6 June 2001

Ms Marianne Herbert
Voluntary Pricing Principles Review
Independent Pricing and Regulatory Tribunal
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Dear Ms Herbert

Re: Gas Pricing in Albury, Wagga Wagga and Other Regional Centres in NSW Supplied by Origin Energy and Great Southern Energy.

Origin Energy Retail Limited ("Origin Energy") welcomes this opportunity to respond to the Independent Pricing and Regulatory Tribunal (the "Tribunal") regarding the Issues Paper: *Gas Pricing in Albury,* Wagga Wagga *and Other Regional Centres in NSW Supplied by Origin Energy and Great Southern Energy (May 2001).*

Please find enclosed Origin Energy's submission to the Tribunal on the Issues Paper. Origin Energy has addressed the six issues identified in the Paper in its submission, with particular reference to the issues as they effect the Origin Energy gas supply areas in New South Wales.

Several matters raised by the Tribunal in the Issues Paper are of particular concern to Origin Energy. These include:

- The meaning of 'effective competition', how it will be measured and how it impacts on the assessment of the time period for regulated price controls.
- The potential extension of the pricing principles, and in particular the application of default tariffs and side constraints, to Include customers and areas not covered by the previous pricing principles and pricing constraints.
- The need to recognise, when setting default tariffs and pricing constraints, the unique costs and risks facing smaller incumbent retailers in relation to FRC cost recovery, wholesale market issues, the nature of cross-subsidies, retail cost structures and retail margins.
- The ability for customers to revert back to default tariff structures and the impact of this on the operations and costs of the incumbent retailer.
- The potential extension of price controls to the area of miscellaneous charges, particularly given the embedded cross subsidies that reside in some of these charges.

Origin Energy is committed to the development of an efficient and competitive gas market in all areas supplied by Origin Energy in New South Wales. The recommendations in our submission are directed towards encouraging the emergence of a competitive market through the approptiate level of market "intervention" by the Tribunal. We hope It is of assistance to the Tribunal in undertaking the Review.

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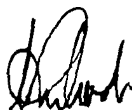
If you have any queries regarding this submission, please contact Beverley Hughson (Pricing & Tariff Manager) on 03 9652 5702 or David Calder (Senior Regulatory Analyst) on 03 9652 5508.

Yours sincerely



Tony Wood
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cc
Beverley Hughson
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ORIGIN ENERGY RETAIL LIMITED

Submission to Independent Pricing and Regulatory Tribunal of New S-outh Wales

Gas Pricing in Albury and Regional Centres in NSW Supplied by Origin

June 2001

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An issues paper *Gas Pricing in Albury, Wagga Wagga and Other Regional Centres in NSW Supplied by Origin* **Energy and** *Great Southern* **Energy was** released by the Independent Pricing and Regulator Tribunal of New South Wales (the "Tribunal") **in May 2001. This** submission provides a commentary and views on some of the issues raised by the Tribunal as they relate to Origin Energy.

1 Background

The New South Wales Government is progressively introducing competition into the natural gas market.

Tariff customers who purchase large quantities of gas became eligible to choose their supplier in October 1999. Low volume users became eligible co choose their supplier from 1 July 2000. However, there have been delays in putting in place the necessary retail market systems, and as a result contestability in the small volume market has not effectively occurred.

The New South Wales Minister for Energy announced in April 2001 that full retail competition in natural gas would be introduced from 1 January 2002, to coincide with the commencement of competition in the electricity industry.

In parallel to the development of the fully contestable market, Origin Energy Retail Limited ("Origin Energy") and the Independent Pricing and Regulatory Tribunal (the "Tribunal") agreed on a set of voluntary pricing principles ("VPP") to apply for the period to 30 June 2001. Under the VPP, Origin Energy agreed to:

- Provide for a "grace period" following contestability until:
  - 31 December 2000 for customers consuming 1-10TJ **per** annum
  - 30 June 2001 for customers consuming O-l TJ per annum
- Provide one months notice of any proposed changes in tariffs for all **customers covered** under the VPP, including **an** assessment of the impact on revenues, analysis of fixed and variable costs and any changes in costs and a customer impact analysis.
- For residential customers only, increases in tariffs to be limited to $20 or CPI+5%, whichever is the greater when compared to a similar period in the previous year, subject to:
  - Where the **full** pass through of a change in network charges, including those associated with contestability, would result in the price constraint being exceeded, then the price constraint would be automatically increased to include the full pass through of those costs
  - Net increases in costs arising from the GST may be added to the price constraint.

Since the VPPs were agreed, Origin Energy has implemented one tariff change in December 2000, an increase that was fully compliant with the VPP. This was the first tariff **change since 1996 when** Energy **21,** the predecessor to Origin Energy, had agreed to a retail price

freeze, prior to the introduction of the approved Access Arrangement for Distribution Services. For residential customers, this tariff change involved:

- An increase in the bimonthly supply charge: this reflected the implementation of a $52/year/customer charge (2001) under the Albury Access Arrangement.
- Introduction of peak and off-peak variable rates, with an increase in peak period tariffs, to better reflect the structure of the Access Arrangement tariffs, transmission tariffs and gas costs.

The Tribunal has now requested Origin Energy to extend the application of the current VPPs until a review can be conducted of the VPP, with a view to establishing a three year tariff plan (2001/2002 to 2003/2004) for areas in New South Wales where Origin Energy is the dominant supplier.

Origin Energy has agreed to extend the current VPP until the implementation of a new VPP and associated three year tariff plan, or the end of 2001, whichever is sooner.

As part of the process of developing a new VPP, the Tribunal has prepared an *Issues* Paper, *Gas Pricing in Albury, Wagga Wagga and Other Regional* Centres *in NSW Supplied by Origin* Energy *and Great Southern Energy* (May, 2001). The six key issues are set out below and discussed in the remainder of the paper:

Key issues identified by the Tribunal:

- Coverage of regulation
- Form of regulation
- Setting the price limits
- Retail margin
- Miscellaneous Charges
- Treatment of Contestability Costs

2 Coverage of Regulation

2.1 Which tariffs in Albury and Moama should continue to be regulated?

Origin Energy understands that prior to the introduction of FRC, some form of retail price regulation is necessary. Currently in NSW, all gas customers are technically eligible to exercise choice of retailer. However practically, only the large customers have such **an** option as the systems to manage and handle large scale gas contestability have not been fully developed.

The issue thus is one of consumption threshold and customer type. The safety net of retail price regulation is more relevant for smaller customers, as they are likely to be less sophisticated in their participation in the competitive market. Larger customers are more

likely to be targeted by competitors as the costs associated with contestability can more easily be absorbed by the gross profit margins available.

The current Voluntary Pricing Principle for Origin Energy that requires detailed analysis and justification of proposed tariffs for customers consuming up to 10 TJ per annum is excessive. As the Tribunal's issue paper states, customers consuming between 1 TJ and 10 TJ face an annual cost of between $12,000 and 5100,000. Applying the Tribunal's May 2000[1] view that AGL's tariff customers generate a profit margin of 3.5% to 4.5%, such customers will generate a profit margin of between $500 and $4,500 per annum after taking into account all related retail costs. A margin of this size is likely to be sufficient to cover costs associated with retail contestability and large enough to be attractive to retailers.

Therefore, with respect to customers above 1 TJ/annum, there is no reason for the Tribunal to require default tariffs with price controls (which are not required in any case under the current VPP) or even a detailed price justification for price changes. Such customers can and will change their retailer if the prices offered by the host retailer are above competitive market rates. Below 1 TJ/annum, there are some 16,500 residential and 700 industrial/commercial customers. Origin Energy's views with respect to default price regulation and the VPP in general, for these segments are as follows:

- Under the current VPP, tariff changes for industrial and commercial customers are not subject to specific price constraints, although Origin Energy is obliged to notify the Tribunal of any tariff changes, explain tariff changes in the context of changes in costs and identify the impact of the tariff changes. Origin Energy believes that introducing specific default tariffs with price constraints for this market would represent a step back from progress towards an effective competitive market, and is unnecessary to achieve the government's other objectives. For instance, if the host retailer were to exploit a monopoly position in the next few months, then this would merely encourage the entry of aggressive competitors on 1 January 2002.
- Under the current VPP, tariff changes for residential customers are subject to specific price constraints (ie $20 or CPI +5%) in addition to requirement for justification and customer impact analysis. Origin Energy believes chat it is this market segment, and this segment alone, where there is any justification for the ongoing regulation of tariffs and price paths - at least until the development of an "effective" competitive market.

[1] Draft Report - Review of the Delivered Price of Natural Gas to Tariff Customers Served from the AGL Gas Network in NSW, Independent Pricing and Regulatory Tribunal, May 2000, p 21

2.2 Who should be the subject of the safety net regulated tariffs?

The Tribunal notes chat under the policy framework developed by the Ministry of Energy and Utilities ("MoEU"), default supply contracts, incorporating default tariffs regulated by the Tribunal, are expected to apply to:

- (Small) customers who are already connected to gas at 1 July 2001.
- Customers who connect to gas after 1 July 2001, where the customer pays separately for the physical connection.
- Customers who connect to gas after 1 July 2001 where the cost of new physical connection is paid for by the retailer and recovered through an initial supply contract, - but only after the termination of that initial supply contract.,.
- Customers who move to a market contract, but elect to subsequently return to a default supply contract.

Origin Energy has a number of concerns with this approach for the Albury and Moama district, which if implemented will add considerably to the costs of managing the customer base after FRC is introduced.

For instance, Origin Energy currently does not charge customers for connection to the system (within certain constraints regarding length of service pipeline from the street to the premise and meter size). The cost of standard services and meters, both assets of the distribution business, are recovered in the Access Arrangement charges for distribution services, and therefore intrinsically embedded in the bundled retail price. Where the service pipeline exceeds the relevant length, or there are additional meter installation requirements, the customer generally pays on an incremental basis only.

The assumptions behind MoEU approach to default tariffs/contracts for new customers connecting after 1 July 2001 are therefore largely irrelevant to the Albury/Moama residential and small industrial/commercial gas market.

On both operational and policy levels, Origin Energy does not support the approach of allowing customers who have transferred retailers to have the right to revert to the default tariff at some subsequent time. Firstly, there are significant practical issues associated with managing this ongoing right of a customer, who has taken a market contract, to revert to a default tariff with the host retailer at any time. For instance:

- How is the host retailer to manage their ongoing physical exposure to such a customer - to what extent will the host retailer be obliged to include such "potential" customers in their supply planning and purchase portfolio?
- Will this option to revert to a default contract/tariff be available to customers who initially connect to gas after 1 July 2001 on a market contract? If so, how will the connection charge issues be managed?

- How will any objections co transfers be managed, including outstanding debts?
- Will the incumbent retailer be obliged to manage and fund the transfer process, the "final" meter reading process for such customers (as they would if a customer was switching Co them for a market contract)!

More broadly, on a policy level, Origin Energy believes that the approach of allowing customers who have taken market contracts to have an automatic right to revert co default contracts/tariffs will undermine the development of an effective competitive market. Clearly, if the customer has taken up a market contract with a third party, then they have done this against the backdrop of the default tariff, and is evidence that effective competition (for that customer segment/type) already exists in the market place. The host retailer will usually have an interest in attracting that customer back through a better market offer. It is only if the default contract/tariff is below the cost to supply that customer that the host retailer would NOT offer a better contract to win back the customer. It is our understanding that the Tribunal will ensure that default contracts are allowed to cover the costs of supply, so the necessity of this policy is unclear to us.

2.3 Which areas should be covered by regulated default contracts and tariffs?

Origin Energy opposes the proposal to extend default contracts/tariffs to geographic areas where they do not currently apply. It is our view that this will constitute a backward step in the progress towards effective competition. As the market is moving towards contestability, where the ultimate aim is to enable customer choice regarding price and service, introducing default tariffs will only make the task of introducing FRC more difficult.

In addition, gas penetration in such areas is generally low and gas suppliers have had to compete against alternative fuels and especially electricity whose price remains regulated. Gas prices are constrained by electricity and solid fuel prices, and gas price elasticity (both own price and cross price elasticity) is quite high in areas of new gas reticulation. Indeed, the primary driver for the gas retailer in these areas is to increase gas consumption per household and kilometre of main, and the gas retailer is more likely to focus on incentives to utilise gas than price increases to discourage the conversion to gas.

On a policy level, Origin Energy is of the view that price coverage by the Tribunal is also inappropriate for areas such as Murray Valley. New reticulation areas, such as the Murray Valley townships, are usually subject to a rigorous public tender process by the local authorities. As such, the initial prices, and price paths set by the pipeline operator and the gas retailer are put forward as part of the competitive tendering process, and are agreed to by the local development authorities. The Gas Code also provides that where an approved tender process has been carried out on a competitive basis by the local government authority, the Reference Tariffs that apply shall be that determined by the tendering

process. It would be incongruous then that the Tribunal should seek to regulate retail tariffs that have also been determined by the same tendering process conducted on a competitive basis.

3 Form of Regulation

The Tribunal correctly states that "for competition to be successful in the gas retail market, it is important that regulated or default tariffs reflect the cost of gas supply". In promoting competition, it *is* also necessary for the tariffs to provide a sufficient profit margin to encourage retailers to compete for such customers and to develop products to suit the customers' needs. Putting coo tight a restraint on prices will only serve to discourage retail competition since there is little incentive for retailers to compete for customers with limited profit margins available. This also serves to undermine gas customers as any lack of retail competition by gas retailers also means that innovative products which could ultimately lower the total cost of gas to customers will not be forthcoming,

3.1 Setting Price Limits

In the current VPP, Origin Energy is limited to increasing prices to residential customers by no more than CPI+5% or $20 pa, which ever is greater. Origin is also allowed to recover any changes in network charges that exceed the limits imposed.

At the same time, the Tribunal has also stated its desire that default tariffs should be cost reflective including the recovery of costs associated with implementing FRC. This aim is laudable as it would reduce cross subsidies that currently prevail in the run up to full retail competition when cross subsidies will result in cherry picking by non-host retailers leaving the host stranded with unprofitable customers.

The aim, however, could result in some customers experiencing tariff increases that exceed the limits imposed if they are currently enjoying large cross subsidies. The rebalancing limits imposed on an individual customer basis limits the ability of the retailer to unwind these cross subsidies in time for the introduction of FRC by January 2002.

In the decision with respect to AGLRE default tariffs, the Tribunal has allowed cross-subsidies to unwind over a three year period, based on the ongoing application of the VPP side constraints. Origin Energy appreciates the specific difficulties facing AGL and the Tribunal with respect to the size of the cross-subsidies, and therefore the need to take a transitional approach over an extended period.

However, we would caution against this approach being taken across the gas market. It is Origin Energy's view that to the extent possible, cross subsidies should preferably be identified and unwound prior to, or in conjunction with, FRC dates because of the potential for cherry picking the more attractive segments of the market. It may be preferable for

the Tribunal to agree that where it can be shown that certain classes of customers **have** been cross subsidised, the limits are widened to increase the pace of unwinding these cross subsidies, These wider limits can then be applied to customers in these classes.

Certainly, on the general issue of whether different price constraints should be applied in different areas, Origin Energy notes that there are differences between retail areas that in our view have an impact on the structure, **the level and the time period of the price constraints.**

Origin Energy's overriding concern is with the lack of clarity in the definition of "effective competition", a concept which is at the heart of the approach taken by the Tribunal to implementing ongoing tariff controls for small consumers. The criteria and benchmarks for "effective competition" are not clear to us. Moreover, while the Tribunal proposes to review the level of the VPP tariff constraints and associated price path mid the proposed three year term, the Tribunal does not appear to be proposing a review of the market itself. In any case, Origin Energy sees no apriori reason to assume that **"effective** competition" will emerge or not emerge at the same rate in different gas supply areas given their fundamentally different market structures.

Specific differences, which need to be considered by the Tribunal in their decision, include:

- the extent and nature of cross subsidies across different retail areas between and within customer classes.
- the differences in the degree of competition likely to be faced in each market - **the** default contracts/tariffs should not extend beyond the **minimum necessary period** in any market, ie beyond the date of effective competition which may vary by area.
- the forward cost projections in different areas, including the nature of the supply arrangements and contracts and the certainty of those arrangements.
- the risks facing the relevant retailers, the future direction and quantum of these risks, and the appropriateness of **passing** through these risks to customers. For instance, because Albury gas is delivered via the Victorian transmission system, and subject to the market carriage model, Origin Energy faces unknown future risks of market uplift charges for gas, that are effectively beyond its control.
- the complexity of the relevant metering, profiling, balancing, apportionment and settlement systems, and the uncertainty with respect to the future costs of these items.

Given the uncertainties of future costs and risks described above, Origin Energy believes that the Tribunal should anticipate and allow different **constraints across different retailer areas.** Indeed, the principle of setting these constraints OR maximum price for three years ahead, albeit with a proposed review at the mid period, should be very carefully considered by the Tribunal as such an approach may be too rigid in the face of market uncertainties.

To the extent that the Tribunal proceeds with this policy, then it is appropriate that the additional risks are incorporated into the retail margin calculation,

4 Retail Margin

The Tribunal seeks comments on whether the net or gross margins should be the same for all NSW gas retailers.

It can he expected that minimum net and gross margins will differ according to the:

- Risks imposed on the retailer by the different market characteristics, as described in Section 3.
- The size of the retailer, and in particular, the size of the retailer within a given jurisdiction.
- The costs and risks borne by the distribution service provider vs the retailer in a particular area.

4.1 Retail margin and Risk Exposure

As noted previously, Albury and Murray Valley are both supplied via the Victorian transmission network and gas supply is therefore subject to the risks and benefits associated with exposure to the market carriage model.

Given that the market carriage model has only been in operation for two years, during which the market experienced both the warmest winter weather on record and a surplus of peak day supply, it is difficult to quantify the exposures under a market carriage model in the next three years. Nevertheless, Origin Energy is of the view that these risks need to be recognised in considering the appropriate level of retail margin, particularly if the Tribunal does not allow the direct pass through of these risks to consumers.

4.2 Retail Margin and Size (by jurisdiction)

While the retail sector may not be as capital intensive as the distribution businesses, it is still a relatively capital intensive sector especially where retail costs are concerned. The up front costs of implementing the systems required to operate a retail business are substantial in comparison to the variable costs associated either with customer numbers or quantity of gas sold. In addition such costs are often lumpy in respect to either time or customer numbers.

In such an environment, one can expect that the minimum gross margins required by larger retailers in a particular jurisdiction may be lower than that of smaller retailers as larger retailers will have a larger customer base and gas throughput to spread their fixed costs

across. Since the net margins are defined prior to interest charges, depreciation and amortisation, net margins too can be expected to be Lower for large retailers.

AGLRE has a retail base substantially Larger than Origin Energy's in the NSW jurisdiction. While Origin Energy has customers in other jurisdictions, the costs of operating across states are considerable, Moreover, systems and processes have to be developed to satisfy the unique regulatory and market requirements of each individual jurisdiction, thus further reducing the potential for economies of scale to transfer across jurisdictional boundaries. It will thus be inappropriate to equate Origin Energy's net and gross margins in Albury and other NSW areas to AGLRE's, either as a proportion of turnover or on a margin per customer basis. Doing so will result in Origin Energy under-recovering its return on investments/equity.

4.3 Retail Margin and Operations

Origin Energy also notes that AGLGN undertakes a very significant marketing effort, the cost of which is recovered through network tariffs. The marketing cost that the Tribunal has approved for AGLGN is equivalent to $16 per customer per year. In contrast, the Envestra tariffs for Albury recover very limited marketing costs, with a greater obligation on the retail business to promote the efficient and effective utilisation of gas.

There are other important differences between the various businesses that indicate the Tribunal should not impose a blanket decision on retail gross margins. For instance:

- Origin Energy currently reads the customer meters, and supplies the meter data to Envestra. The future trading arrangements are not yet defined, but current and future arrangements should be part of the consideration on retail margins.
- Each area is obliged to provide pensioner concessions (currently $14 per year). Different areas may have different level of obligation as a proportion of the customer base, and revenue.

4.4 Retail Margins and FRC

The Tribunal has identified that retail margins should be allowed to increase as competition becomes effective because of higher risks associated with a post-competitive environment. As noted, Origin Energy supports the recognition by the Tribunal of retail risk as part of the analysis of retail margin. However, we also believe that the risk issues go beyond those identified in the Tribunal reports. Consideration needs to be given to:

- The impact of the Retailer of Last Resort obligation on the host retailer - in the gas market, this may require the host retailer to have options on additional gas supply which come at a price to the retailer.

- The higher costs associated with the requirement for the host retailer to implement new systems and processes. Unlike the new retail entrant, the host retailer does not have a choice about providing these facilities (a new entrant can decide not to enter the market, or withdraw from the market if the system costs outweigh the benefits).
- The host retailer generally incurs obligations with respect to advising customers on FRC.
- The need to have sufficient margin above costs to supply, such that new entrants are encouraged to enter the market, and existing retailers are encouraged to enhance their services and product offerings.

5 Miscellaneous Charges

At present, miscellaneous charges applied by Origin Energy in Albury and Moama are charges that are currently unregulated in the NSW market and reflect Victorian market requirements and realities. It is once again our view chat imposing a regulatory regime to an area that is currently unregulated is fundamentally at odds with the stated aim of the market reforms that seek to de-regulate and introduce greater competition.

Closer examination of Origin Energy's miscellaneous charges will show that Origin Energy imposes charges on very few items and often these charges are below those imposed by the other NSW retailers. Such charges are also often below the cost incurred by Origin Energy and therefore form part of the cross subsidies in the market that need to be unwound prior to FRC. Origin Energy is already undertaking a review of these charges in anticipation of FRC in NSW.

In addition, such fees are often set in competition with electricity. As a result, Origin does not charge an account establishment fee as it seeks to encourage gas usage in a environment where electricity is the preferred source of energy. Origin also does not charge a disconnection fee although one is charged for reconnection. However the fee charge is below the cost incurred in disconnecting and reconnecting the customer and, as noted, such intrinsic cross subsidies must be unwound prior to FRC. Also in comparison with Origin's other revenue sources from the retail of gas in NSW, such fees make a very small contribution to its overall revenue. It is thus Origin's view that regulating miscellaneous charges is both unnecessary and unwarranted.

6 Treatment of Contestability Costs

A number of the issues associated with the treatment of Contestability Costs have been previously identified in Section 4.4. Costs associated with enabling the implementation of full retail contestability should be seen as a cost for implementing competition in the retailing of gas rather than a gas retail cost. The benefits of the introduction of

competition is experienced not just by those who exercise the choice to change retailers but also by those who choose to stay with the incumbent. One could also expect that other benefits .of a competitive environment like innovation and price reductions will flow to those who remain with the incumbent retailer as well as those who change.

Retailers who enter the market after the introduction of FRC are unlikely to face the full impact of the costs of implementing FRC which would be Largely borne by the host retailer. Accordingly, the costs of implementing contestability should be borne by beneficiaries prior to the introduction of FRC. After the introduction of FRC, it will be unlikely that the incumbent retailer will be able to recover any of these costs in competition with the new entrant retailer who did not incur them. Requiring that the host retailer recover the cost of implementing FRC within the pricing constraints set out earlier could result in the retailer not being able to fully recover these costs prior to the introduction of FRC.

The Tribunal has also correctly identified that size difference is an important factor in the cost recovery process. Smaller host retailers like Origin Energy will have to recover FRC costs from their smaller customer base compared to incumbents like AGLRE in NSW. FRC costs will thus form a significantly lager proportion of the delivered cost of gas for customers of Origin than of AGL. Requiring that FRC costs be included within the pricing constraints could well then result in Origin not being able to achieve any reasonable return for retailing gas to its customers,

The currently arrangement of including the FRC costs incurred by the incumbent retailer within the price constraints will unfairly disadvantage smaller host retailers and may force such retailers to operate at a loss prior to the introduction of FRC and possibly lead to significant cost write offs after the implementation of FRC.

An associated issue is to allow the recovery of only efficient costs as in the case of AGLRE. While this proposal is theoretically sound, it is uncertain what constitutes "efficient" costs. Where systems need to be upgraded to implement FRC, certain other systems which may not be directly required to implement FRC may also be required to be updated to be compatible with the new FRC systems. Will the additional costs incurred in these other system be included in the definition of "efficient" costs? Origin will contend that such costs should be allowed as it enables the company as a whole to promote the implementation of FRC.