Submission to the Independent Pricing and Regulatory Tribunal on the review of regulated gas retail tariffs and charges from 2013 to 2016, Gas – Issues Paper

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1. Background

The Minister for Resources and Energy in NSW (Minister) has requested that the Independent Pricing and Regulatory Tribunal (IPART) continue regulating default tariffs for small retail gas customers and that IPART ensures that either new Voluntary Transitional Pricing Arrangements (VTPA's) or a gas pricing order operate until June 2016.

In November 2012 Origin Energy (Origin) provided IPART with its proposed Voluntary Transitional Pricing Arrangement (VTPA) for the Albury/Moama, NSW Murray Valley and former Country Energy districts

In November 2012, IPART released a Gas Issues Paper seeking stakeholders' views on the key issues identified by IPART.

Origin welcomes this opportunity to respond to IPART's Issues Paper. Many of the issues IPART has sought comment upon have been addressed in Origin's VTPA proposal, November 2012, for ease of reference this document sets out Origin's response to each issue raised by IPART.

2. Issues upon which IPART seeks comment

2.1 Terms of reference and context for the review

1. Are there any other contextual factors that we should consider that could materially affect our review?

Origin agrees with the range of market developments identified by IPART that may affect the gas market during the term of the proposed VTPA. The most significant considerations are the impact of LNG export projects on wholesale gas costs and the continued development of retail competition in NSW.

IPART notes that LNG project developments will result in large volumes of domestic natural gas production being diverted to international markets, causing domestic gas prices to rise towards international net-back prices.

Origin observes that not only may international prices become an important benchmark, but that in the near term gas prices are likely to rise as producers bring on additional higher cost, unconventional supply sources that were previously uneconomic to develop to meet the increased demand for gas. These increased production costs will be reflected in new supply contracts which are likely to cover significant volumes of domestic supply, with retailers' existing supply contracts rolling off.

IPART has concluded there has been a marked increase in the level of customer participation in the NSW gas retail market since IPART's last review in 2009. It is important that Standard Retailers' VTPAs are assessed within the context of an effective competitive retail environment that will quickly respond to any attempt by retailers to extract more than a reasonable margin.

2.2 Current pricing agreements

2. Do pricing agreements continue to be an appropriate way to regulate the Standard Retailers' regulated retail prices, given the objectives and context for this review? How could we enhance the current approach?

3. What (if any) other forms of regulation should we consider?

IPART considers that current gas pricing agreements have been successful in encouraging competition and customer participation, and transitioning towards the removal of retail price regulation. In IPART's view, moving away from pricing agreements to a more prescriptive, and less light-handed, form of regulation would be a regressive step.

In Origin's view, deregulating retail energy prices should be a priority in accordance with the commitments made by all energy ministers under the Australian Energy Market Agreement.

However, Origin recognises that the Minister for Resources and Energy in NSW (Minister) has requested that IPART continue regulating default tariffs for small retail gas customers until June 2016. So long as retail gas price regulation continues, it is essential that regulated prices are cost reflective so as to protect and promote competition within the retail gas market. Origin considers that the current pricing agreements are the most appropriate way of ensuring prices are cost reflective. Origin agrees with IPART's view that more prescriptive regulation would be a regressive step, and so does not propose an alternative form of regulation.

2.3 Form of price control

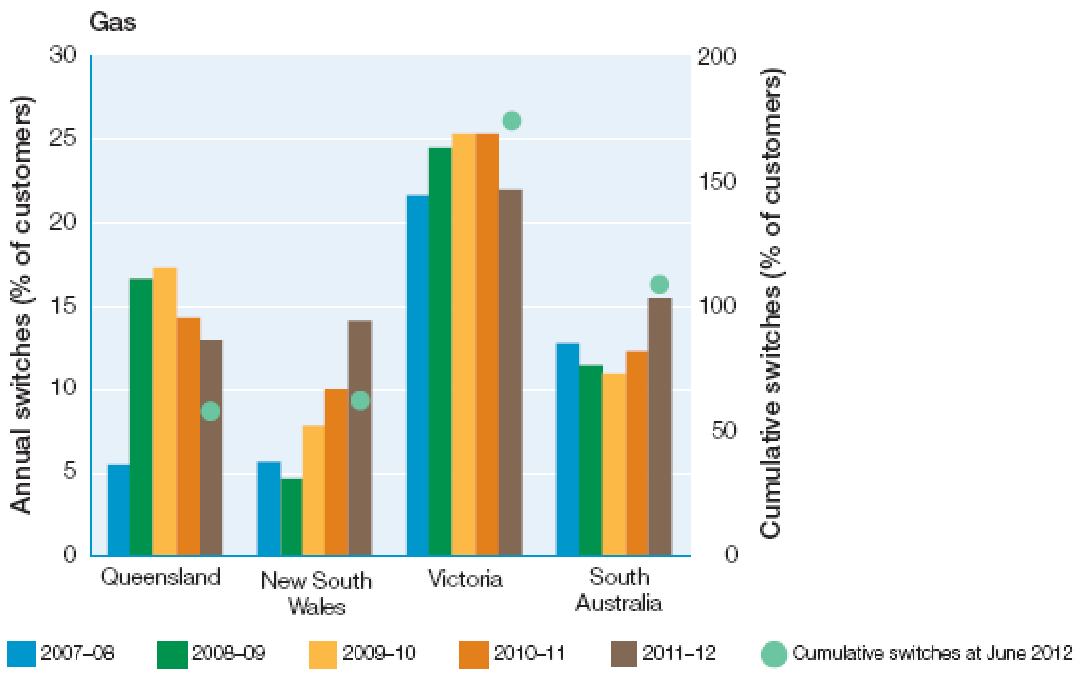
4. Are there any other competitive developments in the retail gas market that are relevant for our review? Are there any structural impediments to competition and customer participation, and if so, can these be addressed through the regulatory arrangements?

Origin agrees with IPART's view that the level of retail competition has increased since the last review, as evidenced by the factors identified by IPART:

- Reduction in proportion of customers on regulated prices;
- Prevalence of competitive discounts in non-regulated prices;
- Transfer of market share from incumbents to new entrants; and
- Ready availability of customer information.

As Chart 1 illustrates Retail gas customer churn has been steadily increasing in NSW over the past 5 years:

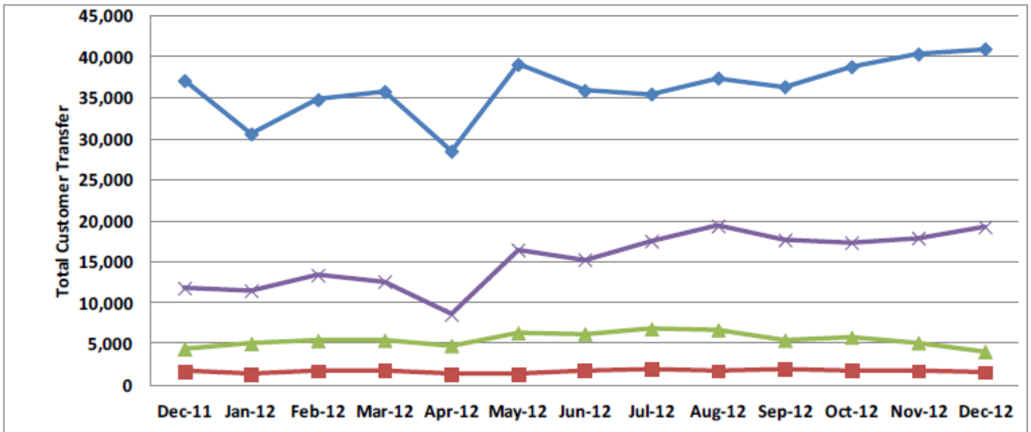
Chart 1. Annual Gas Customer Transfers (%)



Source: Australian Energy Regulator, State of the Energy Market 2012, p 126, available at http://www.aer.gov.au/sites/default/files/State%20of%20the%20energy%20market%202012%20-%20Complete%20report%20%28A4%29_1.pdf

As Chart 2 shows there has also been a significant increase in gas market transfers more recently from around 11,800 per month in December 2011 to 19,272 for December 2012. In December 2011 AEMO reported churn for NSW/ACT at around 11% for the preceding 12 months compared with 14% for the 12 months to December 2012[1]. This transfer activity has led to a substantial reduction in the number of customers on regulated prices, as well as market share gains for new entrant retailers.

Chart 2. Total Gas Customer Transfers by Month



	Dec-11	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	Dec-12
VIC	37,115	30,625	34,799	35,787	28,508	39,100	35,909	35,480	37,427	36,383	38,816	40,347	40,991
QLD	1,660	1,328	1,708	1,756	1,320	1,330	1,791	1,915	1,676	1,955	1,751	1,682	1,544
SA	4,389	5,021	5,383	5,428	4,783	6,334	6,211	6,822	6,695	5,430	5,795	5,134	4,060
NSW / ACT	11,802	11,483	13,387	12,589	8,595	16,465	15,269	17,535	19,380	17,674	17,354	17,916	19,272

Source: Retail Gas Markets Monthly Retail Statistics Dec 2012, AEMO, available at https://www.aemo.com.au/Gas/Market-Data/Gas--Retail-Transfer-Statistical-Data

During this period the availability of customer information has also improved. Customers can access information about competitive offers through retailer websites, price comparator websites as well as through door to door sales.

The current level of competition in retail gas markets is such as to suggest that regulatory arrangements are not required to protect customers from the potential exercise of market power by retailers. Retailers are already constrained by the competitive threat that customers will switch retailers.

Current indications are that the level of competition is likely to continue to increase in NSW. We do not believe there are any significant structural impediments that can be relieved through further regulation.

5. Are there enhancements that can be made to our current Weighted Average Price Cap (WAPC) approach?

IPART considers that a WAPC facilitates the development of competition and customer choice because it provides the Standard Retailers with sufficient flexibility in setting their prices, and allows them to take ownership of their pricing decisions.

Origin supports the application of a Weighted Average Price Cap (WAPC) on the Retail component with no additional price constraints. This should allow the standard retailers

[1] Retail Gas Markets Monthly Retail Statistics Dec 2011 and Dec 2012, AEMO, available at https://www.aemo.com.au/Gas/Market-Data/Gas--Retail-Transfer-Statistical-Data

flexibility to rebalance tariffs by unwinding any remaining cross subsidies.

2.4 Additional mechanisms to address risks and uncertainties

6. Is there any reason not to accept the Standard Retailers' proposal to pass through network costs to customers?

As IPART has stated, network costs are typically regulated by the AER and retailers have no ability to control or influence them. In addition, there is uncertainty regarding regulated fees beyond 30 June 2015, when existing access arrangements expire, and requiring retailers to bear the risk associated with forecasting network costs is likely to increase the overall cost of supplying gas to consumers.

Origin supports the pass through of network costs under the N+ R framework. Network costs are not controlled by retailers and can be difficult to forecast. The most efficient mechanism is to pass these costs through. This also allows for retailers to pass through network price signals to customers, which promotes market efficiency.

7. Are there enhancements that can be made to the proposed approach to managing uncertainty associated with the carbon pricing scheme?

IPART considers that it is appropriate for Standard Retailers to pass through the additional costs associated with the Carbon Pricing Mechanism, as they have no control over these costs. IPART also considers that the review process used in 2012/13 was successful in ensuring that regulated prices move in line with carbon costs incurred by efficient and prudent retailers.

There is significant uncertainty attached to accurately forecasting carbon costs beyond 1 July 2015. Origin therefore supports the Standard Retailers' proposals that, rather than apply a substantial risk premium to carbon cost estimates for FY16, a cost pass-through provision for carbon costs in the VTPA should apply to FY16. This will provide flexibility to account for this regulatory uncertainty while ensuring there is sufficient oversight of the pass-through to provide IPART with comfort as to the appropriateness of the carbon cost component of retail prices.

8. How material are the potential policy, regulatory and market developments affecting the gas supply chain?

Origin considers that the most significant market developments that need to be addressed through the VTPA framework are:

- a significant increase in wholesale gas costs in response to gas demand increases as Queensland's LNG trains begin to service the LNG export market;
- the transition of the carbon price from a fixed to market price and the risk of repeal of the Clean Energy Act; and
- network determinations conducted by the Australian Energy Regulator. These include APA GasNet, Envestra (Alury) and Envestra (Country Energy).

While the current VTPA effectively delivers a pass through of network costs, a three year fixed price path is unable to accommodate the material risks posed by the carbon pricing mechanism and anticipated changes to gas wholesale costs.

The recent gas price modeling work conducted by Intelligent Energy Services (IES) as part of the Queensland Gas Market Review[2] (which is generally consistent with AEMO's Gas Statement of Opportunities) highlights the level of uncertainty. IES adopted a scenario based approach to assessing future gas prices and concluded that the price for large customers in Queensland could lie in a range between $6/GJ and $12/GJ for 2015.

> "Due to all of this uncertainty, domestic gas price projections can only be developed on a scenario basis. Cost of supply will increase in line with development of new reserves, setting the floor price. The cap will be set by LNG export parity. The likely price range is wide, AUD 6/GJ to AUD 12/GJ (real January 2012 dollars), delivered to large customers."

9. Is a mechanism to update the wholesale gas cost element of regulated retail prices an appropriate way to address the uncertainty in relation to wholesale gas costs? What are the implications for customers and what value do stakeholders attach to price certainty? How should this mechanism be designed to best meet the objectives for the review?

Origin acknowledges that the introduction of annual wholesale gas cost review is a shift away from light handed regulation, however Origin considers that in this case the increased level of regulatory intervention and costs of conducting additional reviews is outweighed by the benefits associated with delivering a more accurate and less contentious assessment of gas costs.

A periodic review will deliver a more accurate estimate of the wholesale gas component and will avoid the need to account for wholesale price uncertainty in other components of the regulated price.

Origin's VTPA proposal outlined a proposed mechanism to reset wholesale costs:

- The Standard Retailer would provide IPART with a proposed wholesale gas cost for the following year setting out the rationale and providing supporting information (information in relation to gas contracts will be provided on a confidential basis).

- The submission would note the impact on the R component, the expected margin and tariff.

- IPART would then conduct a review of Origin's wholesale gas cost allowance proposal that would include an appropriate level of public consultation, in much the same manner as the process that applies to the VTPA. The scope of assessment would be limited to the wholesale gas allowance and would not include other components of the VTPA.

10. Should we retain the special circumstance clause in the new agreements? How would this clause sit alongside any periodic review of wholesale gas costs?

The special circumstances clause is intended to deal with issues/events that are not already covered by the regulatory package. The special circumstances arrangement is

[2] Modelling And Analysis For The Gas Market Review 2012 A Report to the Office of Queensland Gas Market Advisor 12 June 2012 FINAL

important to ensure Standard Retailers can accommodate market events that could not reasonably have been forecast. The special circumstances clause as currently framed should not cause inconsistencies with the proposed annual wholesale gas review.

11. How should we review an application for a special circumstance price change? Should there be a materiality threshold? And if so, what should that threshold be?

The special circumstances provision is consistent with the light handed approach to regulation that applies to gas price regulation. Under this light handed approach, retailers should be able to assess materiality of unforeseen changes and make a commercial judgment as to whether this is appropriate to seek cost recovery for this event. Origin therefore does not consider that a materiality threshold is necessary for the special circumstances provision.

2.5 Costs underlying the proposed prices

12. What is the prudent and efficient level of wholesale gas costs for each Standard Retailer over the next 3 years? What are the key factors affecting these costs?

Origin supports the use of publicly available information to determine appropriate benchmarks for wholesale gas costs. However Origin recognises that this information may be difficult to collate in a comparable form and so supports an individual review of each Standard Retailer's current and future gas costs. Origin has provided confidential information on its wholesale gas costs as part of its VTPA submission. Origin would be pleased to discuss the nature of these costs further with IPART.

13. How should we characterise a prudent and efficient retail gas supplier for benchmarking purposes?

IPART intends to establish a set of benchmark wholesale gas costs to assist with its assessment. This set of costs would aim to reflect the cost an efficient and prudent retailer would incur in supplying small customers in each of the supply areas including:

- base gas supply costs;
- additional deliverability costs (to service peak demand);
- transmission costs; and
- other costs.

In considering the characteristics of an efficient and prudent retail gas supplier, IPART would like to know whether there is more relevant public information available than there was at the time of the 2010 review.

Origin notes that since IPART's 2010 review there have been a number of reviews of gas market costs including most recently ACIL Tasman's report for AEMO "Fuel Cost Projections, Updated natural gas and coal outlook for AEMO modeling"[3], and the "2012 Gas

[3] Fuel Cost Projections, Updated natural gas and coal outlook for AEMO modelling, by ACIL Tasman, 28 June 2012

Market Review, Queensland”[4] that may allow IPART to check Standard Retailers’ wholesale cost proposals for reasonableness. As previously noted these reports are scenario based and indicate a wide range of credible gas prices.

If a more detailed approach is required then Origin broadly supports the approach adopted by IPART and its consultant, McLennan Magasanik Associates, in 2010.

14. What is the prudent and efficient level of retail costs for each Standard Retailer over the next 3 years? Have there been any significant changes in gas retail business activities since the 2010 review?

IPART proposes to assess the Standard Retailers’ proposed retail operating costs over the 2013 regulatory period through a combination of benchmarking and sourcing data from other jurisdictions and industries. It is further proposed to use the analysis of retail operating costs being conducted for the 2013 review of regulated electricity prices, as well as seeking information from Standard Retailers and other stakeholders.

In assessing retail operating costs, IPART will consider:

- whether gas retailers are likely to face any changes in costs over the 2013 regulatory period that they have not faced in past years; and
- whether previous analysis and benchmarks are still a valid starting point and, if not, whether there are any alternative approaches.

Origin has provided confidential information on appropriate retail operating costs as part of its VTPA submission. Origin would be pleased to discuss the nature of these costs further with IPART.

15. What is appropriate retail margin for each Standard Retailer over the next 3 years? Has there been any change in the level of systematic risk or other business-specific risks the Standard Retailers will face over the next 3 years and to what extent should these be compensated for in the retail margin?

IPART has indicated that it will take account of the margin range that it previously considered reasonable, whether there have been market or industrial changes that may affect the systematic risk facing gas retail businesses and whether or not any additional risks are most appropriately compensated for in the retail margin. IPART will also consider analysis on the retail margin being undertaken for the review of regulated electricity prices, taking account of the differences between the industries, as well as how additional review mechanisms may affect the risks that retailers face.

Origin supports a retail margin that recovers systematic risks on the basis that non-systematic risks are managed through other elements of the framework. On this basis a margin in the range IPART has previously determined (7.3% to 8.3% of EBITDA) is reasonable.

16. Should the retail margin continue to be expressed as a fixed proportion of costs? To which cost components should the retail margin be applied?

The retail margin should continue to be expressed as a fixed proportion of total costs (an EBITDA margin).

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[4] Modelling And Analysis For The Gas Market Review 2012, A Report to the Office of Queensland Gas Market Advisor, 12 June 2012

17. Is it reasonable for a Standard Retailer to introduce a new fee for payment of gas bills by customer using credit and debit cards?

In assessing the Standard Retailers' proposed increases in miscellaneous charges, IPART will consider the relationship between these fees and retail operating costs, with the intention that costs are recovered only once; either through miscellaneous charges or through retail operating costs.

Retailers are charged merchant fees in relation to their customers' credit card payments. Retailers should have the right to reflect these fees in their charges in order to deliver cost reflective pricing. This is common practice amongst retailers of a wide range of goods and services.

Merchant fees are not recovered through retail operating costs and retailers have been unable to apply merchant fees to date as this would have been inconsistent with the Gas Supply (Natural Gas Retail Competition) Regulations 2001. The NSW Government has announced its intention to adopt the NECF from 1 July 2013. Consistent with this framework, retailers should be allowed to apply merchant fees from 1 July 2013.