2011 Gas Standing Contract Price Path Inquiry

Response to ESCOSA on Draft Inquiry Report and Draft Price Determination

PUBLIC SUBMISSION

May 2011

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Executive Summary

Origin submitted its proposed determination of prices for the sale and supply of natural gas to standing contract gas residential and small business customers in South Australia to the Essential Services Commission of South Australia (ESCOSA) on 19 October 2010.

ESCOSA released its *2011 Gas Standing Contract Price Path Inquiry: Draft Inquiry Report & Draft Price Determination* (draft report) on the 8 April 2011.

Origin has reviewed the draft report and is pleased that ESCOSA has to a large degree accepted Origin's proposed:

- change to annual gas costs over the period;
- load factors;
- demand forecasts for standing contract customers;
- inclusion of customer acquisition and retention costs (CARC) as part of total retail operating cost; and
- allowance for Residential Energy Efficiency Scheme (REES) compliance costs as a separate retail cost item for the 3 years of the determination.

However, ESCOSA has also determined that:

- there should be no allowance for any changes in gas costs due to LNG in 2013-14 and will require Origin to make a special circumstances application if gas prices change significantly;
- the initial base retail operating costs (excluding customer acquisition costs) should be assumed to be the same as allowed in the 2010 South Australia Electricity Standing Contract Price Determination ($78.41 per customer) and be adjusted by an efficiency factor of CPI-2 percent across years 2 and 3 of the determination;
- that customer acquisition costs should be determined on a dual fuel basis; and
- the current retail margin of 13 per cent in South Australia should be maintained.

Origin has serious concerns with this analysis and the resultant conclusions reached in the draft report.

With regard to wholesale gas costs, Origin does not believe that ESCOSA's treatment of Origin's proposed increase in gas costs in 2013-14 satisfactorily mitigates the potential impact on Origin of a change to LNG export pricing parity at that time. Origin requests that ESCOSA either:

- include a provision for forecast gas cost increases due to the movement to LNG export pricing parity. This was an option proposed by its consultants; or
- if no specific provision for LNG export pricing parity be included, it determine that increased wellhead costs post 1 January 2014 be a specific pass through event.

Furthermore, even if ESCOSA elects not to include the movement in wellhead costs for 2013-14 due to LNG export pricing parity, ESCOSA should increase the final gas cost for 2013-14 in-line with Origin's proposed gas volumes and as recommended by its consultants, SKM MMA.

Origin also requests that ESCOSA reconsiders its reduction in the allowance for lateral transmission pipeline costs and Origin has included in its confidential submission additional information on forecast volumes and historic costs to justify this requirement.

With regard to retail operating costs, Origin is most concerned that ESCOSA's recommendations on retail operating costs (ROC) do not give full recognition to the actual costs of supplying gas standing contract customers in South Australia.

First, Origin believes that ESCOSA should accept that a prudent retailer should be able to recover at least its actual base retail operating costs in supplying standard gas customers. The

methodology used by ESCOSA to assume that ROC be based on a benchmark from New South Wales standing electricity retailers that were combined network and retail companies needs be reviewed. Origin requests that a methodology based on Origin's actual costs or ESCOSA's previous findings on gas retail operating costs be used as the starting point.

Secondly, ESCOSA has not taken into account the inherent efficiencies that are already included in the total retail cost proposed by Origin. Origin provided actual cost data to ESCOSA which inherently includes efficiencies associated with the move to a single customer management system and dual fuel savings as the actual businesses' costs of servicing both single and dual fuel accounts are included in these average customer costs. Origin believes that ESCOSA's approach to then place additional efficiency requirements in years two and three of the period is inequitable and indefensible.

In effect, ESCOSA's decision is not providing recovery of efficient costs for a standard retailer and does not provide any incentives for retailers to invest or enter the market. Origin believes that ESCOSA should address costs based on a standalone retailer, an approach that has been widely adopted across jurisdictional pricing decisions and also acknowledge in this, the inherent productivity and efficiency gains that are already built into Origin's proposed future costs.

1. Introduction

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

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

For the purposes of section 34A(4a)(d)(ii) of the *Gas Act 1997* (the Act), Origin submitted its proposed determination of prices for the sale and supply of natural gas to standing contract gas residential and small business customers in South Australia to the Essential Services ESCOSA of South Australia (ESCOSA) on 19 October 2010.

In response, ESCOSA released its *2011 Gas Standing Contract Price Path Inquiry: Draft Inquiry Report & Draft Price Determination* (draft report) on the 8 April 2011 in conjunction with supporting documentation by its consultants, Sapere Consulting Group and SKM MMA. Origin has carefully reviewed the draft report and accompanying consultants' reports, both confidential and public, and this submission raises several issues with the assumptions, information and conclusions reached by ESCOSA.

This submission addresses each of the key elements in the draft report in turn:

- sections 2 and 3 reviews the demand forecasts, rebalancing controls and proposed pass-through provisions;
- sections 4 and 5 address the changes to Origin's proposed wholesale gas and transmission costs; and
- sections 6 and 7 discuss the changes to the allowed retail cost and margin.

1.1 Retail Competition in South Australia

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

> *(a) the long term interests of South Australian consumers with respect to the price, quality of 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) facilitate entry into relevant markets...*
>
> *(iii) ensure consumers benefit from competition and efficiency;*
>
> *(iv) facilitate maintenance of the financial viability of regulated industries and incentives for long term investment".*

Origin notes ESCOSA's view that no prudent retailer would choose to enter the gas only market while the opportunity exists to market dual fuel to every gas customer[1]. Therefore, retail costs should be considered on a dual fuel basis.

[1] ESCOSA, 2011 *Gas Standing Contract Price Inquiry, Draft Inquiry Report and Draft Price Determination*, April 2011, p74

Origin believes that this view is short sighted and the market has developed as it has as a result of regulated pricing of gas in South Australia. The reward: risk ratio for a gas customer is not appealing. Retailers are apprehensive to sign up gas customers to stand alone market contracts as the benefits of obtaining these customers is either negligible or quickly eroded if an error is made in the market. It is important to note that retailers typically use standing tariffs as the reference price for market contracts. If these prices are not reflective of costs nor provide some reward to the retailer in obtaining the customer, competition will continue to be impaired.

This is strongly supported by the Australian Energy Market Commission (AEMC) 2008 review of competition in the South Australian energy market that found that while there was a steady conversion of standing contract gas customers to market contracts, the retail margin was seen to be unattractive and competition would only increase if there was sufficient margin to account for changes in input costs[2].

Instead, ESCOSA has used the current situation to justify a view that gas standing contract prices should be set "*at a level to ensure that the dual fuel market remains competitive*"[3]. If ESCOSA continues with its draft report approach of costs that do not reflect actual retail costs or customer acquisition costs then retailers will not be attracted nor interested in offering dual fuel accounts. This is particularly true:

- given the margins and revenues from a gas account are comparatively low and a retailer will risk losing margin on its electricity account for the sake of minimal revenue on a gas account; and
- new retailers to either the dual fuel or standalone gas market being unable to obtain cost recovery for their initial set up cost nor their ongoing costs.

No regulator has taken the approach that competition for gas should be considered on a dual fuel basis as generally, regulators have recognised that competition in gas should develop in its own right. Cost reflective prices that recognise the risks of operating in the South Australian market will increase the number of retailers and bring greater price offerings to consumers. These price offerings will only increase as the number of retailers increase, but retailers are driven by the level of pay back.

Origin does not support ESCOSA's view that competition should be developed on a dual fuel basis and believes that the objectives of the South Australian and national markets is for competition to develop in each fuel source.

[2] AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia, First Final Report, September 2008.*

[3] ESCOSA, *2011 Gas Standing Contract Price Inquiry, Draft Inquiry Report and Draft Price Determination*, April 2011, p75.

2. Demand Forecasts

ESCOSA has accepted Origin's assumptions with regards to customer numbers and average consumption forecasts for both residential and small business customers. As noted by ESCOSA, estimating these elements is a difficult task for a 3 year period as it requires ESCOSA to project churn rates as well as the average level of consumption[4].

Although SKM MMA conducted an independent assessment and derived the view that average consumption data is unlikely to materially change over the next regulatory period[5], it should be noted that there is a declining trend in average consumption for residential customers in South Australia. This declining trend is supported by Envestra's recent forecast of consumption[6] as contained in it recent proposal to the Australian Energy Regulator (see Table 2.1: Envestra's forecast residential average consumption (GJ/annum)Table 2.1).

Table 2.1: Envestra's forecast residential average consumption (GJ/annum)

	2011-12	2012-13	2013-14	2014-15	2015-16
Envestra proposal	18.22	17.61	17.02	16.44	15.93

Envestra predicts that average consumption will continue to decline over the next 5 years which is predominately being driven by the installation of more efficient appliances such as hot water systems. These declines are significant given that according to Origin, average residential consumption was around 23GJ per annum at the start of the previous regulatory period and is currently around 20GJ per annum.

Origin submits that when ESCOSA is making its final determination, it should consider the impact that a trend to lower average consumption will have on a retailer's dollar per customer margin and level of retailer activity in the market.

[4] ESCOSA, *2011 Gas Standing Contract Price Inquiry, Draft Inquiry Report and Draft Price Determination, April 20*11, pA-43.
[5] Ibid pageA-44
[6] Australian Energy Regulator (AER), *Envestra Access Arrangements proposal for SA gas network*, February 2011, p183.

3. Form of Price Control

In considering the form of price control, it should be explicitly acknowledged that the current methodology places considerable risks on the retailers, particularly in the final year of the period. This is particularly true with wholesale gas costs and the potential impact that commissioning of LNG plants will have on Australian gas costs. The difficulty with recovering these additional costs in subsequent determinations and with a diminishing customer base is significant.

Origin notes that ESCOSA has determined that all elements of the price control framework should remain as previously determined. Broadly, these decisions are accepted by Origin however, Origin would comment on the rebalancing controls and the appropriate cost pass-through events.

3.1 Rebalancing Control

Origin did not propose any rebalancing controls but notes that ESCOSA has deemed that rebalancing controls should be set such that no customer charge under the retail tariff increases annually by more than CPI+2 per cent. While Origin continues to maintain that no rebalancing controls are required, it is content to accept a rebalancing control of 2 per cent around the final average price allowance determined in the final report.

However, Origin believes that ESCOSA needs to make clear in its final determination its intent that the rebalancing provision only relates to years 2 and 3 of the pricing period and will not be applied in 2011-12.

3.2 Cost Pass-through Provisions

In its draft report, ESCOSA has determined that the cost pass through provisions for the 2011 determination be the same as the previous 2008 determination. This being the categories of pass through provisions related to tax events, regulatory reset events and ministerial directions events. ESCOSA has rejected Origin's request, for a pass-through provision without a specified definition of events, claiming that there should be some degree of certainty over the types of events for which a pass through occurs[7].

Origin believes that pass through mechanisms are important as they provide a mechanism for retailers to recover their costs for events that are beyond their control and which have not been taken into account in determining the price path. Origin re-iterates that it believes that the cost pass-through categories are too narrow and do not encapsulate all the potential events that could occur over a three year period. This is especially true with the myriad of market reforms that are currently occurring at a national level.

In particular, Origin is concerned that the specific categories will not cover:

- changes to REES costs. Origin is supportive of the approach taken by ESCOSA in relation to future REES costs, however is uncertain how it would apply for cost pass-through if its actual costs vary given that it would not be a new event. Changes in REES costs due to regulatory requirements would fall under the provisions but changes to market conditions that increase costs would not be covered under the provisions; and
- a move to LNG export pricing parity. If ESCOSA does not recognise these gas costs for 2013-14 in its final decision then Origin will require the impact of LNG export pricing parity to be included as a specific category as discussed further in section 4.

[7] ESCOSA, *2011 Gas Standing Contract Price Inquiry, Draft Inquiry Report and Draft Price Determination, April 2011*, pA-51.

4. Wholesale Gas Costs

Origin's proposed wholesale cost of gas from 2011-12 to 2013-14 consisted of three separate cost elements:

- the annual contract quantity (ACQ);
- maximum daily quantity (MDQ); and
- the cost of carrying additional risks incurred through complying with the new short term trading market for gas.

Origin's response to ESCOSA's analysis of each of these elements in its draft report is discussed in turn below.

4.1 Annual Contract Quantity Costs

Origin is pleased to see that ESCOSA has largely accepted Origin's proposed gas volumes and wellhead costs in the draft report. The major exception being the proposed increase in ACQ costs in 2013-14 due to the price reviews and move to LNG Export Price Parity (EPP) expected at that time.

Upon advice from SKM MMA in its consultant report *Gas Standing Contract Customers: Review of Demand and Wholesale Costs*, ESCOSA has concluded 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.*[8]"

Origin accepts the difficulty that ESCOSA and SKM MMA have experienced in assessing the proposed price review increases. By their very nature, wellhead price increases are difficult to forecast and in tendering a forecast, Origin is at risk should the increase be higher than anticipated.

Within the next three years, the energy industry will be faced with significant wellhead price uncertainty associated with:

- the introduction of any carbon price;
- LNG export projects in central Queensland;
- increased gas production costs; and
- the implications of increased demand for gas fired electricity.

Origin's has focussed its concerns on how best to accommodate the expected move to EPP within this price period.

4.1.1 LNG Export Parity Pricing

SKM MMA advised in its report that there is uncertainty about the extent to which wellhead wholesale prices will move towards EPP in the southern states and the timing of such moves.

SKM MMA's report has proposed two alternatives. The first option (V1) excludes any additional LNG cost component from its forecast and provides for increased wellhead prices resulting from LNG EPP to be passed through in the current period under a special circumstances review. The second option (V2) specifically includes a forecast of additional EPP costs and removes the need for a special circumstances price review.

ESCOSA accepts option V1 in its draft report and has not included any specific amount in the final year of the price path to reflect the forecast increase in wholesale gas costs relating to a transition to EPP. ESCOSA has also concluded that provision for an increase in wholesale gas costs in 2014 via a specific Pass-through Event was not appropriate.

[8] ESCOSA, *2011 Gas Standing Contract Price Inquiry, Draft Inquiry Report and Draft Price Determination, April 2011*, p60.

In determining a cost recovery mechanism, ESCOSA has proposed that Origin may seek recovery of actual increased wholesale wellhead cost relating to a movement to LNG EPP via one of two options: a Reopening Event in the limited circumstance where the increase is considered a Special Circumstance under section 34A(4a)(f) of the ESC Act, or retrospectively in a future price path determination.

The criteria for a Reopening Event under section 34A(Aa)(f) are not clear and ESCOSA states in its draft report that it would only consider such an event if Origin's costs increased significantly. The nature of the clause and commentary suggests that ESCOSA will consider a materiality threshold in their decision of whether to trigger a Reopening Event. However, Origin is concerned there is no indication of what wellhead cost increase would or would not be considered material.

In conjunction with the uncertainty of the Reopening Event materiality threshold, Origin is concerned that ESCOSA is proposing that cost recovery associated with the current price determination period may be applied retrospectively to a future price determination period. Whilst this approach may be used effectively for a regulated monopoly asset such as network infrastructure, the same method is not appropriate in a competitive market. Attempting to levy prior period costs in a subsequent price path period would place Origin at a price disadvantage to competitors seeking to acquire new customer share. In this circumstance, the competitor providing an offer to a contestable customer may not have incurred a similar prior period cost with the likely outcome Origin would not be competitive and would not be able to recover legitimate costs.

Given these factors, Origin requests that ESCOSA either accept:

- the V2 option with its provision for forecast EPP cost increases; or
- the V1 case but include increased wellhead costs post 1 January 2014 as an explicit Pass-through Event to ensure gas prices reflect actual costs rather expecting future gas prices to recover costs in a retrospective manner.

4.1.2 Wellhead Volumes

In its analysis of the potential wellhead cost for 2013-14, SKA MMA has questioned the forecasted wellhead volumes by source as submitted by Origin for the 2013-14 financial year.

Origin can confirm that the modelling of wellhead volumes that were supplied during this regulatory process was constructed independently of this process. The forecast change in proposed volumes is due to a combination of demand and supply factors including the completion of the expanded QSN link from Wallumbilla to Moomba which allows for additional coal seam gas to flow through to the Southern states.

In its report SKM MMA has advised that it:

> *"If the first (V1) ACQ price recommendation proposed by SKM MMA is considered acceptable, then we consider it reasonable to allow a 2013-14 price of $4.24."*

In its draft report, ESCOSA has not accepted SKM MMA's recommendation on wellhead pricing in 2013-14 and has instead provided a constant wellhead price of $4.11. In the determination there is no discussion or justification for this approach and Origin is not able to adequately recover reasonable costs under this arrangement.

Origin has provided a confidential submission to ESCOSA which provides greater detail to support the increase in wellhead gas volumes in 2013-14. Origin requests that if the final decision for the wellhead gas cost for 2013-14 is to accept option V1 then ESCOSA reconsider its determination and use Origin's proposed volumes of $4.24 as the wellhead cost in 2013-14 as recommended by SKM MMA.

4.2 Maximum Daily Quantity Costs

In its draft report, ESCOSA has recommended a flat real MDQ price benchmark of $175/GJ over the period which represents a real increase of 16 per cent on the 2008 determination cost. There is evidence that MDQ rates have been increasing at a faster rate than CPI and the

16 per cent real increase over the last 3 years clearly confirms this as it equates to a 5 per cent real increase year on year.

Therefore, Origin believes that it is unreasonable to expect future MDQ market benchmarks to increase at CPI given the historic increase in costs.

ESCOSA's use of the public benchmark for MDQ cost of $175/GJ in 2011-12 is already a significant reduction to Origin observable and proposed MDQ cost in 2011-12. If ESCOSA is to use this public benchmark for 2011-12 then Origin would request that ESCOSA reconsiders its determination of the MDQ price path for the two remaining years.

Origin proposes that ESCOSA use an annualised average real increase rate of 5 per cent based on recent history. This would increase the benchmark MDQ cost but to levels significantly lower than Origin has forecast in its proposal.

4.3 Short-Term Trading Market (STTM)

In its proposal, Origin included an allowance in the gas costs for the STTM to account for the additional market volatility risks associated with imbalances, deviation and contingency gas. These costs were rejected by ESCOSA as they believed that Origin had not provided sufficient information to substantiate the claim. Further, ESCOSA supported SKM MMA's underlying principle that there is likely to a "zero sum gain" for gas retailers as a whole from participating in the market.

Origin maintains that there is a STTM cost to the business and Origin has provided additional information to ESCOSA on a confidential basis to support this claim.

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5. Transmission Costs

ESCOSA has assessed and primarily accepted Origin’s proposed transmission costs for the regulatory period in its draft report.

ESCOSA has however reduced the allowance for some lateral pipeline transmission costs because Origin’s claims were not fully supported with evidence.

Origin has provided additional details regarding these transmission costs in its confidential submission to ESCOSA.

6. Retail Costs

Origin's proposal for total retail costs included all retail operating costs (ROC) plus customer acquisition and retention costs (CARC) and was based on a prudent, new entrant retailer to encourage competition and thus greater price offerings to customers.

Origin's proposal for retail costs was to use the total South Australian 2010 electricity benchmark cost of $115 ($2010) per customer, excluding REES compliance costs, and to continue to adjust forward using a CPI percent approach to account for increasing operating costs, in particular, labour and wage costs.

Origin also proposed an adjustment for the Residential Energy Efficiency Scheme (REES) costs.

Table 6.1: Origin's proposed retail cost ($Dec 2011)

		2011-12	2012-13	2013-14
Retail Operating Cost	($/cust)	117.87	117.87	117.87
REES Costs	($/cust)	1.60		
Total Retail Cost	**($/cust)**	**119.47**	**117.87**	**117.87**

Origin proposed this benchmark cost with the full knowledge that the total cost would not be adequate to cover the retail operating cost for standing contract gas customers as well as the average business cost for acquiring gas customers. However, Origin recognised that this benchmark had been accepted for South Australian electricity customers and it would be inequitable to request a higher benchmark given the nature of energy retailing in South Australia.

Consequently, Origin is disappointed that ESCOSA's draft report with regard to retail operating cost for gas standing contract customers has decided that:

- an initial base ROC should be assumed to be $78.41 per customer, a 20 per cent reduction in operating cost from ESCOSA's previous decision;
- rather than incorporate an increase in ROC to take account of increasing annual costs, the base ROC should be adjusted by an efficiency factor of CPI-2 per cent across years two and three of the determination;
- although Origin's proposal to include customer acquisition costs be accepted, that customer acquisition costs should only be considered on the dual fuel basis; and
- the CARC allowance should be lower than the 2010 Electricity Standing Contract Price Determination to take into account this dual-fuel assumption.

Origin is very concerned that ESCOSA's recommendations on retail costs do not provide full recognition of the actual costs that a retailer would incur in supplying gas to standing contract customers in South Australia.

Of particular concern is the methodology adopted to determine the initial base ROC, the ongoing forward adjustment of ROC and the treatment of CARC on a dual fuel basis. Each of these issues is addressed in turn below.

6.1 Initial Base ROC Allowance

Origin is confused that ESCOSA would determine that a significant real reduction in operating costs is warranted for the next determination, particularly given:

- increasing labour and wage rates are significantly greater than CPI; and
- the smaller customer base to which to recover the fixed cost nature of retailing gas in South Australia.

As highlighted by ESCOSA, a ROC allowance should represent the cost that an efficient retailer would incur in meeting its responsibilities for supplying small gas customers in South

Australia[9]. ESCOSA further states that although benchmarking is more likely to be consistent with ESCOSA's statutory objectives, an assessment of ROC should be balanced with some consideration of Origin's actual operating costs.[10] Thus, in determining efficient operating costs, Origin understands ESCOSA has had specific regards to:

- interstate benchmarks for operating costs. This has been the main basis on which retail costs have been determined;
- an analysis of Origin's actual operating costs and projected changes to those costs; and
- an independent consultants report conducted by Sapere.

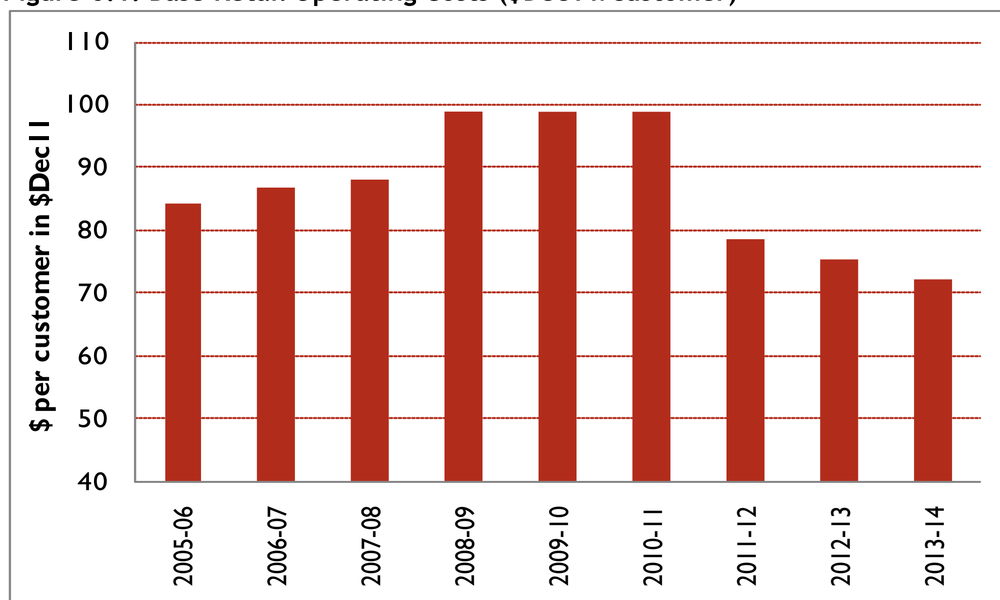
Origin is therefore perplexed with the assumptions ESCOSA and Sapere have made on the starting value for the base ROC. While Origin proposed a total benchmark, Origin did not make any inferences or recommendations to the breakdown of costs between base ROC and CARC.

ESCOSA has taken the view that the base ROC should be on the same basis as the South Australian 2010 electricity benchmark with the base ROC being $78.41 per customer for 2011-12. This ROC is significantly lower than:

- the current allowed ROC under the 2008 gas determination (ie approx. 20 per cent lower);
- the previous two determination allowances (see Figure 6.1);
- actual cost data provided by Origin; and
- benchmark ROC costs used in other jurisdictions for a competitive gas retailer.

Origin strongly refutes the methodology used to determine the base ROC for Origin as the standard gas retailer.

Figure 6.1: Base Retail Operating Costs ($Dec11/customer)



Comments on Origin's actual costs and the benchmark approach adopted by ESCOSA are provided below.

6.1.1 Origin's Actual Costs

Origin provided actual retail cost data to ESCOSA. This data showed that actual operating expenditure for mass market customers in South Australia is considerably higher than the

[9] ESCOSA, *2011 Gas Standing Contract Price Inquiry, Draft Inquiry Report and Draft Price Determination, April* 2011, p71.
[10] Ibid page74

dollar amount approved in the 2008 determination. ESCOSA's draft report acknowledges this fact by stating:

> *"it confirms that Origin Energy's operating costs (reported on a national basis) for 2009-10 are broadly comparable with the amount allowed by the Commission as part of its 2008 gas standing contract price determination"*[11].

Based on the actual data provided to ESCOSA, Origin queries how ESCOSA came to the conclusion that Origin would be seeking a lower base ROC than currently allowed and significantly below its actual costs.

The actual costs provided by Origin included a breakdown of base ROC and CARC. The percentage breakdown of these actual costs is on a different basis to the breakdown of the ESCOSA South Australian electricity cost benchmark. Origin notes that Sapere's report does not highlight that ESCOSA's 2008 allowance for retail operating cost was significantly higher nor provide reasoning as to why this should not be used as a starting point for its analysis.

Origin argues that, if any inferences are going to be drawn on the split-up between ROC and CARC then greater reference needs to be made on the actual data provided (where ROC is 80 per cent of total cost) or ESCOSA's previous decision on ROC (where ROC would be over 80 per cent of Origin's proposed total cost) rather than a breakdown of the 2010 South Australian electricity benchmark (where ROC is only 66 per cent of total retail cost).

6.1.2 Benchmark of ROC Costs

ESCOSA has relied on a benchmarking approach to determine an efficient ROC. As noted, benchmarking approaches have their own difficulties and ESCOSA has attempted to compare past regulatory decisions and other information by disaggregating total retail costs into base ROC and CARC. ESCOSA then utilises these breakdowns to determine an appropriate benchmark for South Australian standard gas customers.

ESCOSA has relied on the 2010 South Australian electricity benchmark for this determination. In assessing this benchmark, it is imperative to note that the South Australian electricity benchmark was adopted based on IPART's 2010 electricity pricing decision in New South Wales. Although IPART conducted a bottom-up analysis, industry voiced its concerns over the methodology used to determine the total ROC amount as well as the breakdown of costs including:

- the benchmark reflects the historical costs and processes of a Standard Retailer rather than a forecast of ongoing retail operating costs. Origin believes these costs are understated and do not take into account future costs nor future regulatory obligations that are relevant to the market;
- while the IPART bottom up analysis provided a range of cost estimates for both the retail operating costs and customer acquisition costs, it selected the mid-point in each range as the point estimate for the price calculations. This methodology is of significant concern to Origin and the business does not believe that this method is appropriate. It appears from each of the elements of the bottom-up analysis that IPART deemed to take a conservative view that the results were in a conservative range of costs. To then take the midpoint of the derived ranges therefore seems to introduce a clear statistical bias and is inappropriate for an assessment of retail costs. This was particularly concerning for Origin as the distribution or average of the cost data was not made available to stakeholders due to confidentiality concerns; and
- the analysis was inevitably subject to the variability and ring-fencing methodologies of the Standard Retailer's accounting systems and some cost sharing from an operational sense given the nature of the integrated retail and distribution network businesses that existed in New South Wales.

Frontier, in their 2007 review of New South Wales electricity retailer's costs, noted that there were "uncertainties" with relying on Standard Retailer data in New South Wales as:

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[11] ESCOSA, *2011 Gas Standing Contract Price Inquiry, Draft Inquiry Report and Draft Price Determination, April* 2011, p78

- economies of scope arise from spreading fixed costs over a wide range of functions and can be evident in functions related to customer information systems, billing and revenue collection in an integrated retail and distribution business[12]; and
- cost can be recovered over a wide range of activities leading to a lower average cost for an activity, such as retailing.

Frontier further noted in its review that the reported costs of a Standard Retailer in New South Wales were lower than those available to a standalone retailer.[13] They found that ROC may include savings from scope economies and therefore may understate the costs of a standalone retailer.

Although Origin agrees that there are economies of scope in retailing across electricity and gas, these economies of scope are limited in the current market framework. The rules and regulations around the gas market are different to that of electricity in both a billing and wholesale sense. That is, issuing of bills and meter reading requirements differ as well as the way in which the wholesale market operates. Although there is a move to a national framework, this will not occur before July 2012 and the exact economies of scope have not been fully determined as each jurisdiction has their own derogations from the framework.

Origin's concerns with relying on the New South Wales electricity breakdown of cost and then further reducing these amounts for South Australia gas is that these costs:

- are already understated and take into account efficiencies due to the cost sharing in these inter-related retail and distribution businesses;
- do not sufficiently recognise the retail cost impacts of known and/or probably changes in retail obligations associated with environmental schemes and changes to regulatory requirements (ie. national consumer protection framework); and
- retail operating costs are then taken as a mid-point which means that only the highest and lowest historic costs are taken into account.

The inherent problem in using a mid-point range is also evident for the benchmarking of the New South Wales Gas Standard Retailers. New South Wales retailers operate under a VTPA arrangement and IPART published a range of standard retailers operating costs which was between $86-$117 (for 2010-11 to 2012-13). The distribution of costs has not been assessed and ESCOSA has not recognised that the lower end of the range exclude CARC. Origin believes that the benchmarking of the mid-point range is misleading as to the true value of total ROC.

In AGL's application to ESCOSA for the 2010 Electricity Determination, they proposed a benchmark range which was in the lower-middle of the available benchmark and was similar to its actual costs[14]. AGL did not propose that the benchmark split be based on the New South Wales electricity benchmark range. AGL also did not suggest that the split between base ROC and CARC based on the New South Wales electricity benchmark was appropriate with the consultants, LEGC, noting that:

> *"We consider AGL's proposals for ROC and ROM, taken together, appear broadly reasonable and appropriate. While our estimates of efficient ROC and ROM diverge slightly from those proposed by AGL, our combined ROC and ROM recommendation is close to AGL's combined ROC and ROM proposal".*

Given the myriad of inherent problems and differences in market frameworks, Origin only proposed a total ROC based on benchmarks and not a breakdown in costs as proposed by ESCOSA. Origin does not believe that the breakdowns in costs are representative of the costs that a prudent gas retailer in South Australia would incur. The inherent issues with the New South Wales electricity benchmark appears to being repeated through South Australian pricing decisions.

[12] Frontier Economics Pty Ltd, *Mass market new entrant retail costs and retail margin - Public Report*, March 2007, p10.
[13] Ibid page 10.
[14] AGL, *Regulated Pricing Proposal 1 January 2011 to 30 June 2014,* 19 May 2010, p33.

Origin would also highlight the difficulties and issues with including the breakdown of retail costs from the QCA determinations in the benchmark. The QCA has never derived an independent estimate of ROC but simply adopted a benchmark from IPART in 2008.

If anything is to be made of the QCA determination as input into ESCOSA's process it would be consideration and comparison of the rate of change in retail operating costs. The QCA determinations have all indicated a rate of change consistent with the change in input costs such as labour that are greater than the change in retail operating costs ESCOSA has currently determined across the three year.

6.1.3 Summary of Origin's position on base ROC

Origin would urge ESCOSA to review the methodology used to determine the breakdown of base ROC and CARC to take into account the real costs that Origin incurs as a gas retailer and to take into account the total ROC that other Regulators have deemed to be efficient for electricity and gas retailers. Typically, allowed ROC (especially operating expenditure) for a gas retailer have been higher than that of an electricity retailer given the smaller customer base to recover the costs, additional risks and variations in market rules in the gas market.

Although there are inherent problems and issues with determining appropriate base ROC and CARC benchmarks, Origin believes that if ESCOSA must breakdown the total operating cost then more appropriate starting points should be used (ie. previous ROC allowances for South Australian gas or Origin's actual costs). However, if the total of Origin's actual costs is similar to benchmarks, then it seems reasonable to adopt a total ROC approach.

Origin considers that ESCOSA should increase the ROC allowance in the draft determination:

- to recognise Origin's actual cost structure in relation to base ROC; and
- recognise real increases in labour costs that are being incurred, but not taken into account in the ROC determination.

6.2 Forecast Changes in base ROC

The Origin price path proposal included no real change in retail operating cost per annum. This was despite retail cost pressures, including the significant increases in labour and wage rates.

The ESCOSA draft report has reduced the rate of change in retail operating cost to CPI-2 per cent in the second and third years of the determination given its' attempt to allow for future benefits that could arise from the consolidation of retailing systems. ESCOSA has taken the view that there should be a 50:50 sharing ratio of benefits from the implementation of a new billing and customer management platform which Origin intends to implement later in 2011. ESCOSA notes that other retailers, such as AGL, have implemented similar systems.

AGL's experience with the implementation of a new customer management system in 2008-09 was not favourable with costs increasing substantially in the short term. AGL stated that in the half year to 31 December 2009, net operating costs per customer increased by 19 per cent over the previous corresponding period to maintain low unbilled levels, cover increased bad debts and spending on retention and acquisition activities[15]. Costs rise due to additional labour costs, temporary establishment of call centres and system exception consultants to manage any teething problems.

Origin accepts that if there are cost savings from future billing projects, then the benefits should be accounted for in the retail operating cost and a CPI minus factor would be reasonable. However, ESCOSA has failed to recognise that there are unlikely to be efficiency gains in this determination period and there are inherent efficiencies included in the businesses actual cost data provided as well as the benchmark ranges. Benchmark costs have efficiencies as they are based on a prudent retailer and not a standard retailers actual cost.

The actual data Origin provided to ESCOSA included forecast cost savings associated with retail transformation and the implementation of the new customer management system[16].

[15] AGL, *Regulated Pricing Proposal 1 January 2011 to 30 June 2014,* 19 May 2010, p32.
[16] Origin provided this confirmation to ESCOSA in an email dated 31 January 2011.

Even with these cost savings included, it is forecast that Origin's operating costs will remain fairly constant over the next 3 years. Origin believes that in adopting the total ROC based on the South Australian electricity benchmark, Origin has in fact taken a conservative approach to costs and places pressure on the business to reduce costs to the benchmark level.

In determining the base change in ROC, it also appears ESCOSA has taken the view that a large number of retailers will have integrated billing and customer management systems. Origin does not believe this is the case in the short to medium term. Although retailers are offering dual fuel products, there are still a large number of retailers who may not have fully integrated back office systems and thus they are incurring costs as though they are separate suppliers. Differences in metering and billing processes between the two fuels will further limit integration support. In determining these costs, Origin understands that these costs should be based on a prudent retailer. Origin's reading of the draft report seems to suggest that ESCOSA has diverged from this and is looking at well established, large standard retailers.

Further, Origin wishes to point out that the low case bands determined for the South Australian 2010 electricity determination does not include an efficiency factor. If ESCOSA believed that this was a necessary element, one would have thought that it would have been taken into consideration in determining the bands.

Origin is concerned with the approach adopted by ESCOSA in this regard. It requires retailers to assume the large majority of the risk on benefits eventuating when it is uncertain the extent to which the benefits will be realised. Such an approach removes the incentives to seek out cost savings as if savings are taken away – there is no incentive to try to reduce costs.

Therefore, if efficiency factors are to be used by ESCOSA then there is obviously no mitigation being provided for increasing cost impact due to labour or wages and Origin would request that ESCOSA revise the retail operating cost for the period to account for this.

6.3 CARC Allowance

Origin supports ESCOSA's approach of the inclusion of CARC within retail operating costs as it is necessary in order to ensure the competitive functioning of the gas retail market. However, the approach adopted by ESCOSA to consider CARC on an incremental duel fuel basis does not appear reasonable nor align with the practices of regulating energy prices around Australia.

Origin did not propose an actual customer acquisition allowance but a total retail operating costs aligned to the 2010 South Australian electricity determination. Origin believed that proposing the same benchmark would prevent the need for ESCOSA to conduct a detailed, forensic analysis of Origin's actual costs. Origin believes there are innate efficiencies already included in proposed benchmark as it is lower than actual costs, as provided to ESCOSA, and already includes cost efficiencies associated with dual fuel accounts.

Origin wishes to point out that in making a pricing determination for standing gas customers, ESCOSA is required to have regard to specific objectives as set out in the *Essential Services Commission Act 2002* (ESC Act) such as to:

> *"promote competitive and fair market conduct, facilitate entry into relevant markets* and *ensure customers benefit from competition…"*.[17]

To take the view that there is no future in a gas standalone business and thus prices should not be set taking into account a prudent retailers true costs goes against the objectives of the market and provides for a short sighted view as to the future of gas as a single fuel source.

Origin understands that ESCOSA has adopted these views based on submissions and evidence provided by The Minister for Energy and SACOSS. It is Origin's view that too much weight has been placed on these submissions.

For example, SACOSS notes that a recent study showed that 63 per cent of accounts are dual fuel with the same retailer. What is not acknowledged is that small samples of 600 individuals were used to derive this percentage. Origin's believes 36 per cent of gas customers nationally have a dual fuel account with the percentage of dual fuel accounts being only slightly higher

[17] Section 6, *Essential Services Commissions Act 2002 (South Australia)*.

in the South Australian market. Origin believes these lower percentages do not warrant costs being determined on a dual fuel basis.

Origin accepts the Minister's comments that competition is most prevalent in the electricity only market and dual fuel market. However, Origin would argue, that competition in recent years in the South Australian gas market has slowed as a consequence of regulated gas pricing. Limited retail margins in the gas market have meant the risks outweigh the benefits of targeting gas customers and retailers have solely used dual fuel offers to acquire gas customers. Origin believes that recovery of cost reflective costs and sufficient margin will develop gas into a single fuel target in its own right.

No energy regulator, at a state or national level, considers regulated pricing for energy on a dual fuel or total energy basis. Prices for each fuel source are determined on a standalone basis with the majority of Regulators determining prices based on a new entrant scenario. Origin believes that the South Australian regulated gas market should be treated no differently to other energy markets.

Furthermore, Origin does not accept that CARC should be determined on a dual fuel basis as there are still a considerable proportion of customers whereby the gas account churns in isolation to the electricity account. Origin has provided some confidential data to ESCOSA to support this claim and the business believes that ESCOSA should take this into account when determining the CARC level.

Origin believes that if ESCOSA was to pursue this approach of determining CARC on a dual fuel basis, it would have a negative impact on investment in the gas industry for South Australian small customers. In a national integrated gas market, gas retailers will seek markets where they can find best value, and if risks are high and returns are low, their willingness to supply gas customers, even on a dual fuel basis, in the South Australian market will decline. While Origin will continue to supply small customers, the effects will more quickly be felt on new entrants' willingness to offer gas contracts (the standard contract price acting as the upper benchmark, or price to beat, for competing retailers) and thus customer's ability to receive price benefits.

6.4 REES Cost

Origin accepts the approach and position taken by ESCOSA in terms of the treatment of REES costs. However, Origin requires some certainty that the business will be able to make an application for price variation if our actual costs go above those allowed in the 2011 determination.

Origin's concerns stem from the definitions of cost pass through items. The pass-through items refer to a "regulatory reset event" or "Ministerial direction event". The pass-through categories do not appear to cover off the situation where there is a change in market circumstances and the costs of completing activities to comply with the scheme increases (ie. have to move to higher cost activities as lower cost activities are at saturation point in the market).

Further clarity is required on how Origin apply for a pass through if there has been no change in a regulatory instrument or no Ministerial direction.

7. Retail Margin

Origin proposed a retail margin on controllable costs of 13 per cent in the first year of the determination transitioning to a benchmark margin of 14.6 per cent in 2012-13 and 2013-14. Origin proposed this based on the ongoing obligations for prepayment of network charges to Envestra and taking into account the additional risks faced by gas retailers. Origin proposed a transition to a cost reflective margin given the impact that the inclusion of customer acquisition costs in total retail costs would have on standard contract tariffs in the first year of the determination.

Origin considers ESCOSA's draft retail margin allowance of 13 percent of controllable costs to be inadequate to cover a retail businesses risk of operating in the South Australian gas market.

In particular, ESCOSA has ignored Origin's examination of the retail margin benchmarked to the dollar gross margin per customer. Origin wishes to highlight that businesses are more frequently referring to the gross margin expressed as a dollar per customer rather than an on a rate of return basis. This is because for the majority of new entrants, required gross margin is fixed and only a smaller number of elements of the required gross margin are related to the size of the customer's bill (ie. discount to acquire, bad debts, working capital). Therefore, setting a retail margin based on variability in consumption, with no reference to the cost base, may lead to a retailer being unable to cover its' fixed costs in the market.

Further Origin does not believe ESCOSA has provided Origin with an adequate explanation as to why a margin of 14.6 percent is not justified in years two and three of the determination. It should be noted that 14.6 percent is the low end of the range for New South Wales gas retailers. IPART did a detailed investigation into margins and determined that a combination of ranges using an expected returns and benchmarking approach were most relevant.

The New South Wales IPART gas decision concluded that that the retail margin for gas should be set higher than that allowed for electricity. This is based on the greater risks associated with being a gas retailer including:

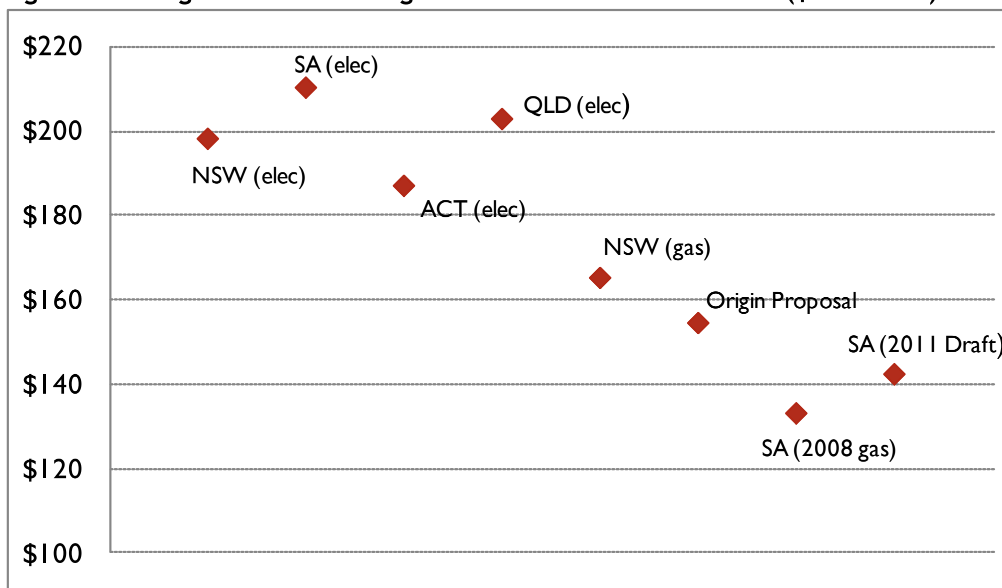
- those related to the higher fixed cost nature of gas retailing;
- variations in demand;
- greater working capital requirements; and
- that annual gas expenditure per customer is typically lower than electricity[18].

Origin submits a retail margin of 13 percent results in the gross margin for a South Australian gas retailer being below that of New South Wales gas retailers for both residential and small business customers. Origin believes the use of gross margin benchmarking is a useful way to verify costs and estimate customer profit given the number of different variables (i.e. size of the customer) in each of the jurisdictions.

As highlighted previously in Origin's proposal, the figure below shows the results of an analysis of gross margins for residential customers in each of the jurisdictions based on the dollar margin of average retail revenue plus retail costs.

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

Figure 7.1: Regulated Gross Margins for Residential Customers ($Dec 2011)



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

Quite simply, Origin does not believe that the ESCOSA decision on retail margin is defensible and it should take into account:

- that the relevant interstate benchmark margin is New South Wales which would support a higher margin than being allowed;
- the limited value of the retail margin in terms of $ per customer; and
- that if ESCOSA was to continue with an efficiency factor, the 50:50 sharing of benefits of Origin's operating cost project requires Origin to assume all risks of project delivery.

Origin believes that a retail margin of 14.6 per cent of controllable costs would be an appropriate margin that reflects the risks of operating in the South Australian gas market. Retailer's risks, especially in terms of consumption risk have increased since the 2008 determination and thus a higher margin is warranted.

Origin believes the margin needs to be set to encourage business efficiencies, new entrants, less reliance on regulated prices and thus competition in the gas market.

8. Customer Impacts

Origin notes SACOSS's concerns over the fixed supply charge element of the standard tariffs and the fact that this has increased over the years[19].

It is widely known that there is a large fixed cost component to the selling and supplying of electricity and gas in Australia in both the transmission and distribution network charges as well as retail operating costs. In the retail market for gas there are the additional fixed costs that arise due to contracting nature of obtaining a fixed gas supply.

A retailer's ability to recover these fixed costs is reliant on pricing structures, customer numbers and consumption. If customer numbers and/or consumption fall, a retailer needs to recover a greater proportion of its fixed costs through the fixed charge component of the pricing structure.

Origin submits that increases in the fixed retail gas charge over recent years have largely been as a result of:

- the network tariff structures and the fact that the networks are designing tariffs with a higher fixed charge component. The Australian Energy Regulator (AER) have placed no constraints on the setting of the tariff components with Envestra recovering a higher proportion of its costs through the fixed network component; and
- customer numbers and average consumption have been declining and are expected to continue to decline in future years. This decline in average consumption is more pronounced in Envestra's forecasts of average consumption over the next 5 years than Origin's forecasts. Falling customer numbers and consumption have a greater impact on Origin's ability to recover the fixed cost nature of retailing.

It should be noted that the indicative customer bill impacts published by ESCOSA in its draft report clearly show that the large increases in the total bill are related to network tariff increases rather than retail costs. A medium residential consumer will only experience an increase of approximately $9 in retail costs, but over $35 in network costs[20].

When setting the fixed charge, retailers are setting them in a manner to recover both network charges and the fixed retail components and this large increase in network tariff will need to be passed through effectively.

[19] ESCOSA, *2011 Gas Standing Contract Price Inquiry, Draft Inquiry Report and Draft Price Determination, April 20*11, p A-99
[20] Ibid page A-98