27 January 2016

Independent Pricing and Regulatory Tribunal
Level 15, 2-24 Rawson Place
Sydney NSW 2000

Submitted online

REVIEW OF REGULATED GAS RETAIL TARIFFS FROM 1 JULY 2016 – PRICING PROPOSAL

Origin Energy Limited (Origin) welcomes the opportunity to provide the Independent Pricing and Regulatory Tribunal (IPART) with a draft voluntary pricing arrangement (VPA) for the Albury/ Murray Valley and Wagga Wagga regions.

As Origin observed in its response to IPART's issues paper the east coast wholesale gas market is in a period of transition with the recent commencement of LNG exports driving an anticipated threefold increase in demand by 2017. Wholesale and retail gas contract prices have in recent years increased reflecting the tighter supply demand balance and expectation that production costs will rise as higher cost resources are accessed to meet the increase in demand. The market outlook is further complicated by the recent decline in oil prices and uncertainty around the future oil price path. The cost of securing flexibility of wholesale gas delivery has also risen as producers seek to maximise output by sustaining a flat production profile.

In spite of this uncertainty retail gas competition has continued to develop with the AEMC finding competition in gas to be effective, that customers are continuing to actively shop around for deals and are reporting higher satisfaction levels with the choice available. Origin anticipates an increase in competitive activity in regional areas ahead of the potential removal of price regulation in July 2017.

It is within this uncertain environment that Origin proposes holding the retail component of its tariffs flat and passing through the change in network prices. Origin considers this approach will deliver stable outcomes for customers, a fair margin for Origin and continue to support the development of gas retail competition in regional areas.

While network tariffs are to increase by CPI the impact on customers is not uniform. As with all price changes the customer impact will not be uniform. Origin will seek to avoid major changes to any one customer group but will nevertheless need to move some way towards more cost reflective tariffs. Average residential customers in the Albury/Murray Valley region will receive sub CPI increases of 1.8% (Albury) and a reduction of -1.6% (Murray Valley) whilst average residential customers in the Wagga Wagga region will receive maximum average increases of 3.1%.

Origin has set out its proposal below. Should you have any questions or wish to discuss this proposal further, please contact Keith Robertson on keith.robertson@originenergy.com.au or (02) 9503 5674.

Yours sincerely,

Keith Robertson
Manager, Wholesale and Retail Regulatory Policy

1. Background

The Minister for Resources and Energy in NSW (Minister) has requested that IPART continue regulating default tariffs for small retail gas customers under the current light handed approach.

The Minister recently announced that the NSW Government will look to deregulate retail gas prices from 1 July 2017 if there is an increase in competition, particularly in regional areas of the state and has also asked that IPART review the competitiveness of the retail gas market in NSW and provide advice on any additional measures to strengthen competition in the NSW retail gas market.

In March 2014 Origin provided IPART with its revised proposed Voluntary Transitional Pricing Arrangement (VTPA) for the Albury/Moama, NSW Murray Valley and former Country Energy districts with prices for FY14/15 and FY15/16.

In November 2015, IPART commenced its review of regulated retail prices and charges for gas to apply from 1 July 2016. IPART released an Issues Paper seeking stakeholders' views on the key issues identified by IPART. Origin provided a response to IPART's Issues Paper on 17 December 2015.

2. Proposed Price FY2017

Origin proposes holding the retail component of its tariffs flat and passing through the change in network prices for FY2017. Origin considers this approach will deliver stable outcomes for customers, a fair margin for Origin and continue to support the development of gas retail competition in regional areas.

While network tariffs are to increase by CPI the impact on customers varies by location and customer size. Customers on standing tariffs in Wagga Wagga are subject to a greater network increase ($/GJ) due to their relatively low and declining average consumption volumes. Origin's proposal is therefore expected to result in a sub CPI increase for residential customers in Albury/Murray Valley. Customers in the Wagga Wagga region will experience average increases of 1.1%. See Attachment 1 for summary of likely bill impacts.

Table 1. Proposed Change to Retail and Network Price Allowances Albury/Murray Valley

Origin (Albury/Murray Valley region)	FY16 ($/GJ) restated for current volumes	Origin Proposal FY17 ($/GJ) restated for current volumes	% Increase
Retail Component R	$15.58	$15.58	0.0%
Network Component N	$6.46	$6.58	2.0%
Standing Tariff (R + N)	$22.05	$22.16	0.5%

Table 2. Proposed Change to Retail and Network Price Allowances Wagga Wagga

Origin (Wagga Wagga region)	FY16 ($/GJ) restated for current volumes	Origin Proposal FY17 ($/GJ) restated for current volumes	% Increase
Retail Component R	$17.03	$17.03	0.0%
Network Component N	$12.65	$12.96	2.5%
Standing Tariff (R + N)	$29.67	$30.00	1.1%

Origin's proposal strikes an appropriate balance between delivering fair and stable outcomes for customers, a reasonable margin for Origin and continuing to support the development of gas retail competition in regional areas.

Origin acknowledges that in light of declining oil prices community expectations are likely to be for lower wholesale gas cost allowances. Origin supports IPART's intent to test retailers pricing assumptions against new entrant costs and has described in section 4.1 why Origin's allowance for wholesale costs is in line with new entrant retailers' likely supply costs. Origin expects any decline in new entrant commodity costs realised by a new entrant would be broadly offset by higher deliverability (MDQ) costs and risk allowances.

Origin's cost to retain and acquire customers in FY16 was $159 per account[1], this is in excess of IPART's previous estimate of a reasonable allowance at $94 to $113 ($2013/14).

Tariff rebalancing

Origin's revenue proposal will deliver an average retail tariff increase of below CPI for residential customers in the Albury/Murray Valley region. As noted above, average usage has declined significantly for regulated customers in the Wagga Wagga region – average residential usage has declined from 37GJ/pa to 35GJ/pa (a reduction of 4% and average SME usage has declined from 230GJ/pa to 144GJ/pa (a reduction of 38% - as higher volume customers pursue competitive market offers reducing the average usage for those customers that remain on regulated tariffs). See Attachment 1 for summary of likely bill impacts. As with all price changes the customer impact will not be uniform. Network tariff increases in recent years have been weighted towards the fixed charge or first consumption block. Origin's retail tariffs have smoothed this impact in recognition of the substantial tariff increase in FY15 further complicated by the introduction and subsequent removal of a carbon price. Origin will seek to avoid major changes to any one customer group but will nevertheless need to move some way towards more cost reflective tariffs. Average residential customers in the Albury/Murray Valley region will receive sub CPI increases of 1.8% (Albury) and a reduction of -1.6% (Murray Valley). Customers in the Wagga Wagga region will experience average increases of 1.1%. As part of the tariff rebalancing and maintaining cost reflectivity, Origin has proposed a significant reduction for Albury business customers and all customers in the Tamworth region.

3. Indicative Price Path beyond FY2017

Origin has also been asked to provide an indication of pricing in FY2018 and FY2019. With all LNG trains in operation the supply demand balance is expected to remain tight in financial years 2018 and 2019. The longer term path for oil prices remains highly uncertain as does its impact on domestic wholesale market prices under tighter supply conditions. Assuming the retail component of tariffs is as proposed above held constant in FY17 Origin would at this stage expect price increases around CPI in FY18 and FY19 with any sustained impact of lower oil prices likely being offset by the tight supply/demand balance, rising production costs and a fuller recovery of retail operating costs.

[1] Origin's Annual Report 2015, page 23. Cash cost expressed on a national basis and so excludes depreciation/amortisation. Further detail to be provided to IPART.

4. Market Developments

Origin's response to IPART's issues paper acknowledged the range of market developments identified by IPART. Origin considers the most significant developments are the shift in the supply/demand balance caused by LNG export projects, the associated impact of the oil price on domestic wholesale gas prices, rising production costs, the continued development of retail competition in NSW and changes in gas network prices.

4.1 Wholesale Market Developments

The commencement of east coast LNG exports will (at least in the short term) result in a tightening of the domestic market given the anticipated tripling in demand. Notwithstanding the increase in demand, there are sufficient gas reserves and resources to meet the needs of domestic customers and for the export industry.

As IPART notes the current transitional period is occurring at a time when some legacy supply contracts are coming to an end, with the negotiation of new contracts under a changing pricing landscape, and greater market uncertainty, likely to require some adjustment.

Historically, domestic gas prices have been well below those observed internationally. However in recent years gas prices have risen in response to the linkage with international prices as an important benchmark, the tightening of the domestics supply/demand balance and higher production costs as producers bring on additional higher cost, unconventional supply sources that were previously uneconomic to develop to meet the increased demand for gas. Gas wholesale prices are therefore broadly bounded by short run marginal netback prices at the upper end and producers' costs at the lower.

As the AEMC has recently observed[2] with the increase in demand, producers are seeking to operate their plants at higher capacity factors. As a consequence supply flexibility, the ability to deliver increased supply on particular days, is becoming more costly for retailers. Securing sufficient Maximum Daily Quantity (MDQ) is a particularly important issue in pricing mass market customers as these customers have a greater variation in their demand profile than commercial or industrial customers.

4.2 Wholesale Market Benchmarks

Origin's response to IPART's Issues Paper suggested that in considering reasonable retail prices IPART should assume that a new entrant retailer would adopt a conservative approach to purchasing and seek to secure cost certainty through bilateral contracts. While new entrant retailers will have different preferences for contract term, Origin would suggest that it is reasonable to assume that a new entrant retailer would secure supply for FY17 across at least the three preceding years.

Origin would expect that a new entrant would value highly supply cost certainty and so seek to secure fixed prices or where possible hedge oil price risk. It may however be useful for IPART to consider, as two possible boundaries, (i) the case where a retailer buys at a fixed price and (ii) where a retailer accepts oil price risk. In the second case the retailer would need to apply a price premium when setting retail prices to cover the risk of supply price movements.

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[2] East Coast Wholesale Gas Market and Pipeline Frameworks Review, STAGE 2 DRAFT REPORT, AEMC , 4 December 2015

Approach (i) Three Year Averaging

As has been well documented, and figure 1 below illustrates the oil price (US$) has fallen dramatically over the last three years.

Figure 1. Oil Price (USD and AUD) on left Hand Scale and the Exchange rate, (USD/AUD) on the Right Hand Scale

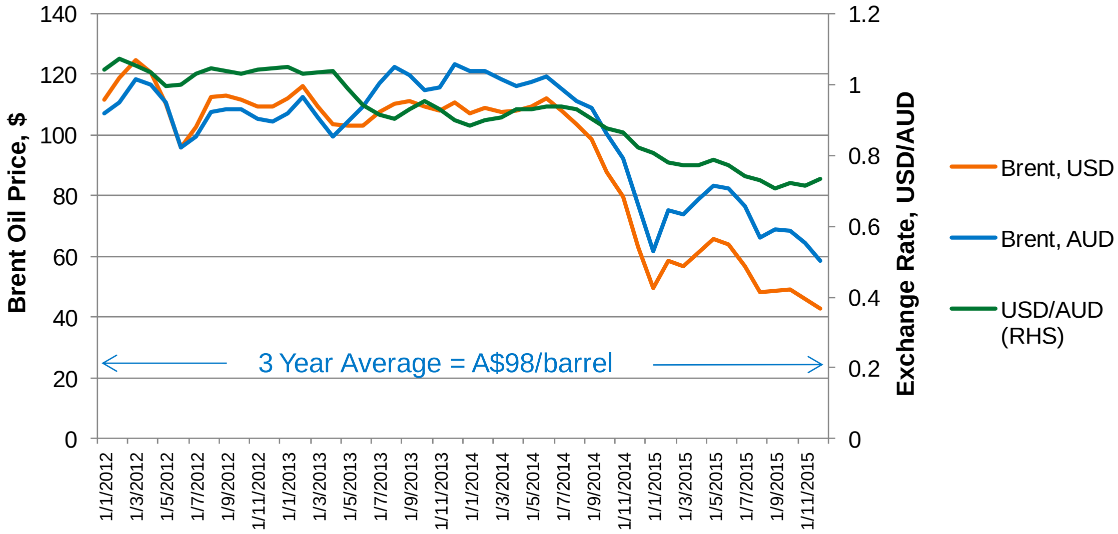


Figure 1 also shows the fall in the USD/AUD exchange rate resulting in a less substantial decline in oil prices expressed in Australian dollars. The average price in Australian dollars over the last three years is A$98/barrel.

As IPART's consultants in 2013 (Jacobs SKM) noted LNG exports are competing with domestic sales for eastern Australian gas resources. IPART has therefore previously considered the LNG Netback price as a useful benchmark. The LNG netback price being the LNG sales price (based on oil prices) less liquefaction and pipeline transportation costs.

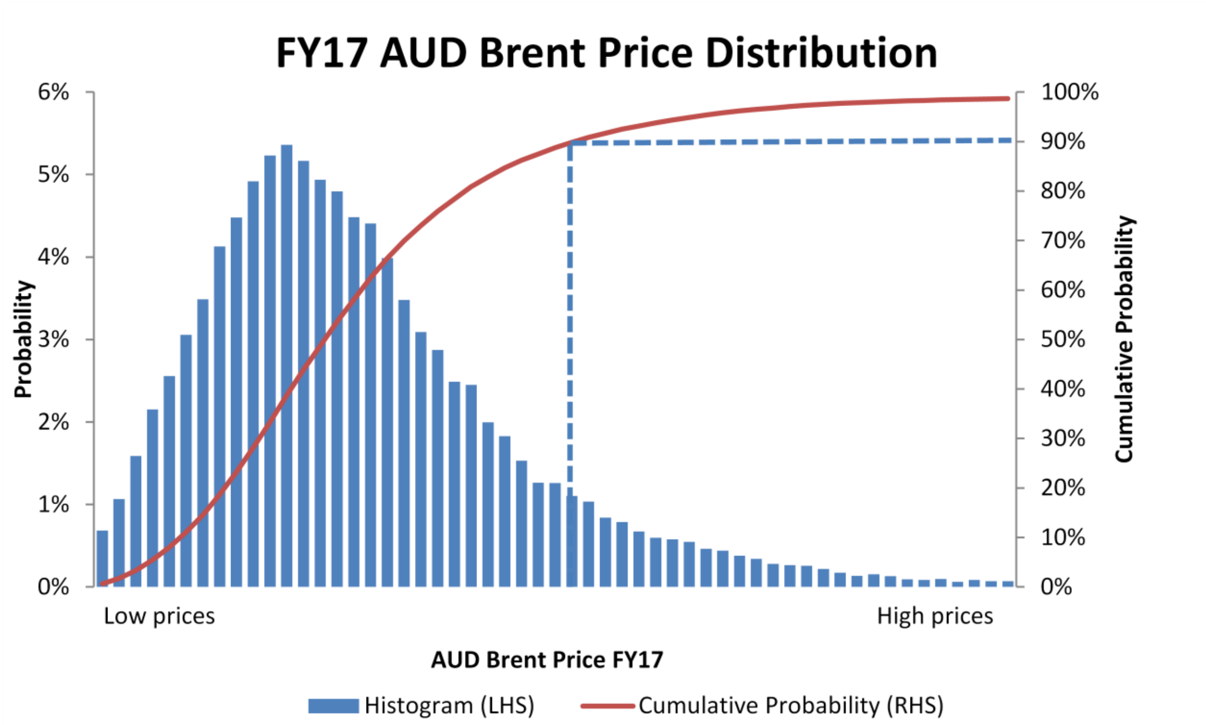
An average oil price at A$98/barrel broadly equates to a short run netback price of A$12.30/GJ gas price in NSW (workings provided to IPART). This provides an upper benchmark with oil linked gas contracts executed in a range between 7.0% and 8.5% oil linkage or 'slope', this equates to $6.86/GJ to $8.33/GJ at A$98/barrel.

Approach (ii) New Entrant Applies Price Premium for Oil Price Risk

If a new entrant retailer secured oil price linked gas supplies then it would face significant oil price volatility risk. We would expect that a new entrant that chose to accept oil price risk would need to factor in a material price premium to accommodate this risk.

Origin's risk model has been applied to assess the volatility in oil prices dating back to the year 2000. Origin's model has then been used to apply this historic oil price volatility through a series of simulations to the (December 2015) forward price curve for FY17 and derive a distribution of possible oil price outcomes (and hence oil linked gas supply prices) for FY17. Figure 2 illustrates the distribution of oil prices to be expected around the December 2015 forward price curve for FY17.

Figure 2. Simulation of oil price outcomes for FY17 based on Dec 15 forward curve.



An assessment can then be made of the (oil price linked) gas commodity price that would be required by a new entrant retailer to recover its supply costs with various levels of confidence. Origin estimates that a gas commodity cost allowance of $7.50/GJ would be required to allow a new entrant to recover oil linked gas supply costs with 90% confidence[3] based on the forward price curve for oil in Dec 2015, the historic volatility of oil prices from 2000 and assuming a simple 7.5% "slope" in the new entrant's oil linked gas supply contract.

Deliverability (Expressed as Maximum Daily Quantity (MDQ))

The tripling in east coast gas demand driven by the LNG trains also has an impact on the value of MDQ. Under tighter supply/demand conditions gas producers are seeking to maximise output by operating at high capacity factors. As a result supply flexibility, the ability to deliver increased supply on particular days, is becoming more costly for retailers. The rising value of MDQ is evident in the recent high price ($1.78bn or about 40 times pre-tax profit[4]) paid by Queensland Investment Corp (QIC) to acquire the Iona storage facility and AGL's announcement of a long term Gas Storage Services Agreement with QIC to provide "swing capacity" to manage its winter gas demand requirements. These transactions demonstrate market participants' expectations of higher prices for MDQ.

Victorian Retailers' Gas Price Changes for 2016

The Victorian gas market is highly competitive, with customers actively switching between ten active gas retailers. In 2013-14 the AEMC found that gas switching rate in Victoria was 23 per cent and that in addition around 24 per cent of customers changed to another gas plan from the same retailer.

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[3] We note the QCA considers a 90% confidence case when assessing electricity wholesale costs

[4] "QIC on lookout for more gas acquisitions", Sydney Morning Herald, http://www.smh.com.au/business/qic-on-lookout-for-more-gas-acquisitions-20151008-gk4f5i.html accessed on 17 December 2016

As Table 1 below shows, gas prices in the deregulated Victorian market have increased by around 7% for 2016 with network increases accounting for around 1.3% of this increase[5].

Table 3. Victorian Retailers' Gas Price Change

	Gas Price Change		Effective Date
	Res	SME	
Origin	7.5%		1 February 2016
Red Energy	7.8%		1 February 2016
EnergyAustralia	5.8%		1 January 2016
AGL	7.3%		18 January 2016
Lumo Energy	11.9%	3.6%	1 January 2016

Many retailers have publicly attributed the price increases to rising wholesale gas costs. AGL's public notice stated that "The main reason for the gas variation is an increase in the wholesale cost of gas". EnergyAustralia noted "The price changes are due to various factors including: increases in wholesale costs for gas, higher charges from distribution companies and increasing retail costs". Origin also noted that its changes reflect "changes to wholesale energy costs, network charges and retailing costs."

Given the intense nature of competition and absence of price regulation in Victoria these announcements provide strong evidence that retailers do not view a decline in wholesale supply costs as likely.

4.3 Retail market Developments

The AEMC published its annual energy retail competition review on 30 June 2015. The AEMC concluded that competition in the NSW retail gas market is effective. The AEMC found that gas customers continued to switch suppliers with the switching rate in NSW and ACT for 2013-14 at 12 per cent. Importantly 88 per cent of residential gas customers in NSW were aware they could choose their retailer and in particularly the proportion of regional customers that were aware they have a choice of gas retailer had increased significantly from 67 per cent in 2014 to 83 per cent in 2015

The current level of competition in retail gas markets suggests 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.

Given the Government's announcement that subject to improvements in competition in regional NSW regulated pricing should be removed from 1 July 2017 it is important that retail prices in FY16 support successful transition to a deregulated market. Finally, as Origin has previously observed the regulatory risks of setting a retail margin are asymmetrical. If the regulated tariff is set too low then standard retailers will not make a reasonable return and retail competition will be stifled, if retail margins are set too high then excess returns will be removed by more intense retail competition.

[5] Origin Analysis

4.4 Network Developments

Origin understands that Envestra's network prices in the region for which Origin is the standard retailer will increase by CPI from 1 July 2016 (Wagga Wagga region) and 1 January 2017 (Albury/Murray Valley region).

The current VPA adequately addresses the uncertainty around future network pricing by allowing for a pass through of network costs under an N+R Methodology. Origin proposes maintaining this approach for FY17.

5. Voluntary Pricing Agreement (VPA) Framework

Origin proposes maintaining the current VPA framework with:

- Origin's default retail prices to be subject to the agreement for a one year period from 1 July 2016;
- No change to the Retail Component of the Default Prices from 1 July 2016 to 30 June 2017;
- Origin to pass-through the Network Component of the Default Prices from 1 July 2016 to 30 June 2017;
- Origin to apply to IPART to vary the R component as a result of any special circumstances;
- Origin is to continue to set the level and structure of their regulated retail gas tariffs subject to a Weighted Average Price Cap (WAPC) on the Retail component with no additional price constraints.

Origin will work with IPART to document an updated VPA.

6. Miscellaneous Fees and Charges

Origin proposes the following fees for FY17, this represents an increase on the FY16 rates in line with CPI.

Table 3. Proposed Change to Fees and Charges

	2015/16 (GST Exclusive)	2016/17 (GST Exclusive)	2016/17 (GST Inclusive)
Account Establishment Fee	$33.85	$34.70	$38.17
Late Payment Fee	$12.00 (No GST)	$12.00 (No GST)	$12.00 (No GST)
Security Deposit	$150 (Residential) (No GST) $420 (Business) (No GST)	$150 (Residential) (No GST) $420 (Business) (No GST)	$150 (Residential) (No GST) $420 (Business) (No GST)
Dishonoured Payment	$27.10	$27.78	$30.56
Retail Administration Fee	$2.66	$2.72	$3.00

CPI	2.5%

Attachment 1. Estimate of Bill Impacts by Town

Albury/Murray Valley Customer Bill Impact	Current FY16 Bill ($/pa)	Proposed FY17 Bill ($/pa)	FY17 $ impact	FY17 % increase
Albury residential	$963	$980	$17	1.8%
Murray Valley residential	$1,006	$990	-$17	-1.6%
Albury SME	$2,483	$2,305	-$178	-7.2%
Murray Valley SME	$2,224	$2,383	$158	7.1%

Wagga Wagga & townships Customer Bill Impact	Current FY16 Bill ($/pa)	Proposed FY17 Bill ($/pa)	FY17 $ impact	FY17 % increase
Residential				
Wagga Wagga	$1,111	$1,138	$27	2.4%
Tumut & Gundagai	$925	$954	$29	3.1%
Culcairn, Holbrook, Temora, Henty, Walla Walla	$845	$848	$3	0.4%
Cooma & Bombala	$1,061	$1,078	$16	1.6%
Tamworth	$863	$781	-$82	-9.5%
SME				
Wagga Wagga	$2,266	$2,348	$82	3.6%
Tumut & Gundagai	$2,796	$2,924	$128	4.6%
Culcairn, Holbrook, Temora, Henty, Walla Walla	$4,116	$3,925	-$191	-4.6%
Cooma & Bombala	$2,913	$2,953	$39	1.4%
Tamworth	$6,467	$5,835	-$633	-9.8%