Submission to the Independent Pricing and Regulatory Tribunal on the review of regulated gas retail tariffs and charges from 2013 to 2016

November 2012

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1. Introduction

Origin Energy Retail (Origin) is a standard retail gas supplier to over 17,000 small customers in the Albury/Moama and NSW Murray Valley region, and to 24,000 customers in those gas networks owned by Country Energy prior to October 2010 (former Country Energy)[1]. Origin is also a new entrant gas supplier in other areas of the New South Wales (NSW) gas mass market.

Origin believes that 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 written to IPART requesting that 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.

Origin welcomes this opportunity to provide the Independent Pricing and Regulatory Tribunal (IPART) with a draft voluntary transitional pricing arrangement (VTPA) for the Albury/Moama, NSW Murray Valley and former Country Energy districts.

This document sets out Origin's proposed approach to the VTPA. A draft VTPA consistent with this approach is provided in Appendix A.

[1] The Country Gas Networks area (now owned by Envestra Transmission services a subsidiary of Envestra limited) is made up of the Wagga Wagga gas network and the networks in the Monaro, Riverina and Tumut Valley towns.

2. Cost Recovery under Existing Tariffs

Origin has reviewed the net retail margins forecast for FY13 for its gas customers covered by the current VTPA. In FY13 the tariffs in the former Country Energy area are forecast to deliver negative net retail margins and the tariffs in the Murray Valley/Albury area are expected to deliver margins well below a sustainable level. It is important that under-recovering tariffs are returned to sustainable levels for the long term viability of retailers and the promotion of effective competition.

Origin is very much aware of the cost of living pressures facing its customers. Origin has therefore sought to establish a price increase that strikes an appropriate balance between addressing this under-recovery and the impact customer on consumers. Origin's proposed price path is set out in section 4.3.

3. Market developments

This VTPA will span a number of significant changes in the energy market:

- a significant increase in demand for gas on Australia's east coast as Queensland's Liquefied Natural Gas (LNG) trains begin to serve the LNG export market and the associated impact on the supply curve;
- the transition of the carbon price from a fixed price to a market price under recent amendments made to the Clean Energy Act; and
- network determinations conducted by the Australian Energy Regulator (AER). These include APA GasNet, Envestra (Albury) and Envestra (Country Energy).

In order to ensure these changes do not have any unexpected negative consequences on competition, Origin believes this VTPA should:

- continue to provide Origin with the ability to directly pass-through network costs;
- provide customers, retailers, and IPART with a level of certainty as to the likely increases; and
- enable the smooth transition to the removal of retail price regulation for gas.

3.1 Wholesale Gas Costs

Wholesale gas costs will significantly increase over FY15 and FY16. The commencement of a number of Gladstone export LNG projects will create a significant increase in demand for gas across the Eastern seaboard. The demand to meet the committed LNG projects is expected to exceed all other gas demand in Eastern and South Eastern Australia. First production for the committed LNG trains in Queensland is expected to commence through 2014 and 2015.

As a consequence wholesale gas costs during the VTPA period are expected to experience a step change increase, driven by the following factors:

- Producers are moving to bring on additional higher cost, non conventional supply sources that were previously uneconomic to develop to meet increased demand for gas. These increased production costs will be reflected in future supply contracts.
- Demand from the LNG export market will likely dominate gas supply costs, with forward domestic supply contract prices now reflecting "netback pricing" that will likely lead to domestic prices higher than we have seen historically.

Transport and Maximum Daily Quantity (MDQ) pricing is also expected to rise over this period as new build gas transport will be required to handle the increase in net gas flows through NSW, and the cost of such infrastructure will be built into the service price.

Origin is now negotiating supply contracts for the VTPA period with contract prices that reflect the development of the LNG export market, and with contract escalation terms now often tied to international oil prices (a driver of the international LNG market price).

Given the level of market change anticipated, Origin expects that substantial analysis will be required in order for IPART and other stakeholders to assess likely wholesale gas prices beyond FY14 and that this analysis may still lead to multiple plausible price paths. Origin therefore proposes establishing a three year VTPA for FY14-FY16 with the wholesale gas commodity cost to be established in the preceding financial year for each of FY15 and FY16. Other than the carbon impact (C) for FY16 (discussed below), the other cost and margin elements within the R component are targeting a real fixed for rate the three year term of the VTPA and will not vary other than in accordance with the Special Circumstances provisions.

Origin proposes that it will submit wholesale gas costs for FY15 to IPART by 1 November 2014 and submit wholesale gas costs for FY16 by 1 November 2015. The wholesale gas submission will set out:

- The proposed wholesale gas cost for the following year.
- The reasons for any change in the wholesale gas cost allowance sought by Origin.
- Information that supports the reasons for any proposed change. This may include gas production costs, wholesale or retail contract prices and carbon costs. Origin notes that information provided in relation to gas contracts will be provided on a confidential basis.
- The impact on the R component.
- An estimate of the impact on the tariff (N+R).

The wholesale gas cost for FY16 will be expressed on a carbon exclusive basis to allow for a pass through of carbon costs. This is addressed in section 3.2 below.

Origin anticipates that IPART would then conduct an assessment 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.

It is expected that this approach will allow all stakeholders to have a better informed view of future wholesale gas prices when considering FY15 and beyond and also assist in assessing carbon costs beyond the fixed price period for FY16.

3.2 Carbon Costs

The Commonwealth Government's carbon pricing mechanism commenced on 1 July 2012 imposing additional costs and risk on gas retailers. The impact of this legislation was reflected in changes made to gas retail prices from 1 July 2012.

The scheme was originally designed with a fixed carbon price to apply in the first three years of the scheme, followed by a floating price that was subject to a floor from 1 July 2015. A further set of amendments to the legislation were made in September 2012 which have the effect of removing the proposed floor price for the scheme between 2015-16 and 2017-18. These changes were made in the context of linking the Australian scheme (Aus ETS) to the European Union Emissions Trading System (EU ETS)

While current European Carbon Unit prices would suggest a low carbon price for Australia in FY16, there is considerable regulatory uncertainty around carbon price forecasts. The risk that European legislation will be changed to address the current Carbon Unit oversupply position, which would place upward pressure on Australian carbon prices, is considerable. This is not a risk that Australian gas retailers can efficiently manage at the present.

Given the large degree of uncertainty attached to policy and regulatory arrangements, particularly overseas, there is significant uncertainty attached to accurately forecasting carbon costs beyond 1 July 2015. An improved view of market prices beyond 1 July 2015 is expected to be available when auctions administered by the Clean Energy Regulator commence in 2014.

Origin proposes 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.

Origin proposes that the process adopted to establish the change in regulated gas costs from 1 July 2012 be applied for changes effective from 1 July 2015. This process is broadly as follows:

- Origin would advise IPART by 1 November 2015 of its proposed carbon cost for FY16, setting out the basis upon which the cost was estimated.

- IPART would assess Origin's proposal, which may include public consultation, and then determine if the charges were appropriate.

- Origin proposes that this review would be conducted in conjunction with Origin's proposed assessment of the wholesale gas cost for FY16.

3.3 Network Determinations

The current VTPA 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 FY14.

This is important as network determinations are currently being conducted by the Australian Energy Regulator (AER) for the Victorian gas distribution networks including Envestra (Albury).

At this point, Origin notes that in setting FY14 retail prices for Albury using the N + R approach Origin will need to consider two network prices increases; the first is expected to apply from 1 July 2013 and a subsequent change from 1 January 2014. Origin will work through this issue with IPART following the AER's final decision in early 2013.

4. Proposed VTPA

4.1 Objectives of the VTPA

The objectives of this VTPA are unchanged from the prior period, and remain to ensure that:

- tariffs are set at cost reflective levels to encourage competition in the NSW market;
- all prudent and efficient costs are considered;
- distribution charges (N) are considered a direct pass-through and are not therefore part of the VTPA;
- that the process is flexible to account for future developments; and
- the process allows a degree of transparency to the analysis without requiring confidential and extremely sensitive commercial information to be disclosed.

4.2 VTPA Framework

For this draft VTPA, Origin proposes maintaining the current framework:

1. Origin's default retail prices are to be subject to the agreement for a three year period from 1 July 2013.

2. Origin is to continue to set the level and structure of its regulated retail gas tariffs subject to a Weighted Average Price Cap (WAPC) on the Retail component with no additional price constraints.

3. Default retail tariffs for FY14 and FY15 are to be defined as being comprised of:

   – the retail component (R) including the cost of complying with the Carbon Pricing Mechanism; and

   – the distribution network component (N) being all the regulated charges levied by a distribution network operator.

4. Default retail tariffs for FY16 are to be defined as being comprised of:

   - the retail component (R) excluding the cost of complying with the Carbon Pricing Mechanism;
   - the distribution network component (N) being all the regulated charges levied by a distribution network operator; and
   - the carbon component (C) being the cost of complying with the Carbon Pricing Mechanism associated with supplying gas to customers.

5. The retail component (R) includes:

   – the wholesale gas cost (inclusive of MDQ costs) and adjusted for published transmission and distribution network losses;

   – cost of complying with the Carbon Pricing Mechanism associated with supplying gas to customers for FY14 and FY15 only;

   – all wholesale market related costs, including AEMO charges adjusted as above for transmission and distribution network losses ;

   – transmission costs, adjusted for distribution loss factors; and

- the retail operating costs and retail margin. Retail operating cost has been estimated at ~$100 per customer in FY14 and held in real terms for FY15 and FY16 – this cost is reflecting only cost to maintain, not cost to acquire/retain. For FY14 Origin has not sought any recognition of acquisition or retention costs given the historically low levels of churn among those gas customers for whom Origin is the standard retailer. However Origin would seek to include these as the tariff achieves sustainable margins in FY15 and FY16.

  Origin's proposed retail margin for FY14 is below the margin range previously proposed by IPART and in the case of the Country Energy district is a negative margin. As part of the proposed process of setting wholesale energy prices each year, Origin proposes to set retail prices to return the retail margin to within the range IPART has previously determined (7.3% to 8.3% of EBITDA) in FY15 and FY16.

6. While the VTPA is concerned with the annual changes in the R component of the default tariff, the VTPA will recognise that:

- Origin will pass-through the distribution network charges (N):
  - as determined under a relevant Access Arrangement determined under the National Gas Law; or
  - by agreement with the distribution company in areas where there is no coverage by an approved Access Arrangement (as in the Murray Valley region).
- The N component direct pass-through may involve consequential changes to the default retail tariff (made up of R+N for FY14 and FY15 and R+N+C for FY16). Origin proposes that such changes will occur no more frequently than 6 monthly intervals and IPART will be advised prior to that change of the reasons for the change.
- Origin will pass through separately the cost of complying with the Carbon Pricing Mechanism associated with supplying gas to customers (C) for FY16 only. In FY14 and FY15 the R component includes these costs.

4.3 Proposed Price Path

Origin proposes that the VTPA will allow:

- a weighted average price increase for the Retail Component of the Default Prices for the Murray Valley/Albury district from 1 July 2013 to 30 June 2014 at or below the change in CPI for the previous Financial Year + 5.3%;
- a weighted average price increase for the Retail Component of the Default Prices for the former Country Energy district from 1 July 2013 to 30 June 2014 at or below the change in CPI for the previous Financial Year + 4.2%;
- the wholesale gas cost to be set for FY15 and FY16 as described in Section 3.1
- Origin to apply to IPART to vary the R component as a result of special circumstances;
- Origin to implement a full and direct pass-through of distribution network charges; and
- Origin to implement a full and direct pass-through of the costs of complying with the Carbon Pricing Mechanism associated with supplying gas to customers for FY16 only.
- Origin proposes to return in FY15 and FY16 to a retail margin within the range IPART has previously determined (7.3% to 8.3% of EBITDA) and commensurately incorporate acquisition and retention costs

The proposed adjustment to the R component is expected to result in a 5.5% nominal increase in the standing tariff in the Albury/Murray Valley district and a 6.4% increase in the former Country Energy district. Origin has assumed a CPI of 2.8% for this analysis.

4.4 Miscellaneous Fees and Charges

Origin acknowledges IPART's previous findings (Review of regulated retail tariffs and charges for gas 2010-2013, Gas – Final Report, June 2010) in relation to miscellaneous fees and charges.

Origin proposes aligning the miscellaneous fees and charges in the former Country Energy district with those that apply in Albury/Murray Valley. The following fees are therefore proposed for FY14 and represent an increase on the FY13 rates in line with CPI.

Proposed Fees for NSW Standing Gas Customers

*Albury/Murray Valley and Country Energy Region**

	Proposed 2013/14 (GST Exclusive)	Proposed 2013/14 (GST Inclusive)
Account Establishment Fee	$32.60	$35.86
Late Payment Fee	$12.00	$12.00 (No GST)
Security Deposit	$150 (Residential) (No GST) $420 (Business) (No GST)	$150 (Residential) (No GST) $420 (Business) (No GST)
Dishonoured Payment	$26.10	$28.71
Retail Administration Fee	$2.56	$2.82

* Country Energy region comprises of the following towns: Wagga Wagga; Tumut; Gundagai; Culcairn; Henty; Holbrook etc

Origin does not believe any changes occurring over the course of the VTPA that are based on distribution network fees, should require further formal approval by IPART under the VTPA format. Origin accepts the need to keep IPART informed of these events but they should not be subject to any 3 month notification and approval process.

4.5 Special Circumstances

The current VTPA allows for Origin to vary average default prices outside of the limits set in the VTPA as a result of special circumstances following approval of the additional costs by IPART. Origin seeks to retain this provision for unforeseen events.

The special circumstances that may give rise to changes in costs include, but are not limited to:

- Regulatory changes;
- Taxation changes;
- Unanticipated field price reviews;
- Unanticipated changes in the cost of transmission; or
- Fundamental changes to gas market frameworks and arrangements.

Transmission costs are within the retail component of the VTPA and are therefore included in the special circumstances provisions. Transmission tariffs have been subject to significant intra-period changes in the past which if repeated, may require use of the special circumstances mechanism to adjust prices during this VTPA. A transmission determination is currently being conducted by the Australian Energy Regulator for APA GasNet.