REVIEW OF GAS STANDING CONTRACT PRICES 2008/09-2010/11

ISSUES PAPER

November 2007

The Essential Services Commission of South Australia
Level 8, 50 Pirie Street Adelaide SA 5000
GPO Box 2605 Adelaide SA 5001
Telephone 08 8463 4444 Facsimile 08 8463 4449
E-mail escosa@escosa.sa.gov.au Website www.escosa.sa.gov.au

REQUEST FOR SUBMISSIONS

The Essential Services Commission of SA (the Commission) invites written submissions from interested parties in relation to the issues raised in this paper. Written comments should be provided by **21 December 2007**. It is highly desirable for an electronic copy of the submission to accompany any written submission.

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

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

Responses to this paper should be directed to:

Review of Gas Standing Contract Prices: Issues Paper

Essential Services Commission of SA

GPO Box 2605

Adelaide SA 5001

E-mail: escosa@escosa.sa.gov.au

Facsimile: (08) 8463 4449

Telephone: (08) 8463 4444

Contact Officer: Nathan Petrus / Luke Wilson

Public Information about the Commission's activities

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

TABLE OF CONTENTS

Glossary of Terms ii

1 Introduction 1

1.1 Background 1

1.2 Inquiry into the fixing of gas standing contract prices 2

1.3 Process and consultation 2

2 Objectives of the Review 5

2.1 Objectives of the Commission 5

3 Previous Inquiry 7

4 Market Developments since 2005 9

4.1 Gas retail market developments 9

4.2 Gas retail prices 10

5 Price Path Establishment 13

5.1 Form of regulation 13

5.2 Building block approach 14

5.2.1 Prudent costs 14

5.2.2 Re-opening of Price Path 15

5.2.3 Tariff Rebalancing 15

5.2.4 Customer and demand assumptions 16

5.2.5 Building Block components 16

6 Origin Energy submission 21

7 Next Steps 23

GLOSSARY OF TERMS

ACCC	Australian Competition and Consumer Commission
THE COMMISSION	the Essential Services Commission of South Australia
CPI	Consumer Price Index
ESC ACT	Essential Services Commission Act 2002
FRC	Full Retail Contestability
GAS ACT	Gas Act 1997
GJ	Gigajoule (10^9 J)
MAPS	Moomba to Adelaide Pipeline System
MDQ	Maximum Daily Quantity
NEM	National Electricity Market
NERA	NERA Economic Consulting
NSW	New South Wales
ORIGIN ENERGY	Origin Energy Retail Ltd.
SA	South Australia
SME	Small and Medium Enterprise
TJ	Terajoule (10^{12} J)

1 INTRODUCTION

1.1 Background

Full retail contestability (FRC) commenced in the South Australian gas market on 28 July 2004, allowing all customers to enter into a market contract with a retailer of their choice. Since that time, competition in the gas retail market has developed and, as at 30 June 2007, 56% of gas customers had switched to a market contract.

For those small customers[1] that have not entered into a market contract, the *Gas Act 1997* provides a measure of protection via the standing contract provisions. Under these provisions, the gas standing contract retailer, Origin Energy Retail Ltd. ("Origin Energy") must offer to supply gas to small customers under a regulated ("standing") contract. The task of fixing standing contract prices in South Australia lies with the Essential Services Commission of South Australia ("the Commission").

The Commission has broad powers to make a price determination regulating prices, conditions relating to prices and price fixing factors which apply to those standing contracts. Such a price determination is of binding effect for a period of at least three years from 1 July 2008.

Unless special circumstances are determined by the Commission to exist, the Commission may only make a gas standing contract price determination if it has received a submission from Origin Energy, stating the price it proposes the Commission fix as the standing contract price together with a justification for the price put forward.

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

On 19 November 2007, the Commission received such a submission from Origin Energy. A public version of this submission is available from the Commission's website.[2]

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

2 Refer: www.escosa.sa.gov.au/webdata/resources/files/071122-OriginEnergySAGasRetailPricePathSubmission-Public.pdf.

1.2 Inquiry into the fixing of gas standing contract prices

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

This paper is the initial document in the Commission's Inquiry into the appropriate price to be fixed as the gas standing contract price from 1 July 2008.

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

The purpose of this paper is to seek comments on relevant issues, to guide and inform the Commission's preparation of a Draft Inquiry Report and Draft Price Determination, to be released in March 2008.

Ultimately, the Commission must make a determination on the appropriate form of regulation and price control for Origin Energy in meeting its standing contract obligations in South Australia for the period 1 July 2008 to 30 June 2011. In doing so, the Commission will be informed by representations and submissions made by stakeholders and interested parties, the advice of specialist consultants, and work undertaken by the Commission's own staff.

This approach is similar to the approach used by the Commission during the 2005 Review and Inquiry into gas standing contract prices.[3]

1.3 Process and consultation

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

Comments on the Origin Energy submission and this Issues Paper should be provided to the Commission by 21 December 2007. Following its consideration of these submissions, the Commission will prepare a Draft Inquiry Report & Draft Price Determination, which is expected to be released in March 2008. Following public consultation on these, the Commission will release its Final Inquiry Report & Price Determination by the end of May 2008. An indicative timetable for the Inquiry is set out below.

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

---

3 Documents relating to the Commission's 2005 Inquiry into gas standing contract prices are available on the Commission's website at www.escosa.sa.gov.au/site/page.cfm?u=134&c=440.

TIMETABLE	
ACTION	BY
Receive Origin Energy Proposal	19 November 2007
Release Issues Paper & Origin Energy Proposal	22 November 2007
1st round stakeholder submissions due	21 December 2007
Release Draft Report & Determination	End March 2008
2nd round stakeholder submissions due	End April 2008
Release Final Report & Determination	End May 2008
Determination takes effect	1 July 2008

2 OBJECTIVES OF THE REVIEW

2.1 Objectives of the Commission

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

Section 5 of the ESC Act sets out the particular functions of the Commission. Section 5(1)(a) specifies that one such function is "to regulate prices and perform licensing and other functions under relevant industry regulation Acts" – the *Gas Act 1997* ("Gas Act") has been declared for this purpose.

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

6 (1) In performing the Commission's functions, the Commission must:

> *(a) have as its primary objective protection of the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services; and*
>
> *(b) at the same time, have regard to the need to:*
>
> > *(i) promote competitive and fair market conduct; and*
> >
> > *(ii) prevent misuse of monopoly or market power; and*
> >
> > *(iii) facilitate entry into relevant markets; and*
> >
> > *(iv) promote economic efficiency; and*
> >
> > *(v) ensure consumers benefit from competition and efficiency; and*
> >
> > *(vi) facilitate maintenance of the financial viability of regulated industries and the incentive for long term investment; and*
> >
> > *(vii) promote consistency in regulation with other jurisdictions.*

In addition to these objectives, as the Commission is making a price determination under Part 3 of the ESC Act, it must also, under Section 25(4), have regard to:

> *(a) the particular circumstances of the regulated industry and the goods and services for which the determination is being made;*
>
> *(b) the costs of making, producing or supplying the goods or services;*
>
> *(c) the costs of complying with laws or regulatory requirements;*
>
> *(d) the return on assets in the regulated industry;*
>
> *(e) any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries;*
>
> *(f) the financial implications of the determination;*
>
> *(g) any factors specified by a relevant industry regulation Act or by regulation under the ESC Act;*
>
> *(h) any other factors that the Commission considers relevant.*

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

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

3 PREVIOUS INQUIRY

The Commission's first Inquiry into gas standing contract prices was conducted in 2005 and led to the making of a Price Determination that established a three-year gas standing contract price path commencing 1 July 2005. Prior to this Price Determination, the Minister for Energy was responsible for setting gas standing contract prices in SA.

In its 2005 Inquiry, the Commission employed a cost-based "building block" approach to reviewing gas standing contract prices, whereby it sought to determine the prudent costs that should be incurred by a gas retailer in meeting the obligations of the standing contract retailer in South Australia. The Commission focused on the prudent costs that were within the control of the standing contract retailer, namely:

(i) Wholesale cost of gas purchases;

(ii) Transmission charges by pipeline operators;

(iii) Retailer operating costs; and

(iv) Retail margin.

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

The Commission determined that the following costs represented a realistic estimate of efficient charges for the three-year period of the price path commencing 1 July 2005:

Summary of the Commission's decisions on retailer controllable costs 2005/06 – 2007/08 (GST exclusive in December 2005 prices)

COST COMPONENT	CUSTOMER TYPE	2005/06	2006/07	2007/08
Cost of Gas ($/GJ)	Residential	3.54	3.64	3.68
	Business	3.30	3.36	3.40
Transmission Costs ($/GJ) (weighted average of 5 regions)	Residential	1.48	1.61	1.61
	Business	1.02	1.12	1.12
Retail Operating Costs ($/customer p.a.) (inclusive of FRC costs)	All	90.26	91.69	93.14

The Commission also determined that the retail margin should be set at a fixed percentage (10%) of the total of these controllable costs.

Having determined these controllable costs, the Commission calculated the aggregate annual revenues during the price path period that would be required to recover these costs. The Commission determined that it would utilise a CPI-X form of regulation, applying an average revenue control, which would cap the amount of revenue per GJ sold on an annual basis. The 2005/06 average revenue control allowed the standing contract retailer to earn a maximum of $9.857/GJ for residential standing contract customers and $5.575/GJ for Small and Medium Enterprise (SME) standing contract customers. These amounts were allowed to increase during each subsequent year of the price path period by CPI + X (with an X-factor for residential customers of 2.50% and 0% for SMEs).

In addition to this primary control, the Commission determined that a secondary control should exist to limit the extent to which any individual gas standing contract tariff can increase each year. This "rebalancing control" was set such that the charge at any level of annual consumption for each "retailer tariff" could not increase by more than CPI + 7% for residential customers, and CPI + 5% for SME customers each year.

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

- a change in taxes event;
- a regulatory reset event;
- a transmission costs event; and
- a Ministerial Directions event.[5]

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

5 The definitions of these events can be found in the Commission's 2005 Gas Standing Contract Price Determination (www.escosa.sa.gov.au/webdata/resources/files/050628-d-GasStandingContractPriceDeterminationPartB.pdf).

4 MARKET DEVELOPMENTS SINCE 2005

4.1 Gas retail market developments

The 2005 Inquiry into gas standing contract prices was undertaken at a time when FRC had just commenced, and the vast majority of small customers in SA were still taking gas supply under the standing contract.

Since that time, retail competition has advanced, so that now less than half of all small customers in South Australia take supply from Origin Energy under the standing contract. Most small customers have moved to market contracts and the rate of switching is remaining steady.

Based on the Commission's monitoring of the energy retail market, the leading indicators of competition reveal that:

- as at 30 June 2007, there were 8 retailers licensed to sell gas in SA, 7 of which were also licensed to sell electricity. Twelve months prior to this date, there were 5 licensed gas retailers in SA;
- there were approximately 5,600 customer transfers per month between gas suppliers in 2006/07, up 21% from 2005/06 (Origin Energy reports an average residential churn rate of 26% through 05/06 and 06/07); and
- 56% of small customers were taking supply under a market offer as at 30 June 2007, compared to 39% as at 30 June 2006.[6]

In early 2007, the Commission engaged NERA Economic Consulting (NERA) to conduct a study on the effectiveness of competition in the SA electricity and gas retail markets. Among other things, the study concluded that the gas retail market was well on the way to becoming effectively competitive, although competition was still lacking in regional areas.[7] NERA found that the most likely barrier to competition outside of metropolitan Adelaide was the ability for new entrant retailers to obtain transmission pipeline capacity for pipeline laterals running off the Moomba to Adelaide pipeline. Much of this capacity is controlled by the standing contract retailer, Origin Energy.

A similar review of the effectiveness of energy retail competition in SA will be conducted by the Australian Energy Market Commission in 2008. This review will be completed after the Commission has concluded its Inquiry into gas standing contract prices.

---

6 The total number of small customers in the gas market is around 372,000, of which 365,000 are residential and 7000 SME (approximately).

7 NERA Economic Consulting, *Review of the Effectiveness of Energy Retail Market Competition in South Australia: Phase 2 Report for ESCOSA*, June 2007, p. 87-88 (available at www.escosa.sa.gov.au/webdata/resources/files/070614-R-Phase2ReviewERMC.pdf).

Irrespective of any conclusions drawn on the status of competition, the Commission observes that it is obliged by the Gas Act to fix gas standing contract prices for at least a further 3 years from 1 July 2008. If no price is fixed, the standing contract price which will apply at 1 July 2008 is the price set by the Minister for Energy as at 31 December 2002.[8] There is no other mechanism by which gas standing contract prices may be set.

4.2 Gas retail prices

As noted in Chapter 3, the price path for the July 2005 to June 2008 period sets an average revenue control. Actual tariff movements are subject to this control, but there is scope for some rebalancing within and across tariffs, which means that movements need not be uniform between the different parts of a tariff.

Table 4.1 sets out the retail part (i.e. not including network charges) of the residential standing contract tariff movements that have resulted from pricing decisions determined from 1 July 2003 to 30 June 2008 in both nominal and real terms.

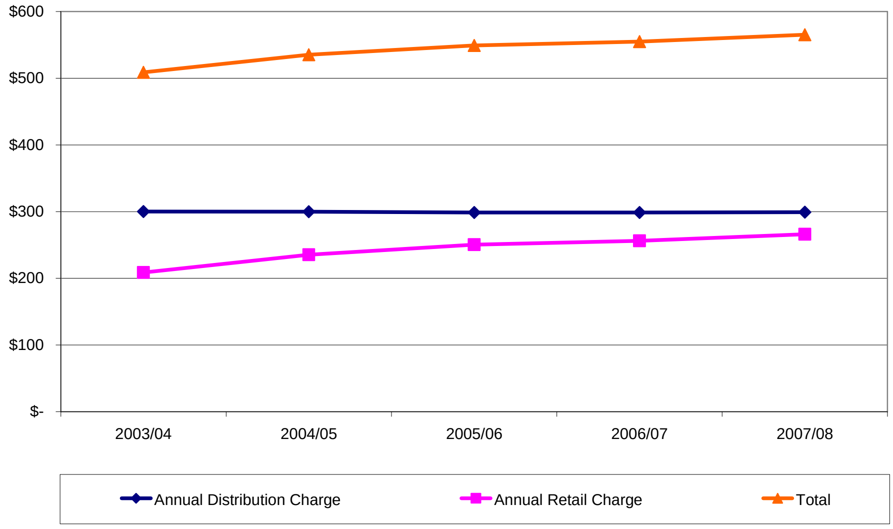
Table 4.1: Residential gas retail tariffs

	2003/04	2004/05	2005/06	2006/07	2007/08
Origin Energy Retail Residential Tariffs (GST Exclusive, $ 2007)					
Supply Charge $/QTR	6.30	12.36	15.66	16.70	17.35
First 4500 MJ (c/MJ)	0.79	0.80	0.81	0.81	0.84
Additional MJ (c/MJ)	0.68	0.69	0.70	0.72	0.74
Origin Energy Retail Residential Tariffs (GST Exclusive, $ Nominal)					
Supply Charge $/QTR	5.73	11.44	14.84	16.30	17.35
First 4500 MJ (c/MJ)	0.72	0.74	0.77	0.79	0.84
Additional MJ (c/MJ)	0.62	0.64	0.67	0.70	0.74

Since 2003/04, there has been an increase in the typical real residential annual gas bill of about 11.1%, which equates to a real increase of around $56. Figure 4-1 below shows how changes to the standing contract price have affected a typical annual residential bill (consumption of 24,000 MJ) for the period 2003/04 to 2007/08. These price trends are expressed in real dollars, removing the effect of inflation.

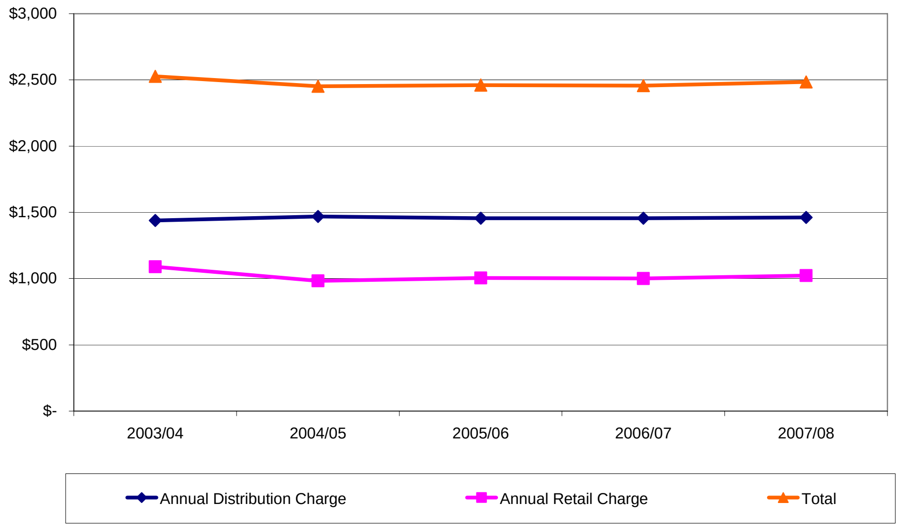
8 Gas Act, S.34A(6)(b)(ii)

Figure 4-1: Typical Standing Contract Annual Residential Bill (24,000 MJ per year, GST exclusive - $Mar '08)



Given the diverse nature of business, the use of averages for SME consumption is less meaningful than for residential consumption. However, this information is provided for a small business customer with annual consumption of 170,000 MJ over the same period (2003/04 to 2007/08) in Figure 4-2 below. Over this period, such a small business customer would have experienced a real price decrease of approximately 1.7%, or around $42.

Figure 4-2: Typical Standing Contract Annual Small Business Bill (170,000 MJ per year, GST exclusive - $Mar '08)



5 PRICE PATH ESTABLISHMENT

This chapter discusses the various elements that the Commission will need to address in the current review.

> Issue for comment:
>
> In respect of each element outlined below the Commission invites stakeholders' views on the approaches, methodologies, data sources and options relevant to each issue, including comment on the merits of the approach that Origin Energy has included in its submission (see Chapter 6 for more details).

Stakeholders may also wish to prepare their comments in the context of the approach that the Commission adopted for the current price path period (see the 2005 Final Inquiry Report).[9]

5.1 Form of regulation

Section 25(3) of the ESC Act gives the Commission broad discretion with respect to the form of regulation. In this Inquiry, the Commission can consider whether any changes are warranted to the form of regulation used for the current price path period (as described in chapter 3).

There are several considerations in the selection of a form of regulation, which should cover the whole of the price path period.

General considerations include:

- Incentive effects – does the form of regulation encourage ongoing efficiencies in energy contracting, does it need to, or does it allow or invite cost increases or cost laxity?
- Regulatory risk – what risks are there of the price path over- or under-estimating prudent prices, how are those risks allocated, to whom are they allocated, and are they allocated to the party best able to manage the risks? What are the consequences for retail competition of setting prices too high or too low?
- Administrative costs – does the form of regulation strike a sensible balance between accuracy and complexity? Some forms of regulation can involve intricate and sophisticated mechanisms designed to achieve desired effects, but end up requiring so much effort, information, and hence cost, to administer that the benefits are wiped out.

[9] The 2005 Final Inquiry Report is available at www.escosa.sa.gov.au/webdata/resources/files/050628-GasStandingContractPricePathFinalInqReport.pdf.

- Robustness – can the form of regulation cope with unforeseen circumstances and unexpected events? Robustness can be achieved by flexible forms of regulation, or can be built in to otherwise stricter forms of regulation by way of pass through mechanisms, re-opening provisions and adjustment mechanisms.

In determining the appropriate form of regulation, the Commission will also have regard to:

- forms of regulation selected in other jurisdictions (e.g. Victoria and NSW);
- the views put forward by the various stakeholders (in particular consumers, Origin Energy and other retailers);
- compliance costs that will be imposed on the retailer;
- the administrative and monitoring costs that will be incurred by the Commission; and
- the current forms of regulation determined for gas and electricity standing contract prices in South Australia, which includes an average revenue control allowing for CPI-X adjustments each year, together with side constraints to prevent large changes to individual tariffs.

5.2 Building block approach

The Commission's existing gas standing contract price determination, along with the previous analysis of gas retail prices undertaken for the Minister for Energy, used a building block approach to build up gas prices from their component parts, using actual costs where available, as well as benchmarking costs where this was more appropriate.

While the Commission expects to use this same approach for the current Inquiry, it is open to suggestions from stakeholders on alternative approaches to reviewing and setting a gas price path for the next three years. It therefore encourages stakeholders who have views on alternative approaches to make a submission to the Commission, so that it can decide if these other approaches can complement or indeed replace the building block methodology.

5.2.1 Prudent costs

In its previous gas standing contract price determination, the Commission placed emphasis on a determination of the costs that a "prudent" retailer would incur in meeting the standing contract obligations.

"Prudent costs" in this context are taken to be the costs incurred by an efficient retailer acting efficiently in accordance with good industry practice, to achieve the lowest sustainable cost of delivering the service, taking into account the circumstances and obligations imposed on the incumbent retailer. The Commission supported this approach in preference to sole reliance upon an "actual" cost methodology, as it believed the latter approach would encourage inefficiencies (in that actual costs could be passed through, no matter how inefficient).

Nevertheless, it has also investigated actual costs incurred by entities and taken these into account in price determinations as a check and balance measure.

The issue of actual versus prudent costs is an important one for this gas standing contract price path determination. As noted above, it is also important to ensure Origin Energy has the correct incentives to minimise customer costs.

5.2.2 Re-opening of Price Path

Setting prices for a period of at least three years ahead requires forecasting of several cost factors – some of which are uncertain even if actual costs are used.

The nature of the gas market is such that these forecasts tend to have a lesser impact on retailer profitability than is the case in electricity.

For example, gas contracts typically allow variations in the amount of gas that is delivered each day and each year. Thus, errors in forecasting demand (within reason) are less of an issue than in electricity wholesale purchasing. (See the following section for a discussion of gas demand issues in particular).

There is little in the way of short-term (potentially highly volatile) pricing of gas as compared to the National Electricity Market (NEM) for electricity (noting that this might change if certain designs for a gas spot market were to be introduced into South Australia). Therefore, errors in forecasts of spot or contract prices should have narrower error bands than for electricity.

Assumptions relating to churn (movement of customers towards market contracts either with the incumbent or a new entrant) will also be required, in order to assess the costs of the incumbent.

Although there are risks and uncertainties involved in a minimum three-year price path, these should be lower than in the case of electricity, and hence it is likely that fewer re-openings of decisions, if any, might be required.

The Commission also notes that the statutory scheme for the establishment of the standing contract gas retail price path, envisages that the Commission may make a new price determination sooner than the expiry of the three-year price path if the Commission determines that special circumstances exist.

5.2.3 Tariff Rebalancing

The Commission understands that, historically, retail gas prices in SA have contained significant cross-subsidies between different customer classes; with business customers generally paying prices that covered more than their costs, while residential customers paid prices that ignored some costs (and were paid for by other customers). Many of these cross-subsidies have been unwound over recent years and the Commission understands that few, if any, remain.

5.2.4 Customer and demand assumptions

The level of demand is a factor (although less so than in electricity) that can affect the wholesale price of gas. Intertemporal demand profiles are important in the gas industry, as the Commission understands that the structure of gas contracts is typically not sufficiently flexible to meet the peak winter demand requirements of households. This is an important technology difference – with electricity, where generating capacity must match (or exceed) demand at all hours of the day compared to gas where only daily requirements need to be met.

As a result, gas retailers must manage the winter peak in other ways – by using short-term storage in line-pack in transmission lines, or other storage, or purchasing a higher "MDQ" allocation from other parties – essentially an option for peaking gas.

Thus, while the peakiness of the gas winter peak does have a direct impact on retailer costs, the volatility in demand is a daily rather than an hourly issue and there are more physical solutions to manage the peak than there are in electricity (since gas, unlike electricity, can be stored).

One area that may require consideration is that of competitive churn, particularly if the prices are structured in a manner that makes some customers more profitable than others, so that Origin Energy's overall margin could be negatively impacted by losing a small number of profitable customers. This is particularly true for the recovery of sunk costs (such as those related to the introduction of FRC) that are fixed and are currently being recovered over all customers.

In establishing a price path, consideration will be given to how the demand profile might change over the period of the price path and how this might affect decisions about the MDQ that is purchased.

5.2.5 Building Block components

Cost of wholesale gas

Wholesale gas costs have key differences from electricity wholesale costs that can affect the desirability or practicality of determining the relevant wholesale cost component. These are summarised below:

CONTRACT TERM	Gas is typically purchased on long-term contracts often around 20 years in duration.
SPOT MARKET	Although there is some potential to purchase additional gas on a 'spot' basis (using, for example, the Victorian gas market and shipping the gas to South Australia), there is no established spot market for gas in South Australia and no spot market price.
MARKET PRICES	Gas contract prices are generally strictly confidential. There are no public benchmarks highlighting an appropriate "market price" for gas.
CONTRACT FLEXIBILITY	Gas contracts allow for different delivery volumes on different days, and to some extent different years. Depending on the exact nature of the contract, therefore, the average price of gas to a Retailer is generally less sensitive to demand than in electricity where there is a relatively strong correlation between price and demand.
HAULAGE	Entry and exit from the gas market is complicated by the need to secure firm haulage rights to ship gas from a particular supply location to the market (essentially Adelaide[10]).

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

In its 2005 Inquiry into gas standing contract prices, the Commission decided to adopt a pragmatic approach to determining prudent costs, whereby the Commission accepted the Minister for Energy's approved 2004/05 gas supply costs as being prudent, and focussed its assessment on any proposed changes to these costs and whether these changes were reasonable. This approach was considered less intrusive than an "actual cost" approach and avoided having to second-guess Origin Energy's past contracting strategy, particularly given that some of its contracts were entered into many years earlier in a very different operating environment.

Origin Energy's proposal incorporates significant increases in gas costs reflecting recent experience in gas contracts in the south-eastern Australian market.

Transmission costs

The gas transmission cost component of the gas supply chain relates to the pipeline systems used to transport gas from production facilities to the distribution systems that supply metropolitan areas – the Moomba to Adelaide Pipeline System (MAPS) and SEA Gas,[11] together with a number of smaller lateral pipelines that transport gas to regional centres.

In the gas supply industry, gas retailers are able to negotiate transmission charges that vary with the retailer's capacity and load factor characteristics. While reference charges for a gas transmission pipeline may be set under an access

[10] More than 95% of the gas is supplied to Adelaide.

[11] Origin Energy is a part owner of the SEA Gas pipeline (together with SPI and International Power) and has entered into fixed price transmission contracts to secure stable returns and cash flows to the asset owners.

arrangement approved by the ACCC, a retailer can negotiate different price outcomes by managing its suppliers and load.

The Commission notes that both the MAPS and SEA Gas pipelines are unregulated, following the recent decision of the SA Minister for Energy to revoke coverage of the MAPS under the *Gas Pipelines Access (South Australia) Act 1998*.[12] Therefore, there are no longer regulated reference prices for these pipelines, with prices being determined through commercial negotiation.

In considering prudent transmission costs in its previous Inquiry, the Commission focussed its assessment on:

- the prudence of Origin Energy's transmission contracting strategy and the efficiency of the contract prices; and
- the allocation of gas transmission costs to gas standing contract customers (which involved allocating costs between standing contract customers and other customers and then allocating costs within the standing contract customer class).

The overall transmission cost will depend on underlying contract prices, changes in the mix of transmission contracts (e.g. the relative volume through MAPS and SEA Gas) and changes in the customer mix itself due to differential churn rates.

Origin Energy's proposal includes an initial increase in transmission costs (over those included in the current price path) but allows for CPI movements thereafter.

Retail operating costs

Retailer operating costs and margins are an important component of gas tariffs.

There are several different ways that retail operating costs could be determined. These include setting retail operating costs based on assessing an entity's submitted (or claimed) costs, utilising external benchmarks, or a combination of both approaches. The Commission has previously determined gas retail operating costs using a benchmarking approach.

The Commission has recognised that there are certain deficiencies in using a benchmarking approach, as there are in using an actual cost approach.

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

---

12 The notice of revocation is available at www.ncc.gov.au/pdf/ReGAMAMD-001.pdf.

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

Origin Energy's proposal on retail operating costs uses the allowance in the current price path as a starting point and proposes a CPI+4% escalation from that point. The explanation for this increase points to the loss of scale economies through churn as causing an increase in per unit operating costs.

Retail margin

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

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

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

Origin Energy's proposal provides for an increase in the margin allowance from 10% on controllable costs to 13%. This is principally linked to the continuation of prepayment of distribution charges, increased risk in wholesale gas markets and the risk of forecast error.

6 ORIGIN ENERGY SUBMISSION

Origin Energy's standing contract submission is based on a building block approach (using benchmarks for wholesale gas costs, transmission costs, retail operating costs and retail margin) and a continuation of the existing form of regulation.

Origin Energy recommends maintenance of the pass-through provisions included in the current price path decision, including network charges. Origin Energy has proposed a different approach to rebalancing controls (if they are to be used), with the use of a relative control linked to the allowed change in the price path.

Origin Energy proposes that its retail component of standing contract prices be varied as follows (in real terms) for the three years from 1 July 2008.

RETAIL COMPONENT CHANGE (%)	1 JUL 08	1 JUL 09	1 JUL 10
Residential	9.3	1.6	2.2
Small and Medium Enterprises	14.9	0.7	1.6

As the retail component accounts for around half of a total bill (the rest being distribution charges) the overall effect of these rises is approximately halved as is shown below in real terms.

STANDING CONTRACT CHANGE (%)	1 JUL 08	1 JUL 09	1 JUL 10
Residential	4.6	0.9	1.2
Small and Medium Enterprises	6.6	0.5	0.9

Origin Energy has provided the Commission with both a public and a confidential version of its submission. The public version of the submission accompanies this Issues Paper. The Commission invites interested parties to comment on the Origin Energy submission, as well as the various issues as raised in this Issues Paper.

7 NEXT STEPS

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

The timetable indicates that the Commission is seeking comment on the issues raised in the paper by 21 December 2007.

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

From November 2007 to February 2008, the Commission will undertake a number of studies with the assistance of consultants to give it a more detailed understanding of the cost components of the standing contracts price.

The Commission will use the information it receives from stakeholder submissions, Origin Energy and consultants to prepare a Draft Inquiry Report and Draft Price Determination for release to stakeholders in March 2008.

Stakeholders will be given an opportunity to comment on the Draft Inquiry Report and Draft Price Determination. Submissions will be required by late April 2008.

The Final Inquiry Report and Price Determination will be released by 31 May 2008, to enable the Price Determination to take effect from 1 July 2008.