01 December 2003

c/o Review of Gas Regulated Retail Tariffs
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

Dear Sir/Madam

Review of Gas Regulated Retail Tariffs – Response to Issues Paper from Origin Energy

Thank you for the opportunity to comment on the Issues Paper: *"Review of Gas Regulated Retail Tariffs – Issues Paper"* (November 2003).

Origin Energy's key continuing concern is that current tariffs in the Albury and Murray Valley regions of New South Wales are under-recovering on costs. Origin Energy cannot continue to incur losses for servicing customers in these areas.

The attached public response to the *'Issues Paper'* elaborates on these concerns and attempts to provide some assistance to the Commission in compiling a set of benchmarks with respect to Gas Purchase Costs, Retail Costs and Retail Margin.

Yours faithfully

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Origin Energy Response
to
Independent Pricing and Regulatory Tribunal (IPART)
Review of Gas Regulated Retail Tariffs Issues Paper

December 2003

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1. General Comments

Origin Energy ("Origin") welcomes the opportunity to comment on the Independent Pricing and Regulatory Tribunal (IPART) 'Review of Gas Tariffs NSW Issues Paper'.

Origin appreciates the difficulty of the task facing IPART in attempting to determine appropriate generalised benchmarks for diverse gas retail activities on the basis of limited publicly available information.

Notwithstanding this, the 'Information Request' model requested by IPART from Origin clearly demonstrates that Origin's NSW tariffs are significantly under-recovering on cost and, in line with the stated objective of IPART in carrying out this review process, should be increased to cost reflective rates.

In this response paper Origin has focused on the following key issues outlined in the IPART Issues Paper:

- the most appropriate form of regulation for regulated retail tariffs;
- the most appropriate levels of costs to be recovered;
- the most appropriate structure for retail tariffs;
- the basis upon which non-tariff charges be regulated;

These issues are addressed in detail in the following sections of this paper.

In brief, it is Origin Energy's view that in constructing benchmarks to apply to a *ring-fenced privatised gas retailer*, operating in the Albury and Murray Valley NSW regions, for servicing deemed and standing offer customers, it is ***critical*** for IPART not to underestimate:

- the true gas purchasing costs;
- gas retail operating costs;
- the retail margin required by shareholders as an appropriate return for risk.

Such a balanced view must go beyond theoretical benchmarking exercises to consider the actual costs facing the businesses and the requirements of equity owners for a fair return on capital investment.

Origin is also concerned about how the benchmark cost ranges will be interpreted and used. It is important that these benchmarks are viewed in such a way that encourages the development of competition and security of gas supply for Origin's regulated retail gas customers in Albury and Murray Valley NSW.

From an overall perspective, Origin concurs with IPART's view that it is essential for regulated retail prices to move to cost reflective levels for all small retail customers in the Albury and Murray Valley regions in NSW. However Origin notes that the previous price path determination has not brought prices to cost reflective levels. Origin believes that a price re-set to cost reflective levels in 2004, followed by the introduction of a smooth cost reflective price path to 2007, is the only realistic way of insuring:

- price stability and a protection against future or prolonged price shock;
- protection of the long term price, quality and reliability of the gas services provided by Origin to it's regulated retail customers in Albury and Murray Valley NSW ;

- efficiency in the gas industry and the incentive for efficient long-term investment;
- effective competition and promotion of competitive market conduct where customers are able to choose their retailer and the best product suited to them;
- the future financial viability of the gas industry.

This strategy is in line with IPART's stated objective of balancing the interests of consumers and retailers and in Origin's opinion represents the best solution to the current problem where existing tariffs significantly under recover in the Albury and Murray Valley NSW regions.

2. The most appropriate form of regulation for retail tariffs

The Tribunal seeks comment on what form of regulation will best assist the Tribunal in meeting its objectives of moving all regulated tariffs towards cost reflective levels without exposing customers on under recovering tariffs to unacceptable price shocks.

Origin's regulated tariff customer base in the Albury and Murray Valley NSW regions currently has a majority of customers paying prices that are significantly lower than the cost Origin Energy incurs to supply these customers.

Current Situation

A detailed breakdown on costs and margins are provided to IPART in confidence.

The below example shows the current EBIT for Origin Energy customers in Albury and Murray Valley NSW.

EBIT Margin for Residential customers in Albury

Figure 2.1.

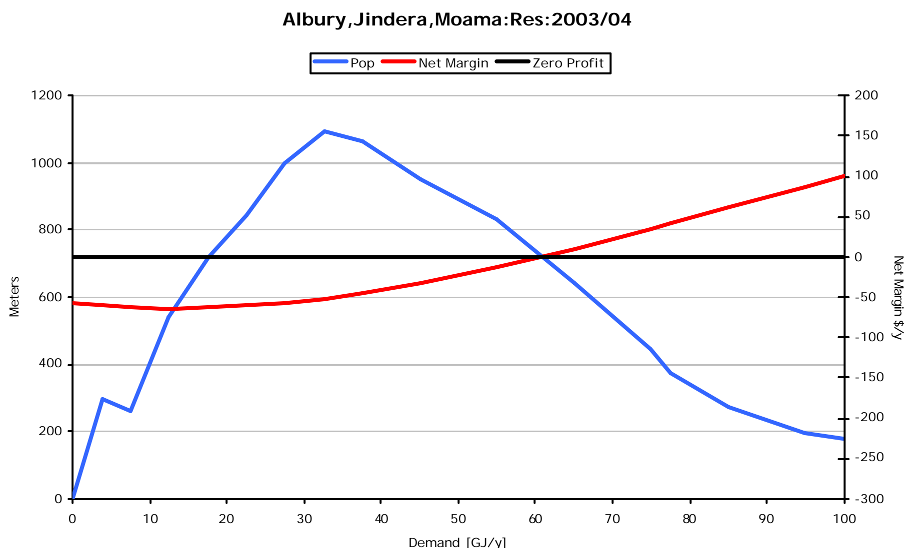


Figure 2.1 shows the net margin of current residential customers in the Albury region on current 2003/04 revenue tariffs. It is readily apparent that for the vast majority of these customers are generating little or no EBIT (red line).

Figure 2.2

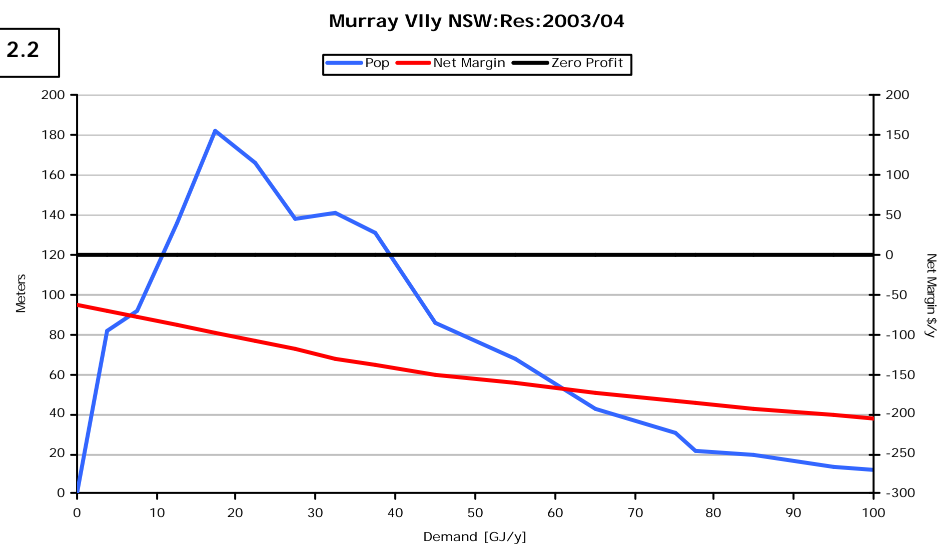


Figure 2.2 shows that in the Murray Valley NSW region the situation is even worse. It can be seen from Figure.2.2 that the EBIT margin for the vast majority of current residential customers on 2003/04 revenue tariffs is considerably negative.

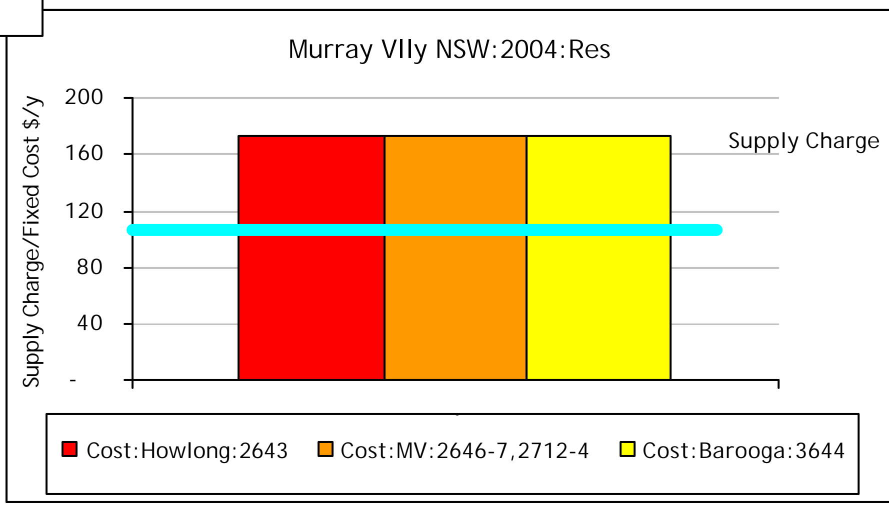
Why is this the case?

Using Murray Valley as an example, the graphs below (2.3 & 2.4) highlight that, for the majority of customers, on current tariffs in NSW are:

1. ***Not recovering at the fixed cost level (Gst exclusive)***

Figure 2.3 Clearly the residential customers in Origin Energy's Murray Valley NSW region significantly under-recover on fixed costs. Appendix 1 shows that this situation exists for each Origin Energy tariff in both the Murray Valley NSW and Albury regions. Clearly this is a major burden for Origin Energy, as the retailer, who is committed to meeting these fixed costs even though the fixed component of the revenue tariff does not recover fully recover these costs from customers. Further, for the majority of customers, the variable component of the revenue tariff is also under-recovering against cost and thus this fixed cost is never recovered from these customers.

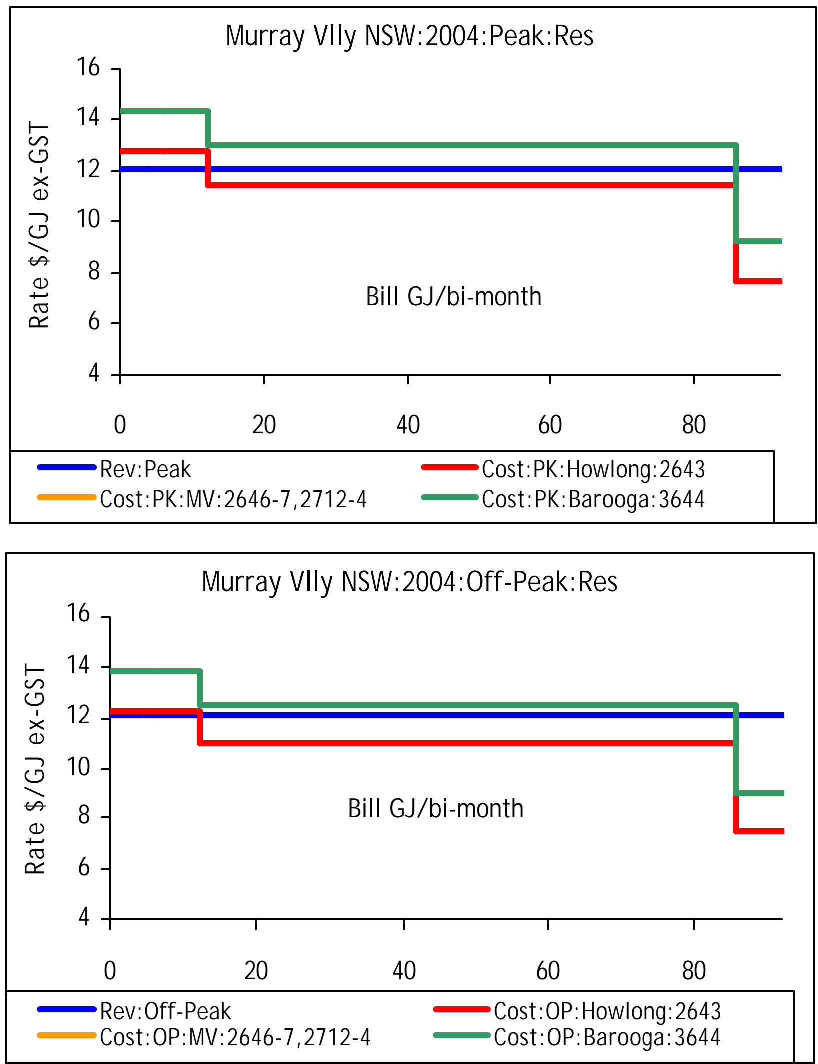
Figure 2.3



2. Not recovering at the variable cost level.

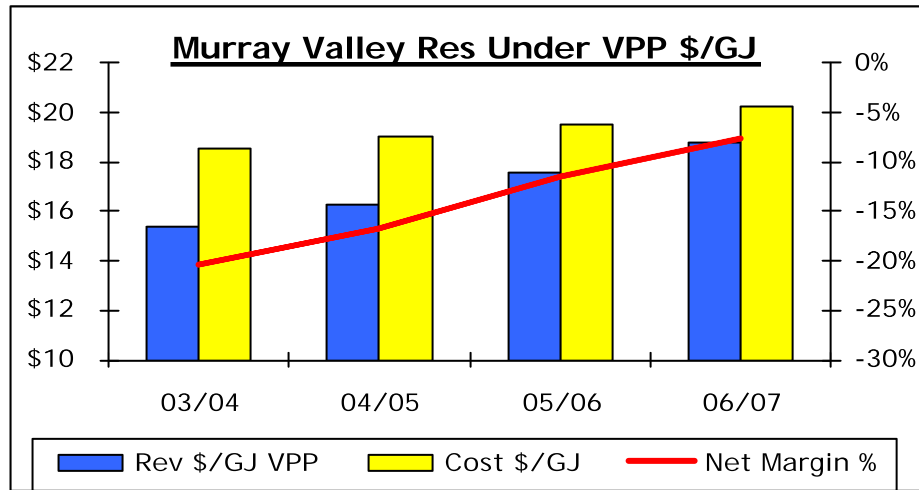
As mentioned previously the cost recovery across the tariff is made worse by the fact that the variable rates also substantially under-recover relative to costs in the majority of cases. Not only does this mean that fixed cost recovery is never achieved for the majority of customers but also that these losses are increasing as customers consume gas on the variable rates.

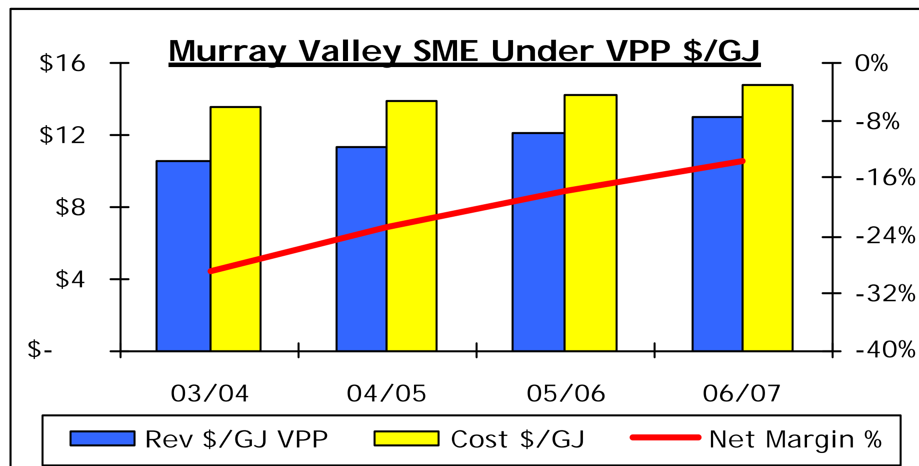
Figure 2.4



It is worth noting that this situation exists despite some rebalancing within the IPART rebalancing controls imposed on Origin Energy via the last VPP and recent interim decisions by IPART. If Origin were to use the same price path and rebalancing constraints to 2007, the issue of revenue tariffs under recovering on cost would still exist for the majority of customers in 2007.

Figure 2.5





These graphs (2.5) show that adopting a simple price path approach (CPI path) in tandem with price constraints for Origin Energy customers in Murray Valley region of NSW will not correct the issue of Origin Energy revenue tariffs significantly under-recovering costs for these regions. Origin cannot continue to suffer losses on these customers.

Origin Energy notes that in the Issues Paper IPART states '*in some cases, price constraints may mean that regulated retail tariffs will not reach cost reflective levels by June 2007*'. Origin Energy tariffs in the Albury and Murray Valley regions in NSW fall into this category.

The IPART Issues Paper goes on to state that 'it *may be appropriate that the Tribunal considers setting retail tariffs for new customers (or new connections) at cost reflective levels. This would mean however that similar customers in the same area would be on different tariffs*'. It is worth noting that customers in similar areas to Origin Energy in NSW are already paying different prices. Origin Energy has compared the annual charge for gas supply faced by our residential customers under current prices with the annual charge (for the same annual volume) facing customers on current 2003 standard supply tariffs for AGL Retail and for Country Energy. The total annual charge for Origin Energy's residential customers is consistently less than the annual charge for gas supply from the other two NSW gas retailers for comparable populations.

The table below includes a comparison of the annual gas bill paid by residential customers based on gas supply tariffs for 2003 for Origin Energy, AGL Retail and Country Energy (Wagga Wagga).

	Origin Albury & Moama	Origin Murray Valley	AGL Tariff 1	AGL Tariff 2	AGL Tariff 3	Country Energy (Wagga) General	Country Energy (Wagga) Hot Water
Small (15 GJ/year)	229	292	348	347	354	289	286
Medium (45 GJ/year)	514	654	754	737	712	587	576
Larger (75 GJ/year)	806	1017	1160	1125	1076	885	866

Notes:

- All relevant retail tariffs as applicable as from 01.07.03 using the same consumption profiles fro each retailer.

It is clear from the table that Origin's prices are significantly lower than it's competitors. However, Origin does not consider setting differential prices at cost reflective levels for ***new customers only*** to be a solution to the current issue of under recovering tariffs. As was demonstrated above, (Figs 2.1 & 2.2), such a pricing strategy not solve the issue for the majority of current customers going forward. Further, implementing such a strategy in our IT systems would be complex and costly.

Origin Energy is a commercial enterprise that has a responsibility to deliver appropriate returns on investment to it's equity shareholders. It has been demonstrated above that the vast majority of the current customer base in NSW are incurring substantial losses for Origin. It has been shown that at nearly every level of the retail revenue tariff Origin Energy is under-recovering costs from the vast majority of customers. It has been shown that adopting the price path to target tariffs approach combined with rebalancing constraints applied in the past have not solved the problem and will not solve the problem moving into the next VPP. Other gas retailers in NSW may have profitable customers to offset these losses or some of the associated costs, but Origin does not.

It is for these reasons that Origin Energy is firmly of the opinion that retail tariffs in NSW need to be reset in a one-off adjustment in 2004 to meet the Tribunal's objective of achieving cost reflective tariffs for all Origin customers.

After this one-off re-adjustment, it will then be possible to adopt a future price path using the IPART suggested method of *'replacing all existing constraints with CPI –X'*. This, in Origin's opinion, would represent a sound basis for future regulation. This approach could be used to reflect adjustments to Access Arrangements, negotiation of new supply contracts or renegotiation of existing supply contracts. Most of the costs associated with gas retailing in NSW are linked to CPI movements year on year. Adopting the approach outlined above would allow IPART to adopt a light handed approach to regulation and let market forces self regulate a competitive market.

This in turn would provide customers with:

- greater price stability and a protection against future or prolonged price shock;
- protection of the long term price, quality and reliability of essential services provided by the gas industry;
- efficiency in the gas industry and the incentive for efficient long-term investment;

- effective competition and promote competitive market conduct where customers are able to choose their retailer and the best product suited to them;
- the future financial viability of the gas industry.

3. What are the appropriate levels of costs to be recovered?

The Tribunal seeks comment on the most appropriate treatment of the various cost components to ensure that retail charges are at, or close to, cost reflective levels for all small retail customers by 2007.

3.1 Wholesale Gas Costs

Origin understands from section 4.2 of the IPART Issues Paper that IPART intends to set an industry benchmark to determine a cost of gas number for the current regulatory review.

From 2004 onwards, virtually all gas supplied by Origin to customers in the Albury and the Murray Valley towns comes from our Victorian gas supply contracts, shipped via the Principal Transmission System (PTS) in Victoria, and also via the Murray Valley transmission pipeline (for most of the Murray Valley customers).

Therefore, as a first principle, Origin's costs cannot be set on the same benchmarking exercise as retailers whose gas is supplied from the Cooper-Basin fields.

Origin is cognisant that benchmarking the gas purchase costs for Albury and Murray Valley NSW is made difficult because of the confidentiality of the legacy supply contracts, the lack of published data on bilateral market contracts and the unique characteristics of the Victorian gas wholesale market. IPART recognises in the Issues Paper that '*there are a number of difficulties with using spot market prices in Victoria to estimate the underlying contract price of gas for a retailer in NSW*'. Origin firmly agrees with this statement and would like to further state that to rely on historical Victorian spot market analysis to assess a retailers' gas purchase costs would be committing a serious error.

Using spot market prices as a benchmark

In determining electricity costs for electricity retailers, regulators in Australia have NOT relied on the electricity spot market prices. Regulators have accepted that the retailers' costs are based largely on the cost of a portfolio of physical and financial hedge contracts and that any significant reliance on spot market purchases would threaten the financial viability of the company.

Assessing benchmark gas purchase costs by reference to the gas spot market prices is equally inappropriate. No major gas retailer would rely on the gas spot market to cover their gas portfolio and, for instance, only around 8% of gas is "traded" in the Victorian gas spot market. Like electricity retailers in Victoria, gas retailers rely on a mix of physical and financial hedges to manage their market exposures.

Thus, the spot market price of gas is only one indicator of one component of the gas retailers' supply portfolio. Origin refers IPART to our November 2002 submission to the Essential Service Commission in Victoria (ESC), where we discuss in detail why the spot market price does NOT reflect the aggregate costs of a retailer's portfolio of supply contracts.

The prudent retailer

If IPART wishes to use a benchmarking approach to determine a fair and reasonable gas purchase cost, then the benchmarks should be based on the wholesale market contracting activity of a financially "prudent retailer" with an obligation to supply customers on a "firm supply" basis in a 1 in 20 cold year. (This is an Office of Gas Safety obligation).

While the contract portfolio for a gas retailer is made up of physical rather than financial hedges (limited liquidity in the financial market), we see no reason why the Commission's approach to benchmarking gas purchase costs for a 'prudent retailer' should differ in principle from that adopted for electricity cost benchmarking in Victoria.

The portfolio of physical contracts will include the following, each of which will have different contractual features such as deliverability, ramp-rate[1] and take-or-pay conditions such as:

- Base load contracts providing contracted supply on most days of the year;
- Peak demand contracts (covering days of high demand);
- Uplift contracts (covering exposure to intra-day uplift charges for uncontrollable market events).

Origin strongly recommends that IPART refer to these market based contract prices in their benchmarking study. To assist this process, Origin has provided some published and unpublished market based prices (below and also provided in confidence to IPART)

In establishing '*an appropriate benchmark for cost of gas going forward*', IPART will need to take into account the market contract prices for products required by any retailer operating a retail gas business in Albury and Murray Valley NSW. Moreover, IPART will need to fully consider the impact of the price of VoLL in the gas market when assessing the strategies of a prudent gas retailer.

The price of VoLL in the Victorian gas market is $800/GJ per day (i.e. $800 for every GJ of demand on that day). The major Victorian mass market retailers would face potential exposures in excess of $250M for a VoLL day on their mass market volumes, if they had no commensurate physical or financial contracts. While the gas market has never risen to VoLL in the last four years, the prudent retailer must ensure the company is not exposed to such an event[2] in the future.

The retailers' legacy Gascor contracts provide a physical hedge for some 70% to 80% of peak demand. The remaining peak demand must, however, be covered by additional physical hedge contracts at much higher rates. Even a small change in the availability of contracted gas on a peak demand day at VoLL prices would lead to huge financial exposure for a retailer such as Origin Energy in NSW.

These risks, and the costs to a prudent retailer to mitigate these risks, must be recognised as part of the benchmarking study. Origin's concerns in this regard may be better understood by

[1] Ramp-rates refer to the time by a producer/supplier to increase the rate of flow from the processing plant into the pipeline system. Hedging for intra-day events require contracts with high ramp rates which can respond to VENCorp's directions within a few hours.

[2]However, the market incident on the 22 July 2002 indicated the potential for such prices with a combination of a very cold day and interruption to interstate electricity flows – only VENCorp's intervention in the market stopped the price (or uplift charges) escalating.

considering the outcome for all the gas industry participants if the retailer were to purchase gas ONLY. The possible outcomes of such a strategy are summarised below:

- The retailer would not purchase new sources of gas or peak demand contracts, as the contract costs will exceed the "allowed" benchmark;
- The spot market price would be considerably more volatile;
- The retailer(s) would face unmanageable exposures to market uplift charges in the event of a forecast error or capacity constraint;
- The retailer(s) would face a high risk of insolvency from spot market exposure or uplift charges;
- The community would risk significant interruptions to gas supply;
- Investment in gas fired generation would be limited by lack of development in alternative gas supplies and spot price/uplift costs volatility;
- Vencorp's capacity to manage the market in an effective an efficient manner would be impeded;
- New retail entrants would not be able to enter the market, at least for mass market customers, as the "regulated prices" would be well below the new entrant cost of supply for these customers;
- Investment in both new base gas supply fields and "peak capacity" fields would be significantly at risk to the long-term detriment of all.

The Benchmark Outcome

As a result of using an inappropriate benchmarking approach that ignored the realities of gas purchasing, the ESC in Victoria came to the conclusion in its Final Decision in December 2002 that a reasonable benchmark range for purchasing gas in 2003 (including a UAFG allowance) was "*between $3.03 and $3.15 per GJ*" (referred to in section A2.2 of the IPART Issues Paper). In December 2002, TXU, AGL and Origin all indicated to the ESC that this benchmark range significantly underestimated the actual gas purchase costs. Subsequent reports by CRA[3] and VENCorp in Victoria, further highlight the issues raised by the retailers. (see *www.vencorp.com.au/docs/Gas_Transmission/Transmission_Planning/APR%202002.pdf*)

Publicly available information on market prices for MDQ, such as the price of Western Underground Storage (WUGS) gas is available on *www.txu.com.au/trading/gasstorage.asp.*

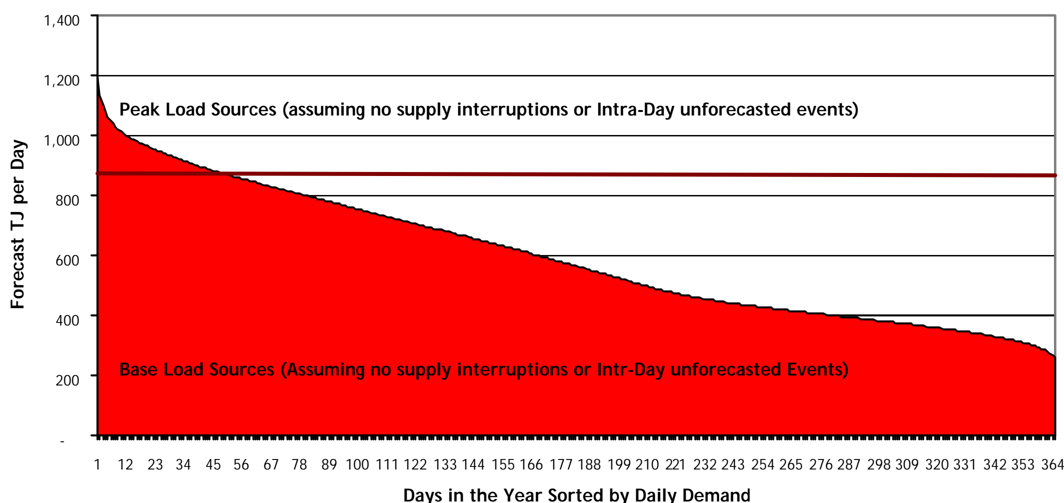
Origin provides a further summary below of both public and commercially confidential information on market prices for MDQ. We note that the price of MDQ contracts for 2004 appears to have increased in the last few months, signalling a tightening of this market. This is consistent with more recent base load contracts on the market which have lower deliverability than the Gascor contracts, thus requiring retailers to obtain additional peak supplies to match their portfolio.

- WUGS published rate for peak supply gas: $120/GJ/MDQ
- WUGS published rate (from October 2003): $150/GJ/MDQ
- Duke Vic Hub: provided to IPART in confidence
- Esso/BHPP MDQ offer (2003): provided to IPART in confidence

[3] E.g. CRA Report: "*Electricity and Gas Standing Offers and Deemed Contracts (2003)*", December 2002

The following chart uses data from VENCorp.
(see:\www.vencorp.com.au/docs/Gas_Transmission/Transmission_Planning/APR%202002.pdf)

Load Duration Curve for Total Victorian Market
(excluding Generation, Interstate Exports & WUGS injections)
VENCorp: 1/20 Forecast 2004



Source: *http://www.vencorp.com.au/html/index.htm. "Load Duration Curves '1 in 2' and '1 in 20' 2002-2007".* February 2002.

VENCorp also acknowledges that in addition to the peak supply gas required to meet peak demand, additional high ramp-rate gas contracts are required to supply the market in the event of an intra-day event. Such events trigger uplift charges in a daily priced market, and can rapidly escalate. Again, the prudent retailer must put in place appropriate risk management strategies via physical contracts or financial tools, and the costs of these should be recognised by the Tribunal.

Fees and Charges associated with Gas Purchasing

There are a number of other costs associated with operating in the gas market to supply customers in Albury and Murray Valley NSW regions. We believe the majority of these costs are readily identifiable and must be included in the assessment of gas retail price. They include: provided to IPART in confidence

Risk Mitigation Costs for a Prudent Retailer:

IPART must also take account of the other costs incurred by a prudent retailer in managing exposure to various risks more indirectly linked to the Victorian gas spot market. These risks include CPI exposure on the base contracts, peak injection day risks; load profiling and settlement risks, portfolio mismatch and congestion uplift (self) "insurance" risk. Further detail provided to IPART in confidence.

Recommended Benchmark Range

Recognising that IPART faces a number of issues in determining the benchmark ranges, Origin provides the following recommendations for benchmarking gas purchase costs that reflect our analysis of the requirements of a prudent retailer.

Gas Purchase Cost Component	Range	Explanation
Base 2004 "gas purchasing cost"	$3.12 to $3.25	As per the ESC's Consultation Paper based on weighted average spot market price for 2003 plus 4% increase.
Add fixed charges, risk management & other contract changes	$XX	Additional costs provided to IPART in confidence.
Add capacity (MDQ) contracts	$XX	Additional costs provided to IPART in confidence.

Notes:

1. All prices are exclusive of GST
2. Gas purchase costs exclude regulated charges (DUoS, TUoS, VENCorp, FRC) but include UAFG on gas purchases.

3.2 Network Costs

Network Costs are made up of Distribution and Transmission Charges ***and FRC Charges***. The IPART Issues Paper states that *"the Tribunal will begin an assessment of network access arrangements for NSW gas distribution service providers in early 2003" (page 10).* This is not the case for Origin Energy.

Origin Energy is subject to the distribution and transmission costs outlined in the table below.

Distribution			
	Tariffs Used FOR 2003	**Tariffs Approved by**	**Price Path Used to 2007**
Albury	Published Envestra Albury Tariffs	ESC	CPI-1
Jindera	Published Envestra Albury Tariffs	ESC	CPI-1
Moama	Published Envestra North Tariffs	Uncovered	CPI-0
Howlong	Published Murray Valley NSW Tariffs	Uncovered	CPI-0
Murray Valley NSW	Published Murray Valley NSW Tariffs	Uncovered	CPI-0
Transmission			
Albury	Woodonga for 2640 & 2641,	ACCC	CPI-3
	Interconnect for 2642	ACCC	CPI-3
Jindera	?	ACCC	CPI-3
Moama	?	ACCC	CPI-3
Howlong	Interconnect for 2643	ACCC	CPI-3
Murray Valley NSW	Murray Valley NSW	ACCC	CPI-0
Network FRC			
Albury	Published FRC for Envestra Albury	ESC	0
Jindera	Published FRC for Envestra Albury	ESC	0
Moama	Estimated based on Albury FRC rates	Agreed with IPART	0
Howlong	Estimated based on Albury FRC rates	Agreed with IPART	0
Murray Valley NSW	Estimated based on Albury FRC rates	Agreed with IPART	0

DUOS FRC costs are reviewed annually by the ESC and adjusted in line with actual costs for the previous years. Envestra anticipate higher than CPI increases for 2004, possibly up to 20% increase; this will be determined by mid-December 2003.

Both Envestra, for distribution, and Gasnet, for transmission, are required to submit tariffs each year for approval to the relevant regulator, in accordance with their respective Access Arrangements.

Origin Energy has used the approved price path for each of these arrangements to forecast distribution and transmission charges from 2004 to 2007. The exception to this is Howlong, Moama and Murray Valley NSW Network FRC costs which have been estimated based on Albury Network FRC rates as agreed with IPART.

3.3 Retail Operating Costs

IPART has cited a number of 'retail operating cost' benchmarks from various states and markets stretching from 2000 to 2003. Origin Energy notes that IPART has ignored the cost to serve published for the most relevant and geographically closest region to Origin Energy's Albury and Murray Valley NSW customers in 2002 – that is the $90 from the CRA study carried out for the Department of Infrastructure in Victoria in late 2002. More recent studies such as the ACT ICRC study in May 2003 and the ESCOSA study in October 2002 put the cost to serve figure at $85 and $80 respectively. Origin's own studies have indicated that the cost to serve number is much higher than this when all appropriate costs are taken into account.

It is important to note that, if the Tribunal proposes to rely on benchmarking to determine a 'retail operating expenditure figure' for Origin Energy customers in Albury and Murray Valley NSW, the Tribunal needs to be thorough in it's investigation of what is included in each particular benchmark. For example are bad debt and debt management costs included in each benchmark? How are retailer operating costs such as ombudsman's fees, depreciation or gas trading costs (such as gas contract management, risk management, weather forecasting, demand forecasting and market operations) to be treated?

For benchmarking to be reliable, it is imperative that consistent definitions be used, otherwise IPART is not comparing like with like. Our experience in benchmarking is that unless all retailer applicable operating costs are included in the "cost to serve", the proposed retailer margin cannot be accurate.

None of the benchmarks quoted by IPART have clear definitions of what costs have been included or excluded. Origin Energy therefore questions their validity. Moreover, we continue to be concerned with the trend for regulators to assess retail cost benchmarks largely based, it would appear, on cross-referencing with other state regulators rather than recognising a retailer's actual retail costs or referencing to independent studies on retail costs. This circular referencing between regulators becomes a self-perpetuating "answer" to the benchmarking problem.

Origin Energy's commercial assessment of it's NSW energy business shows that costs related to retail operations are more likely to be over $100/customer - significantly higher than those quoted by IPART in the Issues Paper.

Origin Energy is not a "stapled" retail/distribution business and therefore does not have the opportunity to allocate costs to a network business that is not subject to substantial competition, nor has it the opportunity to gain economies of scale through sharing of overheads between the businesses. The implication is that, a stand alone retailer such as Origin Energy, has a higher cost benchmark than that of a "stapled" retailer/distributor. The IPART report does not appear to have made this distinction for Origin Energy.

The operating costs in gas retailing move largely in line with CPI – the largest component of cost is labour. Associated development/changes in market rules, retail codes, privacy legislation, and compliance have added to the customer management process and increased retailer costs. IPART should consider as a minimum, CPI increases year on year to the cost to serve benchmark to cover the increased cost to retailers.

In summary, it is Origin's considered view, that retailer costs when appropriately identified and allocated (including FRC recovery, depreciation and amortisation) would be around $XXX to $YYY *[relevant range provided on a confidential basis]*.

3.4 Retail Margins

The IPART Issues Paper proposes a retail margin benchmark for gas retailers of 1.5% to 2.5% of energy sales before interest and tax. The Issues Paper also contains a table (Table A3.3) of retail profit margins for gas and electricity allowed by various regulators in different states stretching back to 2001. As with the cost to serve benchmarking exercise this table does not precisely define in accounting terms what constitutes a "retail margin" and what costs are included or excluded. This is critical to not only allow a comparison of the proposed retail margin to benchmark data but also to be able to calculate whether the proposed retail margin is sufficient to provide a return to investors for the capital employed. It is our experience that EBIT is the best definition for a "retail margin" benchmarking. Unless the definitions are clear, the Commission is comparing "apples and oranges".

We would also like to re-iterate our comments regarding the validity of the benchmarks referenced by IPART and that these retail profit margin benchmarks are largely based on circular cross-referencing with other state regulators rather than recognising actual retail profit margins or referencing independent studies on retail profit margins.

Origin Energy contends that IPART should clearly define the retail margin for operating a gas retailing business as EBIT and that this includes all applicable costs of running such a business (eg bad debts, credit, depreciation and amortisation should not be excluded[4]).

Further, Origin strongly contends that the "profit margin" proposed by IPART is far too low. As noted earlier in this document, Origin Energy is a commercial enterprise that has a responsibility to deliver appropriate returns on investment to it's equity shareholders. Origin Energy is firmly of the opinion that such poor returns, as proposed by IPART, would encourage investors to exit the industry.

Additionally, the revenues and margins of gas retailers are very exposed to uncontrollable events such as the weather; this exposure cannot be hedged at reasonable cost in Australia. This volatility in revenue streams must be recognised in the retail margin or as in the case of retail electricity as a risk premium in the cost of energy.

Origin suggests that the long term retail "profit margin" benchmark should be in the order of 5% to 10%, depending on the costs included in the Retail Operating Expenditure. If an EBIT including all appropriate operating costs is used to equate to "profit margin", then we believe that 5% EBIT/Revenue would represent the minimum acceptable "profit margin" for Origin Energy.

[4] Essential Services Commission (November 2003): *Special Investigation – Establishing gas retail cost benchmarks*, Consultation Paper.

3.5 Other Costs

IPART in its Issues Paper refers to NEMMCO and Gas Market Company (GMC) costs as a direct pass through on a retailer specific basis. Origin Energy is liable to pay published Vencorp tariffs and Vencorp FRC rates for it's customers in Albury and Murray Valley NSW and as such these costs, and their escalation year on year, should be passed through to customers.

4 What is the most appropriate structure for Regulated tariffs ?

The Tribunal seeks comment on the structure of regulated retail tariffs, including whether an inclining block structure is a proxy for cost reflectivity and the implications of allowing more complex price structures for the objective of rationalising the number of regulated tariffs.

Origin Energy is firmly of the opinion that it's regulated gas tariffs should reflect the underlying costs of supplying energy to it's customers. For standard regulated gas contracts being offered to it's customers in Albury and Murray Valley NSW this means a tariff structure which has a fixed component and variable stepped components that as closely as possible mirror the underlying fixed and variable costs. It is worth pointing out once again that the current tariffs for the vast majority of Origin Energy customers in Albury and Murray Valley NSW are significantly under recovering for both the fixed and variable components of the tariff (refer graphs 2.1 & 2.2). The application of a price path with constraints as used by IPART in the past will not solve this problem for the majority of customers. Only a once off re-set will deliver cost reflective tariffs and greater price stability going forward.

5 What non-tariff charges should be regulated?

The current retail regulatory arrangement for gas has fixed non-tariff charges through the Voluntary Pricing Principle (VPP) mechanism. Existing VPPs require that non-tariff charges may only be varied with the Tribunal's prior agreement.

Typically, eleven different charges are listed, and include both retail charges and network charges. While Origin's current VPP does not include non-tariff charges, it is anticipated that these charges will be included in Origin's next VPP, consistent with the Tribunal's approach in the VPPs agreed to by AGL Retail Energy and Country Energy.

The anticipated non-tariff charges for Origin's next VPP are listed below. They are based on the guiding principle that a retailer should be able to recover the fair and reasonable costs of additional services, including administration costs associated with third party charges.

When network operators carry out non-tariff services on behalf of a customer, the retailer incurs the network non tariff charge, before then passing it onto the customer. Managing this transaction imposes additional costs on the retail business, particularly in deregulated markets where separated retail and network businesses have new obligations, and customers greater service expectations. It is worth noting that the Network companies bear no credit risk for these charges, this risk is passed to the retailers and must be managed by the retailers.

While complete data on the incidence and cost of the different types of charges incurred by Origin's NSW customers is not available at this stage, passing through this administrative expense is an important consideration in reaching cost reflective pricing.

To maintain cost reflectivity, Origin would seek the option to apply an annual CPI adjustment to both the administration component of network charges and all retail charges. Network charges would remain a straight pass-through, but are expected to increase by CPI.

Recommended distribution charges (incl GST):

Network Charges	**Envestra Charge (as at November 2003)**	**Recommended Retail Admin Charge**	**Annual Adjustment (Jan each year)**
Meter Testing Fee	$139.70	20% or max $20.00	CPI
Special Meter Read	$7.70-$10.29	20%	CPI
High Bill Field Visit	$139.70	20% or max $20.00	CPI
Disconnection	$35.20	20%	CPI
Reconnection	$46.20	20%	CPI
Network Disconnection Fee	$88.00	20%	CPI

Source: Envestra VIC Access Arrangement

Recommended Retail charges (incl GST):

Retail Charges	**Existing Charge**	**Anticipated Retail Charge**	**Annual Adjustment**
Account Establishment Fee	$0.00	$30.50	CPI
Collector Call Fee	$0.00	$30.00	CPI
Late Payment Fee	$0.00	$5.00	CPI
Dishonoured Payment Fee	$11	$22.00	CPI
Security Deposit	$0.00	$80.00	CPI

Source: Origin Energy