origin

Submission to the
Independent Pricing and Regulatory Tribunal
on the
Review of regulated gas retail tariffs
and charges from 2010 to 2013

December 2009

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1. Introduction

Origin Energy (Origin) is the standard retail gas supplier to over 20,000 small customers in the Albury/Moama and NSW Murray Valley districts as well as being a new entrant gas retailer in other areas of the New South Wales (NSW) gas market.

Origin recognises that the Minister for Energy in NSW (Minister) has requested that the Independent Pricing and Regulatory Tribunal (IPART) regulate standard tariffs for small retail gas customers for the period from 1 July 2010 to 30 June 2013 under section 27 of the *Gas Supply Act* 1961.

Given this constraint, Origin therefore welcomes IPART's proposal within its *Review of regulated retail tariffs and changes for gas 2010 – 2013: Issues paper* (Issues Paper) to continue to regulate gas retail tariffs through the use of voluntary transitional pricing arrangements (VTPAs) with each of the Standing Retailers. Origin believes that the setting of VTPAs is a relatively light-handed regulatory model and it is appropriate for IPART to continue with this approach. Origin expects that this will be the last regulated price period before price deregulation can occur following an AEMC competition review in 2011.

Origin notes that IPART has identified the major future changes to the energy market that will potentially impact on gas costs including the:

- planned introduction of a Carbon Pollution Reduction Scheme (CPRS);
- expansion of the mandatory renewable energy targets (RET);
- growth in gas fired electricity generation;
- development of Liquid Natural Gas (LNG) processing; and
- the network determination of gas distribution networks in NSW by the Australian Energy Regulator (AER).

In order to ensure these changes do not have any unexpected negative consequences on the cost reflectivity of the regulated tariffs and hence competition, Origin supports the final VTPAs providing:

- for direct pass-through of distribution network costs;
- the flexibility for Standing Retailers to pass-through the costs attributable to a CPRS when it is introduced and the costs can be clearly estimated;
- customers and IPART with a level of certainty as to the likely tariff increases; but also
- the ability for Standing Retailers to pass-through any significant cost changes to account for future developments.

Origin notes that its draft VTPA includes the necessary mechanisms to meet these requirements including the removal of distribution network costs from the VTPA formula.

2. IPART Approach

1.	**Do Voluntary Transitional Pricing Agreements (VTPAs) continue to be an appropriate form of regulation for the Standard Retailers' regulated retail gas tariffs, given the objectives and context for this review? Are there enhancements that can be made to the current approach?**
2.	**What (if any) other forms of regulation should we consider?**

Origin's standing position is that deregulating retail prices is a priority in accordance with the commitments made by all energy ministers under the Australian Energy Market Agreement (AEMA).

However, given that price regulation will continue for at least the next three years, Origin supports the continuation of the VTPA approach.

Origin believes that the VTPA set by IPART for the period July 2007 to June 2010 was a relatively light-handed regulatory model that was appropriate for that stage of the development of the market and should continue.

3.	**Is there adequate information available for customers to make informed choices when choosing a gas supplier? If not, what measures could be implemented to address this?**

It is necessary to understand that energy is a low involvement product so customer awareness of energy retailers is not vital but more that consumers can find information on energy products when they actually need it. Origin believes that customers seeking energy products are to access specific information from various energy retailers with little difficulty once they have decided to act.

Access to the internet is obviously an important factor in enabling customers to easily compare prices and offers.

Energy retailers have also individually addressed the need to provide clear and accurate information to consumers through their marketing collateral which highlights:

- the price components of a market contract; and
- the key terms and conditions that the consumer should be aware of under the contract.

Further to this, retailers such as Origin are always seeking to improve customer service including research on how best to present information to customers and consistently uses this information to implement changes to its approach as required.

4.	**Are the proposed assessment criteria appropriate to guide our analysis and decision-making for this review?**

Origin believes that the criteria suggested by IPART in its Issues Paper are appropriate.

Origin would highlight that a common failing of price regulation in recent years has been that in the process of regulating prices that recover the efficient cost of supply, the uncertainty in predicting future costs has been underestimated resulting in regulated prices that do not cover actual efficient costs. This has naturally had a detrimental impact on retail competition.

Origin acknowledges that IPART's VTPA approach may minimise this risk but would suggest that IPART's review and approval be cognisant of this risk.

3. VTPA Proposals

For this draft VTPA, Origin has proposed that:

- Origin's default retail prices are to be subject to the agreement for a 3 year period from 1 July 2010 to 30 June 2013;
- Prior to the introduction of a CPRS, the retail tariffs are to be comprised of a:
  - retail component (R) including the cost of gas, wholesale market related costs, transmission costs and retail operating costs and retail margin; and
  - network component (N) being all the regulated charges levied by a distribution network operator.

Origin proposes that the VTPA will regulate changes to the retail component and allow full and direct pass-through of distribution network charges.

As indicated by IPART, Origin has submitted a draft pricing proposal that the retail component be regulated by a weighted average price cap (WAPC) of a CPI + 1%. Origin would assert that this proposal is accurate for the purposes of determining the price path over the period.

However, this constraint will not be satisfactory for 2010-11 as IPART will determine when it examines Origin's customer information. The reason being that in the last years of the current VTPA, distribution charges to the Albury and Murray Valley have increased in excess of that allowed within the VTPA. This has meant that the retail component of Origin's current retail tariffs has diminished and is no longer cost reflective. Simply removing the network component does not rectify this impact and the retail component will need to significantly increase for 2010-11 to be cost reflective. The retail component will then follow the CPI +1% price path to reflect changes in energy and retail costs.

5. Do stakeholders consider that the Standard Retailers' proposals are reasonable in general? Are there any specific issues or individual components of the proposals that stakeholders wish to comment on?

Origin welcomes any comment form stakeholders on both the framework and quantum of its VTPA proposal.

4. Weighted Average Price Cap (WAPC)

6. Does a WAPC best meet the objectives for this review? Are there enhancements that can be made to the current approach?

7. Is there any evidence to suggest that a WAPC is inappropriate? Are there other approaches to setting retail tariffs that IPART should consider?

Origin agrees with IPART that a WAPC approach is the best approach under the VTPA

Origin has only a small number of regulated tariffs within the Albury and Murray Valley regions applying to a small number of customers and therefore has previously applied the average price constraint evenly across these tariffs.

With the unwinding of distribution network charges from the VTPA, Origin will need to further restructure individual tariffs to better reflect the underlying costs over time.

Origin therefore feels that it is not appropriate to impose an additional side constraint on individual tariffs as it may hinder moving tariffs to cost reflectivity and agrees with IPART that it is against the objectives of reducing customers' reliance on regulated tariffs and improving competition.

Origin believes that consumers will be protected sufficiently by the average price constraint.

5. Risk Mechanisms

Origin supports IPART's premise that all appropriate costs and risks need to be accounted for within regulated prices set under the VTPAs and that risks and costs outside of a retailer's control need to be addressed through additional regulatory mechanisms. For this reason, Origin's has proposed changes to its current VTPA to better handle the impact of uncontrollable costs such as:

- distribution network charges;
- CPRS or climate change costs; and
- other unexpected events.

8. Should IPART accept the Standard Retailers' proposal to pass network charges through to customers?

As IPART has indicated, distribution network costs are not under the control of retailers and therefore should be appropriately passed-through to consumers.[1]

This is especially important when you consider that network charges make up a significant proportion (approximately 50 per cent) of the total retail charge to customers. Therefore, leaving network charges embedded within the retail price regulation greatly increases the risks to Standing Retailers of the retail price path moving away from cost reflectivity.

Origin notes that this is a fundamental issue for the other NSW Standing Retailers given the high level of uncertainty regarding the network costs that will arise from the Jemena Gas Network's future Access Arrangement commencing 1 July 2010.

Origin would acknowledge that its own VTPA proposal to unwind the gas distribution network component from the retail gas tariffs and only regulate the remaining retail component does not carry a similar short-term imperative given that there is less uncertainty regarding future network charges in the Albury and Murray Valley regions. However, Origin believes this is the correct approach in principle and is a more efficient regulatory instrument for handling unexpected network price movements than the pass-through mechanism in the current VTPA.

This has been demonstrated in 2009-10 with network price increases in the Albury region that were unanticipated and therefore not included within the retail prices. The special circumstances provisions of the current VTPA because of both timing and materiality issues did not provide an effective instrument to cater for these unexpected additional charges. This was a substantial cost to Origin. Consequently, Origin believes that effectively accounting for changes to network prices is paramount in this VTPA.

Origin would also note that a CPRS will also impact on network costs as distribution entities will be liable for the costs of their fugitive emissions. Providing for explicit pass-through of network costs ensures that this cost is captured if and when it is included within the network charges.

[1] Origin is not suggesting a separate itemisation of network costs on the customers' bills with consumers still receiving a bundled gas price. However, the final retail price will be derived from the separate VTPA price path and actual network price changes.

9. What is the most appropriate way to address uncertain costs associated with national climate change measures in the new VTPAs?

As currently proposed, a CPRS is planned to commence on 1 July 2011 in the second year of this VTPA period. Consequently, the Standing Retailer VTPAs must make provision for the introduction of the CPRS and the additional costs and risk to gas retailers generated by the scheme that is finally adopted.

The VTPAs must also make provision for the possibility that a CRPS is not implemented as planned. It is therefore incontrovertible that the forecast cost of a CPRS cannot be accurately forecast and included within the VTPA price path at this point in time. However, it is also incontrovertible that the CPRS is a potentially significant price risk that needs to be appropriately assessed when establishing a regulatory price control mechanism for the future supply of gas to small customers.

Consequently, the VTPAs must allow for the pass-through of appropriate retail costs when and if a CPRS is introduced noting that even when the CPRS is finalised, there will remain a significant degree of difficulty attached to forecasting its impact on retailer' costs.

Origin has therefore proposed a specific cost pass-through mechanism for carbon costs in the VTPA that will account for this uncertainty while ensuring there is sufficient oversight to provide IPART with a level of comfort as to the appropriateness of that pass-through.

Origin believes that a specific mechanism is preferable to using the special circumstances provisions as this is not an unforeseen cost but a cost that is not readily quantifiable at this point in time. Furthermore, apart from the forecast carbon cost, the costs will be specific to each Standing Retailer as they will include:

- the incremental costs of production and transmission as a result of operational emissions; and other unanticipated costs that are passed through to the retailer; and
- the incremental costs of administering the CPRS, and in particular, the management of trading and reporting requirements.

Therefore Origin agrees that Standing Retailers are be best placed to forecast and provide its CPRS costs to IPART rather than rely on the general criteria around the Special Circumstances provisions.

10. If the Standard Retailers set retail prices based on their own forecasts of CPRS permit costs, should this forecast ever be reconciled with the actual costs of permits?

Origin acknowledges that an ex-post review by IPART of forecast and actual CPRS permit costs may be appropriate. However, Origin requests that if such a regulatory mechanism was included, that is only implemented based on some form of materiality criteria to ensure that a review is not completed when it is unnecessary.

11. Is the Standard Retailer the only party who should trigger special circumstances and a review or re-opening of a VTPA?

12. How should IPART conduct a review of an application for a special circumstance price change?

13. Should there be a materiality threshold to trigger a special circumstances review? And if so, what should that threshold be?

The current and proposed VTPAs allow for special circumstance reviews. This provides the opportunity for Standard Retailers to vary average prices outside of the regulated limits set in the VTPA following approval of the price changes by IPART.

Origin acknowledges that ideally, other industry participants should be able to trigger a special circumstances review as situations can and do arise that may impact the industry without affecting the Standard Retailer. However, given the nature of a VTPA being an arrangement between a Standard Retailer and the regulator for regulation of only that Standard Retailers price, it is not clear how such an arrangement could work in practice.

Origin also notes that the Issues Paper considers whether a structured review process with clearly defined triggers and materiality limits is more appropriate than the current provisions. Origin does not believe that this is required given that its proposed VTPA allows for pass-through of network charges and also CPRS, the largest foreseeable risks to forecasting and regulating retail prices.

The special circumstances provisions reduce the risk to retailers of unforeseen and material future costs as these risks are not provided for in the current regulated retail margin. Origin does not see how a structured review process could be designed for these unforeseen events?

Origin believes it is sufficient to restrict the set of triggers for a special circumstances review to events such as:

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

Furthermore, Origin does not believe that the materiality threshold is required as a retailer's administrative time and cost in submitting and gaining approval from IPART for a pass-through event provides its own materiality threshold. However, if IPART chooses to pursue a materiality threshold on special circumstance events then it must ensure that the threshold considers the ongoing and cumulative cost of potential pass-through events rather than a single year's costs.

6. Review of Costs of Gas Supply

Origin's VTPA proposal includes a mechanism to allow annual pass-through of the network charges applied by the network operator from 1 July 2010.

Therefore, the VTPA will regulate the retail component of Origin's bundled retail price which consists of:

- the wholesale gas cost including market related and transmission network costs;
- retail operating cost; and
- applicable retail margin.

Origin notes that IPART is proposing to review each of these cost elements to make an assessment of whether the total costs are consistent with Origin's proposed retail tariffs. Origin supports this approach.

6.1 Wholesale Gas Costs

14. Have there been any significant changes to retail business activities since the 2007 review? And if so, what are the implications for wholesale gas costs?

15. Is IPART's proposed approach to assessing wholesale gas costs for the 2010 review appropriate? If not, what are the alternative approaches?

Origin believes that IPART approach for assessing wholesale gas costs is reasonable as the contractual nature of the NSW gas industry and lack of comparable benchmarks will require individual review of each Standing retailer's current and future gas costs.

This individual approach is especially important for Origin as a Standing Retailer because the Albury and Murray Valley regions of NSW are supplied from the Victorian gas market. Therefore, IPART's consultants will need to be cognisant that:

- the wholesale gas is from Longford, Victoria;
- wholesale market related costs will therefore include the AEMO (Vencorp) charges;
- the relevant transmission costs to carry the gas to Albury is via the GasNet principal transmission line (PTL) and to the Murray Valley is via the Murray Valley pipeline or Echuca pipelines.

16. Have there been any significant changes to retail business activities since the 2007 review? And if so, what are the implications for retail operating costs?

17. Are previous retail operating cost analyses and benchmarks a valid starting point? If not what are the alternative approaches?

Origin does not believe there have been any significant changes that warrant additional examination of the retail operating costs for a gas retailer and as such, Origin supports IPART's reliance on previous and current benchmarks and retail operating costs analyses when considering Standard retailers' cost proposals.

However, the format of any carbon regulation and/or efficiency reporting may be such that the costs to retailers increase. Origin would see this as part of any review once the details of these policies (or similar) are known.

6.2 Retail Margin

18. Have there been any significant changes to retail business activities since the 2007 review? And if so, what are the implications for the retail margin?

19. Can the supply of gas be considered an essential service? If not, to what extent are the risks inherent in gas retailing different to those in electricity?

20. To what extent, if any, are the risks inherent in retailing gas in NSW different to those in other jurisdictions?

21. Is IPART's proposed approach to assessing the retail margin for the 2010 review appropriate? If not, what are the alternative approaches?

Origin notes that IPART has suggested the use of three approaches to determine retail margin:

- a bottom-up approach that specifically accounts for the individual risks faced by a retailer when servicing customers;

- an expected returns approach that compensates retailers for the systematic risk to which they are exposed; and
- a benchmarking approach that examines the retail margin earned by comparable retailers on the stock exchange.

Origin supports the approaches to be taken by IPART as the appropriate retail margin needs to ensure that:

- all business risks are suitably covered;
- satisfactory returns are provided to shareholders; and that
- the likelihood of forecast errors reducing retail margins is minimised.

The additional risks to inherent in the gas industry and specifically in NSW that IPART may need to consider are that:

- the supply of gas is not an essential service and therefore gas uptake is not as predictable as electricity connections with the subsequent increased volumetric risk; and
- small customers' gas consumption levels in NSW, especially in Origin's Albury and Murray valley regions, are considerably smaller than in Victoria with commensurate lower revenue per customer. Consequently, the application of retail margin as a percentage of revenue results in a small fixed dollar amount that can easily be rendered inadequate by forecast errors on other cost elements.

Finally, it must always be reiterated that the regulatory risks of setting a retail margin are asymmetrical - while lower margins will have a direct impact on market competitiveness, margins above commercial requirements they will have little impact as competition will remove the opportunity for any additional returns.

7. Non Tariff Fees and Charges

Origin believes that as a principle, additional costs incurred as a result of non-routine services should be fully reflected in miscellaneous charges rather than the costs included in total retail operating cost and therefore in regulated retail tariffs.

Origin would also highlight that there are clearly two types of miscellaneous charges and they must be treated differently under the VTPA:

- retail fees that occur from time to time and reimburse the retailer for costs incidental to the normal supply of gas. The fees are regulated within the VTPA; and
- network fees which customers incur from time to time for services requested by a customer and performed by the network operator. These are not regulated within the VTPA.

22. Is it reasonable for the Standard Retailers to introduce a new fee for the payment of gas bills by customers using a credit card?

Origin proposed the introduction of a merchant fee for bills paid by credit card within its draft VTPA. However, Origin notes that applying such as charge is inconsistent with the *Gas Supply (Natural Gas Retail Competition) Regulations 2001* and consequently, in the absence of any amendment to these regulations, the fee cannot be applied.

The costs incurred by Origin due to financial institutions charging for customers who pay through credit cards will therefore (absent a change in regulation) be included in the general retail operating costs recovered within the regulated tariffs.

23. Is it reasonable for the Standard Retailers to change the level of the late payment fee?

Late payment fees are a fee that both:

- recovers the costs associated with the carriage of bad debt and additional administrative requirements such as reminder notices, warnings and debt collection; and
- incentivises the behaviour of customers to reduce this overall cost.

The costs can be recovered through regulated retail charges but when all consumers are paying the cost, it removes any incentive for customers to alter their behaviour.

Origin believes that the late payment fee should be at a cost-reflective level and are proposing a late Payment Fee of $12.00 for 2010-11. This level is aligned with the late payment fee applied by Origin in other jurisdictions for both electricity and gas.

24. Do other retailers add a premium to miscellaneous charges imposed by distribution network operators? Is it reasonable to add a premium onto network miscellaneous charges?

Origin has proposed in its VTPA that all distribution network fees are passed directly through to the customer and that a small administration fee may be added to these miscellaneous charges when applicable.

To be clear, this is for the distribution network services that are both managed and billed for by Origin with the costs to the retailer including:

- the interest expense incurred as the retailer pays the network fees in advance of passing it onto the customer;
- the credit risk for these fees; and
- the additional retail cost of managing the transaction between customer and distributor.