origin

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Mr Luke Wilson
Review of Gas Standing Contract Prices: Issues Paper
Essential Services Commission of SA
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Origin Energy response to Review of Gas Standing Contract Prices 2008/09-2010/11 - Issues Paper

Dear Mr Wilson

Origin Energy Limited ("Origin") welcomes this opportunity to respond to the Review of the Gas Standing Contract Prices 2008/09-2010/11 – Issues Paper, which has been issued by the Essential Services Commission of South Australia ("the Commission") as part of its Inquiry into standing contract gas prices undertaken under the *Essential Services Commission Act 2002* ("the ESC Act").

Origin is a significant retailer of electricity, natural gas and LPG, with almost two million electricity customers in the National Electricity Market. Since its purchase of SAGASCo, Origin has been the standing contract gas retailer of South Australia.

Origin has been a strong supporter of the development of the gas market in South Australia including the facilitation of full retail competition in the gas market. The Commission's own consultants, ERA Economic Consulting (NERA) confirmed in early 2007 that the gas retail market was "well on the way to becoming effectively competitive…"[1].

Origin believes that with churn from standing contracts continuing at a rate of around 24 per cent per year, the proposed investigation in 2008 by the Australian Energy Market Commission of the status of retail competition will support the findings of the NERA study. In addition, the rate of churn from standing contracts to market contracts amply demonstrates that South Australian gas consumers across the spectrum of gas usage are confident in moving away from the regulated "safety net" prices to market contracts.

Origin therefore considers that the current investigation into standing contract prices should be conducted bearing clearly in mind the commitments made to market reform by the jurisdictional Energy Ministers under the Australian Energy Market Agreement, that is, where effective competition is established, the relevant jurisdiction will move towards price deregulation.

Moreover, the risks associated with the current form of price regulation have been clearly demonstrated in 2007/08. The 2007/08 standing contract prices were set in 2005 based on assumptions about, inter alia, the future direction of gas supply costs and the rate of customer churn away from standing contracts. Both these forecasts have been in significant error. As an example of the first error, the Commission accepted the advice

[1] Cited in the *Review of Gas Standing Contract Prices 2008-09-2010/11 – Issues Paper*, November 2007 at page 9.

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of their consultant that the cost of peak gas supplies for 2007/08 would stabilise in 2007/08, yet in fact the peak gas supply market was under considerable price pressure. Similarly, churn rates were much higher than either Origin or the Commission and their consultants expected.

Origin considers that these important regulatory and market developments should all be taken into consideration as the Commission proceeds through the current Determination process.

More specific comments follow, although Origin notes that our detailed views on each of the issues are contained in the Confidential and Public Submissions provided to the Commission in November. Our views on these matters have not changes and it is not our intention to repeat those here.

Issues for Comment: In the response to the Issues Paper, the Commission invites stakeholders' views on the approaches methodologies, data sources and options relevant to each issue.

Form of Regulation

The Commission, in turn, raises questions with respect to the form of regulation on the incentive effects, regulatory risk, administrative costs and robustness of the determination.

Although Origin did not propose any major changes to the form of regulation, we have consistently highlighted our concerns with the overall framework of the price determination process in South Australia.

For example:

- The minimum of 3-years for a pricing determination is far too long at this point in the maturity of the contestable market. Our earlier views on this matter are only strengthened in the face of high levels of market churn, the changing face of the national gas market, uncertainty in gas supply costs and risks, the increased linkages between electricity and gas market and environmental influences (water and carbon particularly).
- The risks of an extended 3 year determination period are further compounded by the form of the regulation which sets a precise value for key cost components such as the cost of gas and transmission. It is simply not possible (as evidenced in the last determination) to accurately forecast cost inputs 3 years ahead at that level of detail.
- Although the *Gas Act 1997* provides for a review of the costs assumed in the Determination under the "special circumstances" sections of the Act, the process of this review and the fact that it re-sets the determination for a new 3-year period are quite onerous as a means of amending an error in the determination and apply only to costs that "significantly" change due to events "beyond Origin Energy's control"[2].

[2] Issues Paper, op cit, page 8.

These regulatory risks may also, over time, also have a negative impact on investment in the gas industry for South Australian small customers. In a national integrated gas market, gas wholesalers will seek markets where they can find best value, and if risks are high and returns are low, their willingness to supply gas retailers in the South Australian market will decline. While Origin will continue to supply small customers, the effects will more quickly be felt on new entrant willingness to offer gas contracts (the standard contract price acting as the upper benchmark, or price to beat, for competing retailers).

Origin is also concerned that the investigation process itself is very data intensive. Based on the questions received by Origin to date, considerable detail is required by the Commission not only about forecast but also about historical actual costs. Much of this "actual cost" information was not used by Origin in its Submission. It is our view that providing actual cost data is not going to materially assist the Commission, and more importantly, as a national retailer, Origin does not internally discriminate between jurisdictions in its assessment of most internal cost items.

Hence, if the Commission was to require jurisdictional level cost data as the key to setting retail operating costs, it will require considerable internal re-work by Origin of its internal accounts and by the Commission in reviewing these allocations.

Thus, while the cost is high and the value is limited, past history suggests that the Commission can make limited use of the data. Moreover, and equally importantly, with less than 40 per cent (and declining rapidly) of gas customers relying directly on this Determination, it is clear that the costs of the regulatory process should be a very important criteria in setting the process.

The "robustness" of the process has been alluded to previously in the discussion on the limitations of the current form of "re-opening" and adjustment provisions.

If a 3-year price determination period is to be continued (and Origin recognises that this is in the hands of the Energy Minister, not the Commission), then Origin will be seeking a review of this aspect of the form of the regulation over the ensuing months. The "re-opening" provisions must better reflect the risks and uncertainty in setting costs for a 3-year minimum period and the high costs of a new inter-period review.

Finally, we would highlight here that the risks are not only with Origin. Had the process been more accessible and not initiated a new 3-year price path period, Origin would have been able to "smooth" the transition into the new price period instead of seeking a significant increase in the first year of the 2008/09-1010/11 period.

Building Block Approach

The Issues Paper also raises questions with regard to the building block methodology and its individual components.

Origin does not propose any change to the building block approach and in fact, its Public and Confidential Submissions to the Commission address each element of the building block approach when estimating the retail component of standing contract prices going forward.

However, as mentioned above, the Origin submissions did not always rely upon detailed analysis of historic cost information or cost allocations. For instance, the Origin proposal regarding retail operating costs recommended the continued use of the current benchmark retail operating cost with future adjustments compensating for loss of scale.

Origin's view is that this proposal is fair and reasonable, even though forensic examination of actual costs may provide additional cost recovery, as any changes would not be major and given the many difficulties in separating and allocating its national retail costs.

Origin believes that the building block elements be estimated using suitable and practical approaches rather than reliance on an "actual" cost methodology.

Origin would welcome discussion on any of the matters raised in this submission.

Regards

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