008 Gas Standing Contract Price Determination compared to Origin Energy's 2008 Price Path Proposal.

Table 2.2 - Retail Component of Gas Standing Contract Price Commission's 2008 Gas Standing Contract Price Determination

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

The Commission's 2008 Gas Standing Contract Price Determination resulted in an increase of approximately $15 ($Dec08) from July 2008, or 3% to the average annual residential bill compared to the Commission's 2005 Gas Standing Contract Price Determination. The Commission's Final Determination outlined annual price changes thereafter to be lower than the initial price increase (in real terms).

The outcome of the Commission's 2008 Gas Standing Contract Price Determination was driven largely by:

- increases in wholesale gas supply costs, and
- increased retail margin to reflect arrangements for payment of distribution charges in South Australia.

However, the outcome of the Commission's 2008 Gas Standing Contract Price Determination was below the amount proposed by Origin Energy, driven largely by the Commission's decision on:

- peak demand, which impacted on the costs of purchasing peak gas and transmission services, and
- retail operation costs, particularly in relation to costs associated with the introduction of Full Retail Contestability

3 STATE OF THE RETAIL MARKET

The Commission's determination of gas standing contact prices must be made in the context of an energy retail market that continues to evolve. Whilst the majority of small customers (around 72%) are no longer on standing contracts, the gas standing contract price still forms an important price protection for those customers who, for whatever reason, have not sought to participate in the competitive market. Further, it also has a direct impact on the development of the competitive retail market itself, given that it acts as an offer that any small customer can revert to at any time, thereby forming a competitive constraint on market contract offers.

The current state of the gas retail market, and the role that the standing contract price plays within this market, is therefore a key consideration in the Commission's price regulation role.

3.1 Development of retail competition

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

3.1.1 Customer Switching

Figure 3.1 shows the number of small customer transfers between retailers in South Australia since the commencement of FRC in July 2004.[26] It can be observed that the gas market experienced a quick take-up after market commencement, peaking at around 24% in December 2004. The rate of switching has however since declined significantly and fluctuated between 9% and 12% since March 2008.

Figure 3.1 also shows, for comparative purposes, small customer transfers in the South Australian electricity market. There is a strong historical relationship between the level of electricity and gas transfers in South Australia. This is due to the fact that most of the gas retailers operating in South Australia employ a dual-fuel marketing strategy to encourage customers to switch to a market contract. A survey of retailers conducted by ACIL Tasman on behalf of the Commission in 2010 confirmed that most retailers consider gas to be a secondary product that they offer to their electricity customers, rather than as a stand alone business[27] Hence, the level of activity in the small customer retail electricity market significantly influences the level of activity in the small customer gas retail market.

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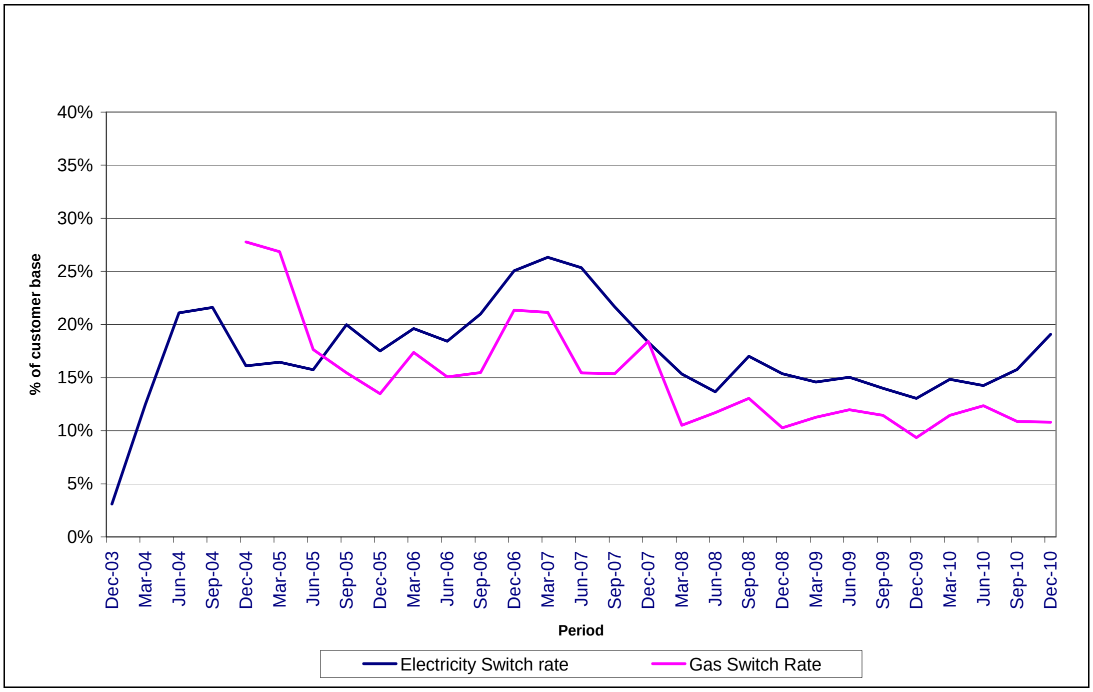
26 The Australian Energy Market Operator's (AEMO) data includes all transfers occurring in the South Australian gas market, capturing both initial transfers to market contracts and subsequent transfers as a result of customers either changing gas retailers, or customers changing physical locations. It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

27 ACIL Tasman, (2010), *Competition in South Australia's retail energy markets, Report on interviews with participants,* p.39 http://www.escosa.sa.gov.au/library/100624-CompetitivenessRetailMarketReport-ACILTasman-Public.pdf

Figure 3.1 - Small Customer Market Switching Rate (Annualised from quarterly data)



Source: Based on customer transfer data supplied by AEMO

3.1.2 Number of Gas Retailers

As at 31 December 2010, there were 10 retailers licensed to sell gas in South Australia, 9 of which were also licensed to sell electricity (refer Table 3.1). However, as has been the case since 2005, only 4 of those licensed gas retailers (AGL SA, Origin Energy, TRUenergy and Simply Energy) are selling to small gas customers in South Australia. Of those 4 retailers, only Origin Energy is actively offering gas market contracts to small customers in regional South Australia. Simply Energy is currently only marketing gas to small customers as part of a dual-fuel energy offer, i.e. Simply Energy is not offering gas-only market contracts to customers.

It is noteworthy that all four of the active gas retailers are relatively large, well established energy companies with a large presence in the electricity retail market and significant upstream interests (in generation and gas production).

Table 3.1 - Retailers licensed to operate in the South Australian energy supply industry (as at 31 December 2010)

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

3.1.3 Market Shares

As at the end of December quarter 2010, Origin Energy continued to hold the largest share of the small customer gas retail market in South Australia, with a total of 54% of small customers (28% on standing contracts and 26% on market contracts). The second largest market share is held by AGL SA (Figure 3.2).[28]

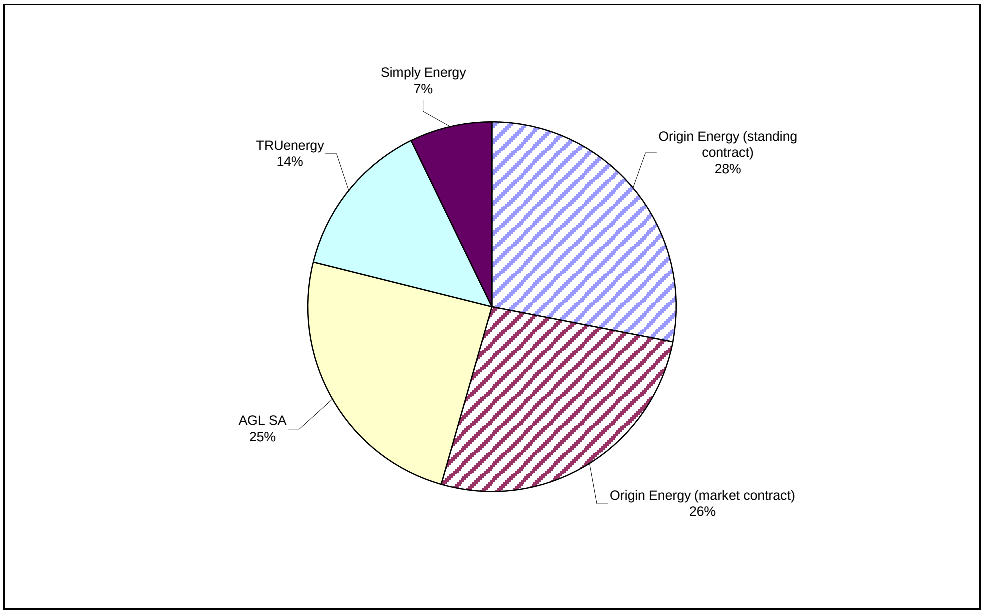
Customer data reported by energy retailers under the Commission's Guideline 2[29] also reveal that the market share held by each gas retailer has remained relatively

[28] As at 31 December 2010, the total number of small customers in the South Australian gas market is around 380,000, of which 372,000 are residential customers and 8,000 are SME customers.

[29] Information relating to the Commission's Guideline 2 data is available at the following website: http://www.escosa.sa.gov.au/projects/135/energy-guideline-no-2.aspx

constant in recent years. The failure of gas retailers, other than Origin Energy to collectively expand their combined market share may be indicative of barriers to expansion within the gas retail market. A survey of retailers conducted in 2010 by ACIL Tasman for the Commission suggested that the main factor inhibiting competition in the gas retail market in South Australia is due to '*the average consumption in South Australia [being] lower than in other states and so the dollar margin per customer is very low*.'[30]

Figure 3.2 – Residential Gas Retail Market share in the South Australia (as at 31 December 2010)



Source: Commission's Energy Industry Guideline No. 2

The movement of customers from a standing contract to a market contract is typically driven by the interaction of the following factors:

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

30 ACIL Tasman, (2010), *Competition in South Australia's retail energy markets, Report on interviews with participants,* p.vii http://www.escosa.sa.gov.au/library/100624-CompetitivenessRetailMarketReport-ACILTasman-Public.pdf

The Commission observes that the rate of switching from the gas standing contract has slowed in recent years, relative to the rate experienced prior to mid-2007. This decline in the rate of reduction of the standing contract customer base is consistent with data published by AEMO (refer Figure 3.1).[31]

3.1.4 Retailer Survey

To build on previous work that has assessed the effectiveness of retail competition in the South Australian energy market (eg that undertaken by AEMC as discussed in section 1.1.6), the Commission engaged ACIL Tasman in April 2010 to conduct interviews with market participants, with the aim of canvassing views on the level of competitiveness, and to identify any common factors being experienced that are having an impact on the level of competition in the South Australian retail energy market.[32]

As noted, gas retailers viewed the retail margin as being the main reason for low participation. As the average South Australian gas consumer has lower gas consumption relative to average customers in other states due to South Australia's moderate climate and lower gas penetration, the retail margin in South Australia translates to a lower dollar margin (which can be easily eroded should an unforseen event occur). In addition, retailers considered the time and effort involved in negotiating access to gas pipelines in regional areas unjustified for the relative value of the customer.

3.1.5 Consumer Awareness and Participation

The Commission has commissioned several surveys of customer awareness of electricity and gas retail market issues over the past few years, with the most recent conducted by Colmar Brunton in 2010[33]. Those surveys have shown high levels of customer awareness about the existence of competition in the gas retail market and have indicated that customers are generally confident regarding the processes for changing providers and/or entering into market contracts. Those survey results also indicated that price remains the dominant reason influencing a customer's decision to switch retailers.

Notwithstanding the fact that confidence among South Australian consumers to switch retailers is relatively high, the Colmar Brunton survey has, however, identified an outstanding group of "sticky residential customers" who are less amendable to churn. Further, it also identified reasons such as brand loyalty, poor

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

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

[33] Colmar Brunton report is available at the following website: http://www.escosa.sa.gov.au/library/100806-ConsumerPreferenceColmarBruntonReportFinal.pdf

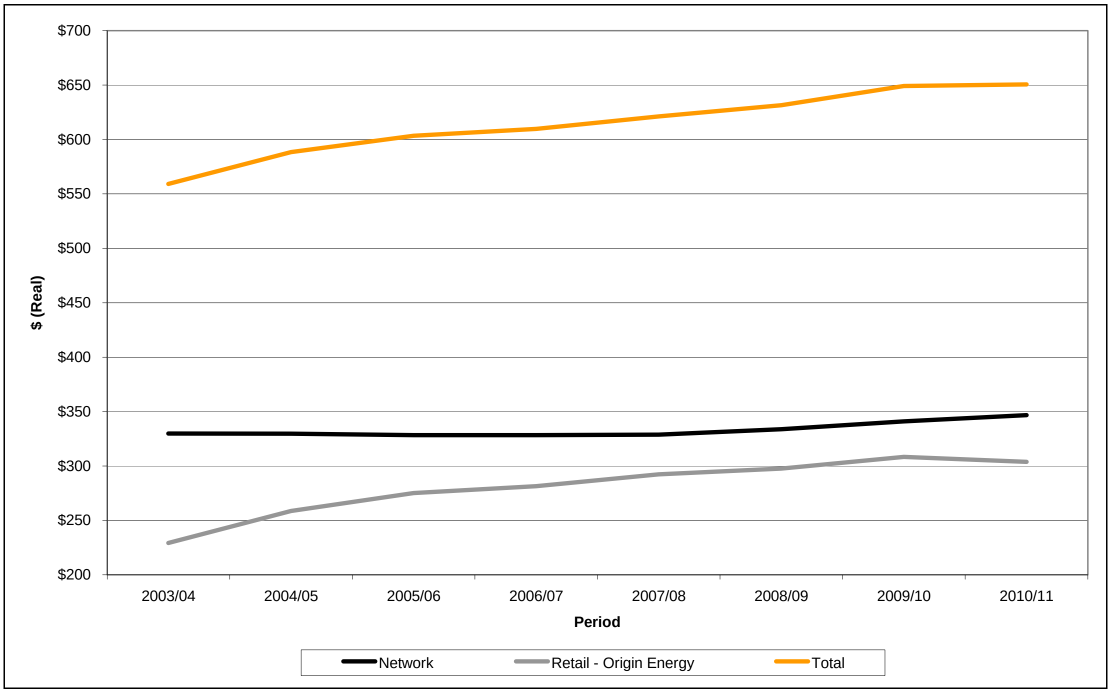
time management and difficulties in the switching process as being key drivers influencing a residential customer's decision not to switch to a market contract.

3.2 Gas retail prices

Figure 3.3 and Figure 3.4 below set out the movements in average bills ($Dec2010) for small customers on a gas standing contract as a result of pricing decisions – network and retailer charges -determined from 1 July 2003 to 30 June 2011.[34]

It can be observed that over the period 2003/04 to 2010/11, there has been a real increase in the annual residential gas bill for an annual consumption of 24 Gigajoule (GJ) of about 16.4% ($91.50), or an average of 2.2% per annum over this period. Whilst network charges have remained relatively constant in real terms, retailer costs have increased over the period, significantly impacted by a decision[35] on gas standing contract prices to apply during 2004/05 which led to a 13% real increase in the retail component of gas standing contract prices.

Figure 3.3 - Residential Gas Standing Contract Annual Bill 24 GJ p.a. GST exclusive, $Dec10

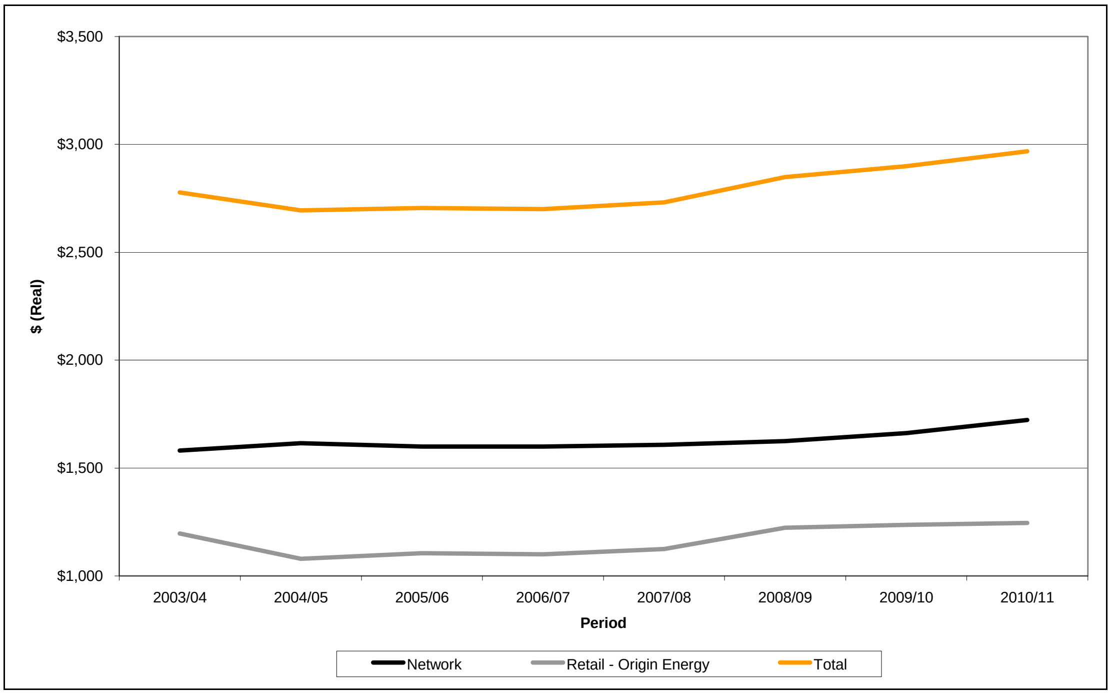


34 Prices to July 2005, retailer tariffs were determined by the Minister for Energy.

35 This price determination was made prior to the Commission being given responsibility for making gas standing contract price determinations.

For a small business customer consuming 170 GJ per annum, the gas standing contract annual bill increased by approximately 6.8% ($190) or an average of 0.95% per annum over the same period. It is noted that the retail component of the small business customer bill was only slightly greater (0.4%) at the end of the period than at the beginning, in contrast to the significant upward movement for residential customers. A gradual reduction in cross-subsidies from small business customers to residential customers contributed to this outcome.

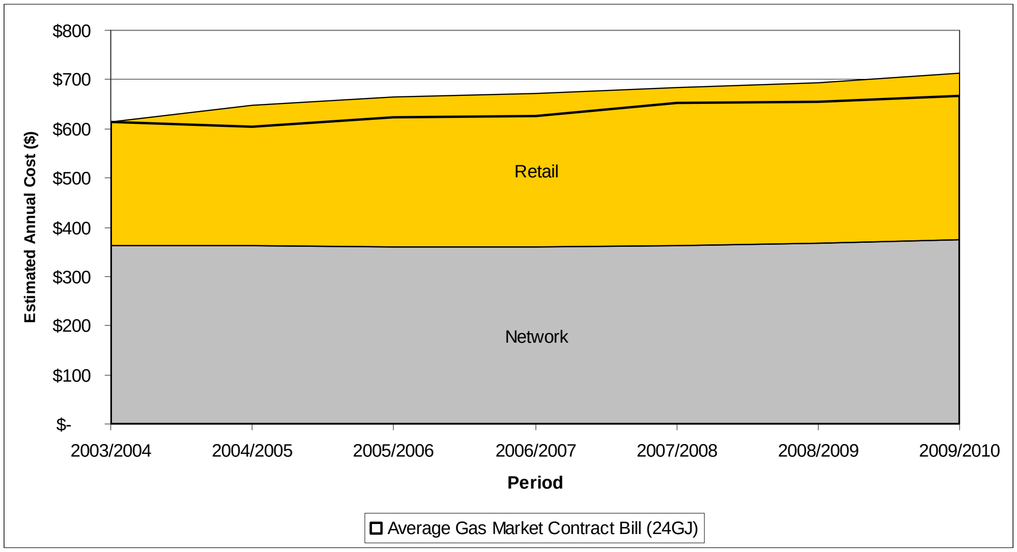
Figure 3.4 - Small Business Gas Standing Contract Annual Bill 24 GJ p.a. GST exclusive, $Dec10



3.2.1 Market Contract Savings

Figure 3.5 shows that South Australian residential gas customers have benefited from market contract prices that are consistently lower than standing contract prices since the commencement of gas FRC in July 2004.

Figure 3.5 - Residential Gas Standing Contract bill compared to average discounted Gas Market Contract Annual Bill 24 GJ p.a. GST inclusive, $Dec10

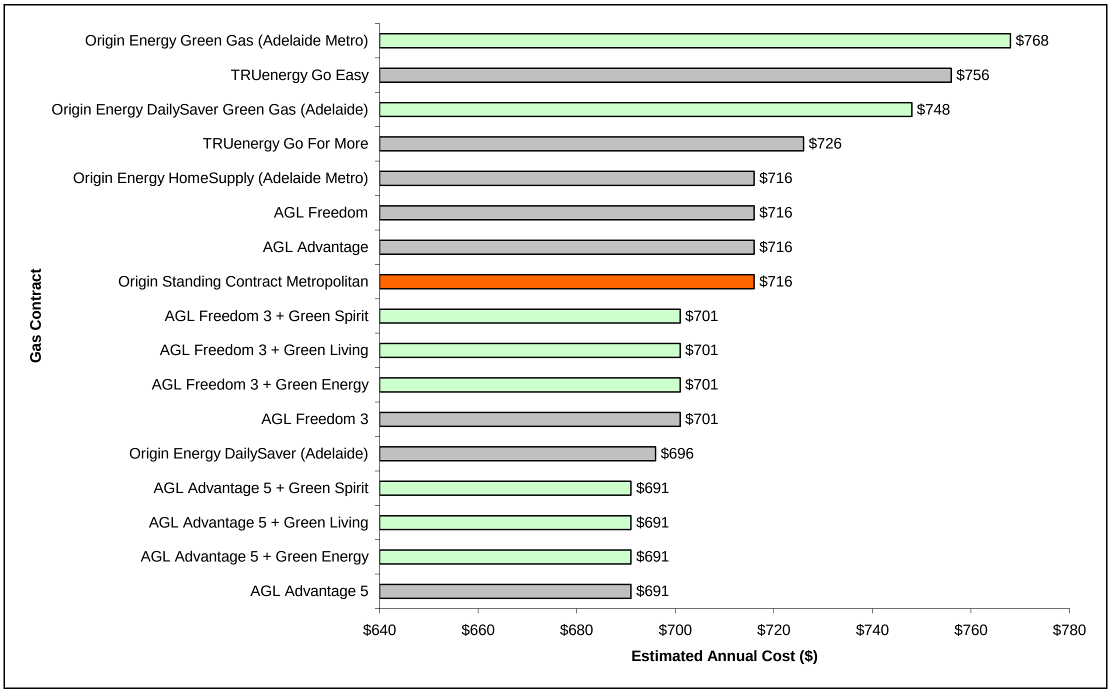


Data for the latest gas market offers extracted from the Commission's Estimator[36] indicates that residential gas customers with an annual consumption of 24 GJ in South Australia are still able to achieve savings of around 2% to 4% off the gas standing contract price. This represents savings of around $15 to $25 per annum for a typical residential customers (refer Figure 3.6). The Commission notes that the availability of price discounts has historically been the dominant factor in the decision by small customers to switch energy retailers.

The Commission also notes that Simply Energy's gas market offers are not shown in Figure 3.6 as those offers are only being made to small customers as part of a dual-fuel energy offer.

36 The Commission's Estimator tool is available at the following website: http://archive.escosa.sa.gov.au/site/page.cfm?u=281

Figure 3.6 - Gas Market Contract vs Standing Contract Estimated Annual Cost (as at 10 March 2011, GST inclusive)[37]



3.3 Extent of Competition in Gas and Electricity

The Commission's determination of gas standing contact prices must be made in the context of an energy retail market that continues to evolve. Whilst the gas retail market represents less than half of the electricity retail market in South Australia in terms of customer numbers (380,000 for gas and 810,000 for electricity), all of those gas customers also have electricity accounts.

Given the smaller size of the gas retail market and lower dollar value of the margins available from selling gas relative to electricity, the Commission observes that energy retailers typically adopt a dual-fuel marketing strategy to earn an additional margin for each customer who signs up to purchase both gas and electricity for an incremental increase in the retailer's customer acquisition cost. Further, strong competition between retailers for higher margin electricity customers has also provided incentive for dual-fuel retailers to compete for gas customers as well.

For these reasons, competition is likely to be more effective in the electricity and dual-fuel retail markets, than the gas-only market; furthermore the level of activity in the small customer gas retail market is expected to continue to be driven primarily by the level of

[37] Note, as discussed in Section 3.1.2 Simply Energy currently only offer gas market contract as part of a dual-fuel marketing strategy. Consequently, the Commission's Estimator data does not identify any Simply Energy stand alone gas market contract offerings in Figure 3.6.

activity in the small customer retail electricity market over the forthcoming price path period.

3.4 Methodology for Fixing Gas Prices

In August 2010, the Commission finalised a review of the methodology for setting electricity and gas standing contract prices.[38] The review examined the ongoing effectiveness of the previous "building block" approach to setting standing contract prices, and the extent to which alternative approaches might better achieve the Commission's objectives in light of current circumstances.

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

- there is currently significant volatility in the wholesale electricity market, which is expected to continue in the medium-term, due largely to uncertainties over carbon pricing and the development of other climate change policies. This uncertainty and volatility makes the Commission's task of forecasting wholesale energy costs for at least 3 years under a traditional cost "building block" approach extremely difficult; and
- the electricity retail market in South Australia has developed significantly since the introduction of FRC in 2003. As noted in section 1.1.6, the AEMC 2008 review of energy retail competition in South Australia found the electricity and gas retail markets to be effectively competitive, with greater competition existing in the electricity retail market than the gas retail market.

Following extensive consultation with relevant stakeholders, the Commission determined that the best methodology for fixing electricity standing contract prices is to implement a hybrid cost-based and index-based approach. Such an approach was incorporated into the Commission's 2010 Electricity Standing Contract Price Determination for the period January 2011 – June 2014.[39]

With respect to the gas market, the Commission found that there was evidence to suggest that, relative to the electricity market, gas wholesale prices exhibit less medium-term volatility and that there was a lesser degree of competition in the gas retail market. This finding was also consistent with limitations identified by the AEMC on competition in the South Australian retail gas market (refer section 1.1.6). In addition, the Commission did not receive any submissions to its Consultation Paper supporting the adoption of an alternative price-setting approach for gas standing contract prices.

Origin Energy's price path proposal is based on the continuation of a cost-based approach to setting gas standing contract prices. The proposal states that:

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

[39] The Commission's 2010 Electricity Standing Contract Price Determination is available at the following website: http://www.escosa.sa.gov.au/projects/143/2010-electricity-standing-contract-price-path-inquiry.aspx.

> *Origin is supportive of this methodological change [to setting electricity standing contract prices] but believes the South Australian gas market is not showing the necessary level of product choice to justify proposing it for this period.*[40]

In the absence of any persuasive arguments or evidence to suggest otherwise, it is the Commission's Draft Determination to use a cost-based approach to setting gas standing contract prices.

[40] Origin Energy Retail Ltd, Proposed Price Path for Standing Contract Gas Customers in South Australia 2011/12-2013/14: Public Submission, November 2010, page 9.

4 ORIGIN ENERGY'S PROPOSAL

A public version of Origin Energy's standing contract price proposal for the period July 2011 – June 2014 was released by the Commission for consultation in November 2010, together with an Issues Paper prepared by the Commission.

Origin Energy has proposed real increases in the retail component of gas standing contract prices across the three-year price path period. The most significant increase for residential customers is proposed to take effect on 1 July 2011, with a smaller price increase in 2012/13, and further substantial increase in 2013/14. For small business users, small price increases are proposed for the first two years of the price path period, with a much larger increase proposed for 2013/14.

Origin Energy's proposed price path is based on a building block approach, utilising an average revenue form of regulation whereby separate caps on revenue per GJ sold are imposed for residential and small to medium enterprise (SME) customers. The cost building blocks are based on forward-looking estimates of the retailer's controllable costs (wholesale gas supply costs, transmission costs, Retail Operating Costs (ROC), and a Retail Operating Margin (ROM)).

Origin Energy has developed revenue forecasts that are designed to recover its proposed controllable costs, and has translated this into a maximum average revenue control. Retailer revenue is to be recovered via retailer tariffs, which comprise approximately half of the total gas to standing contract price (gas distribution charges making up the other half). Origin Energy's proposed real increases (i.e. increases above the Consumer Price Index (CPI)) in the average retailer revenue allowance for residential and SME gas standing contract customers are reproduced in Table 4.1.

Table 4.1 - Origin Energy's proposed price path ($Dec11)

	Residential Customers		SME	
	Average Revenue ($/GJ)	% change	Average Revenue ($/GJ)	% change
2011/12	$14.45	11.0%[41]	$7.58	2.2%
2012/13	$14.61	1.1%	$7.68	1.3%
2013/14	$16.03	9.7%	$9.10	18.6%

Origin Energy has estimated the impact of the proposed increases in retailer tariffs on the total standing contract price, as set out in Table 4.2.[42]

41 Origin Energy has expressed the increase with reference to the 2010/11 maximum average revenue that excludes the impact of a REES pass through that was applied in that year. When the additional REES pass through amount is included in the 2010/11 average revenue allowance, the percentage increase in 2011/12 is 9.9%.

42 These estimated price increases do not incorporate any changes in AEMO charges.

Table 4.2 - Forecast impact of Origin Energy's proposal on total standing contract prices

	RESIDENTIAL CUSTOMERS	SME
	% CHANGE ABOVE CPI	% CHANGE ABOVE CPI
1 July 2011	5.2%	1.0%
1 July 2012	0.6%	0.6%
1 July 2013	4.9%	8.6%

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

- *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*
- *the 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. Industry expectations are that wholesale gas costs will increase significantly at this time, with a move to export price parity. This is driving large increases in the required retailer revenue in 2013/14.*

More specific details on the Origin Energy submission, including the Commission's assessment of its forecast cost increases, are set out in subsequent Chapters of this Draft Inquiry Report.

5 DEMAND FORECASTS

Establishing reliable demand forecasts is important for the purposes of setting gas standing contract prices as it has a direct impact on the ability of a gas utility to recover the revenue requirement established in any particular year. Further, it also assists the Commission in determining a set of fair and reasonable prices wherein customers would pay no less or more than the costs incurred by Origin Energy in the provision of gas services.

In undertaking this Inquiry, the Commission must therefore investigate and reach conclusions on several assumptions concerning standing contract customers that will have a significant impact on standing contract prices. The assumptions cover:

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

The Commission’s assessment of Origin Energy’s proposal concerning these assumptions has been informed by independent expert advice from the Commission’s consultants, discussions with Origin Energy, and work undertaken by the Commission internally.

5.1 *Origin Energy’s Proposal*

The Origin Energy’s Proposal projects standing contract customer numbers and customer consumption over three years from 1 July 2011 based on the following approach:

- extracting historical billing information for small customers on gas standing contract tariffs between 1 July 2007 and 30 June 2010 to derive actual customer numbers and consumption volumes;
- classifying the customer numbers and consumption volumes data into appropriate business segments, geographical regions and related tariff block usage;
- analysing historical relationships between both consumption volumes and tariff blocks, and customer numbers and geographical regions to identify trend lines best suited for forecasting purposes. Those linear trends are then used to forecast the total number of residential and commercial customers that are expected to be billed on gas standing contract tariffs for the period 1 July 2011 to 30 June 2014;
- applying the above forecasts of customer numbers with the estimated annual average consumption per customer to forecast total consumption by business segment; and

- allocating the total consumption forecast into respective geographical regions and tariff blocks using the observed historical relationships.

With respect to the load factors[43] (the ratio of peak to average demand), Origin Energy has adopted a 1 in 25-year maximum planning day for deriving MDQ and the related load factors. While Origin Energy's proposal did not provide any details of the methodology used to derive those load factors, the Commission understands that the approach used by Origin Energy to derive its proposed load factors remains unchanged from that used in the previous pricing proposal, which itself was based on the Origin Energy's pricing proposal for the 2005 – 2008 period. The proposed load factors were based on regression analysis of customer billing data to determine customer base load and heating degree-day (HDD) sensitivity coefficients, and derivation of a 1 in 25 peak day weather.

Details and modelling of Origin Energy's proposed customer numbers, consumption volumes and load factors have been provided to the Commission on a confidential basis as the data are deemed to be commercially sensitive. In forming its view on Origin Energy's proposed forecasts, the Commission has had regard to its own internal analysis and independent expert advice provided by Sinclair Knight Merz McLennan Magasanik Associates (SKM MMA), which was asked to provide the Commission with its own forecasts of standing contract customers, consumption levels and load factors for the July 2011 – June 2014 period.

Details of the Origin Energy's proposal and SKM MMA advice have not been published in this Draft Inquiry Report for confidentiality reasons. The Commission's assessment of this information, as discussed in the following sections, has therefore been summarised.

5.2 Customer Numbers

Estimating the number of gas standing contract customers over the regulatory period is a difficult task, as it requires the Commission to project churn rates for both residential and SME customers over the period. As at 31 December 2010, approximately 72% of small customers had moved to gas market contracts.

The movement of customers from a standing contract to a market contract is typically driven by the interaction of the following factors:

- the level of active marketing being undertaken by energy retailers in South Australia (including the marketing of dual-fuel products);
- the extent to which customers are empowered (e.g. effectively exercising their right to switch gas retailers in response to changing market conditions); and
- price and non-price offers (e.g. available discounts and product innovation).

Figure 5.1 illustrates the trend in the proportion of residential and small business customers on an Origin Energy gas standing contract since September 2004. It shows the

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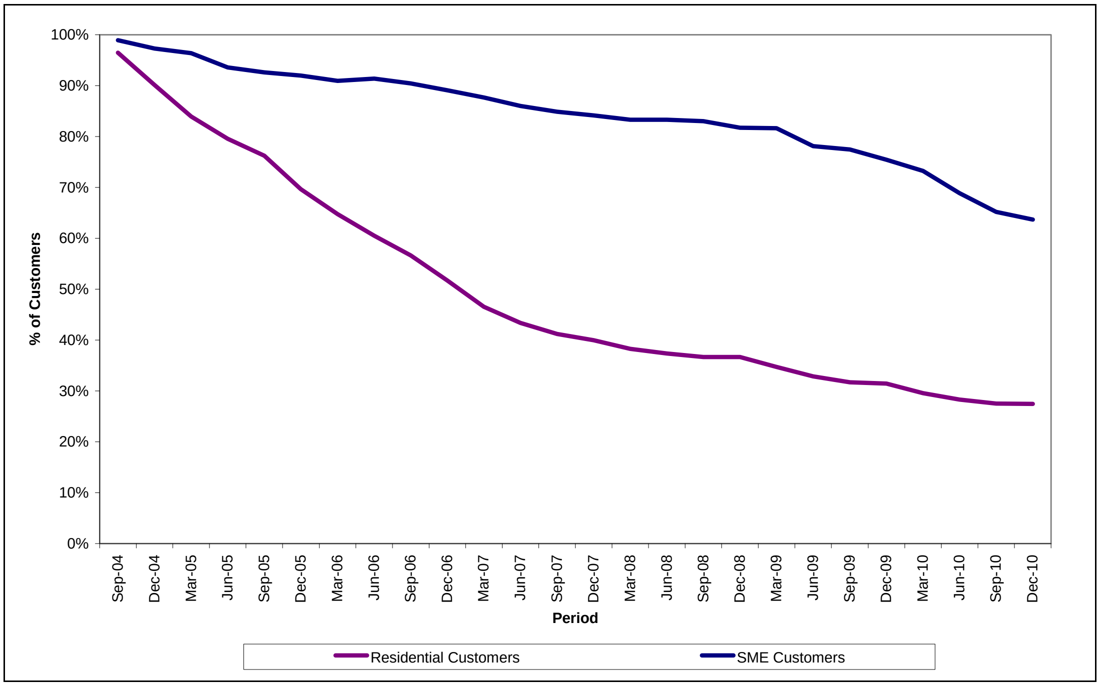
43 Load factors are used in allocating capacity related costs associated with both wellhead and transmission costs, and are established separately for the residential and SME customer market segments.

residential churn has decreased and now seems to have stabilised whereas SME churn stayed relatively constant, but has increased since 30 June 2009. Residential churn typically makes up 98% of the total number of small customers switching from a standing contract to a market contract, with the remainder driven by churn in the SME business segment.

Figure 5.1 - Proportion of Origin Energy's customer base that are Gas Standing Contract customers



Source: Commission's Energy Industry Guideline No. 2

With respect to customer number forecasts, Origin Energy has applied a linear trend line to historical residential and SME standing contract customers since July 2007 to determine forecasts for the next 3 years. This approach delivers a constant reduction in standing contract customers each month, which implies an increasing churn rate for both residential and small business segments (as the constant reduction is applied to a shrinking base).

SKM MMA undertook an independent assessment of customer numbers, and has recommended that the Commission forecast residential churn at a constant rate of around 12% per annum rather than at an increasing rate as proposed by Origin Energy. In the case of the small business segment, SKM MMA has recommended that the Commission forecast small business churn to increase slightly over the price path period, although at a lower rate than that proposed by Origin Energy.

Notwithstanding SKM MMA's recommendations and the inherent difficulty with churn projections, the Commission believes that such projections should not be based solely on analysing past trends in customer switching, noting that it may only provide a reasonable indication of future churn. It is also important to consider the key drivers that could influence churn over the next regulatory period. One such key driver identified by the Commission is the historical relationship between electricity and gas switching rates in the South Australian energy retail market.

Given that relationship and noting that the Commission has forecast increases in churn for both residential and small business segments in its 2010 Review of Retail Electricity Standing Contract Price Path – Final Decision, the Commission believes it is reasonable to assume those increases would flow-on to gas churn over the next regulatory period. As noted, energy retailers typically market gas as part of their dual-fuel marketing activities.

The Commission therefore, for the purposes of the Draft Price Determination, accepts Origin Energy's customer number forecasts on the basis that those forecasts are broadly consistent with the Commission's expectations of retail marketing activities and, thus, customer churn in the South Australian energy retail market.

The Commission's Draft Determination is to accept Origin Energy's customer number forecasts for both residential and small business segments.

5.3 Gas Consumption per Customer

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

Origin Energy has proposed using the 2008/09 average consumption figures (20.7 GJ/pa for residential customers and 147.0 GJ/pa for small business customers) to forecast sales over the next regulatory period on the basis that average consumption for both segments has been relatively stable over the July 2008 – June 2011 regulatory period. Origin Energy noted that 2009/10 average consumption figures were not used in the forecasting process due to slightly higher average temperatures during 2009.

In assessing Origin Energy's proposed sales forecasts, the Commission has compared the historical average consumption figures presented in the Origin Energy price path proposal with the quarterly gas consumption and customer number data collected on a non-regional basis from all retailers under the Commission's Guideline 2, including Origin Energy. For the purposes of Guideline 2 the following definitions apply:

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

Origin Energy's methodology for forecasting average consumption differs from the approach used for data collection under Guideline 2, as the latter is based on customer numbers and consumption at a "point in time" rather than "as billed". Nevertheless, the data are sufficiently adequate to be used by the Commission to cross-check Origin Energy's proposed consumption forecast.

Although the Commission's assessment of the data being reported by Origin Energy under its price path proposal, and that being reported separately to the Commission under Guideline 2, reveals there are slight discrepancies between both data sets, the Commission believes these discrepancies are due to the difference in reporting methodology. The Commission's analysis also shows that average consumption over the current regulatory period has remained reasonably consistent, with the exception of 2009/10 where consumption was affected by higher temperatures. The Commission, therefore, believes that the use of 2008/09 average consumption figures by Origin Energy as the basis to forecast total sales over the next regulatory period is appropriate.

SKM MMA's independent assessment of average consumption data also suggests that there appears to be no basis to assume that average usage will change materially over the next regulatory period and has recommended that the Commission accept Origin Energy's proposed average consumption forecasts.

As the Commission and SKM MMA assessments result in average consumption figures that are reasonably consistent with those proposed by Origin Energy, the Commission has accepted Origin Energy's proposed average consumption forecasts for both residential and small business segments. These average consumption forecasts are used as the basis to forecast total consumption, which is then subsequently pro-rated to each region based on percentages provided under the Origin Energy price path proposal.

The Commission's Draft Determination is to accept Origin Energy's average consumption forecasts for both residential and small business segments.

5.4 Load Profile

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

To develop its peak demand forecasts, Origin Energy undertook a regression analysis of customer billing data to determine customer base load and heating degree-day (HDD) sensitivity coefficients, and derivation of a 1 in 25 peak day weather. The application of this value is then applied to the regression formula to derive the corresponding peak-day consumption and load factors. Further, it assumed that load factors for both residential and small business segments would remain constant for the period of the price path.

To examine the reasonableness of Origin Energy's proposed load factors, the Commission engaged SKM MMA to independently derive a set of load forecasts. In providing its advice, SKM MMA has analysed gas flow information using a suite of regression models, and investigated the derivation of the 1 in 25 peak day HDDs based on 32 years of Kent Town weather station data. SKM MMA used a simulation approach to estimate an aggregate 1 in 25 year load factor from which individual sector load factors are derived.

Notwithstanding the different methodology used by Origin Energy to develop its load factor forecasts, SKM MMA concluded that Origin Energy's forecasts were reasonable on the basis that its simulation analysis produced outcomes which are similar to those proposed by Origin Energy. SKM MMA therefore recommended that the Commission accept Origin Energy's proposed load factors for both residential and SME segments.

Having reviewed Origin Energy and SKM MMA's methodologies for determining customer load factors, the Commission has accepted Origin Energy's proposed load factor forecasts on the basis that both methodologies produce outcomes that are very similar. These load factor values are confidential and cannot be disclosed, but have been incorporated into the Commission's draft price path calculations.

The Commission's Draft Determination is to accept Origin Energy's proposed load factor forecasts for both residential and small business segments.

6 FORM OF PRICE CONTROL

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

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

6.1 Regulation of Controllable Costs

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

The building block components are:

- Wholesale cost of gas purchases;
- Transmission charges by pipeline operators;
- ROC; and
- ROM.

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

6.2 Treatment of Non-Controllable Costs

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

- Distribution charges;
- AEMO charges; and
- Goods and Services Tax (GST).

These non-controllable costs are added to the retailer tariffs to derive the total gas standing contract price. In effect, the non-controllable costs are directly passed through to standing contract customers.

Origin Energy also levies several other fees and charges (eg. late payment fees). These other fees are not the subject of this price determination. The Commission's Energy Retail Code[44] regulates the application and the manner of calculation of such fees, but does not set the quantum.

6.3 Price Path Period

The Gas Act requires the Commission to set a gas standing contract price path for at least a three year period. Origin Energy has proposed that the Commission set the minimum price path period, i.e. 3 years.

The Commission considers this proposal to be appropriate, particularly in light of longer-term uncertainty over the potential movements towards export price parity (EPP) resulting from increased Liquefied Natural Gas (LNG) exporting (discussed in more detail in Chapter 7).

> *The Commission's Draft Determination is to set a gas standing contract price for the minimum period of 3 years.*

6.4 Price Control Formulae

There are currently two elements to the control of the gas standing contract retailer tariffs:

- a control on the maximum average revenue that Origin Energy can earn from residential and SME standing contract customers, and
- a control on the extent to which retailer tariffs can be rebalanced from year to year.

6.4.1 Average Revenue Control

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

The Commission's 2008 Gas Standing Contract Price Determination adopted an average revenue control, with gas sales (in GJ) as the control variable. This form of

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

control recognises that the quantity of gas sold is a significant cost driver of the standing contract retailer and it permits the allowed revenues to change in line with costs. While there may be additional cost drivers (eg. peak demand or the number of standing contract customers), the Commission adopted a single control variable (GJ) to reduce complexity.

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

Origin Energy proposes to continue with separate residential and SME average revenue controls. Submissions to the Origin Energy proposal did not comment specifically on this issue.

The Commission does not consider there to be any significant reason to depart from an average revenue form of regulation, particularly since the Commission has no reason to believe that it is resulting in any perverse outcomes, and because it is now well established and understood by relevant stakeholders.

The Commission Draft Determination is to accept Origin Energy's proposal to continue with an average revenue control ($/GJ), applied separately to residential and SME customers.

6.4.2 Rebalancing Control

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

However, there is the potential for some customers to experience significant price shocks if tariff rebalancing is undertaken rapidly. Therefore, it is common for a secondary price control to exist which limits the extent to which tariffs can be rebalanced in any one year. The rebalancing control applies to price adjustments that occur within the price path period (ie. the second and third years), not the initial price change that occurs at the commencement of the period.

The Commission's 2008 Gas Standing Contract Price Determination incorporates such a rebalancing control, whereby the annual increase in each retailer tariff must not increase the charge at any level of consumption by more than CPI+3% for residential and SME customers. The Commission allowed average revenue to increase by CPI + 1% for residential customers, and CPI + 0.8% for SME customers, meaning that the rebalancing control allowed for individual charges to increase by around 2% above the headline average revenue change.

The rebalancing control does not apply to any rebalancing between residential and SME customers, since there are separate average revenue controls for these customers. Rather, it controls the extent to which tariff components (eg. supply charge) can increase within any tariff category, and the extent to which there can be any rebalancing between geographic regions.

Origin Energy has not proposed a rebalancing control as part of its price path submission, stating that it has moved towards more cost reflective tariffs over the past three years, although an implicit cross subsidy exists between customers in different regions due to Origin Energy's portfolio approach to wholesale gas costs and transmission costs.

The comments made by Origin Energy indicate that it does not intend to undertake any further significant rebalancing. The Commission notes that, even if no further rebalancing is required, any rebalancing controls will not affect the operation of the price path. If limited rebalancing is required, then the controls will allow for such rebalancing while still providing some protection to customers who may otherwise be exposed to substantial increases in price as a result. Therefore, the Commission's view is that there is little, if any, downside in retaining the rebalancing controls. These controls would continue to apply to the retail component of tariffs only.

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

The Commission's Draft Determination is to retain the current rebalancing controls such that the charge under each retailer tariff at any level of consumption does not increase annually by more than 2% above the CPI increase allowed for under the average revenue controls. The Commission considers that this rebalancing control provides sufficient flexibility for Origin Energy to move towards cost reflectivity in its tariff structure and provides customers with some protection over future price changes.

6.5 Pass-through Events

A pass-through mechanism allows (or requires) the retailer to add (or subtract) the cost impact of particular events to its tariffs. Pass-through events are typically limited to events beyond the control of the retailer, in order to maintain appropriate incentives to manage costs. A pass-through can reduce some of the risk that a retailer faces, although it does create some forward price uncertainty given that prices may need to move at any time. For this reason pass-throughs are usually limited in number and nature.

While the exact nature and timing of any pass-through event is typically uncertain, there is a requirement to define, up-front, the type of event that will be allowed. There are currently three types of events that can trigger a pass-through under the July 2008 – June 2011 gas standing contract price determination:

- Change in taxes event – a change in tax that results in Origin Energy incurring materially higher or lower costs in supplying standing contract customers;
- Regulatory reset event – a change in regulatory obligations imposed on the gas standing contract retailer, as a result of which it would incur materially higher or lower costs in retailing gas to standing contract customers than it would have incurred but for that event. The event has been defined to ensure that any carbon pricing arrangements or change in energy efficiency schemes are captured;
- Ministerial directions event –the issuing of Ministerial directions under section 37 of the Gas Act, concerning supply interruptions and gas rationing events.

Origin Energy has submitted that the current set of pass-through items are too narrow, and that the scope of allowed pass-through event be broadened. It has argued that:

> *…[this] is especially true with the myriad of market reforms that are currently occurring at a national level. For example, there are discussion 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.*[45]

Origin Energy proposes that the pass-through provision not include any defined events, creating the maximum flexibility for Origin Energy to apply for a pass-through, which would be subject to approval by the Commission.

The Commission believes that it is appropriate to continue to provide some degree of certainty over the types of events for which a pass-through could occur. It notes that, all of the examples listed by Origin Energy, except perhaps the change in wholesale gas costs resulting from increased LNG demand, would be captured under the current definition of a regulatory reset event. In relation to any increase in wholesale gas costs, the Commission has considered this issue specifically in Chapter 7, and has concluded that a pass-through provision is not appropriate.

Having considered the scope of the pass-through events currently defined, the Commission's view is that it is appropriate to continue with those events for the next price path period.

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

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

6.6 Reopening Events

Unlike a pass-through, a reopening is generally used in a regulatory context where the basis of a price determination has been undermined by events. Conditions for reopening in the context of a gas standing contract price determination are limited, as a result of the operation of the standing contract provisions set out in section 34A of the Gas Act. Under those provisions, a price determination is generally required to be of a minimum three-year duration. This removes the Commission's general powers under Part 4 of the ESC Act to vary any price determination from time to time by means of a subsequent determination.[46]

There is an exception to this general requirement, however, which does allow for limited reopening of a gas standing contract price determination. Under section 34A(4a), where the Commission determines that "special circumstances" exist, then it is permitted to

[45] Origin Energy Retail Ltd, Proposed Price Path for Standing Contract Gas Customers in South Australia 2011/12-2013/14: Public Submission, November 2010, page 17.

[46] Refer ESC Act, section 26(8).

make a subsequent determination which either varies the existing determination for the balance of the period of that determination (refer section 34A(4a)(f)) or revokes the existing determination and substitutes a new determination (refer section 34A(4a)(d)(i)) (in each case, notwithstanding that the existing determination might not have run the full three years).

Section 34A(4a) is reproduced in full below:

(4a) The following provisions apply in relation to the fixing by the Commission of a standing contract price for an entity for the purposes of this section:

(a) the Commission may fix the price by a determination of a kind referred to in section 33(1)(a);

(b) a determination, other than a determination under paragraph (f), must provide for the expiry of the determination at the end of a period of not less than 3 years specified in the determination;

(c) a determination may provide for prices that vary at specified times according to a formula specified in the determination;

(d) unless the Commission determines that special circumstances exist—

(i) a determination may not be made to take effect before the expiry date of the last preceding determination made by the Commission in accordance with this subsection;

(ii) a determination may only be made if the entity has made a submission to the Commission stating the price that the entity proposes be fixed by the Commission as the entity's standing contract price, and the entity's justification for the price, not less than 6 months and not more than 9 months before the making of the determination;

(iii) the Commission must, before making a determination, have conducted an inquiry under Part 7 of the Essential Services Commission Act 2002 into the question of the appropriate price to be fixed as the standing contract price;

(e) a submission under paragraph (d) must comply with any requirements as to the form and content of such submissions imposed by the Commission by written notice served on the entity;

(f) if the Commission has determined that special circumstances exist—the Commission may make a determination that takes effect as a variation of the existing determination (with effect for the balance of the term of the existing determination (unless another variation is subsequently made)).

Given this scheme. it is not for the Commission to include within the price determination itself any provisions which determine whether or not reopening is allowed; the regime is entirely contained within the relevant legislation.

While in previous determinations the Commission has adopted a position which argued that it would only declare "special circumstances" in respect of events of a magnitude such as to disturb the fundamental basis of an existing Price Determination so much as to require a new determination to be made, the same does not hold true for the coming determination. This is largely due to those changed market circumstances and amendments made to the Gas Act in 2010 by the insertion of section 34A(4a)(f) (refer above). The combined effect of those matters is to permit a greater flexibility in the application of special circumstances. While it remains difficult to formulate a precise policy as to when special circumstances might be declared, the Commission's intention is that where circumstances have changed which ought (having regard to the Commission's primary objective under section 6 of the ESC Act, as well as the other factors specified under that Act and the Gas Act) to result in changes in standing contract prices but which cannot be accommodated under the price determination made, then those circumstances may well be considered as "special".

Finally, consistent with its previous position, the Commission notes that it may determine whether or not a given set of circumstances is "special" (or otherwise) of its own volition or, alternatively, Origin Energy or any other interested party may ask the Commission to consider if special circumstances have arisen such that the existing Price Determination should be reviewed and possibly varied or replaced.

6.7 Tariff Approvals

The Commission will determine an initial set of standing contract retailer tariffs to apply in 2011/12 as part of its Final Gas Standing Contract Price Determination. The CPI data that are needed to calculate the 2011/12 tariffs will be known at the time the final determination is released. At present, the indicative tariffs that result from this draft determination are based on a forecast CPI that will need to be updated once the actual value is available.

Prior to the commencement of the 2012/13 and 2013/14 regulatory year, as part of the annual price adjustment process, Origin Energy will be required to submit to the Commission information on the forecast number of standing contract customers and total consumption for each standing contract tariff for the respective years, and demonstrate that:

- for each of the two customer categories (residential and SME), total revenue (from the "retailer tariff" component of the standing contract tariffs, exclusive of any pass-through amounts), divided by total consumption is less than or equal to the average retailer revenue permitted for that customer category during the relevant year of the price path;
- the charge at any level of annual consumption for each "retailer tariff" is no more than CPI+2% for residential and SME customers above the charge applying at that time;

- the Commission will review both Origin Energy's proposed charges, and the Envestra charges (which will be provided to the Commission by Envestra at the same time as Origin Energy provides its information) and, by summation of those amounts, confirm the new prices for each standing contract tariff category, to apply from 1 July each year; and
- Origin Energy will then be required to publish the final standing contract tariffs (GST exclusive and inclusive) before 30 June each year.

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

6.8 Provision for New Tariffs

After 1 July 2011, Origin Energy will be entitled under the Price Determination to seek to introduce new tariffs and close existing tariffs, subject to the Commission's approval. The revenue outcomes from any new or closed tariffs must be such that the average retailer revenue controls set in this Price Determination are not breached by the tariff's introduction or closure, and customers' allocation to the new tariff must be protected by the retailer tariff rebalancing control relative to the previous tariff to which they were assigned.

7 WHOLESALE GAS COSTS

Approximately one-third of total controllable costs of the standing contract gas retailer relate to the costs of purchasing wholesale gas from gas producers. In South Australia, the majority of natural gas has historically been sourced from the Cooper Basin, although this is expected to change in the future, with Cooper Basin gas being increasingly displaced by CSG supplied through the new QSN Link. The QSN Link, which commenced operation in January 2009, provides the first physical link between the South Australian and Queensland markets. Previously, gas was supplied to South Australia from the Cooper Basin or from Victoria via the SEAGas pipeline.

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

7.1 Origin Energy’s Proposal

Origin Energy has proposed increases in gas supply costs of 6.5% for residential customers and 3.4% for SME customers for 2011/12, compared to the 2010/11 allowance provided for under the Commission’s 2008 Gas Standing Contract Price Determination.

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

- Base load supply, or ACQ;
- Peak load supply, or MDQ; and
- STTM costs.

Origin Energy has proposed an ACQ cost for 2011/12 and 2012/13 that is in line with the Commission’s current ACQ benchmark for 2010/11. However, it has proposed a significant increase in ACQ costs in 2013/14, reflecting its expectation that wholesale gas prices will move to export LNG netback price parity from 1 January 2014.[47]

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

- reduced flexibility in gas supply contracts has increased the need for peak contracts;

[47] LNG netback price parity is the delivered price of LNG less the costs of liquefaction and shipping.

- Overall gas demand volatility and peakiness has increased, driven by increased gas-fired generation in Queensland, South Australia and Victoria;
- Reduced flexibility in transmission linepack rights has led to further reductions in the flexibility of the Origin Energy peak supply portfolio; and
- The cost of disposal of non-peak/excess gas on the STTM, Victorian gas market and non-peak generation pool.

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

A more detailed discussion on the derivation of the cost components from Origin Energy's proposal follows.

7.1.1 Load factors

The load factors proposed by Origin Energy are based on an assumed 1 in 25 year peak demand. These load factors are important in allocating capacity related costs associated with both wellhead and transmission costs.

Origin Energy has adopted similar load factors to those proposed for the 2008 Gas Standing Contract Price Determination and these load factors have been provided to the Commission on a confidential basis and are assumed to remain constant throughout the price path period.

7.1.2 Wellhead cost - ACQ

Origin Energy 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 the Commission's 2008 Gas Standing Contract Price Determination was based on the weighted average costs of a portfolio of base load supply arrangements required by Origin Energy to ensure supply security through the period.

Origin Energy continues with this methodology in its current proposal and divides the total gas purchase cost for the entire customer demand by the total yearly volume sold to all of Origin Energy's customer groups. Origin Energy comments that this methodology 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 costs proposed for 2011/12 and 2012/13 are consistent with the allowance for 2010/11.

Origin Energy has proposed an increase in wellhead gas cost in 2013/14 reflecting Origin Energy‘s expectation of gas prices moving to LNG netback EPP from 1 January 2014. LNG netback price parity is the delivered price of LNG less the costs of liquefaction and shipping.

7.1.3 Wellhead MDQ Cost

Consistent with the approach taken in previous Inquiries, Origin Energy has estimated forecast MDQ costs from a portfolio of contracts required to ensure security of supply based on a 1 in 25 year peak day demand. The total MDQ commodity cost has been allocated to customer segments by Origin Energy, based on the contribution of each segment 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 residential market has a much higher load factor than other customer segments and therefore contributes to a higher proportion of wellhead MDQ requirements than to ACQ requirements.

Origin Energy submits that the market price of MDQ has increased 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. Origin Energy argues that the following factors are creating upward pressure on MDQ costs:

- reduced flexibility in gas supply contracts has increased the need to obtain specific peak shaving contracts in recent years with these peak contracts being priced at a premium over flat (load factor 1.0) contracts;
- 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. This has had an impact on overall gas demand volatility and peakiness. Peak cold days in South Australia are leading to increased competition for the limited availability of short term contract cover between gas retailers who off-set their balancing risks on the one hand and gas fired generators who are selling into the electricity market at high prices;
- reduced flexibility with respect to contractual linepack rights on transmission pipelines; and
- the cost of disposal of non peak / excess gas on the STTM, Victorian gas market and non peak generation pool.

7.1.4 Short Term Trading Market Cost

A risk component of $0.02/GJ was included in the 2008 Gas Standing Contract Price Determination based on the operational costs of delivering gas to Cavan on a daily basis to cover Origin Energy‘s swing gas position.

This swing gas risk cost has become redundant with the advent of the STTM. However, Origin Energy has suggested that there are specific market fees and additional risks associated with the operation of the STTM that should be reflected in standing contract prices. Origin Energy has proposed an allowance of $0.05/GJ to account for the additional market volatility risks associated with imbalance, deviation and contingency gas.

Origin Energy claims that the introduction of the STTM into the Adelaide Hub exposes retailers to the price volatility risk associated with an active spot market. A retailer selling and supplying gas to small customers must comply with prudent risk strategies to manage its exposures to extreme demand conditions and stress tests associated with supply outages. These include obtaining physical or financial hedges to meet peak demand.

The actual fees and charges applied by AEMO for the STTM are proposed by Origin Energy to be passed through as non-controllable costs.

7.1.5 Summary of Origin Energy's proposed Wholesale Gas Costs

Table 7.1 summarises the relevant average gas prices for the price path period as forecast by Origin Energy for residential and small business customers.

Table 7.1 - Origin Energy's proposed Wholesale Gas Costs 2011/12 – 2013/14 $/GJ, $Dec11

	2010/11 ALLOWANCE	2011/2012	2012/2013	2013/2014
Residential				
Total Cost of Gas	4.78	5.09	5.17	6.39
SME				
Total Cost of Gas	4.42	4.57	4.60	5.82

7.2 Submissions

In response to the Commission's Issues Paper, an extensive submission was received from SACOSS. In relation to wholesale gas costs, the SACOSS submission comments that the world price to which the Origin Energy proposal assumes parity for 2013/14 is not guaranteed to stay at current high levels. SACOSS argues that the combination of significant growth in LNG export capacity, a reluctance by consumers to strike long term contracts and milder economic conditions may lead to downward pressure on the 'parity price'. SACOSS also argues that, regardless of the future world price, LNG exports are unlikely to be a material influence over the price path period.

The submission received from the Minister for Energy comments that the Commission needs to carefully assess claims made by Origin Energy in its proposal that the transition to EPP for LNG would cause a significant increase in wholesale gas costs for 2013/14. Additionally, AGL SA comments in its submission that it supports the views of Origin Energy on the factors that drive significant increases in MDQ costs and it also agrees with Origin Energy's assessment that the introduction of the STTM creates additional risk.

7.3 Commission's Consideration

In forming its own view on appropriate allowances for wholesale gas costs, the Commission has sought independent advice from SKM MMA. That advice, along with the Origin Energy proposal, has been considered by the Commission in reaching its draft conclusions on wholesale gas costs. The advice provided by SKM MMA contains extensive analysis of information that is largely confidential. The Commission has therefore not published the SKM MMA report, although the substance of its advice is discussed in the following sections.

7.3.1 ACQ

The Origin Energy proposal indicates that ACQ costs remain stable in real terms for 2011/12 and 2012/13. However, it has forecast a significant increase in ACQ costs in 2013/14 on the basis that it expects gas commodity prices to move towards LNG EPP from 1 January 2014.

In relation to ACQ for 2011/12 and 2012/13, analysis by SKM MMA indicates that the proposed sources of gas supply are appropriate, and that the proposed ACQ prices for each source are in line (in real terms) with those reviewed in 2008 and are in line with available benchmarks. Having regard to SKM MMA's assessment, the Commission accepts Origin Energy's proposed ACQ costs for 2011/12 and 2012/13.

The Commission has closely examined Origin Energy's proposed 2013/14 ACQ costs, which are based on a transition price towards EPP. Advice from SKM MMA indicates that there is significant uncertainty about the extent to which prices will move towards EPP in the southern states, and the timing of any such price increases given the uncertainty about the timing of LNG projects.

SKM MMA recommends that the Commission deal with this degree of uncertainty through a "special circumstances" review in the final year of the price path, when there is greater certainty over the impact of LNG EPP. Under this approach, the Commission would reopen the price determination and, subject to it being demonstrated that wholesale gas costs will materially change, could establish a new price for the remainder of the price path period, or for a longer period of up to 3 years.

While SKM MMA has suggested that the majority of the potential increase in ACQ costs in 2013/14 could be dealt with through a special circumstances review, it has recommended that ACQ costs in that year should nevertheless be increased to $4.24/GJ to reflect the fixed costs that Origin Energy will incur, based on existing contracts that it has in place to haul gas from Queensland to South Australia.

The first option for 2013/14 ACQ costs (V1) put forward by SKM MMA does not include any estimate of the EPP impact, other than under the "Origin Energy Volumes" scenario, where the fixed costs of contracting for Queensland CSG is taken into account. The second option for 2013/14 costs (V2) includes estimates of the fixed and variable costs associated with the transition to EPP.

The "Origin Energy Volumes" scenario accepts Origin Energy's proposed change in the mix of gas supply in 2013/14 via each transmission pipeline. SKM MMA has indicated that there is uncertainty over the extent to which such a change will occur, and has included a scenario (reflected in the second row of Table 7.2) that recalculates the weighted average price based on volumes that are largely consistent with those in 2012/13.

SKM MMA's recommended ACQ prices, including alternative ACQ versions recommended for the year 2013/14 (V1 and V2), are provided in Table 7.2.

Table 7.2 - SKM MMA ACQ prices recommended to 2013/14
$/GJ, $Dec11

	2011/12	2012/13	2013/14 v1*	2013/14 v2
SKM MMA prices, Origin Energy Volumes	4.13	4.11	4.24	5.04
SKM MMA prices, changed volumes final year	4.13	4.11	4.11	4.70

* Subject to allowance for special circumstance increase from 1 January 2014

There is significant doubt over the cost of wholesale gas in 2013/14 due to uncertainties around the timing and impact of any move towards EPP. It is noted that the SACOSS submission supports this view.

Due to these uncertainties, the Commission has decided not to include any specific amount in the final year of the price path to reflect a possible transition to EPP. The Commission's preference is to set the 2013/14 ACQ benchmark at the same amount as the 2012/13 ACQ benchmark in real terms ($4.11/GJ), and to address any claimed increase in wholesale gas costs in 2013/14 under the following approach:

- Given that the impact on costs is likely to be for only the remaining 6 months of the price path, the Commission would undertake to reflect the new costs in the following price path (should regulation of standing contract prices continue), with any under-recovery of costs from that final 6 month period to be recovered in the subsequent price path.
- To the extent that wholesale gas costs increase so significantly during the price path period that it is not feasible to defer the recovery of the increased costs to the next period, the Commission would consider a special circumstances review, and re-open the price path.

Whilst understanding the nature of fixed costs associated with Queensland CSG, it is difficult for the Commission to determine the degree to which these are prudent costs.

The Commission's Draft Determination is to establish a wellhead gas cost (ACQ) of $4.13/GJ in 2011/12, falling to $4.11/GJ in 2012/13. The Commission proposes to keep the wellhead cost constant at $4.11/GJ in 2013/14 on the basis that there is significant uncertainty over the timing and extent of any impact of LNG netback export price parity during the 3-year price path period.

7.3.2 MDQ

Origin Energy is proposing that the cost of additional MDQ should increase significantly, due both to the higher customer load factors used than those previously approved and because of the assumed increased price of additional MDQ.

Load Factors

For the current review SKM MMA has taken into account daily information provided by Envestra and applied both deterministic and simulation based approaches to modelling the 1 in 25 year peak day gas requirement. SKM MMA considers the Origin Energy proposed load factors to be reasonable and has used these load factors in its assessment of MDQ costs. The Commission accepts the load factors proposed by Origin Energy and endorsed by SKM MMA.

Additional MDQ

Origin Energy has proposed annual prices of additional MDQ that are above the 2008 Commission Final Decision benchmarks.

SKM MMA considers that the price stated by the operator of the UGS facility, TRUenergy, of $175/GJ MDQ in $2011 remains suitable to act as the benchmark price for additional MDQ in South Australia. This is an increase of 16% in real terms from what was considered reasonable in the 2008 Gas Standing Contract Price Determination, but is lower than the amounts proposed by Origin Energy.

The additional MDQ unit costs recommended by SKM MMA are provided in Table 7.3, along with those proposed by Origin Energy.

Table 7.3 - Cost of additional MDQ, Origin Energy and SKM MMA, $/GJ, $Dec11

	2011/12	2012/13	2013/14
Origin Energy Proposal			
Residential	0.91	1.01	1.01
SME	0.39	0.44	0.44
SKM MMA recommendation			
Residential	0.86	0.86	0.86
SME	0.37	0.37	0.37

Having accepted Origin Energy's proposed load factors (section 5.4), the relevant issue for consideration by the Commission is the price of MDQ. Consistent with the approach used in the Commission's 2008 Gas Standing Contract Price Determination, the Commission concludes that the MDQ price should be based on the published UGS price, which is currently $175/GJ MDQ.

The Commission's Draft Determination is to set an MDQ price that remains constant throughout the price path period as follows:

- *$0.86/GJ for residential customers, and*
- *$0.37/GJ for SME customers.*

7.3.3 STTM cost

Origin Energy has proposed an allowance of $0.05/GJ to account for the additional market volatility risks associated with deviations and contingency gas. While there are likely to be increased risks and additional costs associated with the STTM, there is also the potential for offsetting benefits to Origin Energy, as a large market participant. SKM MMA has commented in its report to the Commission that the costs incurred may well be transfers to other retailers. SKM MMA concludes that it is reasonable to believe that the net outcome to retailers will be zero.

On the basis that Origin Energy has not provided sufficient information to substantiate its claim that the STTM will result in additional costs to retailers, the

Commission's draft conclusion is to make no allowance for STTM costs in wholesale gas costs. It is not clear to the Commission that the cost of purchasing wholesale gas is inadequately covered by the ACQ and MDQ allowances, and that an additional allowance for purchasing gas through the STTM is required. The Commission notes that AEMO's administrative charges for STTM will be treated separately as non-controllable costs.

7.4 Commission's Draft Decision

The Commission's Draft Determination on the wholesale cost of gas to be incorporated into standing contract prices over the 2011/12 to 2013/14 period is set out in Table 7.4. This cost will apply uniformly over the 5 pricing regions.

Table 7.4 - Draft Decision on Wholesale Cost of Gas Benchmarks 2011/12 to 2013/14: $/GJ, GST exclusive, $Dec11)

	Residential			SME		
	2011/12	2012/13	2013/14	2011/12	2012/13	2013/14
Wellhead ACQ	4.13	4.11	4.11	4.13	4.11	4.11
Wellhead MDQ	0.86	0.86	0.86	0.37	0.37	0.37
Other cost	0.00	0.00	0.00	0.00	0.00	0.00
Total Cost of Gas	4.99	4.97	4.97	4.50	4.48	4.48

8 TRANSMISSION COSTS

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

None of the transmission pipelines in South Australia are subject to access regulation. There are no regulated reference prices for transmission pipelines, and a gas retailer is able to negotiate transmission charges that vary with the retailer's capacity and load factor characteristics.

In South Australia, transmission costs represent approximately 14% of the total costs of the gas standing contract retailer (excluding distribution charges) and comprise approximately 6% of the total standing contract price (including distribution charges).

8.1 Origin Energy's Proposal

Origin Energy has provided the Commission with a confidential price path proposal, setting out the detail of its proposed forecast transmission costs. Further confidential information has been provided to the Commission by Origin Energy upon request. The Commission is unable to disclose the detail of the confidential information but has attempted to summarise it in the following discussion.

Origin Energy's proposed transmission costs are derived using a methodology that is consistent with that submitted in previous Inquiries. It has separately identified the costs for the main transmission pipelines of MAPS and SEAGas, and the costs for the lateral pipelines that supply Whyalla, Riverland and Mt Gambier.

8.1.1 Main pipeline costs (MAPS and SEAGas)

Origin Energy has forecast fixed costs for MAPS and SEAGas based on the amount of pipeline capacity needed to meet MDQ requirements, and based on a 1 in 25 year peak demand day.

The load factors used by Origin Energy to apportion costs, which were discussed in Chapter 5, are higher than those determined by the Commission in the 2008 Gas Standing Contract Price Determination, which would lead to a higher fixed transmission cost in 2011/12 relative to the amount approved under the current price path, all else being equal. However, Origin Energy has proposed reductions in other fixed cost components, which results in an overall reduction in the fixed main pipeline costs compared to the current benchmark.

Origin Energy has included the cost of a park service[48] in the fixed costs, which applies to MAPS costs for 2011/12 only.

Variable costs for each of the pipelines have been provided by Origin Energy. The 2011/12 variable costs are consistent with those approved by Commission in its 2008 Gas Standing Contract Price Determination, although the costs increase slightly in real terms over the price path period. The weighted average variable costs across both pipelines have been estimated by Origin Energy based on the contract capacity of MAPS and SEAGas. Included in the proposed variable cost is a SUG cost, which Origin Energy has based on 2.2% of wellhead volume at the weighted average wellhead price on MAPS and 0.5% on SEAGas.

8.1.2 Lateral pipeline costs

Consistent with previous price path proposals, Origin Energy has submitted that all lateral pipeline costs are fixed and charged on a $/GJ MDQ basis, meaning that that annual cost must be divided by capacity.

Origin Energy has proposed an increase in Mt Gambier lateral pipeline costs on the basis that the cost of contracting capacity in the pipeline has increased. It has also submitted that the Riverland lateral costs be increased above the current benchmark set by the Commission, although no reasons have been provided for the increase. The proposed Whyalla lateral costs are slightly less than those approved by the Commission in the 2008 Gas Standing Contract Price Determination.

Origin Energy's proposed transmission costs for the 2011/12 – 2013/14 period are summarised in Table 8.1.

Table 8.1. - Origin Energy proposed transmission costs 2011/12 – 2013/14 $/GJ, GST exclusive, $Dec11

	Residential (weighted average of 5 regions)			SME (weighted average of 5 regions)		
	2011/12	2012/13	2013/14	2011/12	2012/13	2013/14
Transmission Costs	1.91	1.88	1.90	1.32	1.30	1.32

8.2 Submissions

Only the SACOSS submission commented directly on Origin Energy's proposed transmission costs. In its submission, SACOSS states that:

> *Without access to information regarding the applied load factor it is impossible to ascertain if this is a prudent approach and it is not clear where or not there is an evidence base for the claimed load factor. Additionally, given that Origin Energy forecasts a reduction in main pipeline costs, it is envisaged that any*

48 A "park" service allows a pipeline user to inject gas into a pipeline and hold it there for use at a later date.

reduction in transmission costs be passed on to the consumer in the form of a reduction beyond 2011/12.[49]

8.3 Commission's Consideration

The Commission has received advice from SKM MMA on Origin Energy's proposed transmission costs, including SKM MMA's own view on prudent and efficient transmission costs to be incorporated into gas standing contract prices for the next price path period.

The Commission has considered the proposals put by Origin Energy, and the advice received from SKM MMA, and its consideration of transmission costs is discussed below in terms of main pipeline costs (MAPS and SEAGas) and lateral costs.

8.3.1 Main Pipeline Costs

MAPS transmission costs

The majority of the main pipeline costs are fixed, and are related to the amount of pipeline capacity needed to meet peak demand. A key driver of the amount of required capacity to be allocated to the different customer groups is the assumed load factor of each group. The Commission has accepted Origin Energy's proposed load factors for residential and SME standing contract customers, which will have an impact on the fixed costs for all transmission pipelines, including MAPS.

In previous Inquiries, the Commission has considered the potential benefit to small customers that would result allowing for the sharing of pipeline capacity between small and large users of gas. Peak demand for large users may occur at different times to peak demand for small customers, meaning that the total amount of pipeline capacity needed may be less than the sum of the individual demands of small and large customers. Any such diversity benefit could be shared between users.

The Commission has previously not included any diversity benefit in its allowed transmission costs. It has considered that estimating the diversity benefit and determining an approach to allocating costs between users would be highly subjective and may not lead to an outcome that is materially different to a stand-alone costing approach, as proposed by Origin Energy. Having regard to its statutory objectives, which are centred around concepts of economic efficiency, the Commission has found that an approach that ensures that standing contract customers pay no more than the stand-alone cost of their demand will ensure economically efficient outcomes.

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49 SACOSS submission, page 6 (available at http://www.escosa.sa.gov.au/library/110117_GasRegulatoryInstruments_2011-2016-IssuesPaperSubmission-SACOSS.pdf)

The Commission continues to hold this view, and it therefore accepts Origin Energy's proposal to maintain a stand-alone approach as reasonable. The Commission notes that SKM MMA, in considering this approach, also found it to be reasonable.

Origin Energy's submission includes a fixed cost for MAPS that is, in real terms, below the amount proposed by Origin Energy in its 2008 price path submission. SKM MMA has examined the fixed costs, and considers them to be reasonable, except for the inclusion of the cost of a park service, which it suggests is more appropriately considered as an MDQ cost. The Commission agrees with SKM MMA's advice, noting that the Commission did not accept park service costs for MAPS in the Draft Report of the 2008 Gas Standing Contract Price Determination, which was subsequently accepted by Origin Energy. The proposed park service cost has been removed from the MAPS cost approved by the Commission.

SKM MMA has recommended that Origin Energy's proposed variable costs for MAPS be accepted, on the basis that it is similar to that submitted by Origin Energy in the 2008 Gas Standing Contract Price Determination, and is consistent with prices quoted by the pipeline operator. The Commission accepts Origin Energy's proposed MAPS variable costs, noting that they form a relatively small component of the total MAPS cost.

<u>SEAGas transmission costs</u>

Origin Energy has proposed a reduction, in real terms, of the SEAGas fixed cost relative to that proposed in 2008. There are various components to the fixed cost, and SKM MMA has examined each of these components and found most of them to be reasonable. It has, however, not accepted the inclusion of a South East South Australian (SESA) pipeline cost as it understands the cost to be related to the connection to the Mount Gambier region and should therefore be included in Mt Gambier lateral costs. SKM MMA has raised concerns over certain compression charges and imbalance charges, although it recommends the inclusion of these charges for the purposes of the Draft Decision, subject to further investigation.

The Commission accepts the SKM MMA recommendation, noting that further work will be undertaken on two of the SEAGas cost components in preparation for the Commission's Final Decision. The recommendation to remove SESA pipeline costs is accepted, subject to Origin Energy being able to demonstrate that such costs are not incorporated into the Mt Gambier lateral cost. If they are not, Origin Energy should justify why it is more appropriate to include them in the SEAGas cost rather than the lateral cost.

The variable SEAGas cost proposed by Origin Energy is consistent with that proposed in the 2008 Gas Standing Contract Price Determination. SKM MMA recommends that the variable cost be accepted, and the Commission agrees that the cost appears reasonable.

System Use Gas

Origin Energy has proposed a cost of System Use Gas (SUG) for both the MAPS and SEAGas pipelines. The MAPS SUG cost is based on applying the maximum 2.2% of wellhead volume by the cost of the weighted average of the wellhead gas price. While the proposed cost of SUG is consistent with a wellhead gas price of around $4/GJ, advice from SKM MMA suggests that the assumed 2.2% of wellhead volume as SUG may be excessive. It recommends that a figure of 1% be used for MAPS, which is based on the average MAPS SUG amount for 2009/10.

The Commission agrees that a 2.2% SUG factor for MAPS is excessive, and notes that it rejected this figure in the 2008 Gas Standing Contract Price Determination, approving a 1% figure instead. The Commission continues to view a 1% SUG amount for MAPS as more reasonable, having regard to data on actual SUG.

Origin Energy has proposed a 0.5% SUG for SEAGas, which SKM MMA considers to be consistent with 2009/10 daily volume data provided by Origin Energy. The Commission considers the proposed SUG cost for SEAGas to be reasonable.

8.3.2 Lateral Pipeline Costs

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

Information has been provided by Origin Energy to the Commission on the costs of these laterals, and this information has been analysed by SKM MMA as part of its review of transmission costs. Based on the information available to it, SKM MMA has recommended that the proposed lateral costs are reasonable for Whyalla, but do not appear reasonable for the Mt. Gambier and Riverland laterals.

SKM MMA has noted that Origin Energy has not been able to provide key pieces of information requested for the review, including 2009/10 actual costs for laterals or historical MDQ assessments to allow forecast demand to be analysed. The lack of information to justify Origin Energy's proposed lateral costs has therefore made the task of examining the costs very difficult.

SKM MMA has recommended reductions to the Mt. Gambier and Riverland lateral costs on the basis that Origin Energy's forecast demand for those regions appears too low, having examined information on maximum demand for 2009/10.

While the Commission notes the limitations of SKM MMA's advice given the lack of relevant information, the Commission's draft conclusion is to accept the SKM MMA recommendation to reduce the Mt. Gambier and Riverland lateral costs. Origin Energy has not been able to justify its proposed costs for those laterals, and the

Commission's position is to not allow the full amount of those costs until sufficient evidence is provided to support their inclusion

8.4 Draft Conclusion

The Commission's Draft Determination on annual transmission costs are set out in Table 8.2.

Table 8.2. - Draft Decision on annual transmission costs $/GJ weighted average of 5 regions (GST exclusive, $Dec11)

	Residential			SME		
	2011/12	2012/13	2013/14	2011/12	2012/13	2013/14
Fixed TUOS Main and Lateral	1.81	1.78	1.78	1.21	1.19	1.19
Variable TUOS	0.10	0.11	0.12	0.10	0.11	0.12
Transmission Cost	1.91	1.88	1.89	1.31	1.29	1.31

Note, Table 8.2 contains some minor rounding errors

9 RETAIL OPERATING COSTS (ROC)

The ROC allowance is associated with the provision of the following retailer functions:

- Customer service;
- Sales and Marketing;
- Billing and Revenue collection;
- Management and support (including corporate functions); and
- Performance of obligations under the Residential Energy Efficiency Scheme (REES).

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

REES represents a new component in the ROC allowance. Regulations made under the Gas Act 1997[50] established REES, which commenced on 1 January 2009 and is set to conclude on 31 December 2014. REES provides incentives for South Australian households to reduce greenhouse gas emissions and potentially lower their energy bills through reduced energy consumption.[51] REES establishes obligations on electricity and gas retailers (with at least 5,000 residential customers), including:

- Energy efficiency activities (expressed as annual greenhouse gas reduction target) for priority[52] and non-priority groups; and
- Energy audits (expressed as total numbers).

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

9.1 Origin Energy's Proposal

In the 2008 Gas Standing Contract Price Determination, a limited allowance for historical Customer Acquisition & Retention Costs (CARC) was included as part of the ROM. However, subsequent pricing decisions, both in South Australia and in other jurisdictions, have seen CARC being incorporated into the ROC allowance. Consistent with this, Origin Energy's proposal for the 2011/12-2013/14 period includes an allowance for CARC as part of ROC.

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50 Refer to the Commission's website at: http://www.escosa.sa.gov.au/library/080821-GasRegulations_2008.pdf

51 Information regarding REES can be found on the Commission's website at http://www.escosa.sa.gov.au/electricity-overview/residential-energy-efficiency-scheme-rees-.aspx

52 Priorty groups are defined as low income households. For further information on this definition, refer to the Commission's website: http://www.escosa.sa.gov.au/electricity-overview/residential-energy-efficiency-scheme-rees-/rees-faqs.aspx

Origin Energy's proposal for the ROC for the forthcoming price path period is summarised in Table 9.1.

Table 9.1 - Origin Energy's Proposed ROC Allowance, 2011/12 to 2013/14
$ per customer, $Dec11

	2011/12	2012/13	2013/14
ROC allowance	$117.87	$117.87	$117.87
REES Costs	$1.61[53]	-	-
Total	$119.48	$117.87	$117.87

Origin Energy's proposal is based on its assessment of the costs of a new entrant retailer and is supported by benchmarking of recent and relevant regulatory decisions across other jurisdictions. Origin Energy's view is that retail costs do not differ significantly between gas and electricity. For this reason, Origin Energy proposes that an appropriate allowance is that set by the Commission for ROC in its 2010 *Review of Retail Electricity Standing Contract Price Path*[54], of $117.87[55] per customer, excluding REES compliance costs.

Origin Energy has included an assessment of REES costs for the six month period 1 July 2011 - 31 December 2011 in its proposal. Thereafter, due to uncertainty around the REES targets and allowed activities, Origin Energy has proposed that any costs associated with REES (or any other energy efficiency scheme) be treated as a separate retail cost pass-through item.

9.2 Submissions

Submissions to the Issues Paper and Origin Energy's proposal identified the following matters in relation to Origin Energy's proposed ROC:

- Origin Energy expressed concern that the Commission may have suggested setting ROC on a dual-fuel or total energy basis. It stated that no energy regulator, at a state or national level, considers regulated pricing on this basis, and emphasised that retail costs and margins should be determined on a stand alone basis, in order to achieve an adequate level of competition. It further stated that, given the national integrated nature of the gas market, retailers will seek out those markets where they can find best value and, if risks are high and returns are low, retailers' willingness to sell and supply gas to customers in South Australia will decline, to the detriment of competition.

53 Covering the 6 month period 1 July to 31 December 2011 only.

54 Refer to the Commission's website: http://www.escosa.sa.gov.au/library/101208-ElectricityStandingContractPrice-FinalPriceDetermination-PartA.pdf

55 $115.00 allowance ($Dec 10) inflated by 2.5% to $Dec 11 prices

- AGL SA stated that, in order to ensure that competition thrives, the Commission should set a Gas Standing Contract Price that fully considers the costs and risks of a hypothetical stand alone retailer supplying gas to small customers. It further supported the use of external benchmarks to determine this cost, citing the benchmarking recently carried out as part of the 2010 Electricity Price Determination as a suitable basis.

  AGL SA expressed concern at the Commission's suggestion that CARC could be based on the marginal cost of acquiring a gas customer beyond that of acquiring an electricity customer, stating that this would represent a significant departure from established regulatory principles and that the incremental costs would be very difficult to determine in practice.

  AGL SA agreed with Origin Energy's proposed approach that REES costs from 1 January 2012 be considered under a pass-through event.

- The Minister for Energy suggested that consideration be given to setting CARC based on the marginal costs of acquiring a customer, citing evidence that market activity seems to be on a dual-fuel basis.

- SACOSS questioned Origin Energy's proposal to base the ROC allowance on the 2010 Electricity Standing Contract Price Determination, stating that, as every gas customer is also an electricity customer, it is hard to accept that, seven years on from the introduction of competition, supplying a customer with two fuels costs twice as much as for just one.

  SACOSS cited evidence that most customers who have both a gas and an electricity supply now use the same retailer, and that this suggests that most, if not all, gas customer acquisition activity is undertaken in conjunction with electricity marketing. SACOSS therefore recommended that CARC in gas be incremental to CARC in electricity.

  SACOSS also recommended that a REES allowance be set for the full three year price path period, to provide a level of relative certainty in gas pricing.

9.3 Commission's Consideration

9.3.1 Approach

The Commission is assessing the proposed ROC by having regard to the costs that an efficient retailer would be expected to incur in meeting the responsibilities of gas standing contract supply to small customers in South Australia.

This assessment is primarily based on benchmarking of costs against other regulatory decisions. The Commission recognises benchmarking of ROC to be imprecise. As a minimum, any benchmarking must take into account the circumstances of each jurisdiction (including different regulatory arrangements), and normalise for these differences if possible.

The benefit of benchmarking is that it recognises the fact that there are several other retailers that are competing in the same marketplace as Origin Energy, some of which are of comparable scale, and form appropriate comparators to the South Australian standing contract business. Where other regulators have determined their own view of the efficient costs of a regulated retail business, these benchmarks may provide guidance as to the efficient costs of the South Australian standing contract retail business.

This assessment is balanced with some consideration of Origin Energy's actual operating costs. The approach does not seek to determine a ROC allowance based solely on Origin Energy's actual costs, as this has the potential to either penalise high levels of efficiency or reward inefficiencies.

Additionally, there are practical difficulties in identifying the costs associated with Origin Energy's standing contract retail operations, given that it is a small part of an integrated national business.

The Commission observes that, in comparing an actual cost approach to a benchmarking approach, benchmarking is more likely to be consistent with the Commission's statutory objectives of promoting efficiency and providing incentives to reduce costs. The Commission therefore intends to place significant weight on its benchmarking analysis.

A further consideration for this review is the way in which the energy retail market has developed in South Australia. As highlighted in Chapter 3, a competitive market has developed in both electricity retailing and dual-fuel retailing. However, there has been no new entry to the gas-only retail market, nor has the Commission seen any evidence of retailers actively marketing gas as a stand-alone product.

The key issue for consideration here is whether it remains appropriate to continue to set a standing contract price for gas on a stand-alone retailer basis, when the reality of the market is that gas retailing has only occurred to date in conjunction with electricity retailing (i.e. on a dual-fuel basis).

As stated above, the Commission is assessing the proposed ROC by having regard to the costs that an efficient retailer would be expected to incur in meeting the responsibilities of gas standing contract supply to small customers in South Australia.

It is the Commission's view that no prudent retailer would choose to enter the gas-only retail market whilst the opportunity exists to market dual-fuel to every gas consumer. This has been reflected in the development of the energy retail market to date.

It is, therefore, the view of the Commission that the costs of an efficient retailer in meeting the responsibilities of gas standing contract supply to small customers should be assessed as those of a dual-fuel retailer.

It is the Commission's Draft Determination that it is in the long-term interests of South Australian consumers to set the gas standing contract price on an efficient dual-fuel retailer basis, and at a level to ensure that the dual-fuel market remains competitive.

Having established an electricity standing contract price based on the stand-alone cost of electricity retailing, the gas standing contract price, therefore, needs to be set at a level to at least recover the incremental cost of retailing gas under a dual-fuel approach.

Consideration must also be given to the role of the regulated price in both the gas and electricity markets. In the electricity market, where competition is stronger, the Commission took the view in its 2010 determination that the standing contract price should be seen as a "safety net" tariff and should not represent the lowest sustainable cost of providing retail services.

However, the lower level of competition in the stand-alone gas retail market means that there is a greater need for the Commission to ensure that standing contract customers are protected, and a stronger consideration needs to be given to driving efficiencies in the standing contract price.

The Commission engaged Sapere Research Group (Sapere) to provide assistance with the review of ROC. The Sapere report[56] is being released at the same time as this Draft Determination.

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

- the confidential proposal submitted by Origin Energy to the Commission in November 2010;
- additional material provided by Origin Energy in response to the Commission's information request;
- information obtained by the Commission in connection with its 2008 Gas Standing Contract Price Determination;
- information obtained by the Commission in connection with its 2010 Electricity Standing Contract price review; and

[56] A report summarising the Sapere analysis is available on the Commission's website: http://www.escosa.sa.gov.au/library/110406-2011_ReviewGasOperatingCosts-SapereConsultantReport.pdf

- information obtained from other external sources.

The Commission also took account of the views expressed in the submissions received in response to the Issues Paper.

9.3.2 Benchmarking Analysis

In evaluating Origin Energy's proposal, Sapere examined relevant benchmarks of ROC allowances across other jurisdictions. As there are only a limited number of relevant decisions for gas, the benchmarking exercise was widened to include electricity decisions.

A summary of recent relevant decisions by other jurisdictional regulators on ROC is presented in Table 9.2. Where possible, allowances for CARC are split out from base-ROC, for ease of comparison.

Table 9.2 - ROC ($ per customer, $Dec11)

Body/State	Period	Base ROC	CARC	Total ROC
IPART NSW (elec)	Jul10-Jun13	77.0	38.8	115.8
ICRC ACT (elec)	Jul10-Jun12	109.2	0	109.2
QCA Qld (elec)	Jul10-Jun11	89.3	42.1	131.4
IPART NSW (gas)	Jul10-Jun13			106.5[57]
ESCOSA SA (elec)	Jan11-Jun14	78.4	39.5	117.9
ESCOSA SA (gas)	Jul08-Jun11	97.1	-	97.1

As presented above, ROC and CARC allowances vary significantly across jurisdictions. However, it is important to note the differences in methodologies and inputs that underpin each regulatory decision, in considering the differences in outcomes. In particular, the Commission notes that:

- The Independent Pricing and Regulatory Tribunal (IPART) electricity allowance is based on a comprehensive bottom-up analysis of retailer costs.
- The Independent Competition & Regulatory Commission (ICRC) has based its decision on an escalated roll-forward of its 2003/04 ROC decision. ROC includes the costs of meter reading, which are recovered via distribution charges in SA and NSW. ICRC has not included any CARC allowance,

[57] Note that this is the mid-point of a range of ROC allowances, from $90 to $123.

consistent with previous ICRC reviews and reflective of the regulatory framework in which ICRC operates.

- Queensland Competition Authority (QCA) has based its electricity ROC decision on an escalated roll-forward of its 2007/08 decision.
- IPART gas allowances are set under a Voluntary Transitional Pricing Arrangement (VTPA) with retailers. Under this arrangement, IPART does not explicitly specify base ROC or CARC allowances.
- CARC, to the extent that it was allowed, was recovered via ROM as part of the Commission's 2008 Gas Standing Contract Price Determination.

The Commission understands these benchmark costs to be on a stand-alone fuel basis. This has been confirmed by Origin Energy in its response to the Issues Paper, where it states that across other states *'…prices for each fuel source are determined on a stand-alone basis*.[58]'

9.3.3 Analysis of Actual Operating Costs

The Commission requested Origin Energy to provide information on its actual ROC associated with the SA small gas customer segment for 2009/10. Origin Energy provided to the Commission, on a confidential basis, operating costs for its national gas and electricity customers.

Most of the ROC incurred by Origin Energy is common across its retail businesses, both gas and electricity, and cannot be directly attributed to the South Australian gas standing contract business. In order to calculate the operating costs of the South Australian gas standing contract business, costs must be allocated between Origin Energy's various retail businesses. It is recognised that there are limitations in such an exercise, where allocation bases are often difficult to determine and can be somewhat arbitrary. Nevertheless, the Commission has examined the information provided by Origin Energy to provide a check against the results of the benchmarking analysis.

The information provided by Origin Energy focused on the costs of supplying its entire gas and electricity mass market customer base and did not specifically seek to estimate possible differences between the costs of supplying customers on standing as distinct from market contracts. Indeed, there is nothing in the available information to suggest that such differences exist.

While the Commission cannot disclose the details of the actual cost data, it confirms that Origin Energy's operating costs (reported on a national basis) for

[58] Origin Energy (2010), Proposed Price Path for Standing Contract Gas Customers in South Australia: 2011-12 to 2013-14, available at the following website: http://www.escosa.sa.gov.au/library/101217-GasPricePathIssuesPaperSubmission-OriginEnergy.pdf

2009/10 are broadly comparable with the amount allowed by the Commission as part of its 2008 gas standing contract price determination.

9.3.4 Initial base-ROC Allowance

Origin Energy has proposed the same total ROC allowance as the Commission allowed in its Final Decision on Electricity Standing Contract Prices in December 2010, of $117.87 per customer.

Whilst Origin Energy's proposal did not split ROC between base-ROC and CARC, the Commission, supported by advice from Sapere, considers that it is reasonable to base its analysis on a split of costs consistent with the previous electricity price determination. This is provided in Table 9.3.

Table 9.3 – Assumed split of Origin Energy's Proposed ROC (excl. REES), 2011/12 to 2013/14 ($ per customer, $Dec11)

	2011/12	2012/13	2013/14
Base ROC	$78.41	$78.41	$78.41
CARC	$39.46	$39.46	$39.46
Total ROC allowance (Origin Proposal)	$117.87	$117.87	$117.87

These costs were determined by the Commission to be at an efficient level for the electricity standing contract in December 2010. The analysis carried out at that time was primarily based on inter-jurisdictional benchmarking, but with reference to the actual costs of AGL SA, as the standing contract electricity supplier.

Given the short time-span that has elapsed since this decision, it is reasonable to continue to rely on this work, subject to the considerations stated below.

For base ROC (excluding CARC) a number of issues must be addressed to determine whether this is an appropriate ROC allowance for the Gas Standing Contract. Each of these issues is consider in turn below.

Is there any difference between gas and electricity in the activities undertaken that would drive different costs?

Sapere has determined that there appears to be no strong grounds for differentiating base ROC between gas and electricity, for a number of reasons:

- The scope of retailer functions between gas and electricity are similar;
- Retailer systems and business processes serving gas and electricity accounts are converging;
- There is evidence that many customers have both gas and electricity accounts with a single retailer; and

- Available benchmark and other cost data do not readily enable distinctions between serving electricity and gas accounts.

This is consistent with Origin Energy's view that retail costs do not differ significantly between gas and electricity customers.

It should however be noted that, whilst the Commission's electricity decision was based on the costs of a stand-alone electricity retailer, in relation to the Gas Standing Contract Price the Commission is considering the costs of a dual-fuel retailer.

Any fixed costs (common to both fuels) will therefore have already been fully reflected in the electricity decision. Ideally, these fixed costs should be excluded from the gas base-ROC allowance, in order to avoid consumers paying twice. However, there are some practical issues with this approach:

1. Costs are not accounted for in this way by retailers and it is difficult to determine which costs are fuel-specific versus shared.
2. Even if the shared costs could be reliably measured, establishing a methodology for allocating the costs between fuels would be contentious.

Having regard to these issues, and on the basis that the convergence of business processes is currently being implemented, the Commission has sought to address the ongoing efficiencies from dual-fuel retailing as part of the glide-path for ROC, rather than in the starting value.

Have there been any material changes to the external environment since the electricity decision that would drive a change in costs?

The Commission is not aware of any material changes to the external environment.

Further, none of the respondents to the Issues Paper identified any material changes to the external environment since the electricity final decision in December 2010.

Are there any new benchmarking comparators that would lead to a change in the Commission's view of efficient base-ROC costs?

There have been no further relevant regulatory decisions in other jurisdictions since the Commission's determination on Electricity Standing Contract prices in December 2010.

Are there any other factors that would lead to the Commission taking a different view on efficient base-ROC costs from that taken in the Electricity decision in December 2010?

The Commission is not aware of any other factors that would lead to a changed view of efficient costs from that established in the electricity decision in December 2010.

It is noted that this decision was informed principally by inter-jurisdictional benchmarking, with considerable reliance placed on the IPART June 2010 decision on electricity standing contract prices, which was based on a detailed bottom-up assessment of actual costs.

The Commission's Draft Determination is that the initial base-ROC should be the same as that allowed in the 2010 Electricity Standing Contract Price Determination ($78.41 per customer), with the expected efficiencies from increased convergence of retailer systems addressed through forecast changes in the base-ROC.

9.3.5 Forecast Changes in base-ROC

Having established the appropriate starting point for base-ROC, consideration must be given as to how costs are likely to move across the three years of the price path.

Origin Energy has requested an allowance that is constant across the three years, other than allowing for changes in line with CPI. This is consistent with the Commission's decision on the electricity price path in December 2010.

The Commission notes that Origin Energy has, over the last three years, made a number of announcements regarding the transformation of its retail business, establishing a retail transformation program. Origin Energy's 2010 Annual Report states that:

'Origin is transforming all aspects of its retail business. This will result in simplified operating processes and a single integrated SAP billing and customer management system. …This will enable Origin to deliver the innovative energy solutions that the changing energy market will require while optimising its cost to serve.'

The Commission further notes that a significant outsourcing of back-office and IT applications has taken place as part of this transformation project, and that the new systems are scheduled to become operational around the middle of 2011.

Such developments are not unique to Origin Energy, and the Commission notes that other retailers have made similar announcements on retailer systems renewals in recent times. Indeed, such behaviour is to be expected of a prudent retailer in continually seeking out efficiencies in its operations.

Whilst the Commission is mindful of the need to provide an adequate incentive for the standing contract retailer to benefit from such initiatives, it is also keen to ensure that benefits are shared with standing contract customers.

As part of its 2007 Electricity Standing Contract Price Path decision, the Commission carried out an analysis of a similar transformation project undertaken by AGL SA (Project Phoenix). Based on an analysis of the projected benefits of this project, the Commission set an annual efficiency target of 4.1% across the three year price path, based on a 50:50 sharing ratio of benefits between the retailer and consumers.

Further to this, Sapere has indicated that projected efficiencies of up to 5% per annum, before sharing, may be reasonable across the second and third years of the price path period.

The Commission is also aware that there are risks to retailers around the introduction of new IT systems, relating to both timing and cost, and that it is reasonable to allow retailers a bedding-in period, prior to sharing the longer term benefits with consumers.

Given the above information, the Commission considers it appropriate to apply an annual efficiency target to base-ROC over the second and third years of the price path. This will ensure that gas standing contract customers share in the benefits from the transformation initiatives, whilst allowing the retailer a reasonable period for the new systems to become established.

While the Commission did not explicitly incorporate a ROC efficiency factor in its 2010 Electricity Standing Contract Price Determination, the application of the RPM approach in that determination allows for future efficiency gains to be reflected in the standing contract price, on the expectation that such gains will be reflected in market contract prices.

Given that the Commission is not applying the RPM approach in this gas standing contract price determination, and must forecast ROC for the 3-year period, it considers it appropriate to reflect expected future efficiencies, including efficiencies from increased convergence of retailer systems, directly in the gas standing contract price.

The Commission's Draft Determination is that it considers that a base-ROC efficiency target of CPI-2% per annum across years two and three of the price path period is appropriate, as summarised in Table 9.4.

Table 9.4 - Draft Decision base-ROC, 2011/12 to 2013/14 ($ per customer, $Dec11)

	2011/12	2012/13	2013/14
Base ROC	$78.41	$76.84	$75.30

9.3.6 CARC Allowance

As previously identified in Table 9.3, the Commission has assumed that the Customer Acquisition and Retention Costs (CARC) element of the Origin Energy proposal totals $39.46 per customer, consistent with costs that the Commission allowed in its Final Decision on Electricity Standing Contract Prices in December 2010.

It is noted that the Commission's electricity decision was informed principally by inter-jurisdictional benchmarking, with considerable reliance placed on the IPART June 2010 decision on electricity standing contract prices, which was based on a detailed bottom-up assessment of actual costs.

In the November 2010 Issues Paper, the Commission raised the issue of whether the CARC allowance in gas should only be on an incremental cost basis, given that there are no gas-only retailers active in South Australia, and that gas marketing takes place only as part of dual-fuel marketing.

In response to the Issues Paper, both Origin Energy and AGL SA stated that costs need to be determined on a stand-alone retailer basis, to ensure that an adequate level of competition can be achieved in the gas market, to the long term benefit of customers. However, both the Minister for Energy and SACOSS stated that consideration should be given to setting CARC on a marginal cost basis, given the manner in which the energy market has developed in South Australia.

As stated in 9.3.1, the Commission's Draft Determination is that it is appropriate to set standing contract prices on a dual-fuel basis. Therefore, CARC costs should only be considered on an incremental cost basis.

There are three elements within CARC – acquisition costs, retention costs, and transfer costs. Of these, acquisition costs, typically commissions paid to direct sales staff on delivering a new customer, represent the majority of CARC. It is noted that sales staff are typically paid a commission for delivering a new single fuel customer, and an enhanced commission for delivering a new dual-fuel customer. The incremental commission for the second fuel is typically up to 50%[59] of the commission received for the first fuel.

[59] Refer to P32 of LECG Retailers Survey prepared for AEMC 2008 - http://www.aemc.gov.au/Media/docs/LECG%20Consulting%20Report-681915e3-27b6-44ff-9dee-3e5a0a54924e-0.pdf

Given this situation, and based on advice received from Sapere, it is the view of the Commission that it is reasonable to make an adjustment to the acquisition cost element of CARC to reflect only the incremental cost of dual-fuel acquisition.

A further issue to consider is that, as discussed in Chapter 3, switching rates in gas have consistently been lower than those in electricity, over a number of years. Due to the typically commission-based nature of acquisition costs (i.e. sales staff paid for each successful customer acquisition), there is a direct link between total acquisition costs and switching rates. A lower switching rate drives a lower total CARC and, therefore, a lower CARC per customer served.

There is currently a lower number of active suppliers in the gas market compared to the electricity market (4 versus 10), and, given the positive correlation between gas and electricity switching rates (partly driven by dual-fuel offers), it is likely that the lower gas switching rate will continue over the forthcoming price path period.

The Commission notes that switching rates in electricity have averaged 15.2% of accounts annually over the 2008-2010 period, whilst switching rates in gas have averaged only 11.2% of accounts over the same period.

It is therefore the view of the Commission, supported by advice received from Sapere, that the CARC allowance in gas should be adjusted downwards to reflect the lower level of switching activity in gas relative to electricity. Again, this adjustment is only applied to the acquisition cost element of the CARC allowance. This adjustment alone would result in the CARC reducing from $39.46 per customer to $31.55 per customer.

In considering a further adjustment to take account of the incremental nature of gas customer acquisitions, the Commission acknowledges that there are practical difficulties in estimating the incremental CARC, given the limited information available on acquisition costs per fuel type. The Commission has therefore taken a cautious approach to setting a CARC allowance for gas. While the commission-based cost could be up to 50% lower for a gas customer acquisition than an electricity customer acquisition, there are other acquisition costs that should also be taken into account (e.g. account establishment costs). Accounting for these other costs, the Commission's Draft Determination is that the acquisition costs of the second fuel in dual-fuel marketing is 30% lower than the first fuel. A reduction of 30% has therefore been applied to the acquisition component of the stand-alone CARC.

Based on the two adjustments detailed above, it is the Commission's Draft Determination that the CARC allowance should be set at $24.72 per customer. The Commission does not propose to vary the CARC allowance across the three year price path period.

9.3.7 REES

The REES scheme is set to continue across the whole of the three year price path period, although it is noted that the targets to be achieved by obliged retailers, and the allowed activities, may change from 1 January 2012.

Origin Energy has provided a forecast of REES costs for the first six months of the price path period (1 July 2011 to 31 December 2011), and has proposed that, given the uncertainty over the format of the scheme from 1 January 2012, any costs associated with REES (or any other energy efficiency scheme) thereafter be treated as a pass-through event.

The Commission notes that AGL SA is supportive of the Origin Energy pass-through proposal, whilst SACOSS has recommended that a REES allowance be set for the full three year price path period, to provide a level of relative certainty in gas pricing.

Whilst the Commission notes the differing views stated above, there is certainty that the REES scheme will continue in some form across the full three year price path period under the current gas regulations. It is, therefore, appropriate to set an allowance for the full three year price path period, albeit with a provision to make an adjustment, via a pass-through, should costs prove to be higher once there is certainty over the targets and allowed activities from January 2012 onwards.

An analysis of Origin Energy's actual REES costs, carried out as part of the 2010 pass-through application[60], equates to $2.50 per customer per annum. Subject to a CPI adjustment, it is the Commission's Draft Determination to allow this cost to reflect REES obligations across the price path period.

[60] Refer to the Commission's Decision of REES pass through in 2010/11: http://www.escosa.sa.gov.au/library/100618-REESPassThrroughDecisionPublic_2010-11-Origin.pdf

9.4 Draft Determination on ROC Allowance

It is the Commission's Draft Determination that:

- *the initial cost allowance for base-ROC will be $78.41;*
- *the initial cost allowance for CARC will be $24.72; and*
- *the initial cost allowance for REES will be $2.60[61].*

Base-ROC will be subject to a CPI-2% annual efficiency target. All other allowances will be subject to annual escalation by the CPI during the next price path period.

Table 9.5 outlines the Commission's Draft Determination on ROC.

Table 9.5 - Draft Determination on ROC Allowance, 2011/12 to 2013/14
$ per customer, $Dec11

	2011/12	2012/13	2013/14
Base ROC	$78.41	$76.84	$75.30
CARC	$24.72	$24.72	$24.72
REES	$2.60	$2.60	$2.60
Total ROC allowance	$105.73	$104.16	$102.62

61 Being $2.50 ($Jun10) inflated to $Dec11

10 RETAIL MARGIN (ROM)

ROM is the increment above a retailer's operating costs to cover return on capital, depreciation, amortisation and taxes. ROM is set so as to recover the full opportunity cost of efficiently operating the standing contract business.

Under the Commission's approach, ROM is calculated on an Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA) basis. The Commission expresses ROM as a percentage of controllable costs (wholesale gas costs, transmission costs and ROC).

10.1 Origin Energy's Proposal

Origin Energy has proposed setting the level of ROM based on a risk-weighted investment, such that it covers a return on capital, depreciation, amortisation and taxes. Origin Energy considers that the margin should *'encourage business efficiencies, new entrants, less reliance on regulated prices and thus competition in the gas market*.'[62] Further, Origin Energy considers ROM needs to be set at a level such that all business risks are incorporated, to ensure satisfactory returns are provided to shareholders, and to take account of any forecasting errors that may result in reduced ROM.

Origin Energy considers that gas retailing inherently incorporates higher risks than electricity retailing, and the proposed ROM should be set higher to accommodate such risks. Additional risks identified by Origin Energy include; '*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'*.[63]

Origin Energy has proposed that industry benchmarks should be used to determine ROM allowances. It has suggested that determinations for gas markets in NSW (IPART 2010), and electricity markets in South Australia (ESCOSA 2010), NSW (IPART 2010), Queensland (QCA 2010) and ACT (ICRC 2010) form the most relevant benchmarks. Origin Energy has provided further commentary on key differences in these determinations to that proposed for the South Australian gas market. This analysis produced a benchmark ROM between 10.0 – 16.6 per cent of controllable costs, equating to approximately 5.0 – 8.3 per cent of sales revenue.

Origin Energy considers the most appropriate benchmark for the South Australian gas market to be the IPART 2010 gas determination, which provided a ROM of 7.3 – 8.3%of sales revenue, equating to approximately 14.6 – 16.6% of controllable costs. .

Origin Energy proposes that an increase in ROM relative to the Commission's current benchmark is required because of:

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[62] Origin Energy (2010), Proposed Price Path for Standing Contract Gas Customers in South Australia: 2011-12 to 2013-14, p.35 available at the following website: http://www.escosa.sa.gov.au/library/101217-GasPricePathIssuesPaperSubmission-OriginEnergy.pdf

[63] Ibid, p.35

- The limited value of ROM in terms of $ per customer, a risk that is exacerbated by the extent of any forecast error, creating a commercial risk to Origin Energy;
- ROM is not applied to distribution or market charges (i.e. AEMO costs), as these costs are excluded from the retailer revenue calculation. A higher return on controllable costs is therefore required to achieve the same return on sales level, given the lower percentage of controllable costs in the total standing contract price; and
- There remains an additional significant working capital exposure that is unique to the South Australia and Queensland gas markets. The additional cost arises from the continued obligation for prepayment of Envestra's network charges, which make up over 50% of total costs.

As summarised in Table 10.1, Origin Energy has proposed a ROM of 13% of controllable costs be adopted in 2011/12, with a transition to a 'cost reflective' margin of 14.6% in years 2 and 3 of the price path.

Table 10.1 - Origin Energy Proposed ROM, 2011/12 to 2013/14
Percentage of total controllable costs

	2011/12	2012/13	2013/14
ROM	13%	14.6%	14.6%

10.2 Submissions

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

- AGL SA encouraged the Commission to consider raising the ROM, stating that the slow down in competition in the gas market can be attributed to low gas margins. AGL SA considers that a ROM of at least 13% of controllable costs (based on CARC being accounted for within ROC) would be appropriate to encourage participation of other retailers in the gas market.
- Origin Energy stated that the limited ROM in the gas market has meant that the risks outweigh the benefits of targeting gas customers and this is the reason that retailers have solely used dual-fuel offers to acquire gas customers. It then cites the 2008 AEMC review of the effectiveness of competition in the gas retail market, which noted that the ROM was unattractive in the South Australian gas market and at, or below, the bottom of the range required to attract new retailers into the market.
- The Minister for Energy stated that he expects the Commission to closely examine interstate and other relevant data in order to establish a fair ROM level.
- SACOSS stated that it was supportive of the integration of CARC into ROC going forward. However, it notes that this was previously incorporated into the ROM

allowance of 13%. SACOSS recommends that the ROM should be reduced in line with the CARC expenditure, to ensure that no additional costs are passed on to consumers. It further stated that Origin Energy's proposal to increase ROM appears to be largely unjustified, and that any increase in margin driven by the continuing requirement to prepay distribution charges can only be accepted by consumers if matched by a reduction in distribution costs.

- As previously highlighted in Chapter 9, SACOSS has indicated that the relationship between electricity and gas retailing suggests a dual-fuel approach to ROM has the *'potential to lower overall costs passed onto consumers.'*

10.3 Commission's Consideration

10.3.1 Approach

In determining an appropriate ROM allowance, the Commission considers benchmarks from relevant regulatory determinations as being fundamental for the price setting process. Consistent with the approach used in the 2008 Gas Standing Contract Price Determination, the Commission will make any necessary adjustments to reflect changing circumstances. In addition, the Commission will have regard to a bottom-up return on investment analysis of ROM for the standing contract business.

In assessing the proposed ROM allowance, the Commission has had regard to both maintaining the financial viability of the standing contract retailer, and also the development of competition in the gas retail market. The Commission's approach is to strike a balance between the need to attract investment into the South Australian gas retail market, while ensuring that gas standing contract customers are not funding an excessive return to the gas standing contract retailer.

As noted in Chapter 9, the Commission has engaged Sapere to assist with this analysis. The Sapere report is being released at the same time as this Draft Determination.

10.3.2 Benchmarking Analysis

In evaluating the Origin Energy proposal, Sapere has analysed relevant benchmarks of ROM allowances across other jurisdictions. As there have only been a limited number of relevant determinations for gas, the benchmarking exercise has been widened to include electricity determinations.

To ensure consistency, and thereby enable a comparable benchmarking analysis of ROM allowances of other jurisdictions, Sapere has undertaken a 'normalisation' process to convert ROM from a percentage of controllable costs to a percentage of sales revenue.

A summary of recent determinations by other jurisdictional regulators on ROM allowances is presented in Table 10.2.

Table 10.2 - Summary of benchmarking analysis

State	Body	Period	ROM	
			% of allowed revenue	% of controllable costs (estimated)
NSW (elec)	IPART	Jul10 – Jun13	5.4	10.5
ACT (elec)	ICRC	Jul10-Jun12	5.4	10.5
Qld (elec)	QCA	Jul10-Jun11	5.0	9.6
Qld (gas)	QCA	From 2007	6.5	13.5
NSW (gas)	IPART	Jul 10 – Jul 13	7.8	14.7
SA (elec)	ESCOSA	Jan 11 – Jun 14	5.2	10.0
SA (gas)	ESCOSA	Jul 08- Jun 11	5.8	13.0

As presented above, ROM allowances vary across jurisdictions. The electricity ROM benchmarks set in New South Wales, ACT, Queensland and South Australia are relatively comparable, ranging from around 9.6% of controllable costs to 10.5% of controllable costs.

The gas ROM benchmarks in New South Wales, Queensland and South Australia are greater than the electricity ROM allowances. As noted earlier, the Envestra gas distribution payment terms impact on the working capital requirements of gas retailers in South Australian and Queensland, and would impact on the required ROM in those states.

Other matters that the Commission has taken into account when assessing the ROM benchmarks include:

- The IPART electricity ROM allowance of 5.4% of total allowed retailer costs[64] is set at a level sufficient to compensate Standard Retailers for the systematic risk they face when supplying electricity to small customers on regulated tariffs.
- ICRC has set a ROM allowance of 5.4%, with the aim of providing a return on investment at a level commensurate for the provision of retail services, and to encourage retail market competition.
- As previously acknowledged, the Queensland gas market was fully deregulated from 1 July 2007. A 2008 review of gas pricing[65] by the QCA

[64] IPART, 2010, *Final Report: Review of Regulated Retail Tariffs and Charges for Electricity 2010-2013* p129

[65] QCA report, *Final Report Review of Small Customer Gas Pricing and Competition in Queensland*, 2008

estimated a ROM allowance of 6.5% for residential customers, and 4.5% for small business customers were reasonable.

- QCA has based its electricity ROM allowance of 5.0% on an escalated roll-forward of its 2007-08 determination.
- Similar to the IPART electricity determination, the gas ROM allowances of 7.8 per cent of total allowed retailer costs is limited to systematic risk, derived from an average of the expected returns and benchmarked approach. IPART noted the higher ROM for gas relative to electricity, attributable to the following factors[66]:
  - gas retailers' higher fixed costs, which increases the estimated margin under the expected returns approach
  - gas retailers' higher estimated depreciation costs, which increases the estimates based on EBITDA
  - lower assumptions regarding gas retailers' cash operating costs.

A threshold question considered by the Commission in evaluating the above benchmarks is whether or not there are any key differences between electricity and gas retailing, which would justify different margins between the two fuels.

In this respect, it is relevant to note that the Commission's determination on ROM, taken as part of the 2008 Gas Standing Contract Price Determination, was based on the ROM established through the 2007 South Australian Electricity Standing Contract Price Path Inquiry and the ROM established through the 2005 Inquiry into gas standing contract prices. Both margins were set at 10% of controllable costs.

The Commission formed the view that the existing South Australian ROM benchmarks for electricity and gas were comparable, although it acknowledged that an adjustment was necessary to reflect the payment terms that were approved by the Commission under the 2006 review of Envestra's Gas Access Arrangement. The existence of the pre-payment arrangements in gas, which do not exist in electricity, formed the basis of the Commission's determination to increase the gas retail ROM from 10% to 13% of controllable costs.

Origin Energy has argued that a ROM that is greater than 13% is necessary. It has proposed a transition path that would increase ROM from 13% in 2011/12, to 14.6% in 2012/13 and 2013/14. Origin Energy considers a margin of 14.6% of controllable costs to be cost reflective.

Origin Energy has provided three reasons for increasing the ROM allowance:

66 IPART, 2010, *Review of Regulated Retail Tariffs and Charges for Gas 2010-2013*, p.33

- The limited value of ROM in terms of $ per gas account, exacerbated by the forecast error over average consumption levels;
- A higher ROM is required where ROM is calculated exclusive of non-controllable costs (network and AEMO charges); and
- The additional working capital costs that arise from the pre-payment of Envestra network charges, an arrangement that is unique to South Australia.

The Commission has given consideration to each issue as follows:

ROM allowance and forecast uncertainty

Origin Energy has argued that the dollar return from gas retail customers is significantly less than the dollar return from electricity customers and that, as a result, any variation between actual and forecast sales can have a greater impact on the return from gas customers relative to the return from electricity customers.

The Commission agrees that a fundamental difference between gas retailing and electricity retailing in South Australia is the dollar return that can be generated from the different customer groups. This was a principal reason for the Commission reaching the view that gas retail competition is largely a by-product of electricity retail competition.

However, the Commission does not accept that the existence of a lower dollar margin from gas customers is, in itself, a valid reason to allow for an increased gas ROM. The argument made by Origin Energy implies that it is more important to consider the absolute value of the margin earned rather than the rate of return earned. It implies that, should gas consumption (per customer) continue to fall in South Australia, there is an argument to increase the ROM further in order to preserve a constant dollar margin.

The Commission is of the view that the decision on an appropriate ROM is not dependent on the value of gas sales to each customer. The ROM is a proxy for the return on investment by retailers. The rate of return is influenced only by the risk associated with that investment. It is not dependent on the value of the product sold. If investors could earn a much greater return on investment in businesses that provide low value products (with lower absolute dollars per customer earned) relative to high value products (with higher absolute dollars per customer earned), then capital would be attracted towards those types of businesses. There is no theoretical nor empirical evidence to suggest that this is the case.

While the Commission acknowledges that the average gas consumption per account has declined since its peak in 2003/04, sales forecasts used by the Commission in setting gas standing contract prices reflect this reduction. In particular, the Commission has accepted Origin Energy’s proposed average consumption per residential account of 20.7GJ/pa for the next price path period, which is 6.3% lower than that used in the 2008 Gas Standing Contract Price Determination (22.1 GJ/pa).

It is also noted that the risk of mismatches between allowed and actual ROM as a result of sales forecast error is further reduced through the annual price adjustment process, which enables Origin Energy to update its sales forecast each year when proposing adjusted prices.

Calculation of ROM based on controllable costs

Origin Energy's statement that *'a higher return on controllable costs is required to achieve the same return on sales level given the lower percentage of controllable costs in the total standing contract price*'[67] is not considered by the Commission as grounds to increase the ROM allowance.

The Commission has chosen to set ROM with reference to controllable costs to ensure that the margin is not influenced by those costs that are not within the retailer's control. If the Commission were to set ROM with reference to total sales revenue, then it would need to take into account any differences in the mix of controllable and non-controllable costs between regulatory benchmarks. The Commission does not set ROM on this basis, and has only sought to normalise ROM benchmarks to ensure that all regulatory determinations on ROM can be examined on a controllable cost basis.

The Commission's objective in establishing ROM is to ensure that retailers recover the efficient costs of committing capital to their retail businesses. For this reason, the Commission focuses on a retailer's controllable costs only. The Commission does not consider it appropriate for ROM to be dependent on the extent to which total costs comprise distribution charges, which are outside the control of the retail business.

Additional working capital associated with network access

Origin Energy proposed that '*there is an additional significant working capital exposure that is unique to South Australia and Queensland gas markets. This additional cost arises from the continued obligation for prepayment of Envestra's network charges*...'[68]

In the 2005 Gas Price Determination, the Commission assumed that the requirement for retailers to pay distribution charges to Envestra two months in advance would cease in 2006, when the Envestra Access Arrangement was to be reviewed. The Commission assumed that payment terms would move to a 1 month in arrears arrangement, which would bring the payment terms into line with other gas distribution businesses and reduce the working capital requirements for gas

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67 Ibid, p.36

68 Ibid, p.37

retailers. This change in arrangements did not eventuate, and consequently the Commission recognised in its 2008 Gas Standing Contract Price Determination[69] that an increase in the working capital requirements would need to be reflected in the gas retail ROM. Importantly, there was no net impact to consumers arising from these decisions, as the increase in the retail ROM was offset by the reduction in Envestra's working capital allowance.

The Commission accepts that such an allowance should be maintained in the current gas standing contract prices, on the basis that the AER's Draft Determination[70] on the Envestra Access Arrangement to apply from 1 July 2011 supports the continuation of the prepayment arrangement. However, the Commission does not consider that such costs have materially changed since the 2008 Gas Standing Contract Price Determination to justify an increase in the ROM allowance.

While the AER's Draft Determination on the Envestra Access Arrangement to apply from 1 July 2011 would see a real increase in distribution charges, the impact on gas retailers' working capital is not material. In its 2008 Gas Standing Contract Price Determination, the Commission estimated that the additional working capital requirement would add approximately 2.3% to ROM. This figure remains relevant for the current Inquiry.

69 Refer Essential Services Commission of SA, 2008, Gas Standing Contract Price Path: Final Inquiry Report and Final Price Determination, June 2008, p. A-96

70 Refer AER's Draft Determination: http://www.aer.gov.au/content/item.phtml?itemId=743119&nodeId=1fc67b8a1fe55dfa58f2895dbd5a3cd2&fn=Envestra%20draft%20decision%20-%20SA.pdf

10.4 Draft Determination on ROM Allowance

The Commission does not agree with the arguments made by Origin Energy to increase ROM, and it believes that it is appropriate to retain the current margin of 13% of controllable costs for each year of the price path period.

Table 10.3 outlines the Commission's Draft Determination on ROM, compared to Origin Energy's proposal, and the Commission's 2008 Gas Standing Contract Price Determination.

Table 10.3 – Commission's Draft Determination on ROM compared to Origin Energy's proposed ROM, and the Commission's 2008 Final ROM Determination, $Dec11

	Commission's Final Determination 2008	Origin Energy's Proposal	Commission's Draft Determination 2011
ROM (% of controllable costs)	13.0	14.1	13.0
Residential ROM ($/account)	30.45	38.37	32.02
SME ROM ($/account)	119.30	147.58	124.26

11 SUMMARY OF DRAFT DETERMINATION ON RETAILER CONTROLLABLE COSTS

11.1 Overview

This Chapter details the draft determination of the Commission for the retail component of the Standing Contract price path under the building block methodology. The Commission has analysed retailer costs to develop a standing contract price to apply from 1 July 2011.

11.2 Commission's Draft Determination

The Commission's indicative Draft Determination on the retailer controllable cost components of the gas standing contract price (that is; wholesale gas costs; transmission costs; and ROC) are shown in Table 11.1 and Table 11.2. The Commission has determined that a ROM of 13% of these controllable costs is appropriate for the standing contract price.

Table 11.1 - Indicative Retailer Controllable Costs 2011/12 to 2013/14 Weighted average of 5 regions, Residential, $/GJ, GST exclusive, $Dec11

	Origin Energy Proposed				Commission Draft Determination			
	2010/11	2011/12	2012/13	2013/14	2010/11[71]	2011/12	2012/13	2013/14
Cost of Gas	4.87	5.09	5.17	6.39	4.87	4.99	4.97	4.97
Transmission Cost	1.84	1.91	1.88	1.90	1.84	1.91	1.88	1.89
ROC	4.39	5.78	5.70	5.70	4.39	5.11	5.04	4.96
ROM	1.44	1.66	1.86	2.04	1.44	1.56	1.55	1.54
Total Retail Cost unsmoothed	12.67[72]	14.45	14.61	16.03	12.67	13.57	13.44	13.36

Table 11.2 - Indicative Retailer Controllable Costs 2011/12 to 2013/14 Weighted average of 5 regions, SME, $/GJ, GST exclusive, $Dec 11

	Origin Energy Proposed				Commission Draft Determination			
	2010/11	2011/12	2012/13	2013/14	2010/11	2011/12	2012/13	2013/14
Cost of Gas	4.50	4.58	4.60	5.82	4.50	4.50	4.48	4.48
Transmission Cost	1.32	1.32	1.30	1.32	1.32	1.31	1.29	1.31
ROC	0.63	0.81	0.8	0.8	0.64	0.72	0.71	0.70
ROM	0.84	0.87	0.98	1.16	0.84	0.85	0.84	0.84
Total Retail Cost unsmoothed	7.29	7.58	7.68	9.10	7.29	7.38	7.32	7.33

Note, Table 11.1 and Table 11.2 contains some minor rounding errors

71 Benchmarks determined by the Commission for 2010/11 as part of the 2008 Gas Standing Contract Price Determination.

72 Includes a REES pass through of $0.13 / GJ

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

The Commission's Draft Determination on the maximum average revenue to apply for each customer segment during 2011/12, and the manner in which this amount changes in subsequent years (determined by the X factor), has been set to ensure that the present value of this "smoothed" revenue stream over the three-year period is equal to the present value of the "notional" revenue requirement derived from the building block components.

Table 11.3 - Indicative Retailer Average Revenue 2011/12 to 2013/14
Weighted average of 5 regions, $/GJ, GST exclusive, $Dec11

	2010/11	2011/12	2012/13	2013/14	2010/11	2011/12	2012/13	2013/14
	Origin Proposal							
	Residential				SME			
Average Retailer Revenue	13.15	14.45	14.61	16.03	7.42	7.58	7.68	9.1
% change		+9.9%	+1.1%	+9.7%		+2.2%	+1.3%	+18.6%
	Commission Draft Determination							
	Residential				SME			
Average Retailer Revenue	13.15[73]	13.48	13.48	13.48	7.42	7.35	7.35	7.35
% change		+2.5%	0	0		-0.9%	0	0

As outlined in Table 11.3, the Draft Determination on the maximum average retailer revenue in 2011/12 (expressed in $Dec11) is $13.48/GJ for residential customers and $7.35/GJ for SME customers, representing 2.5% increase and a 0.9% decrease in real terms respectively.

The manner in which prices will be developed, including discussion of the customer impact of this Draft Determination, is examined in Chapter 12.

[73] $13.15 is the smoothed average retailer revenue allowance for 2010/11 as opposed to the $12.67 unsmoothed average retailer revenue in Table 11.1

12 CUSTOMER IMPACT

The decisions made by the Commission in the 2011 Review of Gas Standing Contract Prices ultimately impact the gas retail tariffs charged by Origin Energy to its South Australian standing contract customers.

As noted, the gas standing contract is built up from two components: network and retail charges. The network component consists of Envestra's distribution tariffs and currently comprises approximately 54% of a typical residential bill. The retail component makes up the remaining 46% of a typical residential annual bill, and consists of Origin Energy's retailer tariffs which include the cost of energy and ROC.

This Chapter describes the estimated price impact of the Commission's Draft Determination on small customers in South Australia. Noting that the impact of the 1 July 2011 price change will depend on customers' consumption, the Commission has analysed the approximate effect of this determination on small customers based on the following steps:

- estimating the total standing contract annual bills (retail and distribution components) for residential customers with different levels of annual consumption (6GJ, 21GJ and 45GJ), and for an average small business customer consuming 150GJ annually.
- the calculations are based on the actual standing contract retail tariffs that applied from 1 July 2010 and those that will apply from 1 July 2011.
- All amounts are quoted GST exclusive in nominal terms.

12.1 Bill Impact Analysis

Table 12.1 shows the annual increases in standing contract prices for small customers under the Commission's Draft Price Determination, and incorporates both retailer and network charges. The distribution tariffs used by the Commission to calculate the network charges are based on those approved by the AER in its Draft Determination for Envestra's access arrangement proposal for the next regulatory period (1 July 2011 to 30 June 2016).[74] The Commission also notes that the retailer tariffs used in its analysis are exclusive of AEMO's market charges, which will be passed through to customers once they have been finalised by AEMO.[75]

The Commission stresses the bill impact analysis shown below is indicative only, and that the actual impact on small customers will depend on several other factors, such as their actual consumption profile, and their response to rising gas prices and initiatives undertaken by the Commonwealth and State governments (e.g. the South Australian

[74] AER's Draft Determination is available at the following website: http://www.aer.gov.au/content/index.phtml/itemId/743146.

[75] AEMO levies a charge on market participants to cover the costs of its operations. Information regarding those fees and charges is available at: http://www.aemo.com.au/registration/gasfees.html.

Government's REES). At the time the Commission makes its Final Price Determination in June 2011, it will prepare a set of actual standing contract tariffs to apply from 1 July 2011.

Table 12.1 - Indicative impact of the Commission's Draft Price Determination on annual gas bills (GST exclusive)

	2010/11 Bill ($)	2011/12 Bill ($)	Change ($)	Change (%)
Residential Customer - Low Usage (6GJ Annually)				
Origin Energy – Retail Component	$ 137.99	$ 142.51	$ 4.52	3.27%
Envestra – Distribution Component	$ 180.65	$ 216.68	$ 36.03	19.94%
Total	$ 318.64	$ 359.19	$ 40.55	12.72%

	2010/11 Bill ($)	2011/12 Bill ($)	Change ($)	Change (%)
Residential Customer - Medium Usage (21GJ Annually)				
Origin Energy – Retail Component	$ 274.91	$ 283.91	$ 9.00	3.27%
Envestra – Distribution Component	$ 331.22	$ 366.67	$ 35.45	10.70%
Total	$ 606.13	$ 650.58	$ 44.45	7.33%

	2010/11 Bill ($)	2011/12 Bill ($)	Change ($)	Change (%)
Residential Customer - High Usage (45GL Annually)				
Origin Energy – Retail Component	$ 485.27	$ 501.16	$ 15.88	3.27%
Envestra – Distribution Component	$ 456.02	$ 466.27	$ 10.25	2.25%
Total	$ 941.29	$ 967.42	$ 26.13	2.78%

	2010/11 Bill ($)	2011/12 Bill ($)	Change ($)	Change (%)
Small Business Customer - Medium Usage (150GJ Annually)				
Origin Energy – Retail Component	$ 1,111.03	$ 1,115.13	$ 4.10	0.37%
Envestra – Distribution Component	$ 1,546.30	$ 1,703.20	$ 156.90	10.15%
Total	$ 2,657.33	$ 2,818.33	$ 161.00	6.06%

In preparing the standing contract tariffs as part of the Final Price Determination, the Commission will be mindful of the SACOSS submission to the Commission's Issues Paper, which commented on the fact that fixed supply charges have been increasing at a rate that exceeds the increase in variable charges, which creates a higher cost burden on small users of gas.

In its proposal, Origin Energy has not proposed a set of gas standing contract tariffs, although it comments that it would apply similar principles in relation to tariff structure as it did in its 2008 submission, with cost reflectivity being a key driver.

A key consideration when the Commission makes its Final Determination in June 2011, will be whether or not the existing balance between fixed and variable charges remains appropriate. While relatively high fixed charges provide a degree of certainty to retailers over the amount of revenue that they will recover, they provide a weak signal to customers about the cost of energy consumption. The Commission believes that the need for appropriate price signals to customers is vital, particularly in an environment of increasing energy prices. The Commission intends to give significant weight to this principle when establishing the final gas standing contract prices.