2011 GAS STANDING CONTRACT PRICE PATH INQUIRY

FINAL INQUIRY REPORT & FINAL PRICE DETERMINATION

June 2011

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TABLE OF CONTENTS

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
COMMISSION	Essential Services Commission of South Australia
CPI	Consumer Price Index
CPRS	Carbon Pollution Reduction Scheme
CSG	Coal Seam Gas
CSV	Council on the Ageing – Seniors Voice
EBITDA	Earnings before Interest, Tax, Depreciation and Amortisation
ENVESTRA	Envestra Limited
EPIC	Epic Energy
EPP	Export Price Parity
ERC	Energy Retail Code
ESAA	Energy Supply Association of Australia
ESC ACT	Essential Services Commission Act 2002
FRC	Full Retail Competition
GAS ACT	Gas Act 1997
GJ	Gigajoule
GSOO	Gas Statement of Opportunities
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
MOS	Market Operating Service
NEM	National Electricity Market
ORIGIN ENERGY	Origin Energy Retail Ltd
QCA	Queensland Competition Authority
QSN	Queensland to South Australia/New South Wales (pipeline)
REES	Residential Energy Efficiency Scheme
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

EXECUTIVE SUMMARY

Background

The Essential Services Commission of South Australia (the Commission) has undertaken 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, though these are often set with reference to the standing contract price.

This report presents the final conclusions of the Commission's Inquiry. Accompanying this Final Inquiry Report is a Final Price Determination, which is the legal instrument that gives 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 nine retailers that compete with the incumbent electricity standing contract retailer, AGL South Australia, for electricity customers in South Australia.

Competition in the gas retail market has, however, evolved in a different way to competition in the electricity retail market. As has been the case since 2005, there are currently only three 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 also 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 electricity generation market, which provides an opportunity for diversification of their gas sales portfolio between generation and other uses 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, unless there is a sustainable change in the SA gas market dynamics, going forward 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 was based on establishing a price that would provide for new entry to the gas retail market on a stand-alone basis.

Consultation Process

During this Inquiry, the Commission has undertaken various phases of public consultation, including consultation on the Origin Energy proposal, as well as the Commission's Draft Inquiry Report, which was released in April 2011. The Commission has considered all submissions received to the Inquiry, and has taken advice from independent experts on key elements of the review.

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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)

Determining the costs of gas retailing

The Commission's dual-fuel approach has implications for the manner in which it examines Retail Operating Costs (ROC). The Commission's Final Determination 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 $118.83[2] per customer. Whilst Origin Energy's proposal did not split ROC between base-ROC and CARC, the Commission, supported by advice from its consultants, analysed Origin Energy's proposed ROC based on a split of costs consistent with the previous Electricity Standing Contract Price Determination.

The Commission determined a CARC allowance of $39.78 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 Final Determination is $26.37 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 Final Determination base-ROC (ROC excluding CARC), declines from $79.05 per customer in 2011/12 to $75.92 per customer in 2013/04. The Commission has also allowed an additional $2.62 per customer to reflect the costs associated with 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

[2] $Dec11. Note: all financials quoted in this document are at $Dec11, inflated where necessary using the ABS average of eight capital cities CPI indices, and the Commission's nine month lag methodology (i.e. Mar10-Mar11 used as a proxy for Dec10-Dec11)

of a cost pass-through event during the price path period, should Origin Energy be able to demonstrate that the costs of complying with REES 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 Final Determination incorporates wholesale gas costs of approximately $5.09/GJ for residential customers and $4.59/GJ for Small and Medium Enterprise (SME) customers (the difference between the two relates to the increased requirement for peak gas for residential customers). These allowances are around 6% and 3% 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 Final 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 Final Determination sets a residential transmission cost of approximately $1.91/GJ and an SME transmission cost of approximately $1.32/GJ. The difference between the two costs relates to the different load factors for residential and SME customers, which impacts on the 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. The ROM of 13% 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 final findings on the controllable costs to be reflected in gas standing contract prices are summarised below.

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

	FINAL DETERMINATION: RESIDENTIAL				FINAL DETERMINATION: SME			
	2010/11[3]	**2011/12**	**2012/13**	**2013/14**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Cost of Gas	4.91	5.10	5.08	5.08	4.54	4.60	4.58	4.58
Transmission Cost	1.85	1.93	1.90	1.91	1.33	1.32	1.30	1.32
ROC	4.42	5.22	5.15	5.07	0.63	0.73	0.72	0.71
ROM (13%)	1.45	1.59	1.58	1.57	0.85	0.86	0.86	0.86
Total Retail Cost	**12.77[4]**	**13.84**	**13.71**	**13.63**	**7.35**	**7.51**	**7.46**	**7.47**

Note: the above table may not total due to roundings

Impacts of this Final Determination

The Commission has converted its Final Determination on controllable costs over the three year period into a residential and SME price path, expressed as an average revenue ($/GJ). The Final Determination on the maximum average retailer revenue in 2011/12 is $13.74/GJ for residential customers and $7.48/GJ for SME customers, representing a 3.7% real increase and no change in real terms respectively.

The increase in the residential retailer average revenue is driven by various factors, including the Commission's decision on load factors (which impacts on wholesale gas costs and transmission costs) and the inclusion of an explicit allowance for CARC within retail operating costs, albeit that the CARC has been determined on a dual-fuel basis.

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

[4] Includes a REES pass through of $0.13 / GJ

In 2012/13 and 2013/14, the Commission's Final Determination will 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 final price path (nominal price changes)

	1 JUL 11	1 JUL 12	1 JUL 13
Residential Customers			
Origin Energy's Proposal	**CPI+9.9%**	**CPI+1.1%**	**CPI+9.7%**
Commission's final price path	**CPI+3.7%**	**CPI**	**CPI**
SME customers			
Origin Energy's Proposal	**CPI+2.2%**	**CPI+1.3%**	**CPI+18.6%**
Commission's final price path	**CPI**	**CPI**	**CPI**

The Commission's Final Determination to increase gas standing contract prices for 2011/12 will add approximately $18 to an average annual residential bill (around 3%), on the basis that a uniform increase is applied across all tariff components.

It should be noted that this increase applies only to the retail component (approximately 45% of an average residential bill). The remainder of gas standing contract charges, covering the costs of gas distribution, is separately regulated by the Australian Energy Regulator (AER).

Whilst the revised prices were due to take effect from 1 July 2011, the Commission has decided to defer the price changes by one calendar month; this delay allowed the Commission additional time to further consider this Final Determination. For this reason, the current (2010/11) prices will endure across July 2011, with price changes taking effect from 1 August 2011. An adjustment has been made to the final 2011/12 prices to ensure that Origin Energy is able to recover the required total revenue by 30 June 2012.

The Commission notes that there are a significant number of dual-fuel market contract offers available to small customers that are priced below the standing contract price, and the Commission encourages customers to take advantage of the price discounts that are available.

PART A
- FINAL INQUIRY REPORT -

1 INTRODUCTION

Under the provisions of section 34A of the *Gas Act 1997* (Gas Act), Origin Energy Retail Ltd (Origin Energy) is required, as a declared standing contract retailer, to offer to sell and supply gas to any small gas customer (that is, persons using less than 1 terajoule (TJ) of gas per annum[5]), whether a residential or a business customer, on request.[6]

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 (Commission) under Part C of the Energy Retail Code[7] (ERC) and at the price fixed by the Commission under the Gas Act.[8]

This Final Price Determination and Final Inquiry Report deals with the second of those matters, the appropriate price for the Commission to fix for the sale and supply of natural gas by Origin Energy, under standing contracts, for the period 1 July 2011 to 30 June 2014.[9]

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* (ESC Act).

Those Acts require that the price fixing process may generally[10] 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.[11] 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.

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5 Regulation 8E Gas Regulations 1997

6 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.

7 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

8 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.

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

10 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.

11 Section 34A(4a)(d)(ii) Gas 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 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.[12] The Commission's first such Gas Standing Contract Price Determination covered the period July 2005 – June 2008.[13]

On 5 November 2010, the Commission received a submission from Origin Energy for the gas standing contract price to apply during the period July 2011 – June 2014. A public version of this submission is available on the Commission's website.[14]

Following receipt of the Origin Energy pricing proposal, the Commission released a public version of the proposal and an accompanying Issues Paper in November 2010.[15] 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:[16]

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

Having regard to the Origin Energy proposal and submissions to the Issues Paper, the Commission issued a Draft Inquiry Report and Draft Price Determination in April 2011.[17]

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12 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

13 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

14 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 - http://www.escosa.sa.gov.au/projects/160/2010-gas-standing-contract-price-path-inquiry.aspx

15 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).

16 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.

17 The Draft Inquiry Report and Draft Price Determination is available on the Commission's website at http://www.escosa.sa.gov.au/projects/160/2011-gas-standing-contract-price-path-inquiry.aspx#stage-list=2.

Consultation on the Draft Inquiry Report and Draft Price Determination closed on 9 May 2011, and the Commission received five submissions, from the following stakeholders:

- AGL SA;
- Council on the Ageing – Seniors Voice (CSV);
- Energy Supply Association of Australia (ESAA);
- Origin Energy (public and confidential versions provided); and
- South Australia Council of Social Service (SACOSS).[18]

The Commission appreciates the effort made by these stakeholders in preparing submissions, and the Commission has taken each of the submissions into account in developing this Final Inquiry Report and Final 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.

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.

[18] All public submissions are available on the Commission's website at http://www.escosa.sa.gov.au/projects/160/2011-gas-standing-contract-price-path-inquiry.aspx#stage-list=3.

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 and Mt. Gambier.

1.1.3 Distribution

Once the gas is transported by the transmission pipeline to a gate station, it feeds into the distribution pipe network.[19] The distribution pipe network transports the gas to end-users such as 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 distribution network in South Australia is owned by Envestra Ltd (Envestra).

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).[20] 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 gas 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 gas purchase (with gas producers such as Santos), transmission (with Epic or SEAGas) and distribution (with Envestra) of gas. The wholesale gas price and terms and conditions of supply are governed by these agreements.

1.1.5 Retail gas prices

On 28 July 2004, full retail competition (FRC) was introduced into the South Australian gas market. Prior to that date, while retailers other than Origin Energy

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19 Gate stations link transmission pipelines and distribution pipelines.

20 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.

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 other than Origin Energy have been able to compete to sell gas to all customers and increasing levels of competition have been observed in the market.[21]

As competition continued 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.[22]

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.
- South Australian small gas customers have low annual gas consumption relative to some 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.

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

22 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.

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 rejected the AEMC's advice, stating that the SA Government 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.[23]

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 the Australian Energy Market Operator (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 acquiring wholesale gas, either through contracts with gas producers or from their own upstream gas production facilities. However, given the uncertainty of customers' actual demands, there will always be imbalances between a retailer's purchases and sales: this requires a balancing service to match actual supply and demand for every retailer on a daily basis. In 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.

23 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

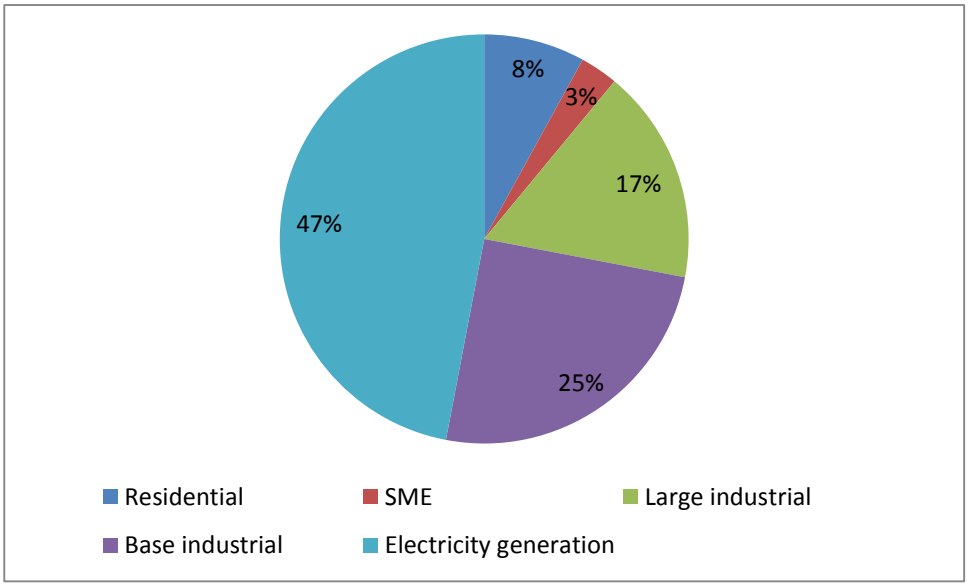
The STTM, which commenced operation on 1 September 2010, is a wholesale market designed to facilitate gas balancing by allowing for the purchase and sale of gas at market-based prices that are set daily. Prices are set for each "hub" of the market, which comprise Adelaide and Sydney initially, although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

1.1.8 Annual consumption

As shown in Figure 1-1, gas fired electricity generators and industrial customers 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, and currently comprise only approximately 11% of total gas consumption. 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.[24]

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 2010, 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.

[24] 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.

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 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.

1.3 Legislative Framework

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

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

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

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

(d) specifying pricing policies or principles;

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

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

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

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

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

1.4 Factors to consider in making the 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[25])

1.4.1 Factors specified in Part 2 of the ESC Act

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

Section 5(1)(a) specifies that one such function is to "regulate prices and perform licensing and other functions under relevant industry regulation Acts".[26]

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

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

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

(i) promote competitive and fair market conduct;

(ii) prevent misuse of monopoly or market power;

(iii) facilitate entry into relevant markets;

(iv) promote economic efficiency;

(v) ensure consumers benefit from competition and efficiency;

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

(vii) promote consistency in regulation with other jurisdictions.

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25 Section 25(6) ESC Act

26 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.

1.4.2 Factors specified in Part 3 of the ESC Act

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

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

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

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

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

(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.

1.4.3 Factors specified in the Gas Act

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

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

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

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

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

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

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

In addition, section 33(2) of the Gas Act provides that the Minister may, by notice published in the Gazette, direct the Commission about certain matters 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.

1.4.4 Other factors

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

1.5 Establishing a Retail Gas Price Path

Section 34A of the Gas Act provides a scheme under which the Commission will exercise its power to make a determination regulating prices, conditions relating to prices and price-fixing factors for the sale and supply of gas to small customers.[27] In particular, section 34A(4a) provides that:

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

[27] Section 33(1) Gas Act

(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 2010 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.

1.6 Approach adopted by the Commission

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

- independently checked Origin Energy's customer, peak demand and consumption data;
- assessed the estimated wholesale gas costs and transmission charges and the allocation between customer groups, to determine the appropriate charge to small customers;
- reviewed and set appropriate allowances for retail operating costs (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 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 Final 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 Final Determination.

2 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 73%) 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.

2.1 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.

2.1.1 Customer Switching

Figure 2-1 shows the number of small customer transfers between retailers in South Australia since the commencement of FRC in July 2004.[28] It can be observed that the competitive gas market offers experienced a quick take-up after FRC commencement, with switching levels peaking at around 28% in December 2004. The rate of switching has however since declined significantly, fluctuating between 9% and 13% since March 2008.

Figure 2-1 also shows, for comparative purposes, small customer transfers in the South Australian electricity market. It can be observed that there is a strong historical relationship between the level of electricity and gas transfers in South Australia. This is due to the fact that gas retailers operating in South Australia typically employ a dual-fuel marketing strategy to encourage customers to switch to a market contract. A survey of retailers conducted by ACIL Tasman Pty Ltd (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.[29] 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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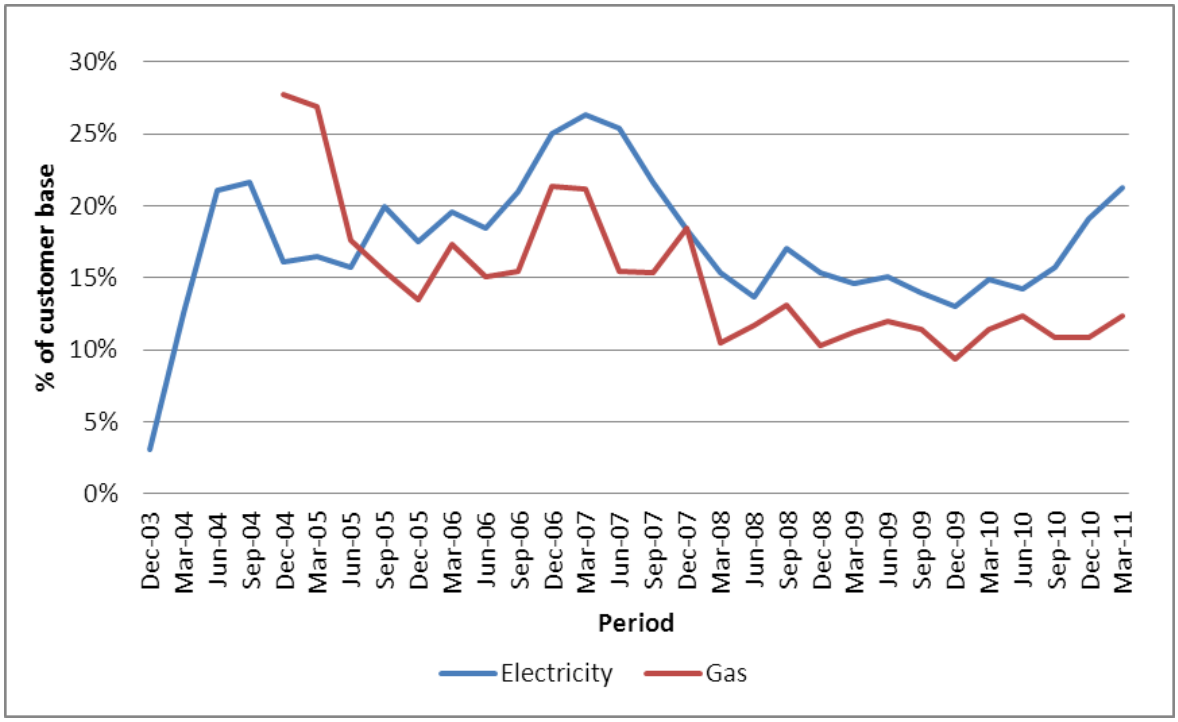
28 AEMO data includes all transfers occurring in the South Australian gas market, capturing both initial transfers to market contracts and subsequent transfers as a result of customers either changing gas retailers, or customers changing physical locations. It does not, however, capture small customers transfer from an Origin Energy's standing contract to an Origin Energy's market contract.

29 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 2-1 - Small Customer Market Switching Rate (Annualised from quarterly data)



Source: Based on customer transfer data supplied by AEMO

The Commission notes that both the electricity and gas churn rates have increased in the quarter to March 2011, reflecting an increase in marketing activity following the revised electricity standing contract prices from 1 January 2011.

2.1.2 Number of Gas Retailers

As at 31 March 2011, there were ten retailers licensed to sell gas in South Australia, nine of which were also licensed to sell electricity (refer Table 2-1). The only exception is Santos Direct which, to date, has targeted only to a limited number of high consumption gas customers. As has been the case since 2005, only four of the licensed gas retailers (AGL SA, Origin Energy, TRUenergy and Simply Energy) are selling to small gas customers in South Australia. Of those four 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 electricity generation and gas production).

Table 2-1 - Retailers licensed to operate in the South Australian energy supply industry (as at 31 May 2011)

RETAILER	ELECTRICITY		GAS	
	CURRENTLY LICENSED	SELLING TO SMALL CUSTOMERS	CURRENTLY LICENSED	SELLING TO SMALL CUSTOMERS
AGL SA	✓	✓	✓	✓
AGL Sales	✓	×	×	×
AGL Sales (Qld Electricity)	✓	×	×	×
Aurora Energy	✓	✓	×	×
Australian Power & Gas	✓	×	✓	×
Cogent Energy	✓	×	×	×
Country Energy	✓	✓	×	×
Diamond Energy	✓	✓	×	×
Dodo Power & Gas	✓	×	✓	×
EnergyAustralia	✓	×	✓	×
ERM Power Retail	✓	×	×	×
Flinders Power	✓	×	×	×
Lumo Energy	✓	✓	✓	×
Momentum Energy	✓	✓	✓	×
Origin Energy	✓	✓	✓	✓
Powerdirect	✓	✓	×	×
Red Energy	✓	✓	×	×
Sanctuary Energy	✓	×	×	×
Santos Direct	×	×	✓	×
Simply Energy	✓	✓	✓	✓
TRUenergy	✓	✓	✓	✓
TrustPower Australia Holdings	✓	×	×	×
Current Total	**21**	**11**	**10**	**4**

2.1.3 Market Shares

As at the end of March quarter 2011, Origin Energy continued to hold the largest share of the small customer gas retail market in South Australia, with a total of 53% of small customers (27% on standing contracts and 26% on market contracts). The second largest market share is held by AGL SA (Figure 2-2).[30]

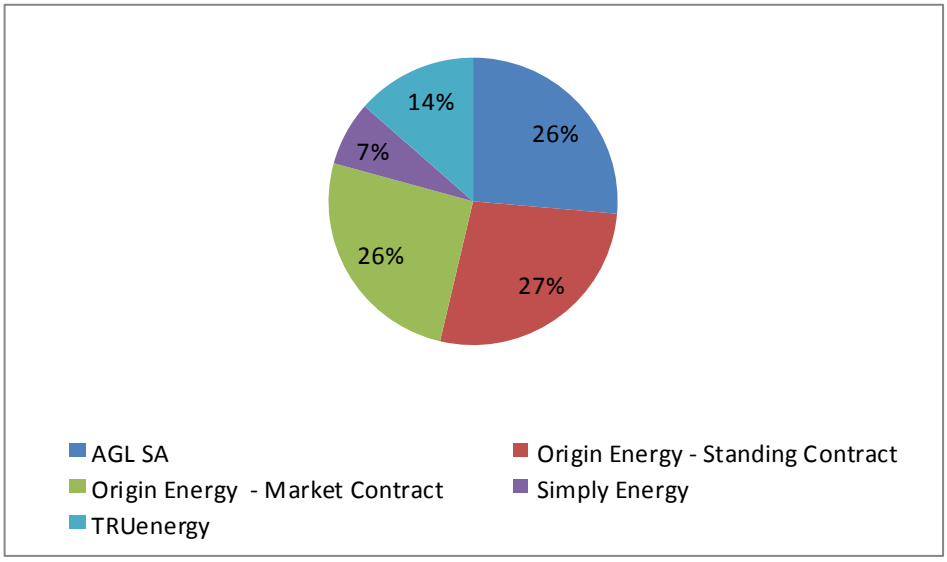
Customer data reported by energy retailers under the Commission's Guideline 2[31] also reveal that the market share held by each gas retailer has remained relatively constant in recent years. The failure of gas retailers, other than Origin Energy to collectively expand their combined market share may 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

[30] As at 31 March 2011, the total number of small customers in the South Australian gas market is around 392,000, of which 384,000 are residential customers and 8,000 are SME customers.

[31] 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.

due to '*the average consumption in South Australia [being] lower than in other states and so the dollar margin per customer is very low*.'[32]

Figure 2-2 – Small Customer Gas Retail Market share in the South Australia (as at 31 March 2011)



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).

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 2-1).[33]

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32 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

33 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.

2.1.4 Retailer Survey

To build on previous work that has assessed the effectiveness of retail competition in the South Australian energy market (e.g. that undertaken by AEMC in 2008), 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.[34]

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 some 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.

2.1.5 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[35]. 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 amenable to churn. Further, it also identified reasons such as brand loyalty, poor 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.

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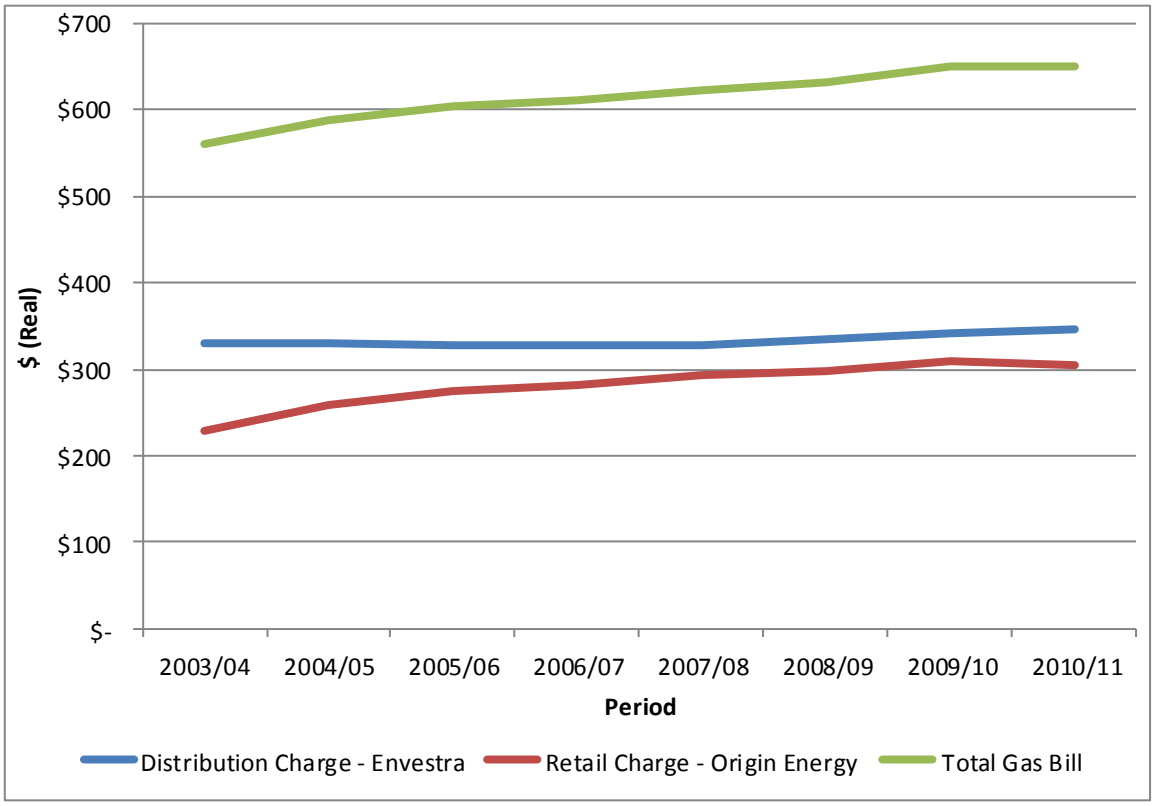
34 ACIL Tasman (2010), *Competition in South Australia's Retail Energy markets – Report on Interviews with Participants*, June 2010 - http://www.escosa.sa.gov.au/library/100624-CompetitivenessRetailMarketReport-ACILTasman-Public.pdf

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

2.2 Gas retail prices

Figure 2-3 and Figure 2-4 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.[36]

Figure 2-3 - Residential Gas Standing Contract Annual Bill 24 GJ p.a. GST exclusive, $Dec10



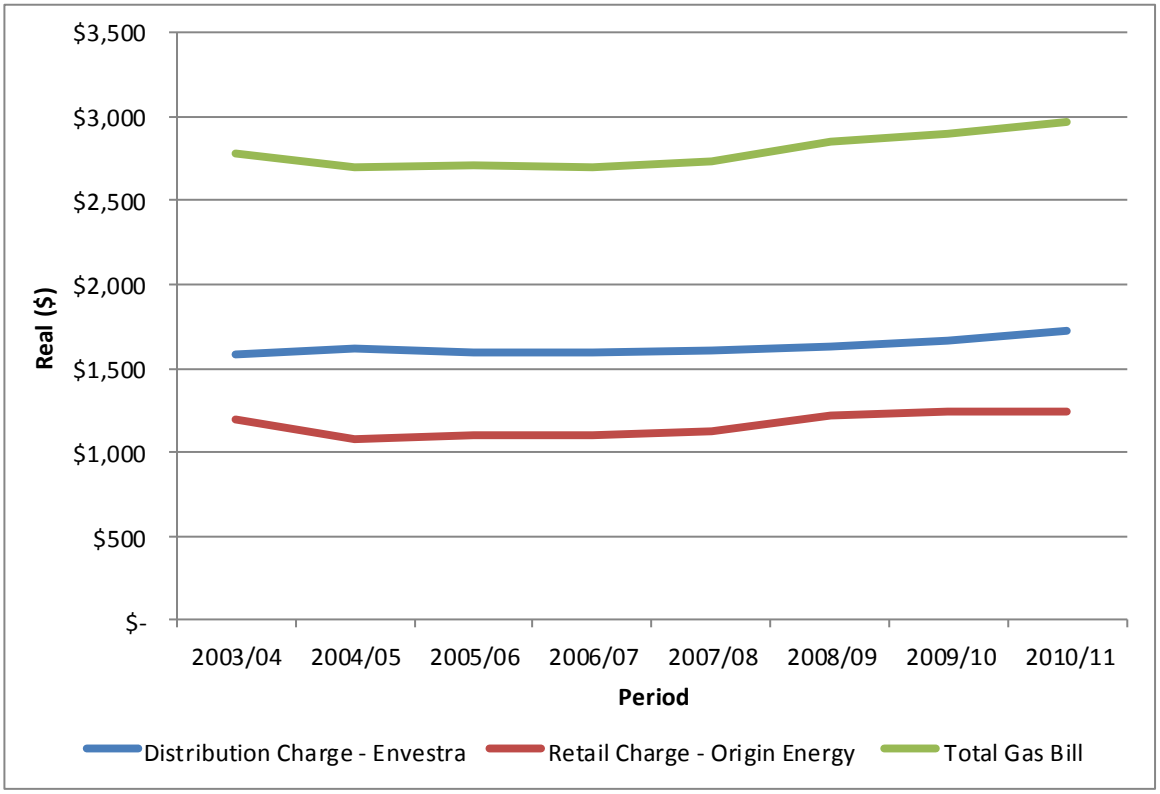
It can be observed that over the period 2003/04 to 2010/11, there has been a real increase in the annual residential gas bill for an annual consumption of 24 Gigajoule (GJ) of about 16.4% ($91.50), or an average of 2.2% per annum over this period. Whilst network charges have remained relatively constant in real terms, retailer charges have increased over the period, significantly impacted by a decision[37] 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.

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

37 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.

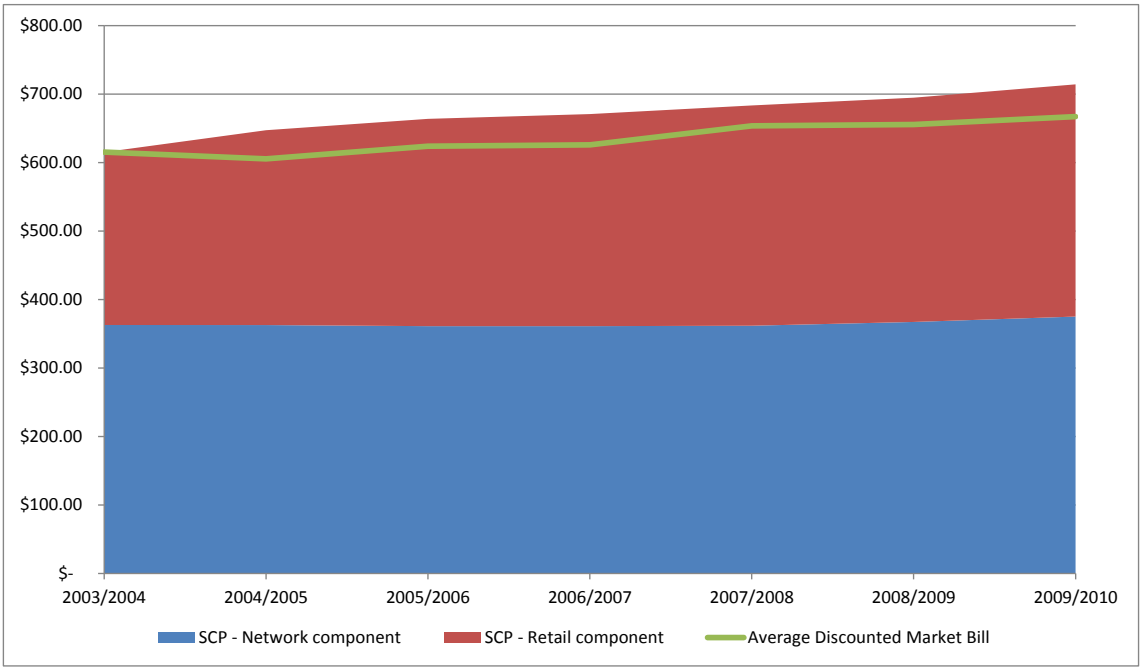
Figure 2-4 - Small Business Gas Standing Contract Annual Bill 170 GJ p.a. GST exclusive, $Dec10



2.2.1 Market Contract Savings

Figure 2-5 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 2-5 - Residential Gas Standing Contract bill compared to average discounted Gas Market Contract Annual bill, 24 GJ p.a., GST inclusive, $Dec10

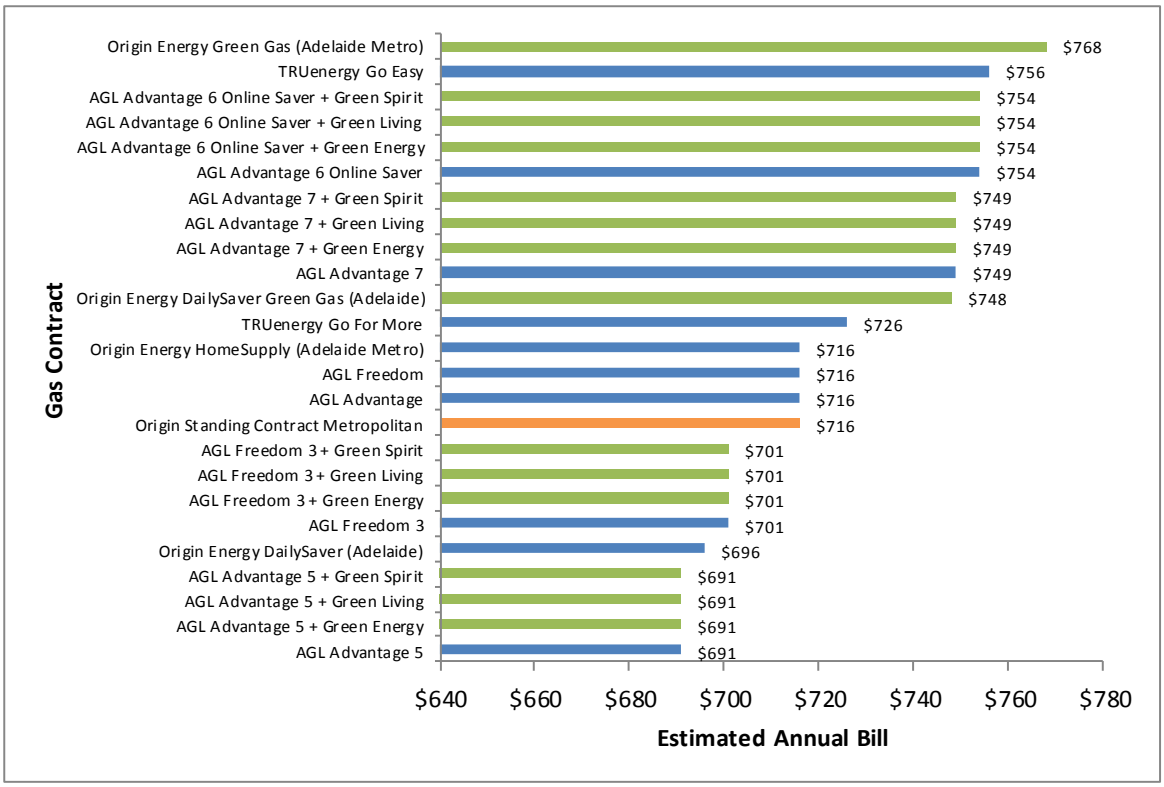


Data for the latest gas market offers extracted from the Commission's Estimator[38] indicates that residential gas customers with an annual consumption of 24 GJ in South Australia are able to achieve savings of around 2% to 4% off the gas standing contract price. This represents savings of around $15 to $25 per annum for a typical residential customer (refer Figure 2-6). 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 2-6 as those offers are only being made to small customers as part of a dual-fuel energy offer.

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

Figure 2-6 - Gas Market Contract vs Standing Contract Estimated Annual Cost (as at 30 May 2011, GST inclusive)[39]



2.3 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 (390,000 for gas and 867,000 for electricity), all of those gas customers also have electricity accounts.

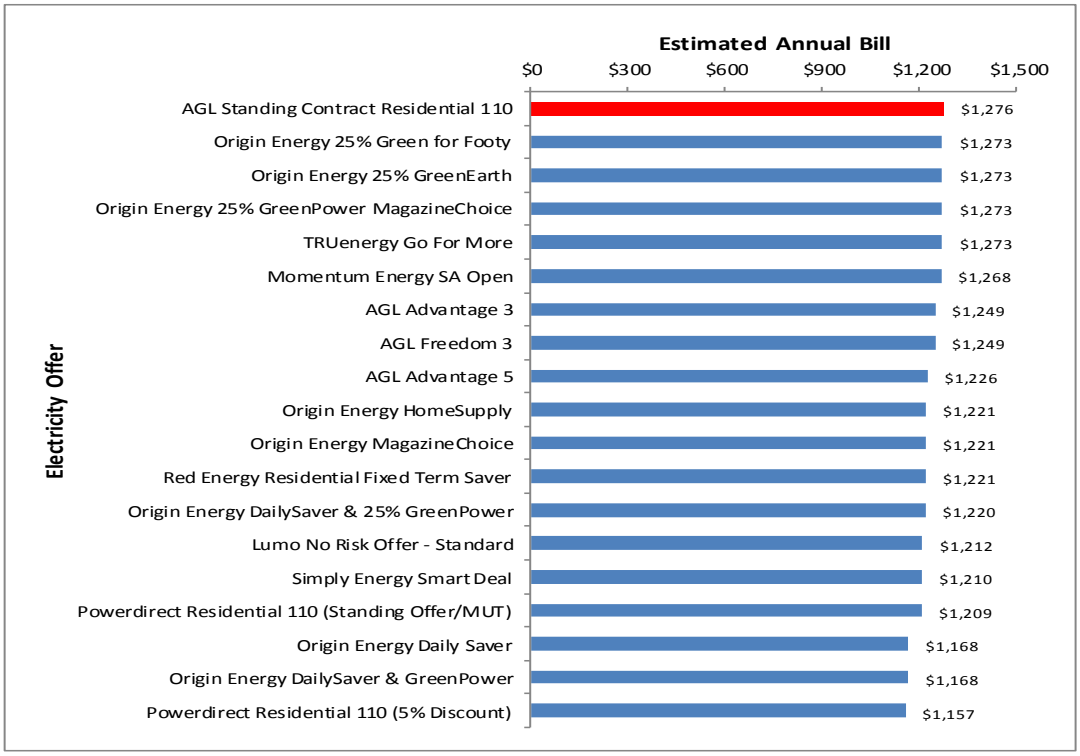
Given the smaller size of the gas retail market, and the relatively low volumes of gas supplied per customer, which drives a lower dollar value of margin available from selling gas relative to electricity, the Commission observes that energy retailers typically adopt a dual-fuel marketing strategy to 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.

39 Note, as discussed in Section 2.1.2 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 2-6.

For these reasons, competition is considered to be effective in the electricity and dual-fuel retail markets, but is not considered to be effective in the gas-only market.

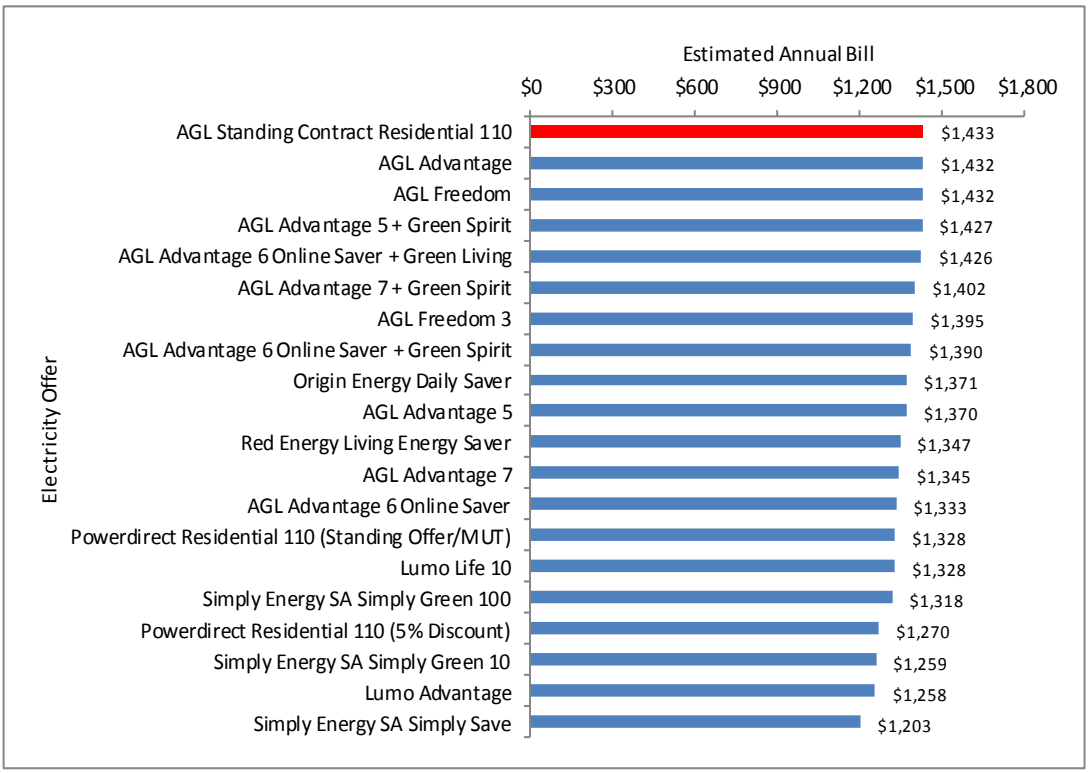
The Commission observes that following its Final Decision on the 2010 Review of Retail Electricity Standing Contract Price Path, there have been increases in customer churn in both the electricity and gas retail markets (see Figure 2-1). Whilst there could be other factors contributing to those increases in churn since 1 January 2011 (e.g. the Commission notes that the retailer offer names have changed during this period), the Commission is of the view that the addition of "retail headroom" provided for in that decision has facilitated competition by allowing other electricity retailers, including second tier retailers, to competitively offer products at a price discounted from the standing contract price. This is supported by the Commission's analysis of data obtained through its Residential Estimator, which shows that the average discount of market offers that are being offered at below the electricity standing contract price has increased from 3.8% (as at 13 September 2010) to 5.9% (as at 31 May 2011). Further, the maximum available discount has also increased significantly from 9.3% to 16.1% over the same period (refer Figure 2-7 & Figure 2-8 below).

Figure 2-7: Estimated annual electricity bill for a typical residential customer – (5,000kWh per annum) – standing contract versus market contracts (as at 13 September 2010, GST inclusive)



Source: ESCOSA, Residential Estimator

Figure 2-8: Estimated annual electricity bill for a typical residential customer – (5,000kWh per annum) – standing contract versus market contracts (as at 31 May 2011, GST inclusive)



Source: ESCOSA, Residential Estimator

In light of the discounts on offer, it is not surprising that churn in the electricity retail market has increased substantially as consumers switch electricity retailers to take advantage of those discounts. A consequence of the increase in marketing activities (e.g. door-knocking) as electricity retailers compete for market share is that those retailers who sell gas are also able to acquire new gas customers at a lower acquisition cost than would otherwise be the case if they had sought to market their gas products separately. This is because the benefit derived from acquiring a new gas customer outweighs the incremental cost associated marketing gas as part of a dual-fuel product. Thus, it is expected that the increase in customer churn in the electricity retail market will lead to an increase in churn in the gas retail market.

2.4 Methodology for Fixing Gas Prices

In August 2010, the Commission finalised a review of the methodology for setting electricity and gas standing contract prices.[40] 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.

[40] 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.

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.[41]

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 is 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), as well as through the 2010 retailer survey conducted by ACIL Tasman[42]. In addition, the Commission did not receive any submissions during the methodology review 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:

> *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.*[43]

The Commission's Final Determination is to use a cost-based approach to setting gas standing contract prices.

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41 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.

42 ACIL Tasman (2010), *Competition in South Australia's Retail Energy markets – Report on Interviews with Participants*, June 2010 - http://www.escosa.sa.gov.au/library/100624-CompetitivenessRetailMarketReport-ACILTasman-Public.pdf

43 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 - http://www.escosa.sa.gov.au/library/101119-OriginEnergyGasPricePathInquiryIssuePaper-Submission.pdf

3 ORIGIN ENERGY'S PROPOSAL

As noted in Chapter 1 of this Final Report, 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 (i.e. increases above the Consumer Price Index (CPI)) 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, ROC, and a ROM).

Origin Energy has developed revenue forecasts that are designed to recover its proposed controllable costs, and has translated these into a maximum average revenue control. Retailer revenue is to be recovered via retailer tariffs, which comprise approximately half of the total gas standing contract price (gas distribution charges making up the other half). Origin Energy's proposed real increases in the average retailer revenue allowance for residential and SME gas standing contract customers are reproduced in Table 3-1.

Table 3-1 - Origin Energy's proposed price path ($Dec11[44])

	RESIDENTIAL CUSTOMERS		SME	
	AVERAGE REVENUE ($/GJ)	% CHANGE	AVERAGE REVENUE ($/GJ)	% CHANGE
2011/12	$14.57	11.0%[45]	$7.64	2.2%
2012/13	$14.73	1.1%	$7.74	1.3%
2013/14	$16.16	9.7%	$9.17	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 3-2.[46]

[44] Both Origin Energy's November 2010 submission and the Draft Inquiry Report assumed a CPI of 2.5% from $Dec10 to $Dec11. The Commission has re-stated the proposed costs using actual CPI of 3.33%, based on the ABS weighted average of eight capital cities index, and using the Commission's nine month lag convention.

[45] 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%.

[46] These estimated price increases do not incorporate any changes in AEMO charges.

Table 3-2 - 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:

(a) *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*

(b) *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 Final Inquiry Report.

4 DEMAND FORECASTS

Establishing reliable demand forecasts is important for the purposes of setting gas standing contract prices as they have a direct impact on the ability of a gas utility to recover the revenue requirement established in any particular year. Further, they also assist 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 has therefore investigated and reached conclusions on several assumptions concerning standing contract customers that have a significant impact on standing contract prices. The assumptions cover:

- customer numbers – which are used to derive forecast consumption and are 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. As the assumptions discussed below concerning standing contract customers are deemed to be commercially sensitive, details of the Origin Energy's proposal and Sinclair Knight Merz McLennan Magasanik Associates' (SKM MMA) advice have not been published. The following sections therefore only represent summaries of the Commission's detailed assessment.

4.1 Summary of Draft Inquiry Report

The Commission's draft conclusions on the various key underpinning assumptions are summarised below.

4.1.1 Customer Numbers

The Commission noted in its Draft Inquiry Report that 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. However, the Commission also identified a number of factors that could influence future churn (e.g. discount availability and the level of retail marketing activities undertaken by energy retailers).

The Commission's approach in the Draft Inquiry Report to examining Origin Energy's proposed customer number forecast was therefore based on both an

assessment of historical churn rates, and consideration of future drivers of churn (i.e. the flow-on effect of switching activities in the electricity retail market on the gas retail market). Further, the Commission also had regard to the set of customer numbers independently forecasted by SKM MMA.

The Commission noted in the Draft Inquiry Report that SKM MMA's confidential advice on customer number forecasts to the Commission had recommended that residential churn be forecast to remain 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 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, the Commission expressed the view in the Draft Inquiry Report that it was important to have regard to the strong historical correlation between electricity and gas switching in South Australia (see Figure 2-1). The Commission noted that as energy retailers typically market gas as part of a dual-fuel marketing strategy, the observed increase in electricity marketing activities following the Commission's 2010 Electricity Standing Contract Price – Final Decision will have a flow-on effect to gas churn over the next regulatory period.[47]

The Commission therefore, for the purposes of the Draft Inquiry Report, accepted Origin Energy's customer number forecasts on the basis that those forecasts were broadly consistent with the Commission's expectations of retail marketing activities and, thus, customer churn in the South Australian energy retail market over the next regulatory period.

4.1.2 Gas Consumption per Customer

Similarly, the Commission noted that 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 both residential and small business customers.

The Commission's approach in the Draft Inquiry Report to examining gas consumption per customer was to compare Origin Energy's proposed consumption figures (20.7 GJ/pa for residential customers and 147.0 GJ/pa for small business customers) against operational data reported by gas retailers, including Origin Energy, under the Commission's Energy Industry Guideline No. 2. Further, it also had regard to SKM MMA's independent assessment of average consumption data.

Whilst the Commission's assessment in the Draft Inquiry Report revealed slight discrepancies between the data reported by Origin Energy under its price path proposal, and that being reported separately to the Commission under

[47] The Commission had forecasted increases in churn for both residential and small business segments in its 2010 Review of Retail Electricity Standing Contract Price Path – Final Decision.

Guideline 2, the Commission concluded that those discrepancies were due to the difference in reporting methodology. The Commission's analysis also revealed that average consumption over the current regulatory period had remained reasonably consistent, with the exception of 2009/10 where consumption was affected by higher temperatures.

However, the Commission also noted that SKM MMA's expert advice suggested that there was no basis to assume average usage in South Australia would change materially over the next regulatory period, and that Origin Energy's proposed average consumption forecasts were reasonable.

In light of the above, the Commission, for the purposes of the Draft Inquiry Report, accepted Origin Energy's proposed average consumption forecasts for both residential and small business segments. Those average consumption forecasts were then used as the basis to forecast total gas consumption, which were then subsequently pro-rated to each region based on percentages provided under the Origin Energy price path proposal.

4.1.3 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 small business market segments.

To examine the reasonableness of Origin Energy's proposed load factors, SKM MMA was engaged by the Commission to independently derive a set of load forecasts. In developing its load factor forecasts for consideration by the Commission, SKM MMA analysed gas flow information using a suite of regression models, and investigated the derivation of the 1 in 25 peak day heating degree-day (HDD) based on 32 years of Kent Town weather station data, and then used a simulation approach to estimate an aggregate 1 in 25 year load factor from which individual sector load factors were derived.

In contrast, the Commission noted that Origin Energy had adopted a different methodology to develop its peak demand forecasts for consideration by the Commission. Origin Energy undertook a regression analysis of customer billing data to determine customer base load and HDD sensitivity coefficients, and derivation of a 1 in 25 peak day weather. The application of this value was then used to derive the corresponding peak-day consumption and load factors using regression.

In the making of its Draft Decision on load factors, the Commission reviewed the different methodologies used by Origin Energy and SKM MMA to derive their set of load forecasts, and concluded that both methodologies were appropriate to be used to forecast load factors. In light of both methodologies producing outcomes that were very similar, the Commission's Draft Decision was to accept Origin Energy's proposed load factor forecasts.

4.2 Submissions to the Draft Inquiry Report

Given that the various underpinning assumptions concerning standing contract customers have not been published in the Draft Inquiry Report for confidentiality reasons, the Commission only received one submission, from Origin Energy, in response to the its Draft Decisions on the abovementioned demand forecasts.

The Origin Energy submission commented that whilst the Commission had accepted its set of proposed demand forecasts in the Draft Inquiry Report, the Commission should have regard to the fact that there is a declining trend in average consumption for residential customers in South Australia, and consider the impact that such a decline would have on retail margin and the overall level of retailer activity in the South Australian gas retail market over the next regulatory period.

Origin Energy also noted that Envestra, in its recent access arrangement proposal to the AER, had forecast average consumption for residential customers in South Australia to decline over the next five years, primarily on the basis that the installation of more energy efficient household appliances such as hot water systems would lead to lower gas sales.

4.3 Commission's Considerations

The Commission's final conclusions on the various key underpinning assumptions are summarised below.

4.3.1 Customer Numbers

As discussed in the Draft Inquiry Report, one of the principal reasons the Commission has accepted Origin Energy's proposed customer number forecasts is the strong historical relationship between electricity and gas switching rates in South Australian energy retail market. This is because energy retailers typically market gas as part of a dual-fuel marketing strategy as opposed to marketing it as a stand-alone product,

Further, the Commission is not aware of any information that would suggest that gas retailers operating in South Australia are considering changing their current marketing strategies to market gas as a stand-alone product as opposed to being part of a dual-fuel product.

Notwithstanding the above, it is also the Commission's view that the recent increases in utility prices (e.g. water and electricity) have had the effect of influencing consumer behaviour by not only encouraging consumers to use those products more efficiently but also to actively seek out ways to reduce their costs. Given that most non-green market offers continue to be offered at a discount to the standing contract price in both gas and electricity, the Commission believes that customer churn in both retail fuel markets will continue to increase as consumers, particularly those still on a standing contract, exercise their right to switch energy retailers to take advantage of those discounts in order to minimise their energy bills. Section 2.3 of this Final Inquiry Report provides evidence of recent increases in customer churn rates in the residential electricity market.

In light of the reasons above, the Commission expects that customer churn in the South Australian energy retail market will continue to increase, and reaffirms its Draft Decision to accept Origin Energy's proposed customer numbers for the purposes of the Final Price Determination.

4.3.2 Gas Consumption per Customer

As discussed in the Draft Inquiry Report, the average consumption profile of small customers in South Australia has been relatively stable over the current regulatory period, with the exception of 2009/10, where consumption was affected by higher temperatures.

Both the Commission and SKM MMA assessments have resulted in average consumption figures that are reasonably consistent with those proposed by Origin Energy. The Commission's assessment of up-to-date sales data reported by Origin Energy under Guideline 2 has also not revealed any abnormal consumption patterns. The Commission therefore believes that there is no basis to assume that the average consumption profile of small customers will change materially over the next regulatory period.

In light of the above, the Commission reaffirms its Draft Decision to accept Origin Energy's average consumption forecasts for both residential and small business segments for the purposes of the Final Price Determination.

4.3.3 Load Profile

As discussed in the Draft Inquiry Report, SKM MMA has recommended that the Commission accept Origin Energy's proposed load factor forecasts on the basis that its independent assessment has resulted in a set of load forecasts that are very similar to those proposed by Origin Energy despite using a different forecasting methodology.

Given that the Commission has not being presented with any arguments to suggest that it should deviate from its Draft Decision, the Commission reaffirms its decision to accept Origin Energy's proposed load factor forecasts for the purposes of the Final Price Determination.

The Commission's Final Determination is to:

- ***accept Origin Energy's customer number forecasts for both residential and small business segments;***

- ***accept Origin Energy's average consumption forecasts for both residential and small business segments; and***

- ***accept Origin Energy's proposed load factor forecasts for both residential and small business segments.***

5 FORM OF PRICE CONTROL

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

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

5.1 Regulation of Controllable Costs

The Commission's assessment of forward-looking costs is limited to 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.

5.2 Treatment of Non-Controllable Costs

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

- Distribution charges;
- 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 (e.g. late payment fees). These other fees are not the subject of this price determination. The Commission's ERC[48] regulates the application and the manner of calculation of such fees, but does not set the quantum.

5.3 Price Path Period

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

The Commission's Draft Inquiry Report considered 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 6).

The Commission did not receive any submissions in relation to this aspect of the Draft Decision.

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

5.4 Price Control Formulae

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

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

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

5.4.1 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 control recognises that the quantity of gas sold is a significant cost driver of the standing contract retailer and permits the allowed revenues to change in line with costs. While there may be additional cost drivers (e.g. 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. The Commission's Draft Inquiry Report supported Origin Energy's proposal. None of the submissions to the Draft Inquiry Report commented on this issue.

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

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

5.4.2 Rebalancing Control

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

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 (i.e. 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 incorporated 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 (e.g. 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's Draft Inquiry Report noted that, even if no further rebalancing were required, any rebalancing controls would 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 Draft Decision was to retain a rebalancing control, which would continue to apply to the retail component of tariffs only. It proposed a control that limited the annual increase in the charge under each retailer tariff at any level of consumption to no more than 2% above the CPI allowed for under the average revenue controls.

Only the Origin Energy submission commented specifically on the Commission's proposed rebalancing control. Origin Energy restated its position that it would prefer to not have any rebalancing controls, but it conceded that it would accept the control put forward by the Commission. It requested confirmation that the rebalancing control would only apply to price changes in the second and third year of the price path period. The Commission confirms that, consistent with the approach taken in previous gas standing contract price determinations, the rebalancing control will only apply to intra-period annual price adjustments, not to the initial price adjustment (i.e. not to the 2011/12 price adjustment).

The Commission's Final Determination is to set the 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.

5.5 Pass-through Events

The pass-through mechanism allows (or requires) the retailer to add or subtract the cost impact of particular events to its standing contract prices in cases where those events are outside the control of the retailer and could not reasonably have been foreseen or were not quantifiable at the time the price determination was made.

The pass-through regime reduces some of the risk that a retailer faces in that it can recover the costs associated with an unforseen event. However, it does create some forward price uncertainty, given that prices may need to move upwards or downwards as a result of the occurrence of an event. In order to maintain appropriate incentives to manage costs, pass-through events are limited in number and nature to events that can be demonstrated to have a material cost implication (positive or negative) in the costs of providing standing contracts to South Australian consumers.

While the exact nature and timing of any pass-through event is typically uncertain, to provide the requisite price certainty, it is necessary to define, in advance, the details of each event. There are currently three events that can trigger a pass-through under the 2008 Gas Standing Contract Price Determination, being a:

- 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 regulatory 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.

These events have been identified as events which may potentially arise and which are substantially beyond the control of the Commission and Origin Energy.

In its submission to the Commission's Issues Paper[49], Origin Energy argued that the current set of pass-through items was too narrow, and that the scope of allowed pass-through events should be broadened. Specifically, it argued that:

…[this] is especially true with the myriad of market reforms that are currently occurring at a national level. For example, there are discussions regarding a national energy efficiency scheme, the introduction of a carbon tax, changes to the cost of gas given potential demand for LNG and the move to a national consumer protection framework.[50]

The Commission addressed Origin Energy's position on this matter in its Draft Decision[51] by stating that it is appropriate to provide some degree of certainty over the types of events for which a pass-through could occur. To do otherwise may lead to an unacceptable level of uncertainty in forward pricing. Further, it noted that all of the examples listed by Origin Energy, with the exception of 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 potential increases in wholesale gas costs, the Commission considered this issue specifically in Chapter 7 of the Draft Decision and provides further discussion on this point below.

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49 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)

50 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- http://www.escosa.sa.gov.au/library/101119-OriginEnergyGasPricePathInquiryIssuePaper-Submission.pdf

51 Essential Services Commission of South Australia, *2011 Gas Standing Contract Price Path Inquiry: Draft Inquiry Report & Draft Price Determination* April 2011 (refer http://www.escosa.sa.gov.au/library/110408-GasPricePath_2011-DraftDetermination-PublicVersion.pdf)

In its submission to the Commission's Draft Decision, Origin Energy reiterated its view that the current pass through events were too narrow as they did not encapsulate all the potential events that could occur over the three year price path period. Origin Energy proposed that there be no set definition of a pass through event, thereby creating maximum flexibility for it to apply for a pass through at any time. In support of this proposition, Origin Energy put forward two events that it believed may not fall within the current categories of pass-through event if they eventuated:

- Changes to costs of the REES. While Origin Energy supports the Commission's approach in relation to the treatment of REES costs, it believes there is uncertainty about how it could apply for a pass-through if the actual costs of REES are greater than the forecast costs given that changes to REES costs would not be considered a regulatory reset event; and
- A move to LNG export pricing parity. Origin Energy submitted that if the Commission is not going to recognise these gas costs in the last year of the price path period in its Final Decision (i.e., the 2013-2014 regulatory year) then it would need to apply for a pass-through for such costs at the time they were realised.

Putting aside for the moment the ability of Origin Energy to apply for a pass through if either of these two situations eventuated, the Commission makes the following comments:

- As envisaged by the Electricity and Gas Regulations[52], REES will continue in operation across the full three year price path period in a similar form. Accordingly, it is appropriate to set an allowance for REES for the entire three year price path. While the overall annual targets for energy audits and greenhouse gas reduction for the next three years of REES have not yet been set by the Minister for Energy, retailers required to participate in REES will have the opportunity to consult with the Minster as these targets are finalised. Other than the targets and the list of REES approved activities to apply from 1 January 2012 (which is discussed below), the Commission does not envisage any material changes to REES over the price path period.

  In making REES determinations for the 2010 REES year[53] the Commission closely examined the types of energy efficiency activities that were performed during the 2010 REES year and found that the majority of activities undertaken were light globe and showerhead replacements, activities that are considered low cost and low risk. As a percentage of all activities reported, light globe and showerhead replacements made up 94.66% of all activities reported under REES. Further, the Commission found that of these activities, only 5.9% were rejected as a result of duplication[54] (i.e., the activity had already been performed in the same household by another retailer). These findings indicate that low cost

52 Refer regulation 7AL(5) of the *Electricity (General) Regulations 1997* and regulation *8DE(4) of the Gas Regulations 1997*

53 Refer Chapter 6 of the Commission's Residential Energy Efficiency Scheme Code dated 30 August 2010

54 The duplication issue only affected light globe replacement activities and not showerhead replacement activities

activities have not yet reached a saturation point and can continue to provide future carbon savings for the purpose of REES.

In addition, in June 2010, the Commission commenced the first phase of its three phase review of approved REES energy efficiency activities. The purpose of the review is to determine the list of approved activities to apply from 1 January 2012, being the commencement of the second three year period of REES.[55] As part of the second phase of the review, the Commission engaged a consultant, EnergyConsult Pty Ltd, which considered the various contextual factors that influence the take-up of energy efficiency activities in the residential sector in South Australia. Specifically, it reviewed trends in these factors that could lead to changes in the approved activities, including the opportunity to approve new activities. A key element of this process was evaluating the cost effectiveness of current and proposed activities that would make up the final list of activities to apply from 1 January 2012.

While the Commission's Final Decision in relation to this review has not been released as at the date of this Price Determination, based on the findings of the review and the analysis carried out on the activities that retailers were undertaking in 2010, the Commission is satisfied that the energy efficiency activities proposed to apply from 1 January 2012, which include both light globe and showerhead replacement activities, are cost effective from:

- a householder perspective, in that the benefits of the activities will exceed the costs to the householder; and
- an implementation perspective, which ensures that retailers can choose activities that minimise the cost of the scheme.

Based on the foregoing, the Commission considers that Origin Energy will have access to cost effective energy efficiency activities to satisfy its REES greenhouse gas reduction targets during the price path period. Further, it is of the view that until it is presented with evidence of a material uplift in REES costs, the current cost allowance for REES, as detailed in section 8.4.5, is sufficient.

Notwithstanding the Commission's position on the foregoing matter, it has nevertheless considered the categories of pass-through event. In particular the Commission has reviewed the scope of the regulatory reset event and notes that, in its current form, it might be arguable that it may not capture an increase in REES costs resulting from the new REES targets or the list of approved activities to apply from 1 January 2012.

[55] Refer "Ministerial Protocol, REES, Protocol set by the Minister for Energy, November 2008, available at http://www.escosa.sa.gov.au/library/081111-REES-ProtocolSetByMinisterForEnergy.pdf

Accordingly, the Commission has expanded the scope of part b(iii) of the definition of "regulatory reset event" as contained in the Price Determination instrument in the following manner (amendments shown in bold and underlined text):

*"**regulatory reset event**" means:*

(b) a decision made by the Commission, the Australian Energy Regulator, the Australian Energy Markets Commission, the South Australian Government or the Commonwealth Government after the commencement date:

(i) imposing a set of minimum standards on the declared retailer in respect of the provision of standing contracts that are different from the set of minimum standards imposed on the declared retailer in respect of the provision of standing contracts at the commencement date; or

(ii) requiring the declared retailer to purchase financial products in respect of the sale and supply of natural gas based on a specified environmental outcome or outcomes; or

*(iii) requiring the declared retailer to participate in a scheme related to a specified environmental or energy efficiency outcome or outcomes **<u>or materially varying an obligation arising under such a scheme</u>***

as a result of which the declared retailer would incur materially higher or lower costs in providing standing contracts than it would have incurred but for that event.

This change to the definition of regulatory reset event provides Origin Energy with comfort that a demonstrable material increase (or decrease) in REES costs that is directly linked to the new targets and list of activities to apply from 1 January 2012 could be the subject of a pass-through application.

- In regards to a move to LNG EPP, the Commission reiterates its view, as expressed in the Draft Inquiry Report, that there is significant uncertainty around the likelihood, timing and impact of this event occurring. Accordingly, the Commission has determined that it will not allow any amount in the final year of the price path to reflect the forecast increase in wholesale gas costs relating to a possible transition to EPP. This matter is discussed in more detail in section 6.4.

Should the transition to EPP eventuate during the three year price period the Commission would address this in one of the following two ways:

- by reflecting the new costs in the following three year price period with any under recovery of costs from the final 6 month period carried forward into the subsequent price path; or

- to the extent that the increase in wholesale gas costs is so significant during the last six months of the price path period that the recovery of these costs could not be deferred, the Commission would consider undertaking a limited "special circumstances" review, and re-opening the price path. For a more detailed discussion of special circumstances reviews, see below at section 5.6.

In light of the change to the definition of "regulatory reset event", and the options available to the Commission should the transition to EPP occur during the price path period, the Commission's view is that it is appropriate to continue with the three pass-through events contained in the 2008 Gas Standing Contract Price Determination.

The Commission's Final 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.

5.6 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 certain events. As a result of the operation of the standing contract provisions set out in section 34A of the Gas Act, conditions for reopening in the context of a gas standing contract price determination are limited. 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.[56]

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 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).

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

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 is entirely contained within the relevant legislation, it is not for the Commission to include within the price determination instrument itself any provisions which determine whether or not reopening is allowed.

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 factors is to permit a greater flexibility in the application of special circumstances.

The Commission's intention is that where circumstances have changed (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) such that standing contract prices cannot be accommodated under the price determination made, then those circumstances may well be considered as "special". As the Commission does not consider that it is appropriate (or indeed possible) to formulate a precise policy or materiality threshold as to when special circumstances exist, the declaration of special circumstances will only be made once all relevant factors are known and considered, and there is sufficient certainty about the impact of the particular circumstances. In other words, the existence of special circumstances will be a point in time assessment undertaken by the Commission at the time a particular event arises.

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.

5.7 Tariff Approvals

Using the CPI data provided by the Australian Bureau of Statistics[57], the Commission has determined the initial set of standing contract retailer tariffs to apply in 2011/12 as part of this Final Gas Standing Contract Price Determination.

As part of the annual price adjustment process, prior to the commencement of the 2012/13 and 2013/14 regulatory year, 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:

[57] The Commission uses ABS average of eight capital cities CPI indices - http://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/6401.0Main%20Features2Mar%202011?opendocument&tabname=Summary&prodno=6401.0&issue=Mar%202011&num=&view=

- 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.

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

5.8 Provision for New Tariffs

After 1 July 2011 and subject to the Commission's approval, Origin Energy will be entitled under the Price Determination to seek to introduce new tariffs and close existing tariffs. 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 the allocation of customers to the new tariff must be protected by the retailer tariff rebalancing control relative to the previous tariff to which they were assigned.

6 WHOLESALE GAS COSTS

Approximately one-third of total controllable costs of the standing contract gas retailer relate to the costs of purchasing wholesale gas from gas producers. In South Australia, the majority of natural gas has historically been sourced from the Cooper/Eromanga 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/Eromanga Basin or from the Iona gas plant in 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.

6.1 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 Annual Contract Quantity (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.[58]

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:

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

- reduced flexibility in gas supply contracts has increased the need for peak contracts;
- Overall gas demand volatility and peakiness has increased, driven by increased gas-fired generation in Queensland, South Australia and Victoria;
- Reduced flexibility in 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'[59] 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 of the derivation of the cost components from Origin Energy's proposal follows.

6.1.1 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.

6.1.2 Wellhead ACQ Cost

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.

[59] Swing gas related specifically to the cost of retaining the option to purchase additional gas through the SEAGas Pipeline, to cover Origin Energy's imbalance position between MAPS and SEAGas, prior to the introduction of the STTM.

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/Eromanaga 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. This is a reflection of the growing reliance on CSG imported from Queensland in Origin Energy's portfolio and a number of proposals have already been put forward to liquefy natural gas and export LNG from Queensland.

6.1.3 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.

6.1.4 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 initially proposed an allowance of $0.05/GJ to account for the additional market volatility risks associated with imbalance, deviation and contingency gas. In its latest proposal, Origin Energy seeks an allowance of $0.065/GJ for the costs of the STTM.

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.

6.1.5 Summary of Origin Energy's proposed Wholesale Gas Costs

Table 6-1 summarises the relevant average gas prices for the price path period as forecast by Origin Energy for residential and small business customers.

Table 6-1 - 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	**4.82**	**5.13**	**5.21**	**6.44**
SME				
Total Cost of Gas	**4.45**	**4.61**	**4.64**	**5.87**

6.2 Summary of Draft Decision

6.2.1 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.

The Commission's Draft Decision concluded that, in relation to ACQ for 2011/12 and 2012/13, 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. The Commission accepted Origin Energy's proposed ACQ costs for 2011/12 and 2012/13.

In relation to ACQ costs for 2013/14, while SKM MMA suggested that the majority of the potential increase in costs could be dealt with through a special circumstances review, it recommended that ACQ costs in that year should nevertheless be increased to $4.27/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.

SKM MMA put forward 2 options in relation to 2013/14 ACQ costs; the first option (V1) 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 position that there will be a significant reduction in the amount of gas being shipped into South Australia via the SEAGas pipeline in 2013/14. SKM MMA has indicated that there is uncertainty over the extent to which such a reduction will occur, and has included a scenario (reflected in the final row of Table 6-2) 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 6-2.

Table 6-2 SKM MMA ACQ prices recommended to 2013/14
$/GJ, $Dec11

	2011/12	2012/13	2013/14 v1*	2013/14 v2
Origin Energy Proposal	4.16	4.14	5.37	
SKM MMA prices, Origin Energy Volumes	4.16	4.14	4.27	5.08
SKM MMA prices, changed volumes final year	4.16	4.14	4.14	4.74

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

Due to the significant doubt surrounding any move to LNG EPP, the Commission decided not to include any specific amount in the final year of the price path to reflect a possible transition to EPP. 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 elected to address any claimed increase in wholesale gas costs in 2013/14 in the subsequent 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, or, 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.

The Commission's Draft Determination was to establish a wellhead gas cost (ACQ) of $4.16/GJ in 2011/12, falling to $4.14/GJ in 2012/13 and 2013/14.

6.2.2 MDQ

The Commission accepted the load factors proposed by Origin Energy and, consistent with the approach used in the Commission's 2008 Gas Standing Contract Price Determination, the Commission concluded that the MDQ price should be based on the published underground storage (UGS) price, currently $175/GJ MDQ. The Commission's Draft Determination set an MDQ price that remains constant throughout the price path period as follows:

- $0.87/GJ for residential customers, and
- $0.37/GJ for SME customers.

6.2.3 STTM cost

Origin Energy proposed an allowance of $0.05/GJ to account for the additional market volatility risks associated with deviations and contingency gas.

On the basis that Origin Energy had not provided sufficient information to substantiate its claim that the STTM will result in additional costs to retailers, the Commission's draft conclusion was to make no allowance for STTM costs in wholesale gas costs. It was 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's Draft Decision on wholesale gas costs is summarised in Table 6-3 below.

Table 6-3 - 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	4.16	4.14	4.14	4.16	4.14	4.14
Wellhead MDQ	0.87	0.87	0.87	0.37	0.37	0.37
Other cost	0.00	0.00	0.00	0.00	0.00	0.00
Total Cost of Gas	**5.03**	**5.01**	**5.01**	**4.53**	**4.51**	**4.51**

6.3 Submissions to the Draft Decision

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

- AGL SA raised concerns that the Commission's Draft Decision did not make any allowance for the costs associated with STTM. AGL SA made reference to the fact that the Commission made an allowance in its 2008 Decision for costs associated with the Swing Gas market. AGL SA argues that any trade market gives rise to risks which must be managed by retailers and that retailers are primarily concerned with managing the downside of risk rather than seeking to gain from speculative trading. AGL SA believes that making an allowance for the downside risk of the STTM will allow retailers to self-insure against losses which it argues are likely to arise from operating in the STTM.
- SACOSS supported the Commission's approach to dealing with the uncertainties of wholesale gas costs in 2013/14 by not including any specific amount in the final year of the price path to reflect any possible transition to EPP and, instead, addressing the issue during the 2014-2017 gas SCP review, or through a special circumstances review.
- CSV stated that, whilst it is not ideal for prices in the final year of the regulatory period to be left uncertain, it supported the Commission's approach to dealing with the uncertainties surrounding any LNG transition to EPP.
- The Energy Supply Association of Australia (ESAA) recognised that uncertainty exists around the timing and extent of any transition to EPP. ESAA expressed concern that regulated tariffs may be set at non-cost reflective levels and thus compromise the overall competitiveness of the market. ESAA sought clarity on what constitutes a material increase (in wholesale gas costs) and how this will be assessed by the Commission.

Origin Energy commented on the difficulties faced in determining future levels of wholesale gas costs. Its preference is to include a specific amount for LNG transition to EPP and to include this in the price path. Should the Commission decide against this, then Origin Energy favour a specific pass through in relation to increased costs due to EPP.

Origin Energy argue that the criteria for a Reopening Event under section 34(Aa)(f) are not clear, and it has asked the Commission to explain the nature of any materiality threshold that would trigger any Reopening Event. The Commission's Draft Decision also explored the potential for recovering any increased costs associated with LNG EPP transition in a subsequent price path. Origin Energy comments that this approach could place it at a competitive disadvantage.

The Commission's Draft Decision applied the MDQ public benchmark of $175/GJ over the price path period. Origin Energy argues that there is evidence that MDQ rates have been increasing at a rate faster than CPI. Origin Energy argue that future MDQ costs will continue to rise at a rate above CPI and it requests that the Commission apply annualised real increases of 5% in its Final Decision.

The Origin Energy proposal included an allowance for trading in the STTM. The Commission Draft Decision did not allocate any costs for this as insufficient information was provided by Origin Energy. It its submission to the Commission Draft Decision, Origin Energy has provided additional information to the Commission to support the basis of its claim to allocate costs to STTM. This information has been provided to the Commission on a confidential basis.

6.4 Commission's Consideration

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

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

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

The advice provided by SKM MMA following receipt of submissions to the Draft Price Determination, contained 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.

6.4.1 ACQ costs 2011/12 – 2012/13

In relation to ACQ for 2011/12 and 2012/13, the Commission's Draft Price Determination accepted that Origin Energy's 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.

Submissions to the Draft Price Determination did not raise any specific issues in relation to 2011/12 – 2012/13 ACQ costs and the Commission has not sought to change those costs (other than through updating for the actual rather than forecast CPI). The primary ACQ issue to be considered by the Commission is the 2013/14 ACQ cost.

6.4.2 ACQ costs 2013/14

The Commission has closely examined Origin Energy's proposed 2013/14 ACQ costs, which are based on a transition price towards EPP. The advice that the Commission received 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.

Forecasting places significant risk on both consumers and Origin Energy, and the level of uncertainty in relation to any LNG EPP is such that it would be inappropriate for the Commission to make a specific allowance for any forecast increase in ACQ costs due to EPP in 2013/14.

In response to Origin Energy's request for a specific pass through for increased ACQ costs associated with LNG EPP, the Commission concludes that pass throughs are designed for events outside of the control of retailers. Increases in domestic gas prices due to EPP can, to a certain extent, be managed by retailers and there would be considerable difficulties in isolating the impact of EPP from other wholesale gas cost pressures.

In its Draft Decision, the Commission concluded that, due to the uncertainties surrounding any LNG transition to EPP, it would not include any specific amount in the final year of the price path to reflect a possible transition to EPP. The Commission's preference was to set the 2013/14 ACQ benchmark at the same amount as the 2012/13 ACQ benchmark in real terms ($4.14/GJ), and to address any claimed increase in wholesale gas costs in 2013/14 by either invoking the special circumstances provisions of the Gas Act or by allowing any

additional costs incurred by Origin Energy to be recouped in the subsequent price path period.

In its submission to the Draft Decision, Origin Energy did not favour the recovery of costs in a subsequent period and instead sought clarification on the precise circumstances that would trigger a special circumstances event.

As discussed in detail in section 5.6 of this Final Decision, the special circumstances provisions of the Gas Act can operate in one of two ways. The Commission can, of its own volition, determine that events have occurred that warrant a re-opening of the price determination, or the standing contract retailer or other interested party can request that the Commission consider if special circumstances have arisen such that the existing price determination should be reviewed and possibly varied or replaced.

It is important to emphasise that it is not the role of the Commission to seek to define the precise characteristics or magnitude of cost change that would lead to a special circumstances event occurring. As previously discussed, the true impact of a set of circumstances can only be assessed when those circumstances exist and all relevant factors are known and can be properly considered. Should the transition to EPP eventuate, and the impact of that transition is that wholesale gas costs increase to the extent that standing contract prices cannot be accommodated under the price determination made, then it would be likely that the special circumstances provisions of the Gas Act could be invoked.

The Commission's Final Determination is to establish a wellhead gas cost (ACQ) of $4.16/GJ in 2011/12, falling to $4.14/GJ in 2012/13. The Commission proposes to keep the wellhead cost constant at $4.14/GJ in 2013/14 on the basis that there is significant uncertainty over the timing and extent of any impact of LNG netback EPP during the 3-year price path period.

6.4.3 MDQ

Load Factors

As discussed in Chapter 4, the Commission has accepted the load factors proposed by Origin Energy and, in part, these higher customer load factors contribute to increased MDQ costs.

Additional MDQ

Origin Energy has proposed annual prices of additional MDQ that are above the Commission's 2008 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 as the benchmark price for additional MDQ in South Australia. This is an increase of 16% in real

terms from the level deemed reasonable in the 2008 Gas Standing Contract Price Determination, but is lower than the amounts proposed by Origin Energy.

In its Draft Decision, the Commission concluded that, consistent with the approach used in the Commission's 2008 Gas Standing Contract Price Determination, the MDQ price should be based on the published UGS price, which is currently $175/GJ MDQ.

In its submission to the Commission Draft Decision, Origin Energy had argued that the Commission should recognise that, historically, MDQ prices have been increasing at a rate above CPI, and that the Commission's proposed CPI increase in MDQ rates is unreasonable.

The Commission has requested advice from SKM MMA on Origin Energy's argument. SKM MMA has analysed both publicly available information on MDQ costs along with Origin Energy's MDQ costs, supplied by Origin Energy on a confidential basis. SKM MMA has concluded that posted prices of UGS have both increased and decreased at various times over the past 6 to 8 years, with the period 2008 to 2010 witnessing a real price increase. Posted prices have remained constant in real terms between 2010 and 2011.

The major price driver for storage costs in Victoria and South Australia (serviced by UGS), is the increase in the peak day capacity requirements in these states against storage availability. Using projected gas requirement data for an average, and 1 in 20 peak winter (and summer) from the Gas Statement of Opportunities (GSOO) produced annually by AEMO[60], SKM MMA has calculated the growth rates expected for the 1 in 20 winter peaks for the Victorian and South Australian market as a whole and for the sectors most accessible to storage. Over the long term, growth rates for these markets are expected to be modest.

Since the assessment of supply and demand suggests that peak day demand will only grow moderately and that underground storage supply capacity has recently seen considerable expansion, the Commission does not agree with Origin Energy's assertion that MDQ prices will rise at a rate greater than CPI for the regulatory period. The Commission has therefore retained its decision to allow for CPI increases in MDQ prices during each year of the price path period.

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

- ***$0.87/GJ for residential customers, and***
- ***$0.37/GJ for SME customers.***

[60] GSOO is available from AEMO website - http://www.aemo.com.au/planning/gsoo2010.html

6.4.4 STTM costs

Origin Energy proposed an allowance of $0.05/GJ to account for the additional market volatility risks associated with deviations and contingency gas under the STTM. SKM MMA advised the Commission that it is reasonable to believe that the net outcome to retailers will be zero.

On the basis that Origin Energy did not provide sufficient information to substantiate its claim that the STTM will result in additional costs to retailers, and having regard to advice received from SKM MMA, the Commission's draft conclusion was to make no allowance for STTM costs.

In its submission on the Commission's Draft Decision, Origin Energy provided additional information to the Commission on a confidential basis to support its claim that there is a cost associated with the STTM. The basis of this claim is that load variability manifests itself in greater costs of serving small customers (including standing contract customers). Origin Energy states that the daily demand of small customers (including SCP) exhibits greater volatility than commercial/industrial customers. Origin Energy argues that the STTM deviation penalties effectively allocate cost to the more volatile customers.

Through its participation in the STTM, Origin Energy comments that the prudent means of hedging deviation costs is by participating in the market operating service (MOS) bidding stack requiring the purchase of a dedicated form of park and loan service independent of day to day wellhead MDQ supply in order to be certain of being able to honour MOS bids. Origin Energy has subsequently calculated the cost of this dedicated park and loan service to be $0.065 /GJ

SKM MMA considers it reasonable that the net cost of a hedge instrument to manage deviations under the STTM be included as a prudent cost to a retailer. The Commission has received confidential information from Origin Energy detailing the costs of the park and loan service to be used as a hedge against deviation penalties faced by a retailer under the STTM. Information about the revenue that Origin Energy has earned from offering in the MOS service has also been received, permitting the derivation of net revenue. The fact that the STTM has yet to operate in a winter period, which would see the greatest potential for demand volatility amongst small customers means that uncertainty exists around the calculation of any amount to be allowed for the costs of operating in the STTM.

The Commission's Final Determination on STTM costs for SCP customers is $0.065/GJ.

The Commission's Final 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 6-4. This cost will apply uniformly over the 5 pricing regions.

Table 6-4 – Final 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	4.16	4.14	4.14	4.16	4.14	4.14
Wellhead MDQ	0.87	0.87	0.87	0.37	0.37	0.37
Other cost	0.065	0.065	0.065	0.065	0.065	0.065
Total Cost of Gas	**5.10**	**5.08**	**5.08**	**4.60**	**4.58**	**4.58**

7 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 pipelines, 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).

7.1 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 summarised 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.

7.1.1 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 6, 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[61] 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 the 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 system use gas (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.

7.1.2 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 the 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 7.1.

Table 7.1. - 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

7.2 Summary of Draft Inquiry Report

The Commission 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 considered the proposals put by Origin Energy, and the advice received from SKM MMA, and its Draft Decision on each of the relevant transmission cost components is summarised as follows.

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

7.2.1 Main Pipeline Costs

MAPS transmission costs

A key determinant for allocating the cost of fixed transmission pipeline capacity to different customer groups is the assumed load factor (relationship of peak demand to average demand) of each group. The Commission's Draft Decision accepted Origin Energy's proposed load factors for residential and SME standing contract customers, which impacted on the fixed costs for all transmission pipelines, including MAPS.

In assessing Origin Energy's proposed fixed cost for MAPS, the Commission did not accept the inclusion of the cost of a park service, on the basis that such a cost is more appropriately considered as an MDQ cost. The Commission noted that it 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 Commission accepted Origin Energy's proposed variable costs for MAPS, 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.

SEAGas transmission costs

Origin Energy proposed a reduction, in real terms, of the SEAGas fixed cost relative to that proposed in 2008. Based on advice provided by SKM MMA, the Commission accepted most of the fixed cost components, other than the inclusion of South East South Australian (SESA) pipeline costs, which were considered to be related to the connection to the Mount Gambier region and should therefore be included in Mt Gambier lateral costs. The Commission's Draft Inquiry Report invited Origin Energy to demonstrate that such costs are not incorporated into the Mt Gambier lateral cost and, if they are not, why it is more appropriate to include them in the SEAGas cost rather than the lateral cost.

The Commission accepted the variable SEAGas cost proposed by Origin Energy, noting that it is consistent with that proposed in the 2008 Gas Standing Contract Price Determination.

System Use Gas

Origin Energy proposed a cost of SUG for both the MAPS and SEAGas pipelines. The Commission accepted the proposed SEAGas SUG costs, but did not accept those for the MAPS pipeline. The proposed SUG costs were 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 suggested that the assumed 2.2% of wellhead volume as SUG may be excessive. The Commission accepted that advice, and decided a figure of 1% be used for MAPS, which is based on the average MAPS SUG amount for 2009/10.

7.2.2 Lateral Pipeline Costs

The Commission's Draft Determination accepted Origin Energy's proposed lateral costs for Whyalla, but did not accept the proposed costs for the Mt. Gambier and Riverland laterals, on the basis that Origin Energy had not provided 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.

In the absence of sufficient information from Origin Energy to justify the Mt. Gambier and Riverland lateral costs, the Commission accepted the advice from SKM MMA that Origin Energy's forecast demand for those regions appears too low, and that the lateral costs should be reduced on the basis

7.3 Submissions to the Draft Determination

Only the Origin Energy submission commented on the Commission's Draft Decision on transmission costs.

Origin Energy argued that the cost of the park service, which was removed by the Commission from MAPS fixed costs, should be allocated to STTM costs. The Commission's consideration of those costs is set out in chapter 6.

Origin Energy's confidential submission provided further information to the Commission in support of its argument for an increase in the Mt. Gambier lateral cost. This information attempts to substantiate Origin Energy's forecast reduction in demand in the Mt. Gambier region. Origin Energy has argued that the standing contract price should increase given the reduction in total demand in the region (in order to recover its fixed costs).

In response to the Commission's Draft Decision to remove the SESA pipeline cost from SEAGas costs, Origin Energy has argued that the Commission should have included that component within the Mt. Gambier lateral costs. It has suggested that the SESA pipeline cost has not been accommodated by the Commission in either the SEAGas or Mt. Gambier lateral costs.

7.4 Commission's Considerations

The Commission has sought advice from SKM MMA on the confidential information provided by Origin Energy in its submission to the Draft Inquiry Report. That process has involved the provision of further information by Origin Energy to the Commission on the proposed Mt. Gambier lateral cost.

In relation to Origin Energy's argument that demand in the Mt. Gambier region has decreased, SKM MMA has accepted the information provided by Origin Energy demonstrating the reduction in demand. However, SKM MMA has recommended to the Commission that there does not appear to be any justification for standing contract customers paying for that reduction in demand, given that it has been caused by other customers.

The Commission agrees with that principle, noting that under a stand-alone cost approach, standing contract customers pay for transmission capacity based on their own demand. If other customers reduce their demand over time, the Commission does not consider it reasonable for standing contract customers to compensate Origin Energy for that reduction.

Origin Energy has also suggested that the SESA pipeline cost should be included within the Mt. Gambier lateral cost. The Commission has requested confirmation from SKM MMA that the cost, which was removed from the SEAGas pipeline fixed cost, was also omitted from the Mt. Gambier lateral cost. SKM MMA has provided the Commission with a breakdown of the costs included within its recommended Mt. Gambier lateral cost, and this breakdown confirms that the SESA pipeline cost was not omitted as argued by Origin Energy.

The Commission's Final Decision, therefore, does not accept the arguments put forward by Origin Energy for an increase in the Mt. Gambier lateral cost. The Final Decision on transmission costs is unchanged from the Draft Decision, other than in relation to an updating of the assumed inflation, to reflect the actual March 2011 CPI.

The Commission's Final Determination on annual transmission costs is set out in Table 7.2.

Table 7.2. – Final determination 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	1.82	1.79	1.79	1.22	1.20	1.20
Variable TUOS	0.10	0.11	0.12	0.10	0.11	0.12
Transmission Cost	1.93	1.90	1.91	1.32	1.30	1.32

8 RETAIL OPERATING COST

The Retail Operating Cost (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 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[62] established REES, which commenced on 1 January 2009 and will continue at least until 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.[63] REES establishes obligations on electricity and gas retailers (with at least 5,000 residential customers), including the conduct of:

- Energy efficiency activities (expressed as annual greenhouse gas reduction target) for priority[64] and non-priority groups; and
- Energy audits (expressed as total numbers).

The ROC allowance should represent the costs of an efficient retailer operating in the competitive energy retail market in South Australia, having regard to the specific obligations involved in the provision of the standing contract[65]. The allowance is reflective of a notional prudent retailer, rather than Origin Energy specifically. The implications of this approach are discussed more fully in the following sections.

8.1 Origin Energy's Proposal

Origin Energy's view is that retail costs do not differ significantly between gas and electricity. For this reason, Origin Energy proposed that an appropriate allowance was

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

63 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

64 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

65 While a standing contract supplier would not be required to incur costs for customer acquisition or retention, for the reasons set out further below, the Commission considers that the standing contract price should reflect overall a price consistent with a competitive market price, so as not to constrain the operation of a competitive market.

that set by the Commission for ROC in its 2010 *Review of Retail Electricity Standing Contract Price Path*[66], of $118.83[67] 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 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.

Origin Energy's proposal for the ROC for the forthcoming price path period is summarised in Table 8-1.

Table 8-1 - Origin Energy's Proposed ROC Allowance, 2011/12 to 2013/14
$ per customer, $Dec11

	2011/12	2012/13	2013/14
ROC allowance	$118.83	$118.83	$118.83
REES Costs	$1.61[68]	-	-
Total	**$120.44**	**$118.83**	**$118.83**

8.2 Summary of Draft Inquiry Report

8.2.1 Approach

The Commission's Draft Inquiry Report examined ROC through a combination of benchmarking against ROC allowances across jurisdictions, in both electricity and gas retail markets, and by reference to actual cost information provided by Origin Energy. In developing its draft conclusions, the Commission had regard to Origin Energy's proposal, submissions from other stakeholders to Origin Energy's proposal, and a report prepared for the Commission by Sapere Research Group (Sapere).

The Commission observed that, almost seven years on from the introduction of full retail competition in the gas market, the South Australian retail gas market has now matured, with only four active retailers offering products to the residential and SME market, all of whom are dual-fuel retailers. Customer churn between retailers has also existed at a consistently lower rate than observed in the electricity market.

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

67 $115.00 allowance ($Dec10) inflated to $Dec11 prices

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

The Commission's draft finding was that the marketing of gas is clearly secondary to the marketing of electricity, and this reflects the reality of how retailers operate. This is supported by retailer comments, provided as part of a retailer survey prepared for the Commission in 2010[69]. Whilst acknowledging that the standing contract price must be high enough to encourage competition, the Commission's Draft Determination was that this should reflect the reality that competition for gas supply occurs in a dual-fuel market context, and that no reasonable standing contract price could be set so as to encourage a gas-only retailer to enter the market (particularly, if such a retailer was not otherwise likely to be competitive against a dual-fuel retailer.)

It was noted that the Commission's 2010 Electricity Standing Contract Price Determination has already provided dual-fuel retailers with a stand-alone Customer Acquisition and Retention Cost (CARC) allowance.

The Commission is also mindful of the need for the standing contract price to provide a level of protection to those consumers who choose to remain on the standing contract, including those in regional areas, who may have no choice of supplier.

For these reasons, it was the Draft Decision of the Commission that the long term interests of consumers would be best served by setting a gas standing contract price reflecting the marginal (or incremental) cost of marketing gas alongside electricity. This was achieved by adjusting the acquisition cost element of CARC.

8.2.2 Initial base-ROC Allowance

Whilst Origin Energy's proposal did not split ROC between base-ROC and CARC, the Commission, supported by advice from Sapere, considered that it was reasonable to base its analysis on a split of costs consistent with the previous electricity price determination. This is provided in Table 8-2.

Table 8-2 – 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	$79.05	$79.05	$79.05
CARC	$39.78	$39.78	$39.78
Total ROC allowance (Origin Proposal)	**$118.83**	**$118.83**	**$118.83**

The Commission tested the proposed opening base-ROC allowance against a number of criteria and found the Origin Energy proposal, based on the above disaggregation, to be reasonable. However, the Commission noted that Origin Energy, in common with other retailers, is making significant changes to its

[69] See p39, ACIL Tasman 2010 report - http://www.escosa.sa.gov.au/library/100624-CompetitivenessRetailMarketReport-ACILTasman-Public.pdf

retail business, introducing new systems and processes, aimed at optimising its cost to serve.

8.2.3 Forecast Changes in base-ROC

Whilst the Commission is keen to ensure that retailers are incentivised to introduce improved systems and processes, it is also appropriate to ensure that consumers are able to share in the benefits of such initiatives. The Commission noted that Origin Energy is well advanced with its retail transformation project, with new systems becoming operational from mid-2011.

The Commission took account of its own previous analysis of the projected benefits from a similar transformation project carried out by AGL SA, based on which an annual efficiency target of 4.1% per annum was set, and of the advice from Sapere that projected efficiencies of up to 5% per annum may be reasonable over the second and third years of the price path period.

Based on the above analysis and advice, taking account of a 50:50 sharing ratio of benefits between retailers and consumers, and allowing a reasonable bedding-in period for the new systems, the Commission set a base-ROC efficiency target across years two and three of the price path period of CPI-2%.

8.2.4 CARC Allowance

The Commission then considered the proposed CARC allowance, and concluded that two adjustments were appropriate:

- The Commission noted that there have been consistently lower customer switching rates in gas, when compared to electricity. Given the lower number of retailers in gas relative to electricity, and the positive correlation between switching rates to date, it was considered most likely that this lower switching rate will continue. As a lower switching rate drives lower total CARC and, therefore, lower CARC per customer served, an adjustment was made to the acquisition element of CARC to account for this.
- As stated above, the Commission determined the appropriate CARC allowance for gas to be the incremental cost of operating as a dual-fuel retailer. The Commission acknowledged that there are practical difficulties in estimating the incremental CARC, given the limited information that is available on acquisition costs per fuel type. Whilst the commission-based cost of acquiring a second fuel may be up to 50% lower than the first fuel, it was recognised that there are other acquisition costs that should also be taken into account The Commission, therefore, took a cautious approach to adjusting for incremental CARC, making a limited reduction of the acquisition element within CARC of 30%.

8.2.5 REES

The Commission accepted that there is some uncertainty as to the targets and allowed activities in REES going forward, but noted that there is certainty that, under the current gas and electricity regulations, REES will continue in some form across the full three year price path period. The Commission, therefore, determined that it is appropriate to set an allowance for the full three year 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.

The REES allowance has been set at a level of $2.62[70] per customer per annum, based on analysis carried out as part of a REES cost pass through application[71] by Origin Energy in 2010.

8.2.6 Draft Determination - ROC

Taken together, the above adjustments resulted in a Draft Determination ROC allowance as provided in Table 8-3:

Table 8-3 - Draft Determination on ROC Allowance, 2011/12 to 2013/14
$ per customer, $Dec11

	2011/12	2012/13	2013/14
Base ROC	$79.05	$77.47	$75.92
CARC	$24.92	$24.92	$24.92
REES	$2.62	$2.62	$2.62
Total ROC allowance	**$106.59**	**$105.01**	**$103.46**

8.3 Submissions to the Draft Inquiry Report

The Commission received five submissions in response to the Draft Determination, all of which commented on ROC issues:

- Origin Energy expressed concern that the Draft Decision on ROC does not provide full recognition of the actual costs that a retailer would incur in supplying gas to standing contract customers in South Australia and does not provide any incentive for retailers to invest or enter the market. Origin Energy stated that, whilst it proposed a total ROC allowance in line with the 2010 electricity determination, it did not propose that the split of this allowance should mirror that of the previous electricity determination. Origin Energy did not, however, propose any alternative split of its ROC proposal.

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

71 Further details available from the ESCOSA website - http://www.escosa.sa.gov.au/library/100618-REESPassThrroughDecisionPublic_2010-11-Origin.pdf

On base-ROC, Origin Energy urged the Commission to increase the allowance to recognise its actual cost structure. With regard to forecast changes in base-ROC, Origin Energy stated that there are unlikely to be any efficiency gains from its new customer management systems in the forthcoming determination period, and urged the Commission to recognise that real increases in labour costs are being incurred. Origin Energy cited AGL SA's recent experience in implementing a new customer management system, which saw costs increase substantially in the short term.

In relation to CARC, Origin Energy stated that the Commission's Draft Decision to consider CARC on a dual-fuel basis did not appear reasonable or align with the practices of other regulators around Australia, and urged the Commission to consider gas costs on a stand-alone basis. Origin Energy stated that, in South Australia, approximately [redacted]% of customers transferring their gas account do not also transfer their electricity account and that, at the very least, the Commission should take account of this single fuel element in its final decision.

Origin Energy accepted the approach taken by the Commission on REES but sought further clarity on how it would make an application for a price variation, if this were to prove necessary during the price path period.

- AGL SA urged the Commission to re-consider its Draft Decision on both CARC and future efficiency gains.

  On CARC, AGL SA stated that the price path should be set based on the costs of a hypothetical efficient stand-alone retailer, this position being consistent with regulatory decisions in various energy price reviews across Australia. Additionally, it stated that the proposed 30% reduction in CARC will not allow retailers to fully recover their costs.

  AGL SA further stated that it does not support the adjustment made to CARC to reflect the lower switching rate in gas, arguing that the adjustment will result in the switching rate staying at the current low level.

  On future efficiency gains, AGL SA stated that it was concerned that the Commission has focused too narrowly on the specifics of Origin Energy's operating model, and urged the Commission to consider the ROC as that of a 'benchmark efficient retailer'. It further stated that any efficiency gains accruing from business transformation projects would not be as immediate as assumed by the Commission.

- SACOSS fully supported the Commission's approach to setting the gas standing contract prices based on gas being a secondary product to retail electricity offers. It viewed the 30% reduction applied to acquisition costs as a conservative decision. It further commented that consumers should reasonably expect the cost of retailing to capture meaningful efficiency gains over the coming years.

- CSV also supported the Commission's position on assessing the efficient gas standing contract costs as those of a dual-fuel retailer, noting that it considered the proposed 30% reduction in acquisition costs to be conservative, and suggesting that a further reduction could well be warranted.
- ESAA stated that the introduction of efficiency factors, and the incorporation of costs based on a dual-fuel retailer into regulated tariffs, creates unnecessary barriers to entry and potentially suppresses the overall level of competition within the retail gas market.

8.4 Commission's Considerations

8.4.1 Approach

The Commission has given due consideration to all of the submissions by stakeholders.

The Commission continues to use benchmarking as the primary approach to this review, with the December 2010 Electricity Standing Contract decision being a key point of reference. This approach is supported by consideration of Origin Energy's actual cost structure. It is noted that, since the Draft Decision, there have been no new regulatory decisions in other jurisdictions that would further inform the decision process.

It remains the view of the Commission that gas and electricity retailing are fundamentally similar activities. It is noted that Origin Energy is supportive of this, stating in its proposal that '*…retail costs do not differ significantly between gas and electricity mass market customers…*'[72].

Indeed, it is noted that retailers are commonly seeking efficiencies in their businesses through convergence of the systems that support both gas and electricity retailing, and that public reporting of retailer costs does not typically differentiate between gas and electricity retail costs.

Given this, the Commission's approach remains consistent with the Draft Decision, with allowances being based on the December 2010 Electricity Standing Contract Final Determination, appropriately adjusted to reflect the specifics of the gas market, and sense checked against Origin Energy's actual cost base.

8.4.2 Initial base-ROC Allowance

The Draft Decision on base-ROC was based on the Origin Energy proposal for the forthcoming price path period, to adopt a total ROC value consistent with the Commission's 2010 Electricity Standing Contract decision. This

[72] Ibid p34

determination was itself based on a bottom-up analysis of costs carried out by the Independent Pricing and Regulatory Tribunal of NSW (IPART) as part of its 2010 Electricity Standing Contract review.

As stated above, the Commission, supported by advice from Sapere, considered that it was reasonable to base its analysis on a split of costs between base-ROC and CARC that was consistent with the previous electricity price determination.

The Commission has considered Origin Energy's comments that this split of costs between base-ROC and CARC results in an allowance for base-ROC that is below the level previously allowed by the Commission for the 2008-2011 period, and notes that this element of the Draft Decision is also lower than the 2009/10 actual cost data provided to the Commission by Origin Energy.

It is also noted that Origin Energy's submission to the Draft Decision did not propose any alternative split of its total ROC proposal between base-ROC and CARC. The Commission further notes that any proposal for an increase in the base-ROC allowance would simply result in the CARC allowance being reduced by the same value.

As stated above, benchmarking remains the primary approach to this review, with the Commission's 2010 electricity determination being the key point of reference (itself based on the 2010 IPART electricity determination, the last bottom-up analysis of costs carried out across any Australian jurisdiction). Given this, and the Commission's view, supported by Origin, that electricity and gas retailing are fundamentally similar activities, it remains the view of the Commission that the split of allowances between base-ROC and CARC in the 2010 Electricity Standing Contract Price Determination is an appropriate starting point for the gas standing contract review.

In section 8.4.6 of this document, the Commission has sought to address Origin Energy's concerns over base-ROC being lower than actual costs, by carrying out some further analysis, which compares Origin Energy's 2009/10 actual costs to service its energy customer base, with a weighted average of the final decision standing contract allowance for gas and the existing standing contract allowance for electricity.

8.4.3 Forecast Changes on base-ROC

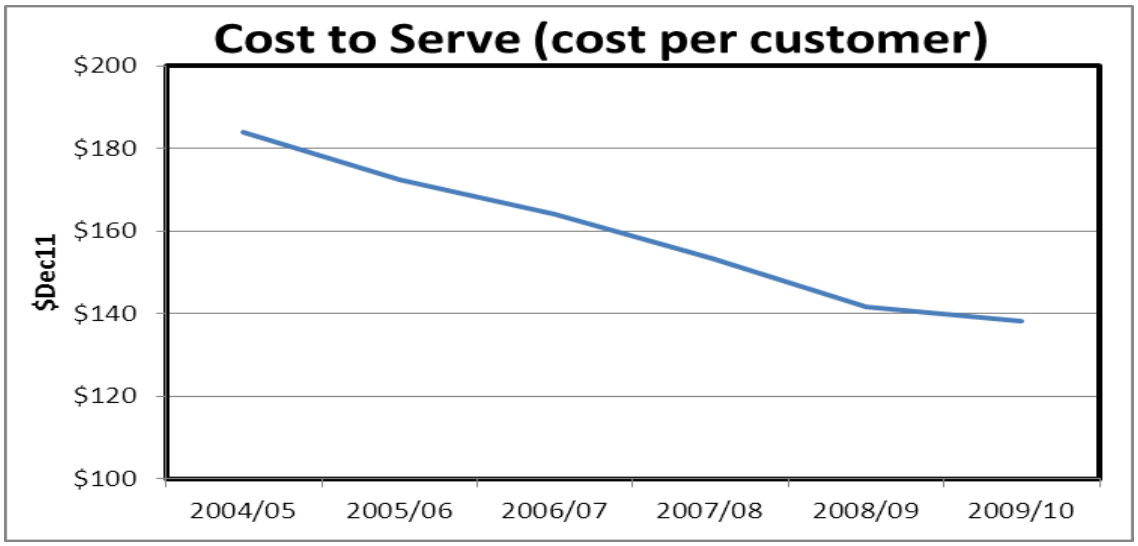
Origin Energy states that there are unlikely to be any efficiency gains from its retail transformation project in the forthcoming price path period, and that any efficiencies are likely to be in the longer term. The Commission notes that this view is supported by AGL SA. However, no evidence has been presented by Origin Energy to support this assertion.

Further to this, Origin Energy states that no ongoing efficiency factor was built into the 2010 Electricity Standing Contract price decision, and thereby questions the consistency of approach between the gas and electricity decisions. The Commission notes these comments and would point out that any ongoing efficiencies in electricity will be automatically addressed via the Relative Price Movement[73] (RPM) mechanism that is now in place. It is, therefore, not necessary for the Commission to forecast movements in ROC under the Electricity Standing Contract price determination.

AGL SA states that the Draft Decision is too focused on Origin Energy, rather than a hypothetical prudent retailer. The Commission is aware that other retailers, including AGL SA (with its Project Phoenix), have programs in place to renew their retailer systems. Indeed, the Commission would expect any prudent retailer to continually seek out efficiencies, including IT system enhancements and renewals where appropriate.

In order to better understand how Origin Energy's costs have moved over time, the Commission has carried out a trend analysis of Origin Energy's 'Cost to Serve' its customer base, as publicly reported in its Annual Reports. These costs are an average cost per account across both gas and electricity, for customers in all states and territories. The following graph illustrates how these costs have moved over time:

Figure 8-1 – Origin Energy 'Cost to Serve', 2004/05 -2009/10, $ per account, $Dec11



Data Source: Origin Energy published Annual Reports 2005/6-2009/10

[73] Further details of the RPM mechanism are available at P109 - http://www.escosa.sa.gov.au/library/101208-ElectricityStandingContractPrice-FinalPriceDetermination-PartA.pdf

When stated on a constant dollar value basis, as shown above, Origin Energy's 'Cost to Serve' per customer has reduced by 25% over the five year period from 2004/05 to 2009/10. The Commission is also aware that Origin Energy is currently well advanced with its retail transformation program to transform all aspects of its retail business, with a phased migration to the new systems having already commenced. One of the stated aims of this project is to optimise its cost to serve going forward.

Given this strong record of reducing costs over time, and the advanced stage of the transformation project that is currently underway, it remains the view of the Commission that there is scope to reduce base-ROC costs within the forthcoming price path period.

Whilst accepting that new systems take time to become established and reliable, the Commission sees no reason to move from its Draft Decision to allow the new systems to become established during the first year of the price path period, then apply a 2% real reduction to base-ROC costs in each of the second and third years of the price path period.

This efficiency reduction is based on the new systems delivering an overall benefit of 4% in each of the second and third years, with a 50:50 sharing of benefits between retailers and consumers, thereby providing an appropriate incentive to Origin Energy to invest, whilst ensuring that the benefits of the new systems are shared with customers.

As demonstrated by Figure 8-1, Origin Energy has consistently achieved annual savings, averaging approximately 5% per annum, in its 'Cost to Serve' over the last few years. This is both supportive of, and aligns well with, the Commission's decision for the forthcoming price path period.

On the specific issue of wage rates, Origin Energy stated that it is facing real increases in labour rates and that this should be considered in setting ROC allowances going forward. The Commission notes that the above year on year reductions in 'Cost to Serve' have been achieved against a backdrop of real increases in wage rates, and sees no reason to assume that retailers cannot continue to more than offset any such real wage increases with improvements in productivity, technology, innovation, and procurement.

8.4.4 CARC Allowance

As noted above, the Commission considers that the ROC allowance should represent the costs of an efficient retailer operating in the competitive energy retail market in South Australia, having regard to the specific obligations involved in the provision of the standing contract.

The allowance is reflective of a notional prudent competitive market retailer, rather than Origin Energy specifically.[74]

The Commission recognises that a standing contract supplier would not be required to incur costs for customer acquisition or retention. However, if the Commission were to set a price which did not reflect customer acquisition or retention costs, but were otherwise set on the basis of the costs of an efficient competitive market operator, this would constrain the operation of the competitive market. In effect, the Commission would be taking into account the scale and scope efficiencies that are achieved by a competitive gas market retailer, in particular scale economies from serving a larger competitive (and regulated) customer base (including a customer base that extends beyond South Australia), as well as the economies of scale and scope that are derived in practice from supplying both electricity and gas customers, without recognising that these economies are derived through the efforts (and with the costs) of acquiring and retaining customers in a competitive market.

Accordingly, the Commission is satisfied that it is appropriate, in setting a price that reflects benchmark costs of national energy retailers, that it is appropriate to include an allowance for customer acquisition and retention costs.

The critical question for the Commission in this review is what is the appropriate allowance for customer acquisition costs - in particular in the context of the competitive market conditions in South Australia.

Taking account of the concerns expressed by retailers in their submissions to the Draft Decision, and being aware that the Draft Decision represented a change from established regulatory precedent, the Commission engaged ACIL Tasman to review and report on the economic principles underpinning the approach used to determine CARC. In particular, the Commission required ACIL Tasman to test two key principles, or assumptions, namely:

- that it is not prudent for an energy retailer to seek to acquire gas customers in the South Australian retail energy market on a stand-alone basis i.e. that a prudent retailer will only seek to acquire gas customers on the basis that it is also seeking to acquire electricity customers; and
- that the long term interests of South Australian energy consumers are best served by setting the gas standing contract price to recover only the incremental cost of acquiring gas customers.

On the first principle, ACIL Tasman concluded that no prudent retailer would choose to enter the energy market on a gas-only basis, for the following reasons:

[74] Having said that, the Commission has, as set out further below, satisfied itself that the price it has determined is likely to be at least sufficient to allow Origin Energy to recover its efficient costs of meeting its standing gas supply contract obligations.

- To refrain from retailing electricity in addition to gas is to refrain from pursuing a profitable activity.
- Electricity is the dominant fuel, with a bigger customer base and a higher level of revenue per customer than gas.
- The presence of economies of scope in acquiring electricity and gas customers together strengthens the case for entering the market on a dual-fuel basis, with single fuel retailers finding themselves at a competitive disadvantage to dual-fuel retailers.
- Due to low penetration and low average consumption, the South Australian gas market is the least attractive jurisdiction of all the Eastern states. It is therefore considered very unlikely that, given the absence of a gas-only entrant elsewhere, any gas-only entrant would set up in South Australia.

For these reasons, ACIL Tasman concluded that efficient entry into the South Australian energy retail market was only likely on the basis of electricity only or (increasingly) dual-fuel retailing. ACIL Tasman further commented that the existing structure of the market supported this conclusion.

On the second principle, ACIL Tasman concluded that the long-term interests of consumers in facilitating competition in the retail gas market, and encouraging economically efficient outcomes, would be best achieved by setting a gas standing contract price to mimic the outcome that would occur in a competitive market.

ACIL Tasman notes that there are, in practice, economies of scope in customer acquisition across gas and electricity. The question for the Commission is what regard it should have to these economies of scope and how that should be reflected in the final gas standing contract price.

ACIL Tasman reviewed the principles of efficient pricing in the face of economies of scope/scale that were developed by Baumol and Willig[75]. Those principles are that the price of each service or set of services must be:

- *less than* the stand-alone cost of supplying the service or set of services
- *more than* the incremental cost of supplying the service or set of services

This ensures that any economies of scope that arise from joint costs are passed on to customers.

ACIL Tasman then considered how scope economies should appropriately be allocated between electricity and gas in the context of the competitive market dynamics in which gas, and electricity, are supplied.

[75] Baumol, Panzar and Willig, 1982, Contestable markets and the theory of industrial structure, San Diego: Harcourt, Brace Jovanovitch.

As a starting point, given that a stand-alone cost for acquisition has already been allowed under the Electricity Standing Contract price, ACIL Tasman considered that to not pass on economies of scope in the gas standing contract price would be to allow super-normal profits (across both gas and electricity prices).

Further to this, any attempt to share scope economies between electricity and gas would damage the ability of stand-alone electricity retailers to compete.

ACIL Tasman also considered efficiencies of scope in the context of a dominant product or service by reference to a number of economic principles. ACIL Tasman referred to the economic principle that, where there is a dominant product or service, all joint costs should be allocated to that dominant product or service, with only incremental costs allocated to other jointly produced products or services. The efficiency and competitive market implications of this principle have been demonstrated by Alfred Kahn[76], and are reviewed in the ACIL Tasman report. In the context of electricity and gas retailing, electricity retailing can reasonably be considered to be the dominant product.

For these reasons, ACIL Tasman concluded that the long term interests of South Australian energy consumers in terms of competitive and efficient markets are best achieved by prices under the gas standing contract which are set so as to recover only the incremental costs of acquiring gas customers.

The ACIL Tasman report[77] has been published with this Final Report.

Both Origin Energy and AGL SA, in their responses to the Draft Decision, raised the issue that the proposed incremental approach to CARC allowances is inconsistent with established regulatory precedent in other jurisdictions. The Commission considers that, whilst accepting that regulatory consistency is important, this must be balanced against taking account of the actual structure of the retail market in South Australia and the long term interests of consumers. In Chapter 11 of this Final Report, the Commission provides further information as to how it has sought to balance its various objectives in making this determination.

The Commission has considered, and accepts, the advice provided by ACIL Tasman. It therefore sees no reason to change the approach outlined its Draft Decision.

Gas Account Churn Rates

[76] Alfred E Kahn, 1998, The Economics of Regulation, Principles and Institutions, MIT Press, Cambridge Massachusetts, London England

[77] The ACIL Tasman report is available on the Commission's website – http://www.escosa.sa.gov.au/library/110630-ACILTasmanFinalReport-Public.pdf

AGL SA stated that adjusting CARC for a lower gas switching rate, when compared to electricity, is self-fulfilling, as the resultant lower standing contract price is likely to reduce competition in the gas market.

It remains the view of the Commission that adjusting for lower churn is an appropriate adjustment to make, as the relative churn rates between gas and electricity have been consistent over the last 3-4 years, and are likely to remain so. Further, as long as the overall ROC allowance is set above the marginal cost of retailing gas alongside electricity, retailers will continue to market energy on a dual-fuel basis.

Whilst the Commission accepts that there may be some validity in AGL SA's view that adjusting for a lower gas switching rate is likely to reduce competition in the gas market, it remains the view of the Commission that this adjustment will not reduce competition in the dual-fuel market.

The relative churn rates, based on an analysis of the last three years, are 15.2% p.a. for electricity and 11.2% p.a. for gas. Adjusting the acquisition element of CARC for this lower churn rate reduces the CARC allowance by $7.98 per customer per annum.

Further Analysis – Dual-fuel Adjustment

In the Draft Decision, a further 30% adjustment was then made to the remaining acquisition element of CARC, to take account of the incremental nature of gas customer acquisitions, and the resultant lower commissions typically paid for gas acquisitions as the secondary fuel in a dual-fuel customer acquisition.

The Commission has carried out a bottom-up analysis on this cost element, considering both the incremental cost of commissions paid to sales staff for gas customer acquisition as a secondary fuel, and the on-costs incurred by retailers in making commission payments to sales staff.

Taking account of these factors, the analysis shows that an appropriate overall reduction to acquisition costs is at a level of 28%, rather than the 30% assumed in the draft decision. This adjustment adds $0.41[78] to the CARC allowance per customer, when compared to the draft decision.

Further Analysis - Gas-only Churn

Origin Energy stated, in its response to the Draft Decision, that it had conducted some internal analysis which showed that approximately [redacted]% of customers who churned their gas account did so on a gas-only basis (i.e. they did not also churn their electricity account within 60 days). This analysis demonstrates that approximately [redacted]% of market-churn for customers who have both gas and electricity supplied to their property is on a dual-fuel basis, and is therefore strongly supportive of the approach that the Commission has adopted.

[78] An adjustment of $6.47 versus $6.88 in the draft decision.

The Commission, however, accepts the issue raised by Origin Energy that, on those occasions where gas-only churn occurs, it is not appropriate to allow for only a marginal acquisition cost. The Commission also notes that AGL SA outlined, in its response to the Draft Decision, that there are circumstances where a gas-only transfer can occur. On these occasions, a single fuel commission payment will be made to sales staff, with the level of the payment being higher than an incremental second fuel payment.

The Commission has sought and received further information[79] from Origin Energy on such situations. This information confirms that, based on actual customer transfer information, approximately [redacted]% of recent gas transfers were on a gas-only basis.

The Commission has, therefore, made an adjustment in its modelling to ensure that a full (single fuel) acquisition cost is allowed on [redacted]% of transfers. This adjustment adds a further $1.04 to the CARC allowance per customer, when compared to the Draft Decision, and takes the overall CARC adjustment to 24%. Table 8-4 provides a trace of the adjustments made from the CARC allowed in the 2010 Electricity Determination to that allowed in the Gas Final Decision:

Table 8-4 – CARC Adjustments
$ per customer, $Dec11

CARC per 2010 Electricity Determination		**Total**	**Notes**
Acquisition Costs	$30.91		Stand-alone fuel, 15.2% annual churn rate
Retention Costs	$6.65		
Transfer Costs	$2.22	**$39.78**	
Adjustments to Acquisition Costs to derive Gas CARC			
Acquisition Costs per Electricity	$30.91		
Adjust for lower churn rate	($7.98)		11.2% p.a.in gas vs. 15.2% p.a. in electricity[80]
Adjust for incremental acquisition cost	($6.47)		Based on $80/$30[81] commission +15% on-costs
Adjust for Gas-only transfers	$1.04	**$17.50**	Based on [redacted]% of gas transfers being single fuel
Retention Costs		$6.65	
Transfer Costs		$2.22	
Final Decision Gas CARC		**$26.37**	

[79] The Commission requested that Origin Energy re-run its analysis based on a 90 day billing cycle.

[80] Based on customer transfer data supplied by AEMO, also see Figure 2-1 of this report

[81] Commission figures sourced from AEMC, p32 - http://www.aemc.gov.au/Media/docs/LECG%20Consulting%20Report-681915e3-27b6-44ff-9dee-3e5a0a54924e-0.pdf

8.4.5 REES

The Commission notes that Origin Energy requested further clarity as to how it would apply for a cost pass-through, if the actual costs of REES go above those allowed in the final determination, due to a change in market circumstances.

The Commission recognises that REES targets and allowed activities from 1 January 2012 may be materially different from those prior to this date. As stated in section 5.5 of this document, the Commission has amended the definition of a 'regulatory reset event', to ensure that it covers the situation where Origin Energy may need to make a cost-pass through application for this reason.

8.4.6 Analysis of Allowances vs. Actual Operating Costs

The Commission notes Origin Energy's statement that the Draft Decision does not provide for the recovery of efficient costs, and further notes that Origin Energy urged the Commission to increase the allowance to recognise its actual cost structure.

In setting the electricity and gas standing contract prices, the Commission is seeking to set prices to facilitate a competitive energy retail market. All gas retailers also operate in the electricity retail market and therefore it is the combined impact of both the electricity and gas ROC decisions that is relevant in considering whether allowances are high enough to cover efficient retailer costs.

Retailers, including Origin Energy, express their ROC in total across both fuels – they do not differentiate between gas and electricity. This was seen in the actual cost data which Origin Energy provided to the Commission, which did not differentiate between fuels. It therefore follows that, if the weighted average of the electricity and gas allowances aligns with Origin Energy's reported actual costs, it will be sufficient to cover Origin Energy's cost structure.

In order to test this, the Commission has calculated a weighted average total ROC using both the 2010 Electricity Standing Contract ROC allowance and the Final Decision Gas Standing contract ROC allowance, appropriately weighted using Origin Energy's current residential and SME customer base:

Table 8-5 – Weighted Average ROC Allowance, Origin Energy
$ per customer, $Dec11

	Electricity	Gas	Total
Origin Energy - no. of accounts as at 31 March 2011[82]	149,661	207,456	357,117
Origin Energy % split of accounts	41.9%	58.1%	100%
Total ROC Allowance	$131.80	$108.04	
Weighted Average ROC Allowance			**$118.00**

As stated above, Origin Energy provided to the Commission, on a confidential basis, details of its actual cost base for 2009/10, albeit based on average costs across its national energy business. The Commission has had regard to these costs in setting the ROC allowance, and is satisfied that the standing contract ROC allowances stated in Table 8-5 provide for the recovery of efficient retailer costs.

8.4.7 Summary

In balancing the statutory objectives to determine the ROC allowance, the Commission is satisfied that the final price:

is reflective of the recovery of customer acquisition costs in a competitive gas market, having regard to the particular dual-fuel nature of competition in the South Australian market;

- allows Origin to recover its actual costs in meeting its obligations as the gas standing contract retailer; and
- is not lower than the current competitive market price (as discussed in chapter 2, and demonstrated in Figure 2-5), and therefore will not preclude competitive market activity, including, the prospect of efficient and competitive new dual-fuel entry.

In doing this, the Commission has considered actual market conditions and competitive prices in chapter 2, and balanced its consideration of the statutory criteria, as described in chapter 11 below. The Commission is satisfied that its decision in not allowing recovery of full stand-alone CARC, as proposed by Origin, sustains competitive dynamics, and serves to protect the long term interests of consumers.

[82] Residential & SME customer numbers, as reported per Energy Industry Guideline 2, March 2011

8.5 Commission's Final Decision on ROC Allowance

It is the Commission's Final Determination that:

- ***the initial cost allowance for base-ROC will be $79.05;***
- ***the initial cost allowance for CARC will be $26.37; and***
- ***the initial cost allowance for REES will be $2.62.***

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

Table 8-6 outlines the Commission's Final Determination on ROC.

Table 8-6 - Final Determination on ROC Allowance, 2011/12 to 2013/14
$ per customer, $Dec11

	2011/12	2012/13	2013/14
Base ROC	$79.05	$77.47	$75.92
CARC	$26.37	$26.37	$26.37
REES	$2.62	$2.62	$2.62
Total ROC allowance	**$108.04**	**$106.46**	**$104.91**

9 RETAIL MARGIN (ROM)

The 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).

9.1 Origin Energy's Proposal

Origin Energy's proposal sought a ROM that it argues should *'encourage business efficiencies, new entrants, less of a reliance on regulated prices and thus competition in the gas market*.'[83] Further, Origin Energy considered that the ROM needed 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 than that allowed for by the Commission in its Electricity Standing Contract Price Determination 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'*.[84]

As outlined in Table 9-1, Origin Energy presented a range of ROMs from recent regulatory decision made in other jurisdictions, ranging from 10% to 16.6% of controllable costs.

Table 9-1 – Retail Margin Benchmarks

STATE	DECISION	PERIOD	RETAIL MARGIN (% CONTROLLABLE COSTS)	RETAIL MARGIN (% SALES REVENUE)
NSW Electricity	IPART	2010-13	10.8	5.4
ACT Electricity	ICRC	2010-12	10.8	5.4
QLD Electricity	QCA	2010-11	10.0	5.0
SA Electricity	ESCOSA	2011-13	10.0	5.0
NSW Gas	IPART	2010-13	14.6 – 16.6	7.3 – 8.3

[83] Origin Energy (2010), Proposed Price Path for Standing Contract Gas Customers in South Australia: 2011-12 to 2013-14, p.25 available at the following website: http://www.escosa.sa.gov.au/library/101119-OriginEnergyGasPricePathInquiryIssuePaper-Submission.pdf

[84] Ibid, p.25

Origin Energy considered that the most appropriate benchmark for the South Australian gas market was 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. Consequently, Origin Energy proposed that 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.

Origin Energy provided three reasons for increasing the ROM allowance:

- 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.

Each point (including the Commission's response established in the Draft Inquiry Report) is discussed in the following section.

9.2 Summary of Draft Inquiry Report

Consistent with the approach used during the 2008 Gas Standing Contract Price Determination, the Commission's Draft Inquiry Report was based on a combination of benchmarking against ROM granted in other jurisdictions, and by conducting a bottom-up "return on investment" analysis of retail margins for the standing contract business.

The Commission engaged Sapere to assist in this analysis.[85]

As outlined in the Draft Inquiry Report, Sapere 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 was widened to include electricity determinations.

To ensure consistency, and thereby enable a comparable benchmarking analysis of ROM allowances in other jurisdictions, Sapere undertook a 'normalisation' process to convert ROM from a percentage of controllable costs to a percentage of sales revenue. The outcome of this normalisation process is provided in Table 9-2. It is noted that the 'normalisation' process undertaken by Spare generates slightly different ROM benchmarks than those outlined by Origin Energy in Table 9-1.

[85] Sapere (2011), Review of the South Australia Gas Standing Contract Retail Operating Cost and Retail Operating Margin: Report to the Essential Services Commission of South Australia, available on the Commission's website: http://www.escosa.sa.gov.au/library/110406-2011_ReviewGasOperatingCosts-SapereConsultantReport.pdf

Table 9-2 - A summary of recent determinations by other jurisdictional regulators on ROM 'normalised' as a percentage of controllable costs

STATE	BODY	PERIOD	ROM	
			% OF SALES 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. 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.

In the Draft Inquiry Report, the Commission considered each of the three key reasons presented in Origin Energy's proposal (as outlined in section 9.1) as justification to support an increase in the ROM allowance above the 13% of controllable costs, provided for under the 2008 Gas Standing Contract Price Determination. The following points summarise the Commission's Draft Decision:

9.2.1 ROM allowance and forecast uncertainty

In the Draft Inquiry Report, the Commission considered this point in terms of the existence of a lower dollar margin for gas customers, and the level of gas consumption per customer:

Dollar margin per customer

The Commission did not accept Origin Energy's proposal that the existence of a lower dollar margin for gas customers is, in itself, a valid reason to allow for an increased gas ROM (expressed in percentage terms). While the Commission accepted Origin Energy's position that a lower dollar margin for gas customers does exist in South Australia, the Commission viewed this as being a principal reason for considering gas retail competition as being a by-product of electricity retail competition.

The Commission expressed the view that an appropriate ROM is not dependent on the value of gas sales to each customer. Further, the Commission considered that ROM should be viewed as a proxy for the return on investment by retailers, with the rate of return influenced only by the risk associated with that investment, i.e. not the value of the product sold itself. 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. The Commission could not gather any theoretical or empirical evidence to suggest that this was the case.

Gas consumption per customer

The implied argument to increase ROM due to falling gas consumption (per customer) in South Australia, to preserve a constant dollar margin, was not accepted by the Commission.

In the Draft Inquiry Report, the Commission established a ROM based on Origin Energy's average consumption per residential account of 20.7 GJ/pa for the forthcoming price path period (being 6.3% lower than that assumed in the 2008 Gas Standing Contract Price Determination). The Commission therefore explicitly addressed the forecast decline in average consumption through the sales forecasts and did not consider it appropriate to also adjust the ROM. The Commission also noted that variability between allowed and actual ROM as a result of sales forecast error during the price path period is minimised by Origin Energy's ability to update its sales forecast each year when proposing adjusted prices.

9.2.2 Calculation of ROM based on controllable costs

Consistent with the Commission's approach to setting ROM in its previous price determination processes, the Commission has set ROM at a level to ensure retailers recover the efficient costs of committing capital to their retailer business.

The Commission did not consider 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'*[86] as grounds to increase the ROM allowance.

While the Commission accepts Origin Energy's argument that South Australia has a lower percentage of controllable costs compared to other states, the Commission considered this as being the argument for normalising jurisdictional benchmarks on a percentage of controllable cost basis (rather than a sales revenue basis).

86 Ibid p.36 (confidential submission)

By setting ROM based on the percentage of controllable costs, the Commission ensures 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.

9.2.3 Additional working capital associated with network access

Consistent with the 2008 Gas Standing Contract Price Determination, the Commission has maintained an allowance of approximately 2.3% within the ROM for the additional working capital required under the Envestra Access Arrangement. The Commission considered that the level of these costs would not change materially during the forthcoming price path period. The estimation of a bottom up margin, undertaken by Sapere on behalf of the Commission, was based largely on information provided by Origin Energy on actual operating costs and asset values for the 2009/10 financial year. There are a number of assumptions that have been made as part of this analysis, including the basis for allocating assets to the standing contract business and judgments about the timing of cash flows (which impacts on working capital).

Given the numerous assumptions and judgements that have been relied upon in developing a bottom-up retail margin, the Commission considers the estimated margin to be indicative only. The Commission cannot disclose the detailed calculations of the retail margin, but can reveal that it produces a dollar amount that, when expressed as a percentage of controllable costs, is consistent with an allowance of 10%.

In the absence of any material changes to circumstance in the South Australian gas retail market, the Commission's Draft Decision proposed to retain the current retail margin allowance of 13% of controllable costs for each year of the forthcoming price path period.

9.3 Submissions to the Draft Inquiry Report

In response to the Commission's Draft Inquiry Report on ROM, a number of submissions were received on the ROM from stakeholders:

- Origin Energy considers the Commission's proposed ROM of *'13% of controllable costs to be inadequate to cover a retail businesses risk of operating in the South Australian gas market.'*[87]

[87] Origin Energy (2011), '*2011 Gas Standing Contract Price Path Inquiry, Response to ESCOSA on Draft Inquiry Report and Draft Price Determination*', p.18, available on the Commission's website: http://www.escosa.sa.gov.au/library/110510-GasPricePath_2011-DraftDeterminationSubmissionPublic-OriginEnergy.pdf

- Origin Energy states that its proposed ROM of 14.6% of controllable costs would appropriately account for the retailer risks (particularly consumption risk) associated with operating in the South Australian gas market.
- Origin Energy believes that the Commission did not adequately justify its decision, in the Draft Inquiry Report, not to accept Origin Energy's proposed ROM of 14.6% of controllable costs, particularly considering:
  - *'the relevant interstate margin in New South Wales which would support a higher margin than being allowed;*
  - *the limited value of retail margin in terms of $ per customer; and*
  - *that if ESCOSA was to continue with an efficiency factor in ROC, the 50:50 sharing of benefits of Origin' operating cost requires Origin to assume all risks of project delivery*.'[88]
- AGL SA did not comment directly on the proposed ROM; however AGL SA expressed its concern that gas prices need to be set at levels that *'…allow retailers the ability to recover the costs of acquiring and administering customer accounts as well as managing the risks associated with supplying gas to them at a fixed price.'*[89]

9.4 Commission's Considerations

9.4.1 Approach

In determining its Final Decision for ROM, the Commission has given due consideration to all the submissions received from stakeholders to the Draft Inquiry Report.

As outlined in the Draft Inquiry Report, the Commission has assessed the proposed ROM allowance with the objective of maintaining the financial viability of the standing contract retailer and facilitating the development of competition in the gas retail market. The Commission has sought 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.

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88 Origin Energy (2011), '*2011 Gas Standing Contract Price Path Inquiry, Response to ESCOSA on Draft Inquiry Report and Draft Price Determination*', p.19, available on the Commission's website: http://www.escosa.sa.gov.au/library/110510-GasPricePath_2011-DraftDeterminationSubmissionPublic-OriginEnergy.pdf

89 AGL SA (2011), 'Review of Gas Standing Contract Prices 2011/12 – 2013/14 Draft Determination', p.1, available on the Commission's website: http://www.escosa.sa.gov.au/library/110509-GasPricePath_2011-DraftDeterminationSubmission-AGL.pdf

9.4.2 Jurisdictional Benchmark

As discussed in section 8.4.1 (and expressed in the Draft Inquiry Report), the Commission does not consider that there are any material differences between electricity and gas retailing that would justify different margins between the two fuels. Consequently for this Final Determination, the Commission maintains the view that jurisdictional benchmarks of ROC and ROM provide an appropriate mechanism for regulatory price setting.

While Origin Energy states that relevant interstate benchmarks (New South Wales gas) support a higher margin than that proposed by the Commission in the Draft Inquiry Report, the Commission maintains its position that the current South Australian ROM benchmarks for gas and electricity are the most appropriate benchmarks to use for this Final Determination. No further evidence is provided by Origin Energy to justify why the New South Wales ROM benchmark would be considered more relevant than the South Australian ROM benchmark for this Final Decision. The Commission does however acknowledge that an allowance is needed to reflect the payment terms that were approved by the Commission under the 2006 review of Envestra's Gas Access Arrangement.

Therefore, the Commission's 2008 Gas Standing Contract Price Determination, and more recently the Commission's 2010 Electricity Standing Contract Price Determination provide an appropriate benchmark for establishing its Final Decision for ROM. Both margins were set at 10% of controllable costs. By including an allowance in ROM for the additional working capital required under the Envestra Access Arrangement, (consistent with that allowed in the 2008 Gas Standing Contract Price Determination), the Commission has maintained its position that ROM set at 13% of controllable costs is appropriate for the Final Decision.

9.4.3 Retail margin per customer

While Origin Energy has re-stated, in its response to the Draft Inquiry Report, the need for the Commission to consider the limited retail margin per customer, no further supporting evidence was provided that would substantiate an increased margin (as previously discussed in section 9.2.1). The Commission considers an allowance set at 13% of controllable costs provides an adequate return on investment, considering the risk associated with supply in the South Australian gas market.

Through the variations to the Draft Inquiry Report discussed in the wholesale gas and ROC chapters, the subsequent calculation of ROM (being based on 13% of controllable costs) directly impacts via a higher absolute dollar margin for ROM in the Final Decision.

9.4.4 Benefit sharing of the efficiency factor

The Commission does not accept Origin Energy's statement, in its response to the Draft Inquiry Report, that a base-ROC efficiency factor, based on a 50:50 sharing of benefits between retailers and customers is a valid driver for an increase in retail margin.

As discussed in section 8.4.3, it is recognised that Origin Energy (as would be expected of a prudent energy retailer) is introducing new systems and processes, aimed at optimising the cost to serve its customers. To ensure that Origin Energy has sufficient incentive to introduce such measures, a reasonable bedding-in period has been allowed, followed by a 50:50 sharing of projected benefits with customers.

Consistent with the Commission's methodology for this review, this issue has been addressed within the ROC allowance and is therefore not an issue that would give rise to a change in retail margin.

9.5 Commission's Final Decision on ROM

The Commission has determined that it is appropriate to retain the current margin of 13% of controllable costs for each year of the price path period.

Table 9-3 outlines the Commission's Final Determination on ROM, compared to Origin Energy's proposal, and the Commission's 2008 Gas Standing Contract Price Determination.

Table 9-3 - Commission's Final 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 Final Determination 2011
ROM (% of controllable costs)	13.0	14.1[90]	**13.0**
Residential ROM ($/account)	30.70	38.68	**32.67**
SME ROM ($/account)	120.27	148.78	**126.49**

[90] Being a simple average of Origin Energy's three year proposal of 13.0%, 14.6% & 14.6%.

10 SUMMARY OF FINAL DETERMINATION ON RETAILER CONTROLLABLE COSTS

10.1 Overview

This Chapter details the Final 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 August 2011.

10.2 Commission's Final Determination

The Commission's Final 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 10.1 and Table 10.2. The Commission has determined that a ROM of 13% of these controllable costs is appropriate for the standing contract price.

Table 10.1 - Indicative Retailer Controllable Costs 2011/12 to 2013/14
Weighted average of 5 regions, Residential, $/GJ, GST exclusive, $Dec11

	ORIGIN ENERGY PROPOSED				COMMISSION FINAL DETERMINATION			
	2010/11	**2011/12**	**2012/13**	**2013/14**	**2010/11[91]**	**2011/12**	**2012/13**	**2013/14**
Cost of Gas	4.91	5.13	5.21	6.44	4.91	5.10	5.08	5.08
Transmission Cost	1.85	1.92	1.89	1.91	1.85	1.93	1.90	1.91
ROC	4.42	5.83	5.74	5.74	4.42	5.22	5.15	5.07
ROM	1.45	1.67	1.87	2.06	1.45	1.59	1.58	1.57
Total Retail Cost unsmoothed	**12.77[92]**	**14.55**	**14.71**	**16.16**	**12.77**	**13.84**	**13.71**	**13.63**

Table 10.2 - Indicative Retailer Controllable Costs 2011/12 to 2013/14
Weighted average of 5 regions, SME, $/GJ, GST exclusive, $Dec 11

	ORIGIN ENERGY PROPOSED				COMMISSION FINAL DETERMINATION			
	2010/11	**2011/12**	**2012/13**	**2013/14**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
Cost of Gas	4.54	4.62	4.64	5.87	4.54	4.60	4.58	4.58
Transmission Cost	1.33	1.33	1.31	1.33	1.33	1.32	1.30	1.32
ROC	0.63	0.82	0.81	0.81	0.63	0.73	0.72	0.71
ROM	0.85	0.88	0.99	1.17	0.85	0.86	0.86	0.86
Total Retail Cost unsmoothed	**7.35**	**7.65**	**7.75**	**9.18**	**7.35**	**7.51**	**7.46**	**7.47**

Note: Table 10.1 and Table 10.2 may not total due to roundings

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

92 Includes a REES pass through of $0.13 / GJ

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

The Commission's Final 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 10.3 - 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 Energy Proposal							
	Residential				**SME**			
Average Retailer Revenue	13.25	14.56	14.71	16.16	7.48	7.64	7.74	9.17
% change		+9.9%	+1.1%	+9.7%		+2.2%	+1.3%	+18.6%
	Commission Final Determination							
	Residential				**SME**			
Average Retailer Revenue	13.25[93]	13.74	13.74	13.74	7.48	7.48	7.48	7.48
% change		+3.7%	0	0		0	0	0

As outlined in Table 10.3, the Final Determination on the maximum average retailer revenue in 2011/12 (expressed in $Dec11) is $13.74/GJ for residential customers and $7.48/GJ for SME customers, representing 3.7% increase and no change in real terms respectively.

These numbers do not include the derivation of the additional amount required to account for the determination taking effect from 1 August 2011 rather than 1 July 2011. This aspect of the determination, for both the retail and the distribution components, along with the customer impact is discussed in chapter 12.

[93] $13.25 is the smoothed average retailer revenue allowance for 2010/11 as opposed to the $12.77 unsmoothed average retailer revenue in Table 10.1

11 FACTORS CONSIDERED BY THE COMMISSION

The introductory chapter of this Final Decision sets out the legislative framework within which the Commission is empowered to make this gas standing contract price determination, and the specific factors that it must take into consideration during the decision making process.

Part 3 of the ESC Act sets out in detail the scope of the Commission's price regulation function, while section 6A of the Gas Act states that the Commission has (in addition to the functions and powers under the ESC Act), the price regulation function conferred by 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).

In the performance of its statutory functions, the Commission is required to meet the statutory objectives set out in section 6 of the ESC Act, which includes a paramount (or primary) statutory objective of protecting the long-term interests of South Australian consumers with respect to the price, quality and reliability of essential services (refer section 6(a)).

There are also a number of additional objectives specified in section 6(b) of the ESC Act to which the Commission must have regard in performing its functions. It is important to note that while the Commission is required to demonstrate that it has had real regard to the need, or otherwise, to pursue these additional objectives, it does not need to ensure that they are necessarily attained. It is the Commission position that, by having a balanced regard to these (often competing) objectives in its decision making processes, its primary objective will be achieved.

Accordingly, in making the Price Determination as set out in this Final Decision, the Commission has made discretionary "trade-offs" between the various factors set out in the ESC Act depending on their overall relevance, importance and weight in making a price determination that protects the long term interests of consumers with respect to the price, quality and reliability of gas supply. These matters are dealt with in detail in the preceding chapters.

Set out below is a summary of the manner in which the Commission has had regard to all of the relevant factors set out in the ESC Act.

11.1 ESC Act - section 6(a): The protection of consumers long-term interests

The Commission's analysis has determined the level of costs that Origin Energy would be expected to incur in meeting the obligations of a standing contract retailer under the Gas Act. It has had regard to Origin Energy's submitted costs and additional information provided by Origin Energy, along with submissions received from stakeholders during the consultation process. In fixing the standing contract price, the Commission has sought to provide a fair return based on Origin Energy's investment in

its business having regard to the nature and scope of its obligations as the gas standing contract retailer.

Accordingly, consumers' long-term interests are protected by ensuring that prices charged are based on efficient costs, while maintaining the financial viability of the retailer and encouraging continued investment in the gas industry. The Commission has sought to ensure that this balance of consumers' and Origin Energy's interests is achieved through this Price Determination.

The Commission is therefore satisfied that its primary objective of protecting the long term interests of consumers with respect to the price, quality and reliability of gas supply has been achieved.

11.1.1 ESC Act - section 6(b)(i): Promote competitive and fair market conduct

The Commission encourages competition between retailers as a way of protecting consumers' long-term interests.

In accepting objectively verifiable costs proposed by Origin Energy, and establishing benchmark efficient competitive market cost allowances for Origin Energy, the Commission is satisfied that it has provided for sufficient revenue recovery to enable Origin Energy to undertake the functions of the standing contract gas retailer.

In recognising the particular risks faced by a gas standing contract retailer, the Commission's Price Determination should provide sufficient margin to encourage ongoing competition between retailers and an ability to offer prices below the standing contract price (including the ability for Origin Energy itself to provide such lower prices in its market contracts). The Commission has undertaken this process having regard to the realities of the South Australian gas market, being a market with only four active retailers offering products to residential and SME market, all of whom are dual-fuel retailers.

The Commission therefore considers that the Price Determination promotes competitive and fair market conduct by retailers in the South Australian context.

11.1.2 ESC Act - section 6(b)(ii): Prevent misuse of monopoly or market power

Although Origin Energy no longer has a statutory monopoly in the sale and supply of gas to small customers, it continues to serve approximately 53% of the gas customers in South Australia, suggesting significant market power still exists.

The Commission therefore needs to ensure that its Price Determination prevents Origin Energy from misusing this position. The prices set should attempt to replicate those prices that would be charged by a retailer operating efficiently in a competitive market, ensuring that Origin Energy's standing contract prices are at a level which provides an appropriate risk adjusted return (and no more).

This Price Determination, which is based on the Commission's examination of costs (both Origin Energy's actual costs and the costs of a prudent retailer with a standing contract retailer's responsibilities), should ensure that the potential for abuse of market power is minimised.

11.1.3 ESC Act - section 6(b)(iii): Facilitate entry into markets

Entry into the South Australian gas market was discussed in detail in section 8.4.4 of this Final Decision and the ACIL Tasman report[94].

In light of the expert evidence and reasoning provided to the Commission, it considers that the nature of the South Australian gas market is such that a prudent retailer is only likely to choose to enter the gas market on a dual fuel basis. In any event, a retailer that did seek to enter on a gas only basis, would need to be competitive with gas market prices that reflect the economies of scope of the dual-fuel business model. If there is any impediment to a gas only retailer, it is from the operation of the competitive market (where competitive market prices are currently already below the standing gas contract price).

The Commission considers this Price Determination leaves scope and opportunity for dual-fuel retailers to enter the market and offer competitive prices to gas consumers.

11.1.4 ESC Act - section 6(b)(iv): Promote economic efficiency

As discussed in Chapter 5 of this Final Decision, incentive-based regulatory schemes provide appropriate impetus to businesses to secure efficiencies. The CPI-X form of incentive-based regulation adopted by the Commission will, therefore, by its nature and the manner in which it has been implemented, promote economic efficiency in South Australia.

The Commission has considered a range of information in setting expenditure benchmarks under its CPI-X form of incentive-based regulation. The Commission considers that, by not basing costs solely on Origin Energy's view of actual costs, it has provided an incentive to Origin Energy to serve its customers in a manner that accords with industry best practice. The benchmarks set by the Commission also provide an incentive to Origin Energy to seek out better ways to provide standing contract services.

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[94] Refer to Chapter 2 of the ACIL Tasman report which is available on the Commission's website – http://www.escosa.sa.gov.au/library/110630-ACILTasmanFinalReport-Public.pdf

Further, the Commission has given due consideration to interstate benchmarks in determining efficient costs for a gas retailer.

Finally, the determination of wholesale gas costs and gas transmission costs has been undertaken so as to produce an economically efficient outcome.

11.1.5 ESC Act - section 6(b)(v): Ensure consumers benefit from competition and efficiency

The Commission has set a price reflective of the efficient operating costs of a competitive market retailer, albeit one supplying the standing contract gas customers. By setting prices against a competitive market benchmark (reflecting the efficiencies achieved by a competitive market operator, but also recognising the costs incurred in customer acquisition and retention), standing contract consumers benefit from these competitive market outcomes.

While it has had regard to Origin Energy's actual costs, it has used them primarily to check that its prudent and efficient cost estimates are credible.[95]

Accordingly, benefits arising from efficient practices and competition have been passed through to consumers in the standing contract prices. Further, anticipated efficiencies are also recognised. For example, Origin Energy must share with consumers the efficiencies that will be recognised following the implementation of its new customer management system.

Further, the standing contract prices also provide an opportunity for retailers to offer market contracts to consumers at even lower prices. The existence of strong competition between retailers should also lead to benefits to those consumers who take up the opportunity to switch. Hence, the decision does not preclude the continued and healthy operation of a competitive gas market (albeit one which in practice reflects a dual-fuel mode of competition).

11.1.6 ESC Act - section 6(b)(vi): Facilitate maintenance of financial viability and incentive for long-term investment

The retail margin set by the Commission provides for a return which supports the current and ongoing investment incurred by Origin Energy.

Further, the other cost components have been set at a level which reflects a standing contract retailer's risks and efficient operating costs.

The Commission's Price Determination should therefore provide an appropriate return to an efficient retailer, and support further investment in the South Australian gas supply industry. This will facilitate the ongoing financial viability of the industry, and protect consumers' long-term interests.

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95 In this regard the Commission notes the requirement of section 25(4)(b) of the ESC Act to have regard to the costs of supplying the relevant services. The term "costs" encompasses a number of concepts, including actual costs, prudent costs, and reasonable costs, and therefore the Commission has, so far as required or permitted under the legislative scheme, balanced each of these elements in having regard to "costs" for the purposes of making this price determination.

11.1.7 ESC Act - section 6(b)(vii): Promote consistency in regulation

The Commission has had general regard to the approach adopted by other regulators and its approach in relation to the electricity standing contract determination.

A direct comparison to other regulatory decisions and approaches is not always possible or illuminating. There are factors present in the South Australian gas market that make it difficult for the Commission to promote consistency in regulation as between jurisdictions. For example, the low penetration and low average consumption of gas leads to low dollar margins when compared to other jurisdictions.

Notwithstanding these unique factors, the Commission has had regard to cost benchmarks from other jurisdictions, and sought to be consistent with decisions of other regulators where they are appropriate for South Australia.

In terms of consistency as between energy sources within this State, the Commission has, in making this Gas Standing Contract Price Determination, had regard to the Electricity Standing Contract Price Determination which it made in December 2010. While there are differences between the energy sources which require different regulatory treatment in the context of a price determination, to the extent possible the Commission has sought to align its two price determinations. For example, the Commission has based Part B of this Price Determination on the equivalent part of the Electricity Standing Contract Price Determination.

11.2 ESC Act - section 25(4)(a): Particular circumstances of regulated industry and goods being regulated

The Commission has specifically focussed its evaluation on the provision of standing contract services in the South Australian retail gas market. To this end it has considered its determination in the context of the actual market conditions in South Australia and not by reference to a hypothetical construct. Accordingly, the Commission has given practical consideration to the presence of economies of scope that exist in the South Australian retail gas market.

Further, it has had regard to Origin Energy's specific circumstances and costs to the extent that it has received information on these matters.

11.3 ESC Act - section 25(4)(b): Costs of supplying the services

The Commission has sought to obtain information on the costs of operating as a standing contract retailer, including by a review of benchmark costs from other jurisdictions.

While it is difficult to estimate future costs when those costs depend on such factors as the weather, contract market outcomes and the behaviour of other participants, the Commission has considered expert advice and modelled a number of different scenarios in producing its best estimate of the future costs of supply.

The Commission has also sought to obtain specific information on the costs to Origin Energy of providing standing contract services. It has (with the assistance of consultants as envisaged under the ESC Act) reviewed historical costs and projections, and modelled future wholesale gas and transmission costs based on actual contract prices.

The Commission is also satisfied that the final gas standing contract price is sufficient to allow Origin Energy to recover its actual costs in meeting its obligations as the standing contract gas retailer.

The Commission considers that its conclusions are based on the efficient costs of providing a standing contract supply.

11.4 ESC Act - section 25(4)(c): Cost of complying with laws and regulations

The Commission has included in its revenue allowances the costs of operating as a standing contract retailer in South Australia. Specifically, the ROC allowance includes sufficient revenue for Origin Energy to comply and operate under the legislative framework for supplying standing contract services in South Australia.

11.5 ESC Act - section 25(4)(d): Return on assets in the regulated industry

The Commission, in determining the appropriate retail margin, has reviewed the return on assets that an investor might expect for investing funds in the retail industry.

11.6 ESC Act - section 25(4)(e): Relevant interstate benchmarks

The Commission has considered the standing contract prices that have been fixed in interstate jurisdictions, particularly New South Wales, and in other jurisdictions where similar gas pricing decisions have been made. It has also had regard to the different components of prices in these jurisdictions, and considered reasons for differences with South Australian costs.

The Commission considers that the interstate benchmarks confirm the credibility of its own determinations on input costs and standing contract prices.

11.7 ESC Act - section 25(4)(f): Financial implications

In setting the relevant cost components for determining the standing contract prices, the Commission has had regard to Origin Energy's costs and the financial implications of this Price Determination on its viability.

The Commission has also had regard to the financial implications for consumers, and has sought to protect consumers' interests with respect to price, particularly those customers in regional areas where Origin Energy is the only gas retailer available to them.

The Price Determination seeks to balance the financial implications between the interests of consumers and the retailer.

11.8 ESC Act – section 25(4)(h): Any other relevant factors

The Commission has had regard to Origin Energy's submissions as well as its actual costs (where relevant), and how those costs are allocated between market contract and standing contract customers in making this Price Determination.

In addition, the Commission has considered the various issues raised by other stakeholders and sought to respond on these issues appropriately.

11.9 ESC Act – section 25(5)(a): Costs and benefits of regulation

The Commission does not consider there are any significant costs of regulation imposed on Origin Energy as a result of this Price Determination. Origin Energy will need to substitute the new prices for those now published, but that should be a reasonably straightforward exercise which does not draw on significant resources. There are no major ongoing or compliance costs associated with the Price Determination, apart from those required by law.

11.10 ESC Act – section 25(5)(b): Articulate trade-off between costs and standards

With regard to the trade-off between costs and service standards, the Commission has been keen to ensure that Origin Energy's existing service standards are maintained and not reduced. The allowance of $108.04 per customer for retail operating costs (subject to efficiency reductions in the second and third years), and the 13% retail margin is sufficient to ensure that service standards can be maintained at current levels. The Commission will continue to monitor and report on Origin Energy's performance against the services standards as it has done in the past.

11.11 Summary: factors considered

As previously indicated, the Commission must have regard to the factors outlined above in making a price determination.

The Commission has given careful consideration to these factors in making this Price Determination. The particular circumstances of the gas supply industry require the Commission to be conscious of the financial and supply security risks borne by retailers, and the implications of setting revenue controls at levels below the input costs.

Of note, in coming to its decision on this Price Determination, the Commission has had regard to the costs incurred by Origin Energy in retailing gas to small customers, the costs of complying with the legislative and regulatory framework, the return on assets or retail margin relevant to gas retailers, benchmark costs for gas retailers operating in the market, the development of the South Australian gas market into one that is a dual-fuel market and the financial implications of any alteration to Origin Energy's proposed prices.

It has decided not to accept Origin Energy's proposed prices primarily because of the changes identified in the underlying cost components on which those prices were based. It has not sought to lower the prices because of a general desire from many stakeholders for lower prices – it has only changed prices in response to identified changes in the underlying costs, and has provided an appropriate retail margin for the retailer obliged to supply small customers under gas standing contract prices.

In summary, the purpose of the Price Determination is to deliver to consumers the lowest price (and hence the maximum benefit) commensurate with a fair return to Origin Energy for the risks and costs it incurs in carrying out its role in the South Australian gas market. The Price Determination seeks to ensure Origin Energy's financial viability, to promote competition where this benefits consumers, and to protect consumers' long-term interests through the creation of an efficient and competitive market.

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 Final Determination on small customers in South Australia. 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 August 2011.
- All amounts are quoted GST exclusive in nominal terms.

In developing the retail component of the gas standing contract price, the Commission has also determined that no rebalancing of cost components take place (i.e. a uniform increase be applied across all tariff components). Whilst the Commission has taken into account concerns expressed by SACOSS over disproportionate increase in supply charges in recent years, it believes that by allowing for a uniform increase, it has struck an appropriate balance between providing a degree of certainty to retailers over the amount of revenue that they will recover and effective price signal to customers about the cost of energy consumption.

12.1 Bill Impact Analysis

This section summarises the annual increases in gas standing contract prices for small customers under the Commission's Final 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 Final Determination for Envestra's access arrangement proposal for the next regulatory period (1 July 2011 to 30 June 2016).[96] The Commission also notes that the retailer tariffs used in its analysis are inclusive of AEMO's market charges[97] and costs associated with REES.

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[96] AER's Draft Determination is available at the following website: http://www.aer.gov.au/content/index.phtml/itemId/738127.

[97] 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.

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 Government's REES).

12.1.1 Residential

It is estimated that the gas standing contract bill in 2011/12 for a residential customer with a consumption profile of 21GJ per annum will increase by around 14%; this equates to an annual increase of around $84. This increase is due to a 6.32% increase in Origin Energy's retail component of the gas standing contract price and a 20.09% increase in Envestra's distribution tariffs.

The indicative impact of the Commission's Final Price Determination on residential customers with different consumption profile is summarised below in Table 12-1.

Table 12-1 – Indicative annual bill impact of the Commission's Final Price Determination on residential customers (GST exclusive)

	2010/11BILL ($)	2011/12 BILL ($)	CHANGE ($)	CHANGE (%)
RESIDENTIAL CUSTOMER - LOW USAGE (6GJ ANNUALLY)				
ORIGIN ENERGY – RETAIL COMPONENT	$ 140.55	$ 149.85	$ 9.30	6.62%
ENVESTRA – DISTRIBUTION COMPONENT	$ 180.65	$ 213.46	$ 32.81	18.16%
TOTAL	**$ 321.20**	**$ 363.32**	**$ 42.11**	**13.11%**

	2010/11BILL ($)	2011/12 BILL ($)	CHANGE ($)	CHANGE (%)
RESIDENTIAL CUSTOMER - MEDIUM USAGE (21GJ ANNUALLY)				
ORIGIN ENERGY – RETAIL COMPONENT	$ 277.48	$ 295.00	$ 17.52	6.32%
ENVESTRA – DISTRIBUTION COMPONENT	$ 331.22	$ 397.77	$ 66.55	20.09%
TOTAL	**$ 608.69**	**$ 692.77**	**$ 84.07**	**13.81%**

	2010/11BILL ($)	2011/12 BILL ($)	CHANGE ($)	CHANGE (%)
RESIDENTIAL CUSTOMER - HIGH USAGE (45GJ ANNUALLY)				
ORIGIN ENERGY – RETAIL COMPONENT	$ 487.84	$ 518.00	$ 30.16	6.18%
ENVESTRA – DISTRIBUTION COMPONENT	$ 456.02	$ 502.17	$ 46.15	10.12%
TOTAL	**$ 943.85**	**$ 1,020.16**	**$ 76.31**	**8.09%**

12.1.2 Small Business

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

It is estimated that the gas standing contract bill in 2011/12 for a small business customer with a consumption profile of 150GJ per annum will increase by around 10%, this equates to an annual increase of around $265 This increase is due to a 2.68% increase in Origin Energy's retail component of the gas standing contract price and a 15.22% increase in Envestra's distribution tariffs.

The indicative impact of the Commission's Final Price Determination on a typical small business customer is summarised below in Table 12-2.

Table 12-2 – Indicative annual bill impact of the Commission's Final Price Determination on a typical small business customer (GST exclusive)

	2010/11BILL ($)	2011/12 BILL ($)	CHANGE ($)	CHANGE (%)
SMALL BUSINESS CUSTOMER - MEDIUM USAGE (150GJ ANNUALLY)				
ORIGIN ENERGY – RETAIL COMPONENT	$ 1,113.59	$ 1,143.43	$ 29.84	2.68%
ENVESTRA – DISTRIBUTION COMPONENT	$ 1,546.30	$ 1,781.65	$ 235.35	15.22%
TOTAL	**$ 2,659.89**	**$ 2,925.08**	**$ 265.19**	**9.97%**