2008 Gas Standing Contract Price Path Inquiry

Response to ESCOSA on Draft Inquiry Report and Draft Price Determination

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Contents

Executive Summary

Origin has reviewed the Draft Inquiry Report and Price Determination released by ESCOSA on the 20 March 2008 and has serious concerns with several of the calculations and conclusions reached by ESCOSA.

Specifically, the Draft Inquiry Report has determined:

- that Origin's 1 in 25 peak day heating degree-days should be replaced with lower estimates provided by MMA that excluded weekends and resulted in reduced load factors;
- to use the retail operating cost from 2007-08 as the starting point in the next regulatory period but only to escalate the 2008-09 retail operating cost at CPI for the term of the next price path;
- to not incorporate any allowance FRC capital expenditure that has not be fully recovered by Origin; and
- that no allowance be made for the impact of customer losses on retail operating cost through either its impact on scale economies nor through customer acquisition costs but instead to make an adjustment to retail margin to account for impact.

Origin believes that its analysis used to derive the load factors for the 2005 Determination was reasonable and should continue to be utilised as the MMA analysis is not appropriate because of several factors including the exclusion of weekends from the analysis.

Origin's has tested the MMA and the Origin load factors against the 2006-07 load data and it shows that the Origin load factors are a better predictor.

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

First, Origin believes that ESCOSA should accept that there was a commitment for Origin to fully recover its FRC capital costs and that this is provided as a further allowance in 2009-10.

Secondly and more importantly, ESCOSA has not offset the impact of customer churn on retail costs and instead has focussed on compensating for customer acquisition costs through the retail margin.

Origin does not believe that this method has provided sufficient compensation for loss of scale or customer acquisition costs as the retail margin calculation only produces a margin of the quantum that Origin already expected in order to accommodate the prepayment of gas distribution charges to Envestra.

In effect, the ESCOSA draft decision does not provide any compensation to Origin for loss of scale or customer acquisition costs. Origin believes that ESCOSA should address the customer acquisition cost directly in the retail operating cost, an approach that has been widely adopted across jurisdictional pricing decisions and also acknowledge in this, the importance of scale impacts in the retail gas market.

1. Introduction

For the purposes of section 34A(4a)(d)(ii) of the Gas Act 1997 (the Act), Origin Energy (Origin) submitted its proposed determination of prices for the sale and supply of natural gas to standing contract gas residential and small business customers in South Australia to the Essential Services ESCOSA of South Australia (ESCOSA) on 19 November 2007.

ESCOSA released its Draft Inquiry Report and Price Determination (draft report) on the 20 March 2008 in conjunction with supporting documentation by its consultants, McLennan Magasanik Associates (MMA) and the Allens Consulting Group (Allens). Origin has carefully reviewed the draft report and accompanying consultant's reports and this submission raises several issues with the assumptions, information and conclusions reached by ESCOSA.

Origin notes that the ESCOSA's draft report has resulted in average prices that are substantially lower than that sought by Origin in its November 2007 price path submission. This is most significant in 2008-09 when ESCOSA has reduced the 8.60 per cent and 17.25 per cent nominal increases proposed by Origin for residential and small business retail tariffs to 4.04 per cent and 9.30 per cent respectively. ESCOSA has also reduced the annual changes in retail tariffs for 2009-10 and 2010-2011 from CPI+1.6 per cent and CPI + 0.7 per cent respectively to CPI.

These changes will have a significant commercial impact so Origin would requests that ESCOSA appropriately consider and address the issues identified in this response in its final price determination.

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

- section 2 considers the forecast of customer demand and consumption for each customer group;
- section 3 reviews the rebalancing controls and proposed pass-through provisions;
- section 4 comments on the treatment of load factors by ESCOSA;
- sections 5 addresses the changes to Origin's proposed wholesale gas and transmission costs; and
- sections 6 and 7 discuss the changes to the allowed retail cost and margin.

2. Customer Number and Consumption Forecasts

The ESCOSA draft report reviewed Origin's assumptions regarding forecast customer numbers and customer consumption for small customers on standing contracts and concluded that Origin's:

- forecast of customer numbers based on current average churn rates is reasonable and has therefore accepted these forecasts; and
- estimation of customer consumption does not reconcile with the quarterly consumption data collect by ESCOSA and hence, has based its analyses on consumption forecasts derived from the ESCOSA data.

In determining the forecast customer numbers and consumption, Origin used two years of data on gas consumption and customer churn which indicated that:

- usage patterns are reasonably stable over time, particularly with respect to the important parameters of average consumption and allocation of consumption to the consumption blocks; and
- churn rates away from standing contracts have been reasonably constant at around 24 per cent per annum in aggregate, although differing between residential and SME customer segments and between Adelaide and the regional centres.

Based on these observations, Origin determined the forecast of standing contract customers based on the continuation of the average churn rate for 2005/06 and 2006/07. ESCOSA has acknowledged in the draft report that the current churn rates are higher than forecast under the previous price path period and that the current churn rates are not likely to decline over the next three years. Based on MMA's recommendation, ESCOSA has accepted Origin's forecast customer numbers.

In relation to consumption, ESCOSA has expressed concerns with Origin's approach, particularly with the higher average consumption figures quoted in the Origin proposal.

Origin adopted a particular methodology with respect to consumption (and revenue) calculations that focussed on the analysis of individual bills where these bills applied to standing contract customers. Because it was linked to actual bills, it was our view that this approach provided the most robust assessment of costs and revenues associated with standing contract customers over the course of a year. In particular, it seemed the most appropriate methodology to use when such a significant number of standing contract customers were transferring to a market contract (with Origin or a third party) over the course of the year.

As discussed in Origin's submission, the "average consumption" that emerges from this calculation was actually a mathematical construct derived from the analysis of bills and used for forecasting purposes rather than an empirical statement about consumers' usage patterns.

Rather, it is simply the total billed consumption for standing contract customers over a period of 12 months divided by the estimated number of active standing contract customers at a point in time (December of the relevant financial year).

Given that the retail price control formula uses the revenue control form of average $/GJ (by market segment), the forecasting of annual consumption and consumption by tariff bands is a central element in the process.

ESCOSA has determined an average residential consumption forecast of 22.1GJ/pa and average SME consumption forecast of 155.4GJ/pa.

Origin understands that ESCOSA has had some difficulty reconciling Origin's consumption data in the submission with external data. We note, however, that MMA's comparison of

Origin's "average consumption" with Envestra's average consumption derived for the purposes of their network determination is not particularly relevant. Envestra's analysis does not take account of the differences between standing contracts and other contracts, nor does it take account of the analytic issues of identifying the gas consumption amounts associated with standing contract customer in the context of such a significant movement away from standing contracts to market contracts (with Origin or other retailers).

Nevertheless, for the purposes of this determination, Origin accepts the use of the average consumption forecasts and the allocation to the tariff blocks for the 2008/09 to 2010/11 period as set out in the ESCOSA draft report.

3. Form of Price Control

In considering the form of price control, it should be explicitly acknowledged that the current methodology places considerable risks on the retailers, particularly in the later years of the 3-year period. These risks that were clearly demonstrated during the current determination period when Origin's costs increased more rapidly than those allowed under the theoretical forecasts of the 2005 – 2007 price determination.

The difficulty with recovering these additional costs in subsequent determinations and within a rapidly churning market is significant. For example, only the pass-through provisions appear to allow for correction of past events and these do not canvass such events as a spike in MDQ prices as occurred in winter 2007.

A clear example of this was the forecast in the previous determination that MDQ costs would remain constant in real terms in the last 2 years of the determination. This proved to be a significant error, but it was not an error that could be corrected by the pass-through mechanism and it is certainly not clear that it could be addressed appropriately under the special circumstances provisions.

The ESCOSA's draft report provides for the following changes to the form of price control:

- that REMMCo charges are treated as non-controllable costs rather than be incorporated into the retailer tariffs as was done in the 2005 gas standing contract price determination;
- that the average revenue control ($/GJ) continue to be applied separately on residential and SME retailer tariffs but that the annual revenue be based on revised sales forecasts in each year rather than using the forecast volumes from this decision as proposed by Origin;
- that Origin's proposal for no rebalancing controls is not accepted and that rebalancing controls be set such that no customers charge under the retailer tariff increases annually by more than CPI + 3 per cent;
- that the pass-through events exclude the transmission cost event from the 2005 determination and be limited to:
  - changes in taxes;
  - regulatory reset events; and
  - ministerial direction events;
- that the specific events identified by Origin, namely significant forecast error and major operational failures, be captured under the "special circumstances" provision of the Gas Act rather than as pass-through events; and
- that Origin will be able to seek new tariffs or close existing tariffs after 1 July 2008, subject to ESCOSA approval.

All other elements of the price control framework remain as previously determined.

These decisions are accepted by Origin however, Origin would make further comment on the rebalancing controls and the appropriate cost pass-through events including the special circumstance provisions.

Origin would also seek specific and explicit recognition in the Final Determination that "special circumstances" events include events arising from national and jurisdictional responses to climate change. This would include, but not be limited to:

- national schemes such as the expanded MRET scheme and the Emissions Trading Scheme; and
- jurisdiction specific schemes such as REES and Solar PV schemes.

Any one of these schemes may lead to fundamental changes in the gas market including the cost of gas, cost of MDQ, cost of transmission and changes in average consumption.

Our concerns are exacerbated by the length of the price determination period, which continues to 2010/2011. There is a good deal of uncertainty around the new carbon abatement arrangements and their impact on electricity and gas prices, particularly beyond 2009/10. It is therefore critical that all parties in the current determination explicitly acknowledge the risks and challenges of attempting to predict energy costs beyond 2009/10.

3.1 Rebalancing Control

The current gas standing contract price determination incorporates a rebalancing control, where the annual increase in each retailer tariff must be no more than CPI+7 per cent for residential customers, and CPI+5 per cent for SME customers. Origin has undertaken significant tariff rebalancing but further small changes may be required within and between tariff categories in the future.

Origin believes the ESCOSA decision of a rebalancing constraint of CPI + 3 per cent is sufficient to reach this objective.

However, Origin would reiterate that the rebalancing control should be based on an "average increase plus X%" control rather than using CPI plus X. This is consistent with the approach adopted in Victoria and allows some controlled tariff rebalancing even in the context of significant price changes.

Of course, in the current draft report, the average increase and CPI are the same values in years 2 and 3 of the price path so it has no impact but ESCOSA should consider this approach as it provides additional flexibility for tariff reform.

3.2 Cost Pass-through Provisions

ESCOSA has accepted pass through provisions for change in taxes events, regulatory reset events and ministerial directions events. ESCOSA has previously rejected Origin's request for the pass-through of significant supply interruption events, claiming that these matters are better addressed through the "special circumstances" provisions of the Gas Act.

Origin disagrees with the ESCOSA's rejection of Origin's request for a pass-through of significant supply interruption events.

The delay in the decision process under the "special circumstances" provision of the Gas Act creates a major practical and administrative problem in its own right for both Origin and ESCOSA. With high levels of customer churn, the customer base to recover the costs will be significantly eroded between the time of the event and the recovery of the costs. Remaining standard contract customers will be forced to pay for all customers that were on standard contracts at the time of the event (there being no means of recovering from those who had churned in the interim), clearly an inequitable outcome.

In addition, Origin would specifically request that the cost pass-through provisions include an event for Wellhead Price Review. This would cover the significant risk of any wellhead price review pushing gas prices up during the period of the price-path without having to accommodate this risk within current prices. Origin therefore seeks a specific pass-through under these provisions as well as the additional specific provisions under the "special circumstances" provisions as discussed above.

4. Load Profile

A key assumption reviewed in the ESCOSA draft report was Origin's assumption of maintaining the load factors that have previously been used in the 2005 price path determination.

The load factors required for the price path are related to the regulatory requirement and accepted industry practice to meet 1 in 25 year peak demand and are vitally important in allocating capacity related costs associated with wellhead and transmission costs. Given the stability of customer's consumption characteristics, Origin chose to adopt the same constant load factors as previously accepted.

The draft report has concluded that:

- Origin's modelling of load factors used in the derivation of gas demand are reasonable; but
- Origin's 1 in 25 peak day heating degree-days (HDD) should be replaced with lower estimates as provided by MMA based on excluding weekends; and
- the resultant load factors be reduced for residential and SME customers.

Origin does not accept the review of the 1 in 25 peak day HDD and resultant derivation of significantly reduced load factors for South Australia.

Origin believes that its analysis used to derive the load factors was reasonable, as acknowledged by ESCOSA and should be maintained and that the MMA analysis of the peak day is not appropriate because:

- MMA appears to have used Origin's sensitivity coefficients, that were derived from Degree Day (DD) data, in conjunction with their HDD data;
- the exclusion of weekends from the analysis has no fundamental basis; and
- when the resultant load factors are tested practically against actual data, the load factors proposed by Origin are reasonable while the MMA load factors would result in customer curtailment.

These issues are discussed in detail in a confidential submission to ESCOSA.

4.1 Forecast Load Profile and Load Factors (2006-07)

Origin has undertaken an empirical analysis of peak day weather and demand in 2006-07 to assess the practical viability of the load factors proposed by MMA. To do this, Origin has used the load factors from both the Origin submission and the ESCOSA draft report and applied them to the load profile of 2006-07 to analyse their predictive capability.

ESCOSA's proposed reduction of Mass Market and SME load factor significantly reduces the volume and allowable cost associated with Origin's purchase of Wellhead and Transmission Maximum Day Quantities.

Origin's analysis <u>showed that</u>, even on an average peak day, the MMA approach will seriously underestimate mass market gas supply requirements. If Origin were to purchase its transmission and peak gas supply for mass market customers on the basis of the draft report, it would not be able to fulfil its statutory obligations.

In saying this, it is inappropriate to set prices such that Origin can only meet its obligation to supply small customers on peak days by curtailing supply to other larger customers. Such an obligation is unfair to both Origin – who cannot commit to supplying large customers to the same service level as our competitors in the large customer market - and to other competing retailers in the mass market (in that it is a cross subsidy).

5. Wholesale Gas and Transmission Costs

There are three elements to the wholesale cost of gas:

- annual contract quantity ("ACQ") costs;
- maximum daily delivery ("MDQ") costs; and
- swing gas costs.

Origin's response to ESCOSA's draft report for each of these areas including transmission costs is discussed in turn below.

5.1 Annual Contract Quantity Costs

In the draft report, ESCOSA has largely accepted Origin's proposed gas volumes and prices but has not considered the risk of any future price review.

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

Within the next three years of the price path the energy industry will be faced with significant wellhead price uncertainty associated with carbon cost, LNG export projects in central Queensland, increased gas production costs and the implications of increased demand for gas fired electricity.

Origin requests that 'Wellhead Price Review' be explicitly included as a pass-through event and explicitly acknowledged and documented as such.

5.2 Maximum Daily Quantity Costs

ESCOSA has proposed an average increase in the price of MDQ that is less than the increase proposed by Origin. Origin maintains that its original proposal is appropriate and has commented on such in a confidential submission to ESCOSA.

5.3 Swing Gas Costs

ESCOSA has proposed a $0.02/GJ allowance for Overrun and Imbalance costs. This is less than the rate proposed by Origin.

It is evident to Origin that ESCOSA is not comfortable including a risk premium and that a more appropriate mechanism is to explicitly allow for the pass-through of risk under 'Reopening Events'. Origin acknowledges that for this provision to be evoked the event should be "large and unusual".

5.4 Transmission Costs

In assessing Origin's proposal, ESCOSA has reduced the amount allowed for transmission costs by removing or reducing certain services.

Origin has commented on these changes in its confidential submission.

6. Retail Operating Costs

Origin's proposal for retail operating costs was to use the current cost of $80.85 per customer for 2007/08 ($Dec 08), excluding the FRC allowance, and to continue to adjust this forward using a CPI + 4 per cent approach to account for cost pressures and the significant impact of customer churn both historically and going forward.

Origin also proposed an adjustment of the FRC cost allowance to ensure Origin's full recovery of its FCR capital costs based on actual customer losses rather than the forecasts used for the 2005 decision.

Table 8: Proposed retail operating cost per customer, 2008/09 to 2010/11

	December 2008 $/customer, GST exclusive			
	2007/08	**2008/09**	**2009/10**	**2010/11**
Retail operating cost	80.85	84.08	87.45	90.94
FRC operating cost	9.03	9.03	9.03	9.03
FRC capital costs	11.49	8.55	8.55	8.55
Total	101.38	101.67	105.03	108.53

Source: Origin Energy

The ESCOSA's draft report has made the following decisions regarding Origin's proposal for retail operating cost for gas standing contract prices:

- to accept Origin's proposal and use the retail operating cost from 2007-08 as the starting point in the next regulatory period;
- to incorporate the allowance for FRC operating expenditure into retail operating costs going forward;
- for FRC capital expenditure recovery to only be included in 2008-09 as per the 2005 decision and that no allowance be made for capital investment that has not be fully recovered by Origin;
- to escalate the 2008-09 retail operating cost at CPI for the term of the next price path;
- to not make any allowance for the impact of customer losses on retail operating cost through either its impact on scale economies nor through customer acquisition costs; and instead
- to make an adjustment to retail margin to account for this negative impact.

As a consequence, Origin is concerned that ESCOSA's recommendations on retail operating costs do not give full recognition of the actual costs of supplying gas to standing contract customers in South Australia and each of these issues is addressed in turn below.

Origin would highlight that it requires ESCOSA to maintain a consistent approach to its analysis of the price path for gas standing contract customers. As such, Origin believes it is inappropriate to analyse different retail cost elements by considering gas customers in different ways such as:

- standing contract customers in South Australia in one analysis;
- total South Australian standing and market gas customers in another; or
- all Origin's gas customers nationally for another.

Origin would like ECSOSA to clearly define how it is analysing the South Australian prices for gas standing contract customers.

6.1 Initial Retail Operating Allowance

Origin proposed and therefore accepts the use of retail operating cost from 2007-08 as the starting point for the next regulatory period.

However, in doing so, Origin would highlight that using this figure as a starting point for retail operating costs was only part of Origin's complete proposal for retail costs which included just as importantly:

- recognition of the extent of customer losses from gas standing contracts during the previous period compared to the forecasts in the 2005 determination;
- that customer losses are also expected to continue in the future price period, as accepted by the ESCOSA draft report, and that they need to offset any further negative impacts on Origin's underlying cost to serve due to losses of scale; or alternatively
- that ESCOSA consider the costs associated with customer retention and acquisition that are needed to avoid the loss of scale impacts.

ESCOSA has accepted the 2008-09 retail operating cost but has decided not to offset the impact of customer churn on costs and instead focussed on compensating for customer acquisition costs through retail margin.

Origin does not believe that this method has provided equivalent compensation for loss of scale or customer acquisition costs as it is clear that the customer value has been reduced substantially in order to provide a palatable retail margin. This is discussed further in the retail margin section but Origin recommends that ESCOSA reconsider it approach and utilise retail operating cost to attend to this issue.

Origin would highlight that the approach of including customer acquisition costs in retail operating costs has been accepted in other jurisdictions and applied by ESCOSA to AGL's electricity Price Determination. Origin therefore cannot understand why, in this instance, ESCOSA has chosen a different theoretical approach (putting aside the practical limitations of the approach as discussed in the retail margin section of this submission).

6.2 Full Retail Contestability Capital Expenditure

The ESCOSA draft report has:

- incorporated the allowance for FRC operating expenditure into retail operating costs going forward; but
- made no allowance for FRC capital expenditure that has not been fully recovered by Origin.

Origin acknowledges the inclusion of the FRC operating cost and the rationale in considering this cost as part of the total retail operating cost rather than treating it as a separate allowance.

However, Origin is genuinely concerned that no further consideration is to be given to its FRC capital expenditure. On this issue, ESCOSA has commented that:

- Origin has not provided them with any evidence of a commitment by the South Australian government that Origin will be able to recover its FRC cost;
- the allowance for capital cost is also included in Origin's sales to market customers and this indicates that Origin has already recovered a significant amount of the FRC capital expenditure; and
- it does not consider it appropriate to effectively reopen its previous decision in order to approve a different amount for the FRC capital expenditure allowance.

For the introduction of FRC in South Australia, Origin, as the incumbent gas retailer, was required to make capital investments to allow its competitors to acquire its customers.

Origin believes that a commitment was given to Origin prior to commencement of FRC and its investment in new FRC systems for the South Australian gas market and the adaptation of existing systems to FRC. This commitment gave Origin reassurance that the specific costs associated with enabling gas FRC to take place would be recoverable in future years. These costs were prudent and efficient costs associated with an incumbent retailer implementing and operating the capability to allow retail FRC to be implemented and did not include marketing activities. Origin has provided ESCOSA with evidence of this commitment and believes this evidence should be sufficient and considered in the determination.

Origin highlights in this context that the approach taken by ESCOSA in the draft report means that Origin has been denied the opportunity to recover its capital costs incurred in establishing FRC for the benefit of the South Australian community. This is unreasonable and would be in clear contrast to the allowance of full FRC cost recovery that has been granted to the distribution company. There is no reason why one party should be denied full recovery of the capital cost to enable FRC while another party is granted this. Should Origin's justifiable cost recovery be denied, the resulting regulatory risk should be a factor that is incorporated into the retail margin analysis.

Origin is also of the understanding that ESCOSA can make further allowance for the FRC capital expenditure shortfall in this price path determination without considering it a reopening of the previous decision. The options are many.

Origin proposed a number of alternative options for the calculation of the FRC costs to achieve full cost recovery and address a number of other limitations of the modelling of costs over the recovery period. This was provided on a confidential basis to ESCOSA and Allens, the ESCOSA consultants, have reviewed and calculated appropriate FCR charges for these scenarios which can be utilised.

As to the matter of standing versus market contracts, Origin calculated the FRC capital recovery on standing contract customers and ESCOSA accepted the approach proposed by Origin which was also consistent with that adopted by the Minister in setting 2004/05 standing contract prices.

Origin believes that this cost recovery should therefore continue to be calculated based on standing contract customers.

However, even if the calculation was conducted including all Origin market customers and using the precarious assumption that all market customers paid the full FRC cost, there would still be a capital recovery shortfall, albeit smaller.

Origin therefore proposes that ESCOSA accept that there was a commitment for Origin to fully recover its FRC capital costs and that this can be provided as a further allowance in 2009-10.

6.3 Rate of Change in Retail Operating Costs

The Origin price path proposal included a change in retail operating cost of CPI + 4 per cent per annum. This was to accommodate retail cost pressures but predominantly, to account for the impact that customer losses had had, and would continue to have on the scale efficiencies of servicing gas standard contract customers.

The ESCOSA draft report has reduced the rate of change in retail operating cost to CPI given it attempts to allow for the impact of future customer churn through the retail margin.

Origin accepts that if the impact of future customer losses is accounted for in the retail operating cost then a CPI rate of change would be reasonable, given that ESCOSA has concluded that the escalation of retail costs (such as labour) is being offset by productivity improvements.

However, ESCOSA should note that Origin's proposal for the retail operating cost starting point was made recognising that it had not accounted for the impact of customer churn in the previous period but accepting that this would be partially accounted for going forward through the CPI + 4 per cent annual change.

This was consistent with ESCOSA's decision to escalate using CPI+2 per cent in the previous period which was, in fact, an under-provision for the loss of economies of scale given that churn was substantially higher than forecast. As highlighted by Origin in its price path proposal, the extent of customer losses from gas standing contracts during the previous period would have required a escalation in retail operating costs in excess of CPI+10 per cent in that period to account for the impact on retail fixed costs.

In summary, had we used the 2005 approach to adjust 2007/08 starting point for actual churn rates, the starting point for this determination would have been much higher than the one proposed.

In adopting the previous determination as the starting point, Origin has in fact taken a conservative approach.

Therefore, if CPI escalation is to be used by ESCOSA then there is obviously no mitigation being provided for the previous period level of churn and its cost impact and Origin would request that ESCOSA revise the retail operating cost for 2008-09 to account for this.

7. Retail Margin

Origin's price path proposal included a retail margin of 13 per cent on controllable costs, predominantly to account for the prepayment terms for Envestra's network charges and to ensure a base margin on gas sales of 5 per cent with additional allowance for prepayment working capital. Origin has noted previously that this pre-payment cycle creates an additional cost that is not incurred in the electricity market and applies only to the SA gas market.

The ESCOSA draft report has concluded the following regarding the appropriate retail margin for gas standing contract customers:

- that it is ESCOSA's intent to provide a 10 per cent margin on controllable cost and it can only acknowledge that this will result in a lower margin on sales revenue of 4 per cent when compared to its electricity decision of 5 per cent;
- that the retail margin should be uplifted to 12.4 per cent to account for the additional working capital required because of the gas distribution payment terms; and
- that attributing a value of $28.11 to gas customers and using bottom-up approach to calculating retail margin would provide a retail margin of 13.05 per cent; and
- given the bottom up approach uses unverified data, they have taken all factors into account and only approved a retail margin of 12 per cent of controllable cost.

Origin does not believe that the ESCOSA decision is appropriate.

Quite simply, ESCOSA has not provided Origin adequate compensation for loss of scale or customer acquisition costs. It has utilised a bottom-up approach to retail margin with a value given to standing gas customers so that theoretically, customer acquisition cost cannot be included in retail cost. However, it is clear that the customer value that has been used is substantially reduced and not reasonable.

ESCOSA has obtained the $28.11 value for gas customers by using the ratio of IPART's $210 acquisition cost estimate to electricity customers' profitability and applying this to the ESCOSA estimate of the profit from gas customers.

Apart from the circularity of this calculation given that ESCOSA fundamentally sets the profit level on gas customers depending on their decision, it is obvious that this customer value estimate is not reasonable and does not accord with any analysis of the cost of acquiring customers or their true value. Origin is happy to provide evidence of this from both regulatory decisions and actual market sales of customers.

The disparity in the margin calculation is patently clear when you consider that ESCOSA's draft report has stated that the 10 per cent margin on controllable cost should be increased to account for the gas prepayment terms and this would result in a retail margin calculation of 12.4 per cent. ESCOSA's attempt at taking into account customer acquisition costs must therefore only increases the retail margin by 0.6 per cent. This by itself is unsatisfactory and is a result of using the retail margin calculation to assess retailer return given prepayment costs and customer churn, the result being a confusion of both.

However, to compound the issue, ESCOSA then reduces the margin to 12 per cent in their draft report, a margin below the 12.4 per cent which they had calculated as that required to account for only the aforementioned prepayment terms for gas distribution <u>on its own</u>.

The result is unacceptable in terms of the aggregate assessment of Origin's retailing costs and Origin recommends that ESCOSA revisit their retail margin analysis and:

- apply a retail margin of at least 12 per cent to account for the prepayment to Envestra; and
- remove any consideration of customer acquisition costs from the retail margin calculation and instead, make transparent allowance for its impact through both the initial retail operating cost and the rate of change to retail operating cost.

As a final point of analysis on retail margin, Origin must restate its concerns with the setting of precise tariff outcomes for a 3 year period when there is considerable uncertainty around the input cost components.

Origin has already highlighted the limitations of the previous forecasts used by ESCOSA, whether in respect to gas and transmission costs or customer churn. There is no-where in the margin assessment that accounts for these additional forecast risks particularly in future years.

Origin suggests that given a 3 year decision making framework and limited capacity to correct historical forecast errors, ESCOSA should explore using a retail margin that increases each year of the forecast period would then account for future uncertainties. Origin is happy to discuss such an approach further with ESCOSA.