ORIGIN ENERGY RETAIL LTD

Proposed Price Path for Standing Contract Prices for Supply & Sale of Natural Gas: 2008/09 to 2010/11

SOUTH AUSTRALIA

Public Submission

CONTENTS

Executive Summary

For the purposes of section 34A(4a)(d)(ii) of the *Gas Act 1997* (the Act), Origin Energy Retail Ltd (ABN 22 078 868 425) ("Origin") has submitted a proposal to the Essential Services Commission of South Australia (the "Commission") for the determination of prices for the sale and supply of natural gas to standing contract gas residential and small business customers in South Australia.

Origin made a confidential submission on the 19 November 2007 and this public submission contains all relevant information for the review of stakeholders' apart from some confidential or commercially sensitive data. Although these specific figures have been removed from this submission, Origin has provided detailed explanation of the inputs and influences upon which Origin's price path proposal have been based and it will still allow stakeholders to make valuable contributions to the consultation process.

Origin has applied for a 3 year price path determination from 2008/09 to 2010/11, the minimum period of a determination under section 34A (4a), and relates to small customers (annual consumption of less than 1 terajoule per year, as defined in the *Gas Regulations 1997*).

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

> "protection of the long term interests of South Australian consumers with respect to the price, quality of and reliability of essential services";

and include the promotion of competitive markets, providing for an appropriate return to the regulated entity and ensuring there are sufficient incentives for investment in consumers' long term requirements.[1]

The Commission's current 3-year determination on gas prices for standing contract customers (2005/06 to 2007/08) consists of the following steps:

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

In setting the average retailer revenue under Step 1 above, the Commission established 3-year cost paths for Origin's "controllable" costs. These controllable costs included the wholesale costs of gas and transmission, retail operating costs and retail costs associated with the establishment and management of contestability ("FRC" costs). The Commission also included an allowance for retail margin of 10 per cent on these controllable costs.

Origin supports the continuation of this approach for the next 3-year price path period. Therefore, this submission focuses on establishing the average retailer revenue for residential and small business standing contract customers required to recover the forecast controllable costs and return an acceptable commercial margin on these costs.

The retailer tariffs for a particular customer segment and pricing zone will be calculated by Origin to ensure compliance with the average revenue control and with any rebalancing constraints. In this submission, Origin has only provided indicative retailer tariffs and

[1] See for instance, Essential Services Commission of South Australia; *2007 Review of Retail Electricity Price Path: Draft Inquiry Report & Price Determination*, 2007, p.26.

standing contract prices for 2008/09 by market segment and pricing zone. The final retailer tariffs and standing contract prices for 2008/09 will be submitted in June 2008 for approval by the Commission as consistent with their Final Determination.

Average Retailer Revenue:

The starting point for Origin's submission on average retailer revenue is the customer number and demand forecast for residential and small business customers for each year (2008/09 – 2010/11). Annual churn rates from standing contracts are continuing at higher rates than previously forecast as customers take up market contracts with Origin and other retailers.

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

Table A.1: Proposed Changes in Average Retailer Revenue (Real $/GJ, GST exc)

	Residential Segment		Small Business Segment	
	$/GJ ($2008/09)	% change	$/GJ ($2008/09)	% change
2008/09	$11.85	9.3%	$6.89	14.9%
2009/10	$12.04	1.6%	$6.94	0.7%
2010/11	$12.30	2.2%	$7.05	1.6%

The proposed percentage increases in average revenue are relative to the average retailer revenue in 2007/08 calculated on the 2007/08 retailer tariffs and adjusted to account for the changes in standing contract customer base compared to the previous forecasts. It is the adjusted revenue that provides the appropriate base for calculating future revenue requirements.

The key drivers of the percentage increases in the average revenue requirement between 2007/08 and 2008/09 relate to:

(i) increases in the costs components detailed in section 6 ; and

(ii) an adjustment for under-recovery of a number of thse costs in 2007/08. Origin has not sought recovery of the additional costs incurred in 2007/08 (with the exception of FRC capital costs), rather, the revised costs feed into the 2008/09 cost base. This does create a greater impact in terms of the percentage change in the transition from the 2007/08 determination to the new 2008/09 cost base. The impact in later years is much less.

However in 2009/10 and 2010/11, Origin is only proposing small real increases in retail tariffs. These small changes are largely the result of continued real increases in the cost of gas and the effects of customer churn on Origin's retail operating costs per customer. Other costs remain reasonably constant in real terms across these years.

Standing Contract Prices:

Given the proposed increases in retailer tariffs set out in Table A.1 above, and assuming that non-controllable costs increase each year in accordance with the current Access Arrangement (CPI + 0.2%), standing contract prices would be expected to increase as set out in Table A.2 (subject to the actual changes in non-controllable costs and treatment of the Retail Market Company ("REMCo") charges.

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

	Residential Segment	Small Business Segment
	% change	% change
2008/09	4.6%	6.6%
2009/10	0.9%	0.5%
2010/11	1.2%	0.9%

Note: Does not include adjustments for the treatment of REMCo charges.

<u>In summary:</u>

Origin has proposed to the Commission a 3-year price path for average retailer revenue for residential and small business standing contract customers that, while built on the same elements as the previous determination, reflect most particularly:

- increases to wellhead gas costs including MDQ driven by new contract prices and the rapidly changing supply/demand balance in the south-eastern gas market;
- increases to retail operating costs and the extension of the FRC capital cost recovery period, in both instances reflecting the high churn rates;
- increases in the retail margin in recognition of the ongoing working capital impacts of the unique gas network payment arrangements and of the substantial wholesale risks and forecast error risks; and
- the under-recovery of costs in 2007/08, which together with the demand forecast errors in 2007/08, drive additional adjustments to the average revenue requirement in 2008/09.

The proposed retailer average revenue increases, however, stabilise in future years. As a result, while customers are expected to see changes of the order of six percent real in 2008/09 in their standing contract prices, future years are more in line with the current regulatory determination.

Finally, Origin notes that the current submission highlights the real risks of adopting a relatively rigid 3-year price path, particularly given the extent of forecast error revealed under the current determination. While Origin recognises that the Commission is constrained by the legislative framework, we will be proposing a shorter determination period to the relevant Minister for his consideration.

In Origin's view, a shorter determination period will also be consistent with the likely findings of the AEMC FRC effectiveness review programme which will investigate the level of competition in South Australia in 2008.

1. Introduction and purpose

1.1 Submission for price path determination

For the purposes of section 34A(4a)(d)(ii) of the *Gas Act 1997* (the Act), Origin Energy Retail Ltd (ABN 22 078 868 425) has requested the Essential Services Commission of South Australia (the Commission) determine the average retail revenue component of the South Australian standing contract prices for the sale and supply of natural gas in accordance with its price path proposal.

The Origin price path proposal was provided to the Commission in a Confidential Submission on the 19 November 2007 and this public submission is essentially the same document, however, certain information has been omitted because of its confidential or commercially sensitive nature. Origin has provided detailed explanation of the inputs on which Origin's price path proposal have been based within this submission and it will allow stakeholders to understand the reasons for Origin's proposal.

Origin requests that the Commission continue with its current approach of adopting separate average retailer revenue controls, applied on a dollar per gigajoule ("$/GJ") basis, for each of the residential and small business ("SME") customer categories. The period of the determination requested is three years, from 1 July 2008 to 30 June 2011 and is in respect of small customers (annual consumption of less than 1 terajoule per year, as defined in the *Gas Regulations 1997*).

The average retailer revenue components for each year in the current determination period were set by the Commission in June 2005 with effect from 1 July 2005[2], and were designed to apply up to 30 June 2008. Subsequently, the Commission approved the 2005/06 standing contract prices that were based on delivering the allowed average retailer revenue and a pass through of the approved network charges and other non-controllable costs. The standing contract price for the remaining years of the price path consisted of tariffs that recovered the approved retailer tariff component for that financial year plus the relevant published network charges, and other regulated market charges, for that particular year.

As set out in section 1.2 below, Origin proposes to continue this approach in the next determination period. Proposed changes in average retailer average revenue will therefore be based on forecast changes in controllable costs. In addition, a key issue facing Origin in developing this proposal, particularly with respect to proposed increases in average retailer revenue and tariffs between 2007/08 and 2008/09, are the variations in the following factors:

(i) variations between the forecast customer numbers and demand in the current determination for 2007/08 and the actual 2007/08 standing contract customers and their gas demand;

(ii) variations in average retailer revenue in the base year 2007/08 based on the changes in customer numbers and demand and the resulting modelling changes; and

(iii) variations between the "allowed" costs for 2007/08 under the previous determination and the actual costs for 2007/08.

With respect to variations between 2007/08 actual costs and the costs approved in the previous determination, Origin has not to date sought recovery of these additional costs under either the pass through provisions in Chapter 4 of Part B of the first Determination or under the "special circumstances" provisions of the Gas Supply Act. Nor does Origin propose to include any retrospective adjustment of the under-recovery within this current submission - with the notable exception of FRC capital costs that were not recovered (see section 6). Instead, Origin has focussed on identifying these key variations and ensuring that the average revenue and retailer tariffs in the next determination period appropriately reflect these changes. However, there will be an impact on percentage increases in

[2] Essential Services Commission of South Australia, *Gas Standing Contract Price Path, Final Inquiry Report and Final Price Determination,* June 2005.

average retailer revenue in the transition from the last year of the current determination (2007/08) to the first year of the next determination period (2008/09).

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

1.2 Approach to developing the price path proposal

Origin's submission was prepared with regard to the objectives of gas industry regulation, as set out in the Act, together with the objectives set for the Commission under the *Essential Services Commission Act* 2002 and the factors that the Commission is required to have regard to in making a price determination under that Act.

Origin has sought to protect the long term interests of South Australian consumers by proposing a price path that reflects the underlying costs of selling and supplying gas to small customers given a competitive wholesale market for gas. The proposal results in outcomes that are fair and reasonable at an individual customer level while preserving the viability of supply to small customers in the face of constrained supply and growing demand for gas across the whole south-eastern gas market, largely driven by electricity generation. These trends are expected to continue through the determination, along with the increasing interdependence of gas markets, creating a great deal of uncertainty about future gas costs particularly out to 2010/11.

The proposed average revenue price path applies only to Origin's standing contract customers and excludes Origin's market contract customers. It is important to note that the number of customers on gas standing contracts is rapidly declining as customers move to market contracts with Origin and other gas retailers. This rate of decline in customers relying on standing contracts has been maintained since the commencement of FRC. This factor has, in turn, influenced Origin's approach to the current forecasts of gas customer numbers and gas consumption.

It highlights the difficulty facing all parties in imposing a 3-year price path based around an average retailer revenue approach. Nevertheless, for the purposes of this submission, Origin has constructed the proposed price path using the process set out in Figure 1.1 including:

- Demand forecasts: Separate demand forecasts are built up for each customer segment and geographical region. For each of these segments the demand forecast is a function of both forecast customer numbers and forecast gas consumption.

  Historical churn rates were applied to July 2007 actual customer numbers to derive annual forecast customer numbers on standing contracts. A separate analysis of customer billing data from standing contract customers, taken across the whole year, was undertaken to derive annual forecast consumption and allocate this consumption to the retail tariff bands.

- Cost building block approach: after forecasting standing contract demand for 2008/09 to 2010/11, the associated retailer revenue and average revenue per gigajoule requirement for each year is calculated by adding up forecasts for all controllable cost components that form part of the retailer tariff. These include wellhead gas prices, transmission charges, retail operating costs, recoverable retail FRC costs and retail margin on controllable costs.

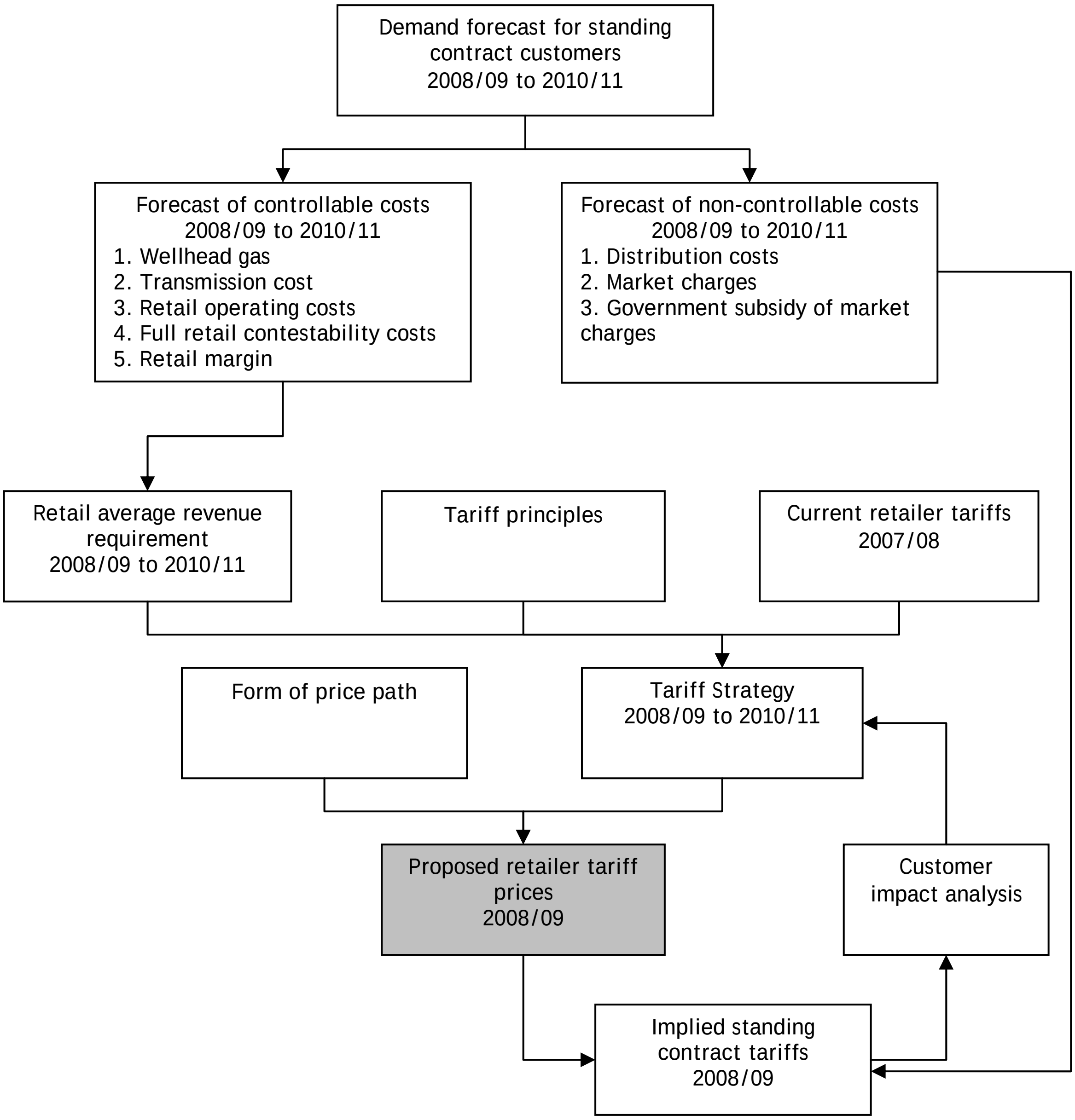
- Tariff strategy: to recover the average revenue requirement defined by the building block methodology, a tariff strategy is formulated to guide the setting of retailer tariffs given relevant tariff principles (such as cost reflectivity) and the design of current (2007/08) tariffs.

  In the Confidential Submission, Origin has put forward indicative retailer tariffs and standing contract prices for 2008/09 to provide guidance to the Commission on the possible impacts on standing contract customers of the proposed changes. Final prices will be agreed with the Commission around June 2008.

- Form of the price path: as noted above, the form of the price path takes account of the distinction between controllable and non-controllable costs, and also specifies the instrument of control, conditions for re-opening, pass-through items and need for ongoing flexibility in rebalancing.

- Proposed price path: the proposed price path combines the form for the price path with the tariff strategy necessary to achieve the average retailer revenue requirement within acceptable customer impact limits.

Figure 1.1: Approach to developing the proposed price path for average retailer revenue and retailer tariffs.



Source: Origin Energy

1.3 Organisation of the price path submission

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

- a background on Origin Energy, the SA gas market and the sale and supply of gas under standing and default contracts — sections 2 and 3;
- demand forecasts for standing contract customers over the period — section 4;
- a discussion of the appropriate form of the price path — section 5;
- an item by item justification of controllable costs — section 6;
- an identification of non-controllable cost items and likely movements — section 7;
- a summary of Origin's retailer revenue requirement — section 8; and
- a discussion of Origin's tariff strategy for 2008/09 to 20010/11 — section 9.

1.4 Important Caveats

Origin's proposal is subject to a number of important caveats which may lead to some further amendments to Origin's proposed retailer tariffs. They are as follows:

I. The treatment of the annual per customer charges of the Retail Market Company ("REMCo") given that the current subsidies will be removed from 2008/09; and

II. Substitution of forecast CPI figures with actual CPI figures which, in turn, will flow through to the relevant costs and revenue.

1.5 Confidentiality

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

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

2. Background on Origin Energy and the SA gas market

2.1 About Origin Energy

Origin is a leading Australian energy company that supplies natural gas, electricity and liquid petroleum gas (LPG) to business and residential customers in Australia, New Zealand and the Pacific region. Origin is a participant in most segments of the energy supply chain including exploration and production, power generation and energy retailing and trading. Origin has more than 140 years experience of meeting the energy needs of Australians. Origin sold approximately 125 PJe of energy to customers in 2006/07.

On 2 July 2007, Origin completed the sale of its Network businesses, including all interests in Envestra and in the SEA Gas Pipeline, to the APA Group. Following the sale, Origin's interests in the gas market in South Australia is now solely focused on gas retailing and some interests in gas production.

In addition to its South Australian gas retail business, Origin is a participant in the electricity retail market and has invested in a number of generators in South Australia. Origin is joint owner of the Osborne generation station (180MW) and has full ownership of Ladbroke (80MW) and Quarantine (95MW) generation stations. In May 2007, Origin announced that it was planning to expand the open cycle gas-fired Quarantine station with the construction of a new 120 MW peaking power generator. The expansion will be supplied with natural gas through the SEA Gas Pipeline and will provide additional peaking capacity that will add to the security of electricity supplies in South Australia while limiting growth in greenhouse gas emissions. The additional generation capacity is expected to come on line in time for summer 2008/09.

2.2 A brief history of the development of natural gas in SA[3]

The South Australian Gas Company (SAGASCO) was incorporated in 1861, over 140 years ago, initially as a distributor of coal, then of LP gas. Following the discovery of natural gas in the Cooper/Eromanga Basin SAGASCO entered a supply and purchase agreement with the Cooper Basin Producers in 1966. However, it was the subsequent growth in demand for natural gas for electricity generation that made the development of the gas fields and the construction of the Moomba to Adelaide pipeline economically viable. Electricity generation now accounts for some 47 per cent of gas use in the State, a trend that might be expected to increase under any emissions trading scheme.

The first natural gas was supplied to Adelaide in November 1969 and during the 1970s natural gas became the major source of energy for the State's industries. Wider distribution of natural gas to regional centres developed during the following two decades. Origin's predecessor, Boral Energy, purchased the SAGASCO company from the South Australian Government in 1993.

In addition to the Cooper Basin, South Australia now has access to natural gas from Victoria. The new source of gas supply from Victoria adds significantly to the security of gas supply to South Australia. However, it also demonstrates the increasing integration of the gas market, a factor that provides for greater competition between buyers in times of scarce supply such as the peak winter period. With the predicted decline in supplies from Cooper/Eromanga Basin, competition for gas supplies, particularly peak gas supplies, is becoming an increasingly important consideration to retailers and their customers alike. For example, the most recent ABARE projections for natural gas production states[4]:

> Production from the Cooper Eromanga basin was 254 petajoules in 2004-05 and is projected to decline to 183 petajoules in 2011-12. After this, production from Cooper Eromanga is projected to decline sharply for the rest of the outlook period, averaging a rate of decline of over 17 per cent a year.

[3] Factual information includes information available in the Energy South Australia web-site: http://dtei.sa.gov.au/energy/index.html

[4] ABARE Research Report 06.26: Au*stralian energy national and state projections to 2029-30,* page 41.

While Victorian sources will continue at current production levels beyond that date, there will nevertheless be increasing pressure towards interstate movements of gas linking back, for instance, to the coal seam methane fields in Queensland with Moomba perhaps emerging as a hub. Figure 2.1 illustrates this interconnectivity.

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

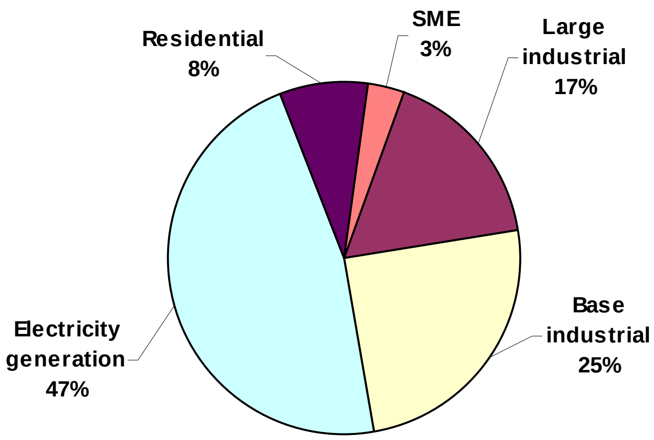
Source: Origin Energy. Note, Mount Gambier is now connected directly to the SEA Gas pipeline.

2.3 Demand characteristics

2.3.1 Annual consumption

As is shown in Figure 2.2, electricity generation and industrial businesses (ie mining, manufacturing and construction) are the dominant users of natural gas in South Australia, forecast to be around 47 per cent and 42 per cent respectively in 2007. Residential and small business users have not typically been large consumers of gas in South Australia. ABARE data further forecasts that gas consumption will continue to grow on a similar proportional basis for the next 20 years with the greatest increases in gas consumption in the electricity generation sector.

Figure 2.2: Forecast composition of South Australian natural gas annual demand, 2007-08



Source: Australian Bureau of Agricultural and Resource Economics (ABARE), Australian Energy: National and State Projections to 2029-30.

2.3.2 Maximum daily consumption

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

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

These concepts are particularly important in considering the costs associated with supply to residential and small business customers as these customers generally have a more peaky demand profile but also require "firm supply". For instance, during winter when demand by residential customers on a cold day may be very high, it is generally larger industrial customers who will have their supply constrained if there is a shortage of gas in the market.

2.4 The natural gas wholesale market

In conjunction with the introduction of full retail contestability ("FRC"), a new wholesale market structure was developed to manage the daily supply/demand balancing of gas and the allocation of gas between various gas retailers on the basis of the net system load profile ("NSLP"). This wholesale market is administered by REMCo.

REMCo also operates a commercial Swing Service to ensure physical balancing between the two principal gas pipelines (MAPS and SEAGas). Physical imbalances between parties on the one pipeline (e.g. between users of the Moomba to Adelaide Pipeline ("MAPS") are in turn settled on the basis of private commercial arrangements between the pipeline parties.

Significant costs have been incurred by gas retailers under these arrangements and the wholesale gas market is expected to become even more volatile due to the expansion of gas fired generation. Moreover, Origin, as the largest retailer to small customers and the "host retailer" faces additional risks under the balancing and settlement processes. The new market arrangement has significantly increased the commercial risks facing Origin in particular as Origin is exposed to residual settlement risks as the host gas retailer.

3. Sale and supply of gas under standing contracts

3.1 Regulatory framework

3.1.1 Introduction

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

3.1.2 Regulation of standing contract prices

The current standing contract prices are set by ESCOSA via a determination under the *Essential Services Commission Act* 2002 and are designed to apply up to 30 June 2008. From 1 July 2008, new standing contract prices must be set by the Commission.

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

3.1.3 What guides the assessment of an 'appropriate price'

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

Origin has considered the objectives of these Acts and believes that the objectives, as set out in the Commission's *Final Report on Gas Standing Contract Prices* in 2005, provide a reasonable basis for setting gas prices in the new determination period from 1 July 2008. The focus here is on protecting the long term interests of gas consumers by establishing a price path consistent with the costs of supplying standing contract customers, promoting competition, providing for an appropriate return to the regulated entity and ensuring there are sufficient incentives for investment in consumers' long term requirements.[5]

Once the retailer revenue is determined, the network and other non-controllable costs are treated as a simple pass-through; only the retailer tariffs are subject to the price control formula.

Origin expects this approach to continue in the new determination, and for the new determination to be limited to the minimum period of three years.

3.2 Nature of the service and service standards

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

Meeting these service standards, together with complying with the various rules set out in the Energy Retail Code is a factor that must be recognised in the assessment of retailer

[5] Op cit., ESCOSA, Final Determination, June 2005, page B-1.

operating costs. Moreover, the jurisdictional nature of these rules means that potential synergies across Origin's total customer base are limited at least until the establishment of national rules under the Australian Energy Market reform process.

The potential cost impact of a change in regulatory requirements is allowed for in Origin's proposal via a regulatory re-set pass through event (see section 5). As noted in section 5, Origin considers that the costs involved in moving to a national regulatory framework, including changes to the distributor-retailer relationship, should qualify for this pass-through test.

3.3 Charges not covered by the submission

In addition to the non-controllable costs identified previously, there are a number of other fees that are not included in the average retailer revenue proposal such as:

- Special meter reading charges;
- disconnection/reconnection charges;
- account establishment fees; and
- dishonoured cheque fees.

4. Demand forecasts

Origin's costs, and consequently its tariffs, vary between customer segments (residential and SME) and across pricing zones. As a result of this, in order to estimate the average retailer revenue requirement for the period 2008/09 to 20010/11, 10 sets of customer and demand forecasts are required — one for each combination of customer segment and pricing zone.

In preparing the forecasts for small customer gas demand, it is also important to allow for the impact of weather on demand and to capture the dynamic aspects that arise from the high rates of customer movement from standing contracts to market contracts with Origin or other retailers.

To allow for these factors Origin has first analysed consumption patterns at the level of customers' quarterly bills and second, averaged consumption patterns over two years. Analysing consumption at the bill level means that outcomes are not distorted by the rapid movements of customers during the year.

4.1 Conceptual approach

The conceptual approach used to develop the demand forecasts for the price path period is set out below. It involves a number of discrete steps, first to obtain the customer number forecast and second, to obtain the volume forecast by market segment and zone.

4.1.1 Customer Number Forecast: Standing Contract Customers

The customer number forecast provides an important input into the consumption forecast and is also indicative of the fixed (per customer) costs and revenue. Given the difficulties in accurately forecasting the number of customers remaining on gas standing contracts over a three year period (as illustrated by the forecasting inaccuracy in the current determination) a relatively simple approach was adopted by Origin in our current submission.

The approach consisted of taking a series of "snap shots" of the number of customers remaining on standing contracts, deriving an average movement rate from standing contracts to market contracts and projecting this forward for each forecast year.

The principal output of this analysis was, therefore, a set of forecast customer numbers for December 2007, 2008, 2009, 2010 and 2011 that reflected an average movement of consumers away from the regulated standing contracts (to various market contracts).

4.1.2 Consumption Forecast: Standing Contract Customers

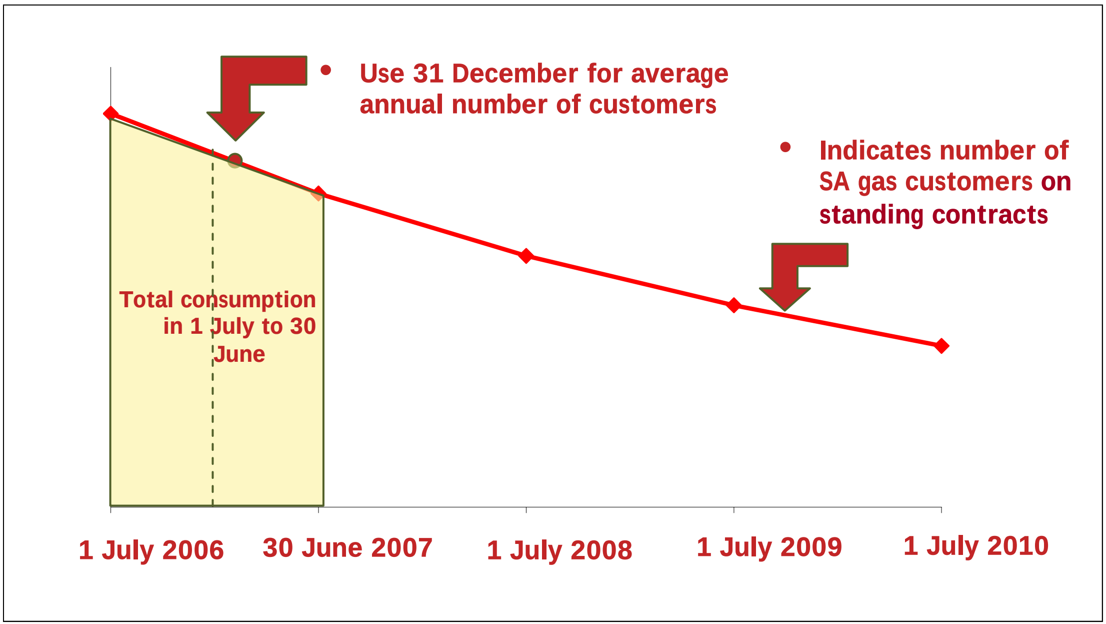
As the retailer average revenue control formula is based on a target expressed as the average $ per GJ (by market segment), the forecasting of annual consumption and consumption profile (by retail tariff bands) was a central element in the submission process.

Origin's approach reflected the analytical difficulties of analysing consumption trends in a limited market (of standing contract customers) in which there is a high rate of movement across to market contracts.

Rather than considering annual consumption at the customer level, Origin has therefore chosen to forecast demand on the basis of analysis of each quarterly (or monthly) bill where the relevant bills were issued to a customer on a standing contract. For example, if a customer moved to a market contract during the year, only those bills that were issued while the customer was on a standing contract were included in the analysis.

Figure 4.2 illustrates the separate processes of identifying customer numbers and gas consumption. The gas consumption in a given year is represented by the area under the curve and is based on any bill issued in the period to a customer then on a standing contract tariff (that is, even if the customer has subsequently transferred to a market contract).

Figure 4.2: Standing Contract Customer Numbers and Consumption, 2006/07 to 2010/11 (**illustrative only**)



Source: Origin Energy

4.1.3 Load factor

Load factors are used to determine gas demand and therefore gas supply requirements to meet peak day demand and are established separately for the residential and for the small business customer market segments. For the residential customer segment, for instance, the peak daily demand is around three times their average daily demand. For the small business customer segment the peak demand is around twice their average daily demand.

This in turn means that the total costs for gas and for transmission are different for residential and small business customers. However, in Origin's current submission we have used the same load factors as in our previous submission such that there is no change in the cost differential between the two market segments.

4.1.4 Movement of Standing Contract Customers to Market Contracts

When setting the previous determination for 2005/06 to 2007/08, both Origin and the Commission's consultant, NIERA, expected that the rate of movement out of standing contracts to market contracts would decline from an initial high to around 5 per cent or a quarter of the rate seen in the first half year of gas FRC.

However, standing contract customers in South Australia have continued to move to market contracts with Origin and other retailers at much the same rate as seen at market start. As noted above, Origin has therefore based its forecast of standing contract customers for the period up to 2010/11 on a continuation of this rate of movement to market contracts. This forecast assumption is also consistent with the findings of the recent report by NERA to the Commission into the effectiveness of competition in South Australia[6].

[6]NERA Economic Consulting: *Review of the Effectiveness of Energy Retail Market Competition in South Australia. Phase 2 Report for ESCOSA*, June 2007, page iii. A copy of the NERA report is available on the ESCOSA web-site http://www.escosa.sa.gov.au/site/page.cfm?u=4&c=2187

4.2 Forecasts

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

They have been based on the historical trends and forecast assumptions summarised above.

5. Form of the price path

Origin proposes that the form of the price path remain as currently set by the Commission with the exception of a review of the price constraint mechanism.

5.1 Scope of control

Origin proposes that the price control apply only to controllable costs with non-controllable costs treated as a direct pass through into standing contract prices. As with current practice, gas transmission costs are to be classified as controllable costs because they are contracts negotiated by the retailer with the relevant transmission company. In particular, the ACCC has determined to remove coverage of the Moomba to Adelaide transmission pipeline and for the purposes of Origin's submission, all transmission contracts are treated as commercially negotiated, confidential contracts.

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

In the current submission Origin has also treated REMCo charges as non-controllable costs and therefore they are not included in the average retailer revenue proposal which is based on controllable costs only. This is a variation in the treatment of these charges in the 2005 Final Determination and arises largely because of the ending of the Government's interim subsidy to residential consumers for this charge in 2008/09. The interim subsidy was put in place by the Government to reduce the initial impact of new FRC charges on residential gas consumers.

It is important to note therefore that a further amendment to Origin's current proposal will be required to adjust for the change in the treatment of REMCo charges.

5.2 Instrument of control

Origin has requested that the Commission determine an average retailer revenue price control for residential and, separately, for SME customers. The agreed price control formula will then form the basis of Origin's "retailer tariffs" to apply to residential and SME customers at the regional level – a total of 10 tariff sets. While tariffs will vary between the regions, in aggregate, the revenue from the tariffs will be consistent with the overall average retailer revenue control formula.

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

5.3 Period of price path

Under the Act, the minimum period for the price path is three years. Given the pace at which the retail energy market is developing in South Australia and the difficulties of accurately forecasting costs within a three year period, Origin proposed to the Commission that the price path be limited to this minimum period.

Origin will, however, be undertaking discussions with the relevant authorities to consider amendment to this minimum period due to the difficulties and risks for both the retailer and the customers of locking in prices for 3 years in a volatile and unpredictable market. These risks are clearly demonstrated in Origin's current submission which illustrates the large discrepancies between the 2005 forecasts of standing contract customer numbers and supply costs and the actual customer numbers and supply costs for 2007/08.

Such an amendment is also consistent with the progress of FRC in South Australia, the rapidly decreasing reliance of gas consumers on standing contracts and the national energy market reform agenda.

5.4 Pass through items

In the previous Price Determination, the Commission provided for the pass through of the net cost change associated with a number of specified events, in particular:

- change in taxes events;
- regulatory reset events;
- transmission cost events; or
- Ministerial Direction events.

At this stage, Origin proposes these pass through arrangements continue into the new determination period.

5.5 Conditions for Re-opening

Under the Gas Act, the Commission's price path can be reopened in "exceptional circumstances", however, this is a non-trivial exercise and means that a new 3 year determination must be put in place from the time of the new decision.

While Origin has designed its price path proposal to minimise the requirement for re-opening, the price path approach in South Australia takes the form of a very specific average revenue allowance (expressed in $/GJ). This inevitably imposes a significant forecast risk burden on the retailer which to date has not been adequately compensated for in the allowed retail margin. Origin notes that the allowed retail margin was benchmarked against retail margins in other jurisdictions that do not impose such a specific form of price control.

5.6 Flexibility for Rebalancing

For this initial submission on the proposed price path for 2008/09 to 2010/11 Origin is not proposing specific rebalancing constraints at this stage.

The current approach to setting rebalancing constraints (on a CPI + X% basis for any individual retailer tariff) has enabled restructuring of the retailer tariffs to better reflect cost inputs. At this stage, Origin does not envisage that these rebalancing constraints need to be continued.

However, in the event the Commission chooses to continue with such constraints, Origin has recommend to the Commission an alternative approach which consists of setting the constraint target relative to the average allowed revenue increase rather than to CPI.

6. Controllable costs

6.1 Key assumptions

In developing the forecasts of controllable costs, Origin's key assumptions include the demand forecasts discussed in section 4 and the CPI forecasts as set out below in Table 6.1.

Table 6.1: December CPI assumptions (2008/09 to 2010/11)

	2008/09	2009/10	2010/11
All Groups, Weighted average of Eight Capital Cities – change in index from December of previous financial year	2.4%	2.0%	2.5%

Source: Access Economics, September 2007

As a number of the cost inputs are reliant on actual CPI, Origin will seek to amend the submission to account for actual CPI in 2008/09 prior to the final approval by the Commission of 2008/09 retailer average revenue and the specific retailer tariffs in June 2008.

6.2 Gas Supply

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

- sufficient availability of gas to meet the annual forecast demand of Origin's gas customers; and
- the level of supply security required to meet the peak demand forecast for the residential and SME customers.

As a result, Origin's supply portfolio can be viewed as made up of a variety of physical, financial and swap contracts to supply "base" load and "peak" load demand. In addition, Origin incurs additional risk management costs in meeting other supply requirements such as short term 'swing' gas (gas balancing) requirements.

Base Load Supply contracts are characterised by a flat daily supply of gas with little tolerance between the maximum and minimum daily quantity. Base Load Supply contracts are characterised by a maximum daily volume, a yearly maximum volume and a yearly minimum volume. Generally, more recent gas contracts have less flexibility in these parameters.

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

In the South Australian wholesale market, with potentially significant pipeline imbalance and swing penalties, "locking in" capacity to meet peak demand is even more important.

The details of Origin's approach to both annual supply and peak day supplies have been provided to the Commission in the Confidential Submission and are summarised below. Our approach has been developed from, and is consistent with, our obligations to provide for firm supply, to satisfy the wholesale market rules under REMCo and, more generally, with acting as a commercially prudent retailer within sound risk management parameters.

The approach adopted by Origin in the Submission to the Commission is the same as that used in the 2005/06 tariff submission and was the basis for extensive discussion in the Commission's Draft and Final Determinations in 2005.

6.2.1 Summary of forecast gas supply prices

The total cost of supply for each year is calculated by the addition of the prices associated with wellhead gas, wellhead MDQ and Swing Gas.

Origin forecasts a real increase in the gas supply portfolio costs for residential and SME customers of 4 to 6 per cent per annum over three years. However, these average increases are referenced to the average gas price allowed for under the previous determination for 2007/08, which did not allow for the growing competition for gas, particularly in peak demand periods, and the impact of this on wellhead gas prices.

If the actual gas cost for 2007/08 was the base, rather than the 2005 forecast gas cost, then average real increases in gas costs would still be required, but somewhat less than above.

6.2.2 Wellhead price for annual contract quantity (“ACQ”)

Origin supplies its South Australian customers from a diverse portfolio of supply contracts. This portfolio will, over the course of the determination period, include gas originating from the Cooper/Eromanga Basin and from interstate gas fields, particularly Victoria.

The wellhead price incorporated into Origin’s 2005 submission was based on the weighted average costs of the portfolio of base load supply arrangements required by Origin to ensure supply security through the period. This methodology is continued in the current submission by Origin.

The portfolio approach allows mass market customers to benefit from the purchasing and negotiating synergies of Origin’s total demand base and mitigates (somewhat) the risks of a changing customer base. This methodology also ensures that all small customers receive the same wellhead price irrespective of their geographic location or whether they are supplied from the Cooper Basin, Victorian or Queensland gas fields.

Since the 2005 submission, competition for gas supplies has increased, an outcome which flows through to real increases in the cost of gas for both new gas contracts and to many existing contracts via price review clauses. To meet demand, Origin has to negotiate new contracts so both these factors have had an influence on the forecast cost of gas.

The combined effect of these factors, plus the lower base for 2007/08 has resulted in proposed real increases in allowed gas costs that are larger in the first year (2008/09) than in subsequent years. This, in turn, is one factor driving the larger increases seen in the proposed average retailer revenue for 2008/09.

6.2.3 Peak Day Supply (“Wellhead MDQ”)

The supply of wellhead MDQ required over the determination period is based on the total portfolio of contracts required to ensure an appropriate level of security for non-interruptible customers. As in the ACQ, this approach provides some synergies for small customers and allows regional customers to be treated (in terms of cost of gas) in the same way as urban customers.

The total MDQ commodity cost, calculated on the portfolio basis, is allocated to customer segments based on their contribution to the peak day demand (similar to the contribution to transmission costs – see below), as expressed via the load factor of the segment.

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

The market price of MDQ has increased faster than ACQ over the course of the current price path period reflecting some key changes in the South Australian gas and electricity supply market and competing demands from interstate buyers. In particular, our view on future MDQ prices is based on the following factors:

- reduced flexibility in base gas supply contracts including reduced flexibility in daily deliverability compared to annual deliverability;

- uncapped exposure to swing gas (see below), and the general tightening of intra day supply drives both increasing demand for and the price of back-up gas sources for all South Australian gas market participants;
- the increase in gas fired generation units in Queensland, South Australia and Victoria has compounded these trends as generators compete for limited intra day balancing and other short term gas supplies. Similarly, overall gas demand volatility and "peakiness" increases;
- reduced flexibility with respect to contractual linepack rights on the key transmission pipelines; and
- the current drought across the eastern states has led to a dramatic tightening of gas supply through southern and eastern Australia and exacerbated the peak supply issues identified above.

  Due to a substantial reduction in rainfall and dam capacities, hydro generation plants such as Snowy Hydro have been unable to generate electricity at non drought operating levels. Gas generation has been required to make up much of this generation shortfall with an increase in gas use nationally in the order of 50 -70 PJ per year. Snowy Dam levels are currently 18 per cent, the lowest October level recorded and are not expected to recover for some years.

As a result of these factors, Origin has submitted substantial real increases in Wellhead MDQ relative to 2007/08.

6.2.4 Swing gas charges

While Origin's access to multiple supply sources enhances gas supply reliability to all gas consumers, there are specific charges associated with this such as the operational costs of delivering gas on a daily basis via the SEA Gas Pipeline. Beyond that, a significant uncapped exposure to the swing gas market operated by REMCo.

These risks are discussed further in section 6.4, however, it is clear that the introduction of the wholesale market in conjunction with FRC has increased the overall risk profile of gas retailing and the cost of risk mitigations strategies.

This matter of uncapped residual risk in the wholesale market must be part of the consideration of the appropriate retail margin for supplying small customers.

6.3 Transmission

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

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

The great majority of the main transmission pipeline and all of the lateral pipeline costs are based on fixed capacity costs, that is, on dollar per gigajoule of MDQ per month (or per year) rather than actual volume flows. This cost structure means that transmission costs are largely allocated on the same basis as the wellhead MDQ, that is, on the basis of the contribution of a market segment to the peak day demand rather than the annual demand.

More particularly, it is essential that Origin purchases enough pipeline capacity for its small customers that sufficient supply is available on peak days. This capacity must, for a prudent retailer, be purchased in advance rather than "on the day", particularly when there is a limited short term market for additional capacity. In effect, Origin is purchasing an option for a capacity right that is independent of year on year actual peak demand.

The approach in the current Submission is therefore the same as proposed by Origin in 2005 and largely accepted by the Commission in their 2005 Final Determination.

Origin has provided in its Confidential Submission details of its transmission pipeline costs across the price path period, averaged across all regions and market segments for the purposes of determining the average retailer revenue[7].

These costs remain constant in real terms compared to the actual 2007/08 transmission costs but result in real increases of 1 to 3 per cent per annum for residential and SME customers due to the approved 2007/08 transmission costs being lower than the actual costs.

6.4 Retail operating costs

6.4.1 Summary

The retail operating costs put forward in Origin's submission are exclusive of marketing and acquisition costs (although there are alternative approaches that include recognition of these costs) consistent with the previous 2005 Determination.

Origin's proposal for retail operating costs is for the Commission to use the current benchmark costs, excluding the FRC allowance, and to continue to adjust this forward using a CPI + X% approach to account for increasing labour costs and the significant impact of customer churn.

In the 2005 Determination, the Commission allowed CPI + 2% as the cost path for retail operating costs (on a per customer basis). Origin proposes in the current submission that the base cost from 2007/08 should be adjusted using an annual adjustment of CPI + 4%. Such an adjustment is necessary to account for the impact of much higher rates of customer movement than were forecast when the CPI + 2% cost path was allowed.

Origin also proposes that the Commission continue with its previous approach of separately assessing general retail operating costs and those retail FRC costs that were recognised as efficient and prudent in the 2005 Determination. This will allow transparency and surety in the recovery of these FRC costs, particularly the FRC capital costs, consistent with the commitments made to Origin at the commencement of FRC.

Origin has included in its Confidential Submission an assessment of retail FRC costs, consistent with the approved costs allowed by the Commission in their Price Determination in 2005 but also accommodating what has actually occurred and adjusting for the under-recovery of FRC capital investment costs to date due to customer churn. Origin seeks full recovery of these approved capital costs, but has smoothed the impact over the next three years based on updated customer losses and forecasts.

6.4.2 Guidance from the Commission's electricity inquiry

In its recent Draft Inquiry Report and Price Determination for the Retail Electricity Price Path, the Commission has predominantly relied on benchmarks in the setting of retail operating cost with validation by referencing AGL SA's actual costs.

It concluded that an operating cost of $96 per customer was appropriate for the start of the price path – this figure being equivalent to the retail operating cost that the Commission allocated for 2007/08 in their previous electricity price determination in 2005.

Origin notes that the Commission has, inter alia, quoted the Queensland Competition Authority ("QCA") in examining retail cost benchmarks in other jurisdictions. Origin considers this may be misleading as the QCA process for determining 2007/08 costs was much truncated and, in any case, was focussed on examining changes in costs rather than the absolute value of the costs. Consequently, Origin strongly cautions the Commission in using the QCA figure as a benchmark for any analysis that purports to represent a build up of actual retail operating costs.

For forecast changes to retail operating costs, Origin notes that in its previous Determination, the Commission recognised the impact of customer losses on the retail

[7] Specific retailer tariffs will reflect in part, the additional costs of the lateral transmission pipelines.

operating costs of the incumbent retailer, based on the fact that the incumbent retailer has invested in systems and processes to support a certain customer base pre-FRC. As such, many of the incumbent retailer's costs are fixed and invariant to customer numbers. As customer numbers decline following the introduction of FRC, fixed costs per customer will inevitably increase. The Commission made allowance that AGL SA's retail operating cost would increase in real terms by 2 per cent each year as small customers move to other retailers. A similar allowance was made for Origin.

However, in this 2007 electricity retail price Draft Determination, the Commission has argued that the per customer cost provided for in 2007/08 year is sufficient to account for loss of scale or alternatively, customer acquisition costs in the forecast. The Commission then proposes an annual reduction in retail operating costs based on purported efficiency gains by AGL SA.

Origin disputes this approach noting that AGL SA and Origin are the sole electricity and gas incumbent retailers in South Australia and where there is a single incumbent retailer, a significant net loss of customers is the almost inevitable outcome. Origin firmly believes that the cost of loss of scale, or in the alternative, customer replacement costs needs to be adequately recognised.

6.4.3 Gas and electricity retail operating costs

Origin's view is that customer operating costs do not differ significantly between gas and electricity mass market customers <u>providing they each have sufficient scale economies</u>.

Generally, gas customer bases are smaller than electricity, in South Australia for instance, the residential gas customer base in total is less than 40 per cent of the electricity base. In addition, the regulatory, operational and market requirements for gas remain distinct in many areas from electricity markets, thus limiting the synergies in retail operating costs for dual fuel retailers.

The jurisdictional variations in gas markets (versus the national electricity market under NEMMCo) also limit efficiency gains for a national gas retailer and push up the cost of gas retailing at the jurisdictional level.

Origin would therefore propose that cost to serve gas mass market customers should be essentially on a par with the electricity retail operating cost allowed by the Commission for 2008[8], inclusive of FRC operating costs - *but excluding FRC capital costs*. Origin's proposed price path accomplishes this purpose.

6.4.4 Origin's approach

Origin is generally supportive of the approach used by the Commission in the setting of the retail gas price path from 2005/06 to 2007/08.

Origin has supplied details of its operating costs to the South Australian price regulator on previous occasions, however, we are comfortable with the continued use of <u>appropriate</u> cost benchmarks with some comparison to actual reported costs to assure validity is maintained – noting however, the difficulty in isolating costs associated only with the standing contract customers as required in South Australia price determination process.

However, we would strongly argue that there are no grounds for a reduction of this over the three years. Rather, Origin has adopted the Commission's previous methodology, albeit with recognition of the impact of greater than forecast customer movements which impact on both fixed cost allocation and also operational costs.

In summary:

[8] The electricity draft determination does not make a specific allowance for FRC costs. However, due to the operation of a national electricity market, the incremental capital cost of FRC in the South Australian electricity market was very small on a per customer basis. No such synergies were available to the host gas retailer in South Australia, a large factor in making a separate determination for FRC costs.

- retail operating costs have a large fixed cost component and therefore, there are significant economies of scale. Scale issues are even more important as the customer base changes over the period;
- labour costs have direct and indirect impacts on retail operating costs (including fixed costs) and labour costs are increasing at rates above CPI;
- high rates of customer movement from standing contracts to market contracts impose greater operating costs on the host retailer than previously expected;
- the introduction of FRC has had a significant direct impact on retail operating costs including increased costs from greater regulatory and compliance obligations, data management issues, call centre demand, credit management, information and audit requirements etc; and
- trading and wholesale market management functions are considerably more complex requiring more staff, systems investment and management input.

Therefore, efficiency gains in some areas are more than off-set by additional costs in others, particularly in the short to medium term with high churn rates.

As the incumbent gas retailer, Origin has proposed to the Commission that they take account of all these factors and, in particular, the issues of loss of economies of scale for the host retailer. Origin's retail operating cost proposal takes these impacts into account and has been based on a retail operating cost increase of CPI + 4% per year. The impact of this relative to the previous determination is somewhat mitigated by the changes in consumption profile such that the average retail operating cost expressed in terms of $ per gigajoule is relatively static at least in the transition year to 2008/09.

However, Origin has suggested that, in the alternate, the Commission consider the approach adopted in some other jurisdictions of providing an allowance for customer acquisition activity so that scale can, notionally, be maintained through the period.

We do note here, however, that properly applied, the impact of the "customer acquisition" approach on allowed retailer operating costs given the smaller size and dynamics of the South Australian gas market would be much greater than Origin's recommended approach of CPI + 4%.

Origin has submitted Confidential Information to the Commission on both these options for assessing retail operating costs over the 3-year period.

6.4.5 Full Retail Contestability ("'FRC")

Origin received a commitment at the commencement of FRC, that the prudent and efficient costs of implementing FRC systems and processes for South Australian consumers would be fully recoverable. The allowed costs must be clearly associated with the incumbent retailer implementing and operating the capability to allow retail FRC; they were not costs associated with marketing, branding and the like.

These costs were independently reviewed and largely accepted as appropriate and recoverable over a period of five years (from 2004/05 to 2008/09) as a "per customer" annual fixed charge. However, the extent of customer movement means that the approved amounts have not been recovered as expected up to 2007/08 and the original assumptions were far too conservative.

Although the FRC cost allowance was to be continued until 2008/09, Origin believes that adjustments must be made to allow recovery of at least the relevant capital costs and if imposed on the 2008/09 retailer revenue requirement would lead to significant "price" shock. To this effect, Origin has proposed to the Commission that the FRC cost recovery be extended for the next three years to achieve Origin's full FRC cost recovery of the initial capital investment costs on a net present value basis.

6.5 Retail margin

6.5.1 Guidance from the Commission's Electricity Inquiry

In its Draft Inquiry and Price Determination Report into the Retail Electricity Price Path, the Commission continued its approach of:

- using a combination of benchmarks and conducting a detailed return on investment style of analysis to estimate a range for the net margin; and
- expressing the retail margin as a percentage of controllable costs.

The Commission settled on a benchmark of 10 per cent of controllable costs for AGL SA. With non-controllable costs averaging 50 per cent of total costs across AGL SA's small customer base, this expression of the retail margin is consistent in terms of its financial quantum to the 5 per cent sale revenue margin comparable with some other jurisdictions.

6.5.2 Origin's approach

The Commission needs to set an appropriate retail margin taking into account that:

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

Origin has proposed that in recognition of the particular circumstances of the gas industry in South Australia, the relevant retail margin should be 13 per cent on controllable costs rather than the 10 per cent allowed to AGL SA and to Origin in the previous 2005 Determination.

There are a number of reasons for this proposal for a 13 per cent margin that are set out in the Confidential Submission including the significant risk of forecast error, particularly during a period of rapid change in both the retail and wholesale gas market. Our concern here is exacerbated by the experiences of the current Determination which has understated both costs (particularly in 2007/08) and overestimated standing contract customer numbers.

Although the above factors are important, the main reason for proposing a 13 per cent margin on retailer operating costs arises from the unique requirements for prepayment of network charges that are imposed on Origin and other gas retailers by the network operator, Envestra. This prepayment requirement leads to a working capital cost for the retailer that is significantly greater (relative to revenue) than in jurisdictions such as Victoria where payment to the network is made in arrears.

In the previous Determination, the Commission rejected our request for a higher margin that allowed some partial recovery of this additional working capital cost. The Commission's rejection was explained at the time on the basis that changes in the 2006 network Access Arrangement would correct this anomaly. In fact, the anomaly remains in the current Access Arrangement. Origin (and other gas retailers) continue to incur this working capital cost but have, to date, had no recognition of this in the retail margin.

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

7. Non-controllable costs

7.1 Distribution

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

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

Envestra's 2007/08 charges for these services are set out in Table 7.1. For the purposes of modelling the impact of Origin's current proposal on customers' standing contract prices Envestra's service charges are assumed to increase according to the 2006 Access Arrangement price path, that is, around CPI + 0.2% and that no network tariff restructuring occurs within this average price path.

Table 7.1: Envestra reference service tariffs, 2007/08

Reference service	Charge, GST exclusive
Domestic haulage reference service – daily charges	
Base charge ($/day)	0.240
First 49.3 MJ (cents/MJ)	1.015
Additional MJ (cents/MJ)	0.482
Commercial haulage reference service – daily charges	
Base charge ($/day)	0.490
First 9,86.3 MJ (cents/MJ)	0.755
Next 4,274 MJ (cents/MJ)	0.432
Next 11,178 MJ (cents/MJ)	0.188
Additional MJ (cents/MJ)	0.079
Inlet disconnection service ($)	56
Inlet reconnection service ($)	56
Special meter reading service ($)	8.20

Source: Envestra SA Tariff Schedule, 1 July 2007.

Envestra has recently applied for an increase in the base charge to reflect the increases in their licence fees. This charge is not included in the above table nor in Origin's assessment of the impacts on standing contract prices. However, Origin intends to address the issue separately with the Commission.

There are a number of other network related charges and costs (in addition to the working capital imposition discussed in section 6) such as charges for vacant premises that will need to be captured in the Determination of the retailer tariffs and standing contract prices. Origin will also separately address these matters with the Commission

7.2 Market charges

Under the established South Australian gas market rules, the not-for-profit market administrator REMCo levies a charge on its members to cover its operations. This charge is struck on a per customer basis, and is subject to a cap established via a price determination by the Commission.

As part of the introduction of FRC, the Government agreed to subsidise the market charge for residential customers for a period of five years with the subsidy diminishing year by year and ending in 2008/09.

Given the complexity of the process, and the uncertainty regarding any future subsidies, Origin has proposed to the Commission to treat these charges as non-controllable costs and directly pass through to small customers the actual REMCo market charge net of the Government subsidy for 2008/09 and for future years if relevant.

8. Revenue requirement

Based on the controllable and non-controllable costs discussed in sections 6 and 7, the resulting revenue requirements for small customers (both residential and small business customers with annual consumption of less than 1 terajoule) are as set out in Tables 8.1 and 8.2.

Table 8.1: Revenue requirement (ex-GST) – residential customers, 2008/09 to 2010/11

	2008/09	2009/10	2010/11
	December 2008 dollars per GJ, GST exclusive		
Total retailer cost	**11.85**	**12.04**	**12.30**
Percentage change	9.3%	1.6%	2.2%

Table 8.2: Revenue requirement (ex-GST) – small business customers, 2008/09 to 2010/11

	2008/09	2009/10	2010/11
	December 2008 dollars per GJ, GST exclusive		
Total retailer cost	**6.89**	**6.94**	**7.05**
Percentage change	14.9%	0.7%	1.6%

9. Tariff strategy

9.1 History of tariff restructuring for gas sale and supply to small customers

In considering the history of price changes, it is important to understand that Origin has five pricing zones[9] and charges different prices to residential and small business (less than 1 TJ) customers in each of those zones. As highlighted in section 6 (on controllable costs), geographic and customer type distinctions are important in determining the retailer tariffs in each region because of underlying differences in the associated costs of supply.

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

Under the current Determination retailer prices have increased at only CPI + 2.5% in the residential segment and CPI in the SME segment, notwithstanding all the many changes in the gas retail and wholesale markets.

While this has provided some stability and allowed tariff rebalancing, the price path constraints have meant that by 2007/08 retailer revenue was less than required to achieve the allowed 10 percent margin on retail revenue.

As a result, to move towards efficient cost-reflective prices requires a higher than average adjustment in prices going into 2008/09. However, Origin has not sought to recover within the current Submission to ESCOSA, the losses incurred by cost changes and customer movement over the last few years, with the exception of FRC capital costs.

9.2 Tariff principles

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

Nevertheless, over the last 3 years Origin has not sort full cost-recovery at the level of each gas supply region as this may have significant impacts on consumers in a number of specific gas supply specific regions outside Adelaide.

Origin proposes to continue this approach of balancing cost-reflective principles in setting the retailer tariffs with consideration given to the customer impacts in specific areas, and will therefore progressively unwind cross-subsides through the next determination period rather than in 2008/09.

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

As part of this process, and when retailer tariffs are submitted for approval to the Commission in June 2008, Origin will be clearly setting out the impact of any retail tariff rebalancing on individual customer bills to the Commission.

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

[9] The pricing zones are: Adelaide and Peterborough; Mt Gambier; Port Pirie; Riverland and Murray Bridge; and Whyalla.

9.3 Other Tariff Issues

As noted in the discussion of the tariff history at start of this section, much restructuring has already occurred under the current retailer tariff price constraints.

However, Origin has proposed that the price constraint formula be reviewed by the Commission. In particular, we recommend that the linkage to CPI be replaced by a tariff constraint formula that is based on the average allowed increase in retailer tariffs. This will enable ongoing reform of tariffs while still limiting the impacts on particular customer segments relative to the average increase.

In summary, Origin will be working closely with the Commission to develop a set of gas tariffs for standing contract customers that are consistent with the average revenue controls and Origin's general principles for tariff reform. However, our approach will take into account impacts on particular types of customers and customers in particular regions. Where there are significant cross-subsidies, Origin proposes to un-wind these over a longer period than one year.

It must be recognised, however, that network (non-controllable) costs are approved separately by the Commission and that these cots make up some 50 per cent of Origin's total costs to supply small customers. Origin will continue to pass these costs through to customers in the standing contract prices in the quantum and form they are charged to Origin.