



Review of Small Customer Gas
Pricing and Competition in
Queensland

June 2008

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1. Executive Summary

The Queensland Competition Authority is conducting a review on the effectiveness of retail competition and natural gas prices for small customers at the direction of the Minister for Mines and Energy. The Queensland natural gas retail market has been a fully contestable market since 1 July 2007. Prior to this date, retail prices in Queensland were regulated for small customers and for larger customers that had not chosen to become contestable¹.

The Queensland Competition Authority is gathering information to determine the extent of competition and ensure natural gas pricing is efficient. Due to the relative immaturity of the Queensland full retail contestability (FRC) market for natural gas, i.e. it has been in operation for less than 12 months, it would be premature and dangerous to make assumptions regarding future competition based on a small snapshot of developing competition.

Before deregulation, the Queensland natural gas retail market suffered from historical problems mainly based around the absence of cost reflective pricing for regulated customers. Consequently, competition was not expected to present net benefits to customers and at the outset the progress of competition was expected to be slow. Pricing issues have been largely resolved due to a transitional pricing strategy implemented by Origin Energy. Small customers experienced price increases; not the result of a lack of competition, but as an inevitable consequence of aligning prices with the cost of supply. It is a well established competition theory that price increases will only demonstrate a lack of competition if those prices achieve monopoly rents.

Notwithstanding the negative features of the market, the churn rates to this point demonstrate a willingness of retailers to compete. The gas retail market is benefiting from the rivalry of competitors in the electricity market and this rivalry will gravitate toward the natural gas market in time as the gas market expands.

The Queensland natural gas market has specific features influencing the development of the retail market but as demand increases and the market expands there will be greater potential for further competition in the future. To encourage this, industry participants must concentrate on further developing the market through:

- Future network expansion and development strategies;
- Encouragement of greater gas penetration to households;
- Effective price signals so that inefficient usage (such as cooker only) is priced reflectively; and
- Simplification of non-price regulation of the market (to lower entry costs).

¹ Commercial customers with an annual consumption of greater than 1 TJ had the option of becoming contestable. Many of these customers remained on regulated tariff.

2. Introduction

Origin Energy (Origin) supplies electricity, natural gas and liquefied petroleum gas (LPG) to more than three million customers in Australia and the Pacific, and has recently consolidated its position as Australia's leading retailer of green energy products.

Origin has a long history in Queensland and has been a natural gas retailer in Queensland dating back to the inception of the Brisbane Gas Company in the 1860s. Formerly known as Boral Energy, Origin was formed in February 2000 when Boral demerged its energy business. In February 2007, Origin acquired the Sun Retail business from the Queensland Government which added more than 890,000 electricity customers to Origin's customer base. The Sun Retail business also included many LPG customers.

Origin is also a participant in the electricity and gas retail market in South Australia, Victoria and New South Wales with Origin's retail business contributed revenues of over \$4 billion for the year. Origin focuses on maintaining and growing its customer base and expanding market position as the leading retailer of environmentally-friendly energy solutions. As a leading retailer, Origin now has 790,000 dual fuel accounts and recently acquired almost 230,000 electricity customers in New South Wales and South Australia as a new entrant.

Origin has a strategic focus upon the competitive segments of the Australian and New Zealand energy markets as a fuel integrated generator and retailer. Origin continues to deepen the integration within our business across the competitive segments of the energy supply chain, to more effectively manage risk and create opportunities for growth.

2.1 Purpose of review

Origin is conscious that the purpose of the review into small gas customer pricing and competition in the Queensland gas retail market is to assist the Queensland Government (Government) with the task of determining whether additional measures are necessary to improve competitive market outcomes for natural gas customers, incumbent retail market participants and new entrants.

With this purpose in mind, Origin is happy to assist the Queensland Competition Authority (QCA) in properly assessing the gas market with a view to seeking improved outcomes, where possible, for consumers and market stakeholders.

2.2 Queensland Retail Gas Pricing and Contestability

Origin believes a background to the history of gas retail pricing and the introduction of contestability in the gas retail market provides some context to the nuances of the natural gas market in Queensland.

Origin has been subject to the maximum retail tariff regime for its retail authority areas in Brisbane North/Ipswich; Gladstone/Rockhampton and the Wide Bay gas supply area.

The structure of the maximum retail tariffs have not been amended by the Minister since the early 1990s despite the significant changes in the structure of network costs, particularly following the implementation of the first Gas Access Arrangements in 2001. This Gas Access Arrangement sought and partially achieved the introduction of cost reflective pricing in network pricing. However, Origin's regular requests to have these new network pricing structures reflected in the natural gas retail prices were consistently rejected in favour of uniform price increases.

Overall, the maximum retail prices in place prior to contestability were inconsistent with:

- the objective of national and jurisdictional reform of maximising the efficient use of gas in domestic, commercial and industrial markets;
- statutory obligations on the Minister under the Gas Supply Act (2003) to set retail prices consistent with both customers interests and the economic sustainability of the gas retailer; and
- supporting the operation of an open and competitive gas market in all sectors.

The issue of natural gas retail pricing went far beyond 'pockets of uneconomic customers' and touched all segments of the customer base including residential, small and medium business and large commercial and industrial businesses. The only way these pricing issues could be addressed to enable competition to exist was for immediate and complete deregulation so that cross subsidies could be eliminated and prices set in line with costs.

Nevertheless, full retail contestability for Queensland electricity and gas was announced in November 2005. The announcement was made after an FRC cost benefit analysis report (May 2005) concluded there were net benefits available to the Government and consumers if contestability for electricity was introduced. There was no similar cost benefit analysis for the Queensland gas market². The absence of a cost benefit analysis for gas FRC in Queensland suggests there was no improvement in the gas market since a previous cost benefit assessment undertaken by MMA in 2003. In that report, the consultants concluded the introduction of contestability to customers between 1TJ and 10TJ was weakly positive as there were high costs of acquisition relative to size of customer.

The report did not consider contestability for the residential market. Origin believes it is important for the QCA to recognise that on the basis of the cost benefit studies, FRC was not expected to present net benefits to small customers due to the features of the market and also due to the absence of cost reflective prices at that particular time.

Accordingly, by removing price regulation from 1 July 2007, the Government was taking one step in facilitating the development of a workable contestable retail gas market.

In addition, the introduction of FRC involves significant set-up costs for the incumbent retailers and for networks. There are important policy decisions on how these costs are to be recovered and over what period. In some jurisdictions these costs were recovered from the customers but in South Australia, for instance, the Government provided funding for the network FRC costs.

In Queensland, the decision was made to recover network and retail FRC costs from customers through their gas prices. However, given the nature of these costs (largely fixed cost per customer) the impact of a price pass through is particularly significant for small residential users.

² MMA report, Gas Further Contestability Cost-Benefit Assessment, 28 March 2003

3. Competition in the Queensland Gas Market

3.1 General Overview

The QCA observes the analytical framework adopted by the AEMC to assess the level of competition in Victoria³ and South Australia⁴ may be a useful approach to review the level of competition in the Queensland gas retail market. The analytical framework was developed with the purpose of demonstrating competition, yet the QCA recognises the retail market cannot be expected to have fully matured having been subject to competition for less than 12 months.

Origin has been supportive of the process undertaken by the AEMC in Victoria and South Australia. Accordingly, Origin accepts the AEMC criteria will provide a useful measure to inform itself of developments in the retail market in Queensland although it is important to recognise the Queensland market is distinguishable from the Victoria and South Australian competitive environments, as discussed further below.

The QCA suggests if competition was present in the retail market then it might expect to observe:

- new retailers entering the market for a range of customer classes;
- emergence of differentiated products and services with new types of competitive contract offerings with varying terms and conditions; and
- customer switching between retailers in response to these competitive offerings.

Origin appreciates these factors may positively support the presence of competition but believes these factors are not definitive of a developing contestable market nor will they provide a snapshot of competition in the future. Evidence of participants entering a market will signify the presence of low barriers to entry. However, potential entry is considered a meaningful threat to curb the conduct of incumbents. Such that, the appearance of new retailers will assist to demonstrate the growth of competition but entry itself presents no more substance than the presence of a threat of potential entry.

It is a well recognised principle that for competition to exist, prices must be pitched above efficient prices. Therefore, it is necessary for prices to contain a portion of headroom to encourage entry by other participants. This is of particular significance to the Queensland market as the retail prices have historically been low. Accordingly, the QCA must be very careful to avoid the circularity trap of using classical competition measures to assess markets where prices below supply costs inhibit competition

In conducting its review, Origin encourages the QCA to be mindful of the contrasting purposes of the AEMC's assessment and the QCA's terms of reference. Given the Queensland retail market is fully contestable but is a relatively immature competitive market this criteria in isolation, will not reveal future behaviours in the retail market. Origin takes the view a pragmatic approach must be taken including consideration of the peculiar features of the Queensland market and experiences of smaller retail markets such as the Australian Capital Territory (ACT) where similarly price regulation was removed for the competitive market.

The Queensland gas market is considerably smaller than New South Wales, Victoria, South Australia and Western Australia. The reticulated gas market in Queensland

³ AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria*, Second Final Report, 29 February 2008.

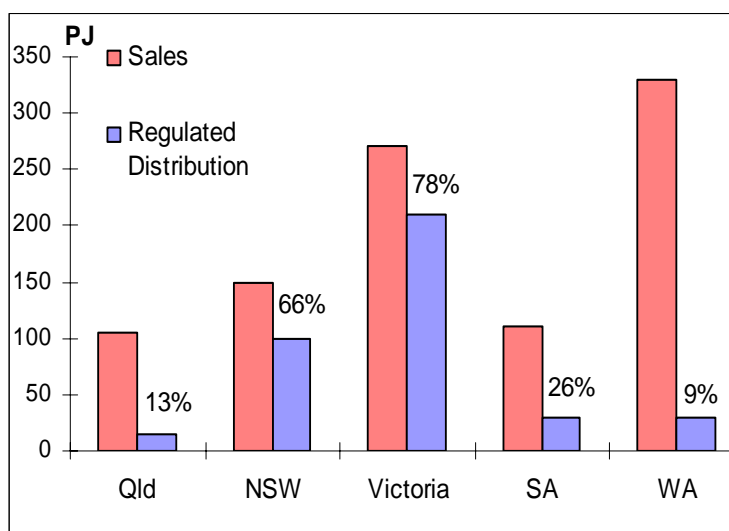
⁴ AEMC, *Review of Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia*, Issues Paper, 14 March 2008.

comprises relatively few customers using lower quantities of gas. In general, this is caused by the warm climate, low heating load and lower penetration of natural gas (relative to Victoria and New South Wales). Residential customers use gas for cooking and hot water with limited space heating (e.g. Toowoomba). There are a significant number of customers that use gas for cooking only. This outcome in turn has been exacerbated by the historical pricing structures where small consumers were effectively subsidised by larger consumers and “sheltered” by the tariffs from seeing the true costs - and inefficiency - arising from supply of reticulated gas to small residential and business customers. Due to the high fixed costs of gas, cooking is an area which gas commonly competes directly with electricity and LPG.

The Queensland market has less than 10 per cent penetration of gas in Queensland households and the average load of Brisbane residential customers is only around 12 GJ per annum compared with over 60 GJ in Victorian households. Low volumes are compounded by higher prices that reflect lack of economies of scale in distribution.

Additionally, gas sales provided via the distribution pipelines in Queensland are only a small portion of total gas consumption. As distribution network utilisation is relatively low with approximately 13% of the Queensland load delivered via the distribution systems, the reliance on large customers is significant and the unit price of gas is higher. Figure 1 below, provides a comparison of gas sales with gas sales via the distribution system. Queensland load delivered by the distribution system is significantly lower than NSW and Victoria.

Figure 1: Total and Distributed Gas Sales, by State



Source: AGA (2003)

Origin strongly believes the imposition of alternative retail pricing arrangements for small customers will not resolve the structural impediments and indeed may create barriers to entry. Previous price regulation failed to respond to changing cost structures in the market, and imposed financial losses on retailers creating cross-subsidies between consumers. This in turn, discouraged investment and encouraged inefficient capitalisation and utilisation of the network to the long term cost of all consumers.

Price regulation is therefore, in our view, not a viable option in the fledgling Queensland retail market and would be detrimental to the competitive environment for both customers and retailers. Origin takes the view it is premature to make assumptions about future competition and believes as prices align with

efficient costs; the behaviours of participants will better indicate future competition.

3.2 The reticulated natural gas market for small customers

As acknowledged in the NERA report, to understand the influence the gas supply chain has on competition at a retail level, it must be recognised that gas supply and transportation costs account for as much as 90 per cent of the price paid by residential customers.⁵ Due to the unique nature of supply in each jurisdiction, each eastern Australian gas market are characterised by discrete localised sub-markets. Hence, the prices in each sub-market are determined by local demand and supply conditions.

3.2.1 *Are there features of the Queensland gas supply chain that have a bearing on development of competition in the retail market?*

The Queensland gas supply chain has unique features not representative of other natural gas markets in Australia. These features will impact on the development of competition to varying degrees.

Four important features impact the development of competition in the retail market:

- The capacity constraints on the Roma to Brisbane Pipeline (RBP);
- The relative size of the residential market is small and has limited fluctuations in demand;
- The inefficient utilisation of the natural gas networks; and
- Historical regulated retail prices were not representative of the true cost of supply.

Roma to Brisbane Pipeline

The NERA report⁶ identified factors which may impact a retailers' competitiveness for supply and delivery of gas:

- capacity constraints on the RBP given the capacity of the pipeline is fully contracted to 2012⁷. As such this may impede a new entrant obtaining firm supply of gas;
- the availability of gas for a new entrant retailer or any expansion in demand will require a retailer to contribute to the expansion of the pipeline or negotiate to purchase capacity from existing users of the pipeline; and
- Additional entry costs for a gas retailer to transport gas via the distribution pipelines in Brisbane and payment of market participant fees to the GRMO (Gas Retail Market Operator).

Regardless of the concerns about capacity constraints on the RBP, at least one second tier retailer has announced it was able obtain gas supply and enter the Queensland natural gas retail market. Australian Power and Gas Company Limited (APG) entered the market and obtained gas supply to July 2009. Accordingly, APG

⁵ NERA Economic Consulting, "The Gas Supply Chain in Eastern Australia - A report to the Australian Energy Market Commission" available at www.aemc.gov.au/pdfs/reviews at 104

⁶ NERA Economic Consulting, "The Gas Supply Chain in Eastern Australia - A report to the Australian Energy Market Commission" available at www.aemc.gov.au/pdfs/reviews

⁷ NERA Report states, "prospective retailers would have the same gas supply choice however it would either need to enter into an arrangement with existing users of the pipeline to obtain spare capacity or alternatively agree to pay a negotiated tariff which includes the cost of expanding the current capacity of the RBP."

demonstrates the supply of gas is not prohibitive to entry into the Queensland market.⁸

Inefficient gas network utilisation

The characteristics of the retail market in Queensland contribute to the inefficient network utilisation. The Queensland natural gas market is comprised of relatively few customers using low average quantities of gas. The previous control on retail pricing has led to an over-investment in gas networks and service connections to supply small customers. A customer, for example, with a small consumption (e.g. gas cooking only) did not see the full cost of supply as the regulated retail price previously did not cover the pass-through of relevant network charges. Accordingly, the high costs for a small gas user makes the switch to alternative forms of energy (such as bottled LPG or electricity) a viable option.

The upshot of the small market with limited gas penetration is inefficient use of the natural gas network. Inefficient network utilisation guarantees a high average cost of the network to customers in Queensland. Low network utilisation coupled with the low volumes results in a high fixed cost for residential customers.

Equally, off-peak electricity prices for controlled load customers have been relatively low in Queensland under the electricity price regulation arrangements. While this situation remains, there is little economic incentive for households and businesses to use gas water heating, yet without gas water heating, gas reticulation in Queensland is not viable. Origin acknowledges that the Government has introduced a Gas Rebate Scheme to provide rebates to consumers that switch to gas hot water systems and other gas appliances. Recent changes to new housing regulations may also impact on this, although this is yet to be established.

Retail Pricing

The Queensland regulated retail prices did not keep pace with the rising costs of supply which resulted in significant operating losses for retailers supplying residential and business customers with usage below 100TJ per annum. Origin incurred significant and unrecoverable losses in the Queensland market as a result of historical under-recovery, a factor which in turn discouraged investment in gas demand growth. Some customer segments even had prices set below the network charges, with no recovery for the cost of gas, transmission or retail operating costs. Inevitably, at these prices there was little appetite for continuing to invest in gas marketing.

3.2.2 To what extent do retailers compete with each other to acquire new customers and retain existing customers?

There are 5 general retail authorities issued to potential gas retailers in Queensland. Since the Queensland Governments announcement for gas full retail contestability, an additional three general retailer licences have been issued. Three new licensed retailers publish terms and conditions on the QCA website (as required through the regulatory framework) for the supply of small customers⁹. Of these three retailers, two currently publish standard prices for small customers.

Retailers compete to acquire customers as shown by the churn figures published by the Gas Retail Market Operator, Vencorp. There are over 150,000 small customers

⁸ On 23 November 2007, APGCL announced, "it has secured an underpinning gas supply and transportation contract for QLD market; the gas supply contract will meet all the forecast supply demands for Australian Power and Gas Customers in Queensland. The gas contract is scalable up to 1.5PJ per annum and runs until end of July 2009."

⁹ Small customer is a customer consuming less than 1 TJ of gas per annum.

in Queensland, the customer transfer statistics indicate, as at 30 April 2008, the GRMO¹⁰ has completed 5,280¹¹ small customer transfers. Remarkably to 30 April 2008 8,297 small customer transfers were lodged and for whatever reason 1,321 were cancelled. This indicates a significant degree of marketing activity by natural gas retailers within such a small market segment.

Origin competes to acquire market contracts from its existing customer base in Brisbane and other regions in Brisbane. Predominantly Origin targets electricity customers and dual fuel customers to minimise the cost of customer acquisition. The customer churn numbers are an indicative factor of retailers competing to acquire customers. Churn rates indicate a change in retailer but do not show the retention rates of incumbent retailers.

Origin is willing to share its own gas market data on a confidential basis with the QCA.

3.2.3 Are retailers able to recover their efficient costs at their current prices?

Due to the fact regulated prices were not appropriately adjusted over the years and to allow a smooth transition to contestability, Origin implemented a two phase process¹² to bring pricing structures for small customers to cost reflective levels. For 1 July 2007 the first phase of the process involved both increases in prices on average and, equally as important, restructuring of the prices to better reflect the underlying cost structures of gas supply, in particular, the network charges approved by the QCA. The result being some small consumption customers saw price increases that were, proportionately, much larger than average. The introduction of a new network FRC charge by the gas networks exacerbated the impact on small customer prices.

The standard prices for the Brisbane and Northern areas (excluding the Wide Bay area)¹³ are now structured and designed to achieve recovery of the following business costs:

- pass-through of distribution charges (including network FRC costs), GRMO charges and Government imposed charges (uncontrollable costs). The uncontrollable costs, in particular the network costs, are by far the largest component of the cost build up. Network costs account for some 65 per cent of total costs compared to 1 per cent for retail costs and 43 per cent for the delivered cost of gas;
- recovery of prudent¹⁴ costs of supply for a mass-market customer (controllable costs); and
- return on investment, specifically a net margin return on sales set at the minimum compatible with economic sustainability.

The restructured tariff was designed to replicate the price signals for efficient gas utilisation, including the distribution network¹⁵. The impact of the tariff

¹⁰ Gas Retail Market Operator (GRMO): Vencorp

¹¹ Figure indicates the completed transfer for basic meters. Basic meters include customers consuming less than 10TJ/annum.

¹² Origin recognised in its two phase process it was important to manage the impact on customers, as best as possible, along with the shorter term acceptance of gas. As pricing reform took place concurrently with FRC two years was the maximum period for implementing pricing reform to prevent unfair competitive opportunities.

¹³ In the Wide Bay region, transmission and distribution pipelines are not covered pipelines under the National Gas Code. They are negotiated prices and currently, the network prices are structured in a very different manner than the other network areas.

¹⁴ Costs of supply include cost of natural gas purchases, cost of transmission services, retail operating costs and retail contestability costs.

¹⁵ As identified by the Queensland Competition Authority and applied in the setting of network prices.

restructure on customers can be provided on a confidential basis to the QCA, if required.

From 1 July 2008, Origin will recover its efficient costs of supply from small customers in Queensland in most supply regions.

As Queensland gas retail prices are now unregulated, the opportunity for retailers to price at levels to recover efficient costs is far greater and more precise than the previous regulated environment. Where prices are set below or at an efficient cost level such pricing may impose a deterrent to enter the market and hence stifle competition. Accordingly, the removal of regulated pricing was the first step to developing a contestable gas retail market in Queensland.

3.2.4 Are future expected profit margins likely to be sufficient to encourage new entry and increase competition or insufficient such that new entry is deterred?

The future profit margins are dependent upon the level of retail margin a retailer considers sufficient to maintain market share in such a small gas market.

As discussed in 5.5.1, Origin considers the adoption of 5 per cent net margin is very conservative for such a small market and equates to the minimum acceptable for Origin's legitimate business interests. Given about 75% of residential customers in Queensland have 12 GJ per annum bill, the average customer pays \$400 for gas in Queensland. Based on a 5 per cent retail margin, this equates to approximately \$20/customer per year (after minimum operating cost allowance).

The impact of low historical prices created an expectation of relatively low subsidised gas prices in Queensland. Given Queensland customers have seen recent price increases to resolve the previous pricing inadequacies and to account for FRC costs, it is arguable this perception creates an obstacle to retailers imposing higher retail margins to recover reasonable profit margins for this type of customer.

As the average gas usage in Queensland is relatively low and with retailer risk in the Queensland market relatively high,¹⁶ the expected future profit margins based on current volumes alone may not be sufficient to encourage entry into the gas retail market.

3.2.5 Are there any barriers facing new, or existing, retailers that affect their decision to enter the Queensland market?

The decision of new entrant retailers in Queensland to target the electricity market rather than natural gas customers suggests there are some barriers to entry existing in the Queensland gas market.

Some features (as outlined in 3.1.1) of the Queensland market that may impact the development of competition in the retail market include:

- capacity constraints on the Roma to Brisbane Pipeline (RBP);
- high fixed network costs due to inefficient utilisation of the gas networks;
- high retailer risk associated with previous regulated retail pricing not representing the true cost of supply;
- a trend showing a reduction in gas usage in Queensland;

¹⁶ The low \$/customer margin gives little room for error or additional cost pressures. Plus the possibility of future regulatory intervention in the market or added regulatory complexity creates significant retailer risk.

- general market characteristics, ie a small gas market, low penetration and low volumes on average; and
- natural gas in Queensland is a fuel of choice. There are significant competitive pressures on gas uptake due to the developed LPG market in Queensland and the low off-peak electricity tariffs for water heating.

Excluding the two incumbent retailers, there are 3 licensed gas retailers in Queensland each with newly acquired licences. Each licensee actively participates in the electricity market by vigorously acquiring market share. On a basic level this suggests a barrier to entry may exist. Origin hypothesises this may be due to a varied number of factors such as:

- Prices are below cost reflective levels deterring new entrants;
- Failure of retailers to obtain delivered gas at a reasonable cost; or
- Market is too small and expected profits margins are low to justify the costs of setting up contractual arrangements¹⁷ for delivered gas for entry.

In terms of the cost of delivered gas, the proposed expansion of capacity on the RBP and the availability of gas including coal seam methane in Queensland may see a change in the delivery costs to Brisbane, although there is great uncertainty about the direction of these costs as the nature of overall gas usage in Queensland may change significantly over the next five year period under a carbon constrained world.

At the very least, however, the pipeline expansion will improve the prospects of more gas retailers acquiring delivered gas.

Origin does not perceive that these issues are formidable barriers to entry and the constant threat of entry of competent, experienced energy retailers is a recognised deterrent to parties exerting monopoly power. The presence of licensed gas retailers operating in the electricity market guarantees new entrants are swift to enter as market prospects improve.

3.2.6 To what extent might retailers be expected to compete in the small customer market in the future?

Future competition in the small customer market remains uncertain in Queensland whilst its present characteristics remain. Queensland has a relatively small gas retail market. It is characterised by a large number of residential customers with small volumes and relatively few commercial/industrial customers with high volume and load factors. The residential sector consumes only 1.4 per cent of total Queensland gas consumption.¹⁸ The average annual residential consumption for south east Queensland is 12 GJ compared to 60GJ in Victoria.

The present churn rates indicate retailers are motivated to compete within the gas retail market. Origin takes the view that in time as the gas retail market in Queensland expands the fixed cost of supply will reduce, as a proportion of the total bill, which may provide a further opportunity for retailers to acquire profitable customers. There are opportunities available for improved utilisation which remain mostly in the hands of the networks, are driven by government policy initiatives and rely upon increased market penetration for gas appliances and a healthy commercial and industrial sector to share the network investment costs.

¹⁷ To obtain market entry a retailer must negotiate contracts of supply in advance of acquiring customers which may involve significant costs and associated retailer risk.

¹⁸ Allgas Access Arrangement Information for the Queensland network, 7 June 2006, at 8.

A key determining factor for future competition will include support from distribution companies in network development to grow the customer base and improve gas take up. In essence, the network utilisation must improve to bring down the fixed costs for small gas users.

Possible impediments to the growth of the market are:

- failure of network companies to build load, implement capital works for expansion and seek new connections within distribution areas;
- failure of Government policy to promote gas penetration and uptake of gas appliances; and
- the substitution of natural gas for electricity usage is limited in the residential sector to water heating, cooking and minimal space heating;
- pricing trends in off-peak/controlled load electricity tariffs; and
- a continued trend showing a decline in average domestic gas consumption, in part driven by improvements in energy efficiency (an effect that is being observed in other states).

Current Government policies such as the Queensland Residential Gas Installation Rebate support increased domestic usage and penetration of gas appliances. The program introduced in July 2007 has led to more than 600 gas appliances installed.¹⁹ A positive start for the program, although LPG appliance installations have outnumbered natural gas appliances. Consequently, the program has marginally improved network utilisation to date. Other programs directly compete with the Residential Gas Installation Rebate such as the subsidisation of solar hot water and Government incentives for electrical heat pumps.

It is expected as the market further develops the active electricity retailers will continue to compete for customers in Queensland and move to acquiring gas customers as and when gas is more accessible to the Brisbane market. The emergence of new entrant electricity retailers has contributed to a reasonable level of rivalry in the electricity market with customers switching in response to competitive behaviours. It is expected in time, these retailers will move to acquire gas customers as and when the opportunity arises.

3.3 Small customer gas market activity

3.3.1 Are retailers currently competing, or likely to compete, to acquire new customers and retain existing customers?

As detailed in section 3.2.2, retailers currently compete to acquire new customers and retain existing customers.

3.3.2 Are retailers currently responding, or likely to respond, to consumer taste by offering differentiated and better product packages?

The successful marketing experience of Origin in other contestable markets enables it to strive to improve service to customers and positively meet their energy needs.

Observations in other markets show retailers actively compete on energy products and Origin has found that the vast majority of customers who have switched energy retailer have done so because of the product being offered. As a result of this, Origin responds quickly to changes in consumer choices or new products that have

¹⁹ Figures to May 2008.

motivated or renewed consumer interest. These new products are brought to other markets such as Queensland in recognition of consumer interest.

There has been a marked escalation in the number of retailers offering green products indicating innovation by retailers and the influence customer needs has on the availability of energy products. Many customers continue to exhibit a desire to make positive contributions to the environment and as such are willing to pay more for a premium green product to meet their energy needs. Origin has, for instance, a "Green Gas" product in addition to its standard gas products enabling customers to have a wider variety of choice and to express their environmental concerns.

Additionally, retailers carry out their own research to inform themselves on how best to present information to customers and to use this information to implement changes to its marketing and product strategies.

3.3.3 What marketing strategies are retailers currently using to engage with potential customers? What marketing strategies do they propose to use in the future?

Origin views the current marketing strategies of energy retailers in Queensland are predominately door to door sales, telemarketing and internet offers. Such modes of engagement are preferred due to the nature of the energy product being:

- Low involvement product;
- A small part of the household disposable income; and
- A basic, hygiene commodity.

The success rate of second tier retailers, in particular, for electricity churn suggests there is competition between the energy retailers to acquire greater market share. Experience has shown these modes of approach appear to attach no incumbency advantage, and that the uptake of market contract is in response to retailer marketing activities rather than direct customer approaches.

The success of marketing campaigns such as television and media advertising considered as high exposure and high cost may have alerted customers to the availability of choice. Such campaigns are generally not highly utilised by energy retailers, at least on an ongoing basis. Having said this, the Queensland market may be distinguishable from the other Australian jurisdictions as the sale of the Government-owned electricity retail businesses may have contributed to a different market dynamic. The television and media advertising in the Queensland market seems to be positioned more toward brand building as incumbents have appear to have little advantage over other new entrants in terms of brand familiarity.

Origin's marketing activities within other energy markets in Australia involve similar activities and it is difficult to assume or propose a change to what are considered successful strategies, although clearly a retailer will adapt these to changing consumer preferences over time. The "do not call" register, for instance, which was introduced in 2006 across Australia, may lead to changing marketing strategies over the next few years.

3.3.4 Are customers prepared to switch retailer and, if so, what are the reasons behind their choice?

A key driver for a customer switching appears to be to take advantage of a competitive offer. From experience in other markets as well as Queensland, Origin has observed a customer's decision to enter a market contract or take-up an energy product is dependent on many elements such as:

- Price
- Desire to change their existing supplier;
- Being encouraged to look at their options;
- Moving house;
- Advertising; and
- Non-price benefits such as magazine subscriptions, loyalty benefits or environmental reasons.

Customers appear to respond to products that appeal to them, this may be price driven but sometimes not. It is apparent from the statistical data the customer experience seems to prefer to have one retailer meet their energy needs and the take-up of gas market contract is predominately done via an electricity market offer. Anecdotal evidence from other jurisdictions suggests at least some consumers like to consolidate their energy supply with one supplier. Recent experiences in the Queensland seem to support this view.

Observations in other markets show retailers actively compete on energy products and Origin has found that the vast majority of customers who have switched energy retailer have done so because of the product being offered. As a result of this, retailers respond quickly to changes in consumer choices or new products that have motivated or renewed consumer interest. Some of these new products are brought to other markets such as Queensland in recognition of consumer interest.

3.3.5 Are customers able to make an informed choice to switch gas retailer or are there obstacles to customers effectively participating in the competitive market?

Customers in Queensland are able to make an informed choice to switch gas retailer. The number of customers switching equates to 3.5% churn in the first 10 months of competition. This would suggest customers are amenable to consider competitive offers and thus able to effectively evaluate and search for market offer information if and when they need it. Once a customer makes a choice it is reasonable to regard such a choice as informed.

There are no obstacles to prevent a customer participating in the competitive market. Currently, Origin will provide an offer to anyone who requests it. This is regardless of whether Origin is the designated provider for the service or area. The churn rates suggest there are no recognised barriers to customers switching.

3.3.6 Is there sufficient information available to customers about their options and is this information easily accessible and able to be understood by them?

The relatively high²⁰ uptake of market contracts for gas customers in the first 10 months of competition is an indicator customers are able to access and compare product offers in the energy market. Origin's experience is that customers are able to access information if and when they require it such as when a customer moves house.

Retailers individually address the needs of customers to have access to clear and accurate information through well prepared and targeted marketing collateral highlighting:

- The price components of a market contract;

²⁰ Relatively high due to the small number of retail gas customers in Queensland.

- The existence of exit fees or otherwise; and
- The key terms and conditions that the consumer should be aware of under the contract.

The marketing collateral is available to customers on our website, during contacts with the customer or in hard copy upon request.

4. Competition in the Substitute Fuel Market

4.1 Pricing of LPG

4.1.1 What is the extent of the reticulated and bottled LPG market in Queensland?

Origin and its predecessor have been involved in the Queensland LPG market for approximately 30 years. Origin supplies a large number of Authorised dealers with LPG for supply to industrial, commercial and domestic customers. Authorised Dealers served by Origin are dispersed throughout Queensland from the Gold Coast up to Cairns as well as regional areas in far west Queensland. Additionally Origin has over 100,000 direct bottled LPG customers in Queensland.

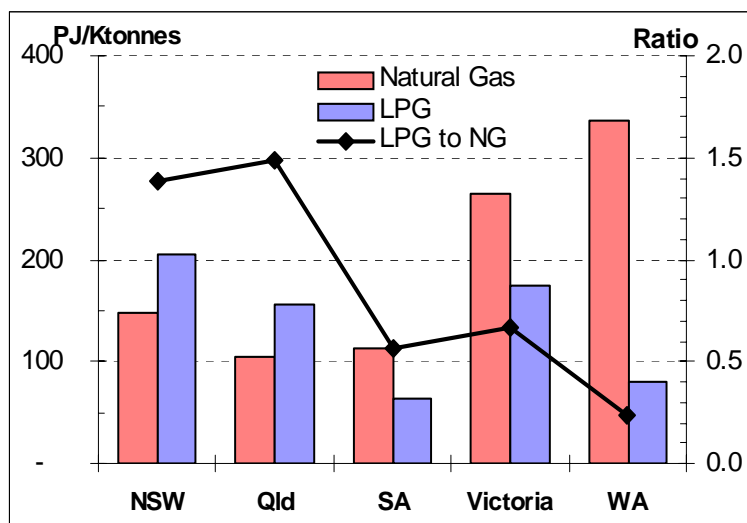
With regard to reticulated LPG Origin has many separate LPG distribution systems across Queensland with most located along the east coast from the Gold Coast up to Cairns. In the main these distribution systems supply small groups of domestic customers but several systems are located in business districts supplying commercial and small industrial customers.

Origin is happy to provide specific numbers of customers and Authorised dealers to the QCA on a confidential basis.

Origin believes that at least two other major national LPG suppliers have LPG reticulation systems in Queensland. The LPG market in Queensland is a close substitute for natural gas for end use, in particular for cooking, hot water and barbeques.

The LPG industry in Queensland exhibits strong growth and as a strong substitute is highly competitive with natural gas. The demand for LPG in Queensland is at similar levels to that of larger states of New South Wales and Victoria, even though Queensland has negligible heating load. Figure 2, indicates the ratio of LPG demand to natural gas across Australia States for 2002.

Figure 2: LPG Demand versus Natural gas Consumption, by State



Source: ALPGA

4.1.2 What issues should the Authority consider regarding the level of competition in the reticulated and bottled LPG market?

The supply of bottled LPG to small customers in Queensland has been an extremely valuable resource to this vast state considering the range of geographical and off shore locations. LPG has supported the initial and ongoing energy needs of residential and small business consumers in these locations. Bottled LPG is extremely flexible in that it can be readily supplied to almost any location with minimal infrastructure and in short lead times.

It should also be recognised that competition between bottled LPG suppliers is particularly active as there are minimal barriers to small customer churn and or new market entry. Origin is aware of at least 5 active and significant suppliers of bottled LPG in the Queensland market. All these suppliers would each have their own network of independent authorised dealers the same as Origin Energy has to service all the regional and remote areas.

Reticulated LPG has been more prevalent in Queensland than any other jurisdictions due to the absence of a comprehensive natural gas network; the immense distances between regional towns; and the unique approach to the establishment of new residential developments. Many of the initial LPG reticulations in Queensland were seen as transitional arrangements until such time as natural gas trunk infrastructure was expanded to allow these reticulations to be converted to natural gas. Installing gas reticulations during “greenfield” stages can be up to four times less expensive than retro installation after development. It also assures the installation of suitable gas appliances at new premises and guarantees a long term gas load.

Over time the economics of expanding the natural gas infrastructure has not proven to be viable and therefore these LPG reticulations have become almost stranded. Nevertheless, LPG is an excellent fuel for domestic usage and customers continue to utilise the LPG service. Given the environmental benefits of gas over electricity, the LPG reticulated services continue to be sought.

Due to the bulk supply arrangements and the relatively small nature of LPG distribution systems, it is not practical or economic to justify third party access.

Rather, competition is readily available in the form of bottled LPG, as reticulated LPG can readily be disconnected at the property, and replaced with a bottled supply without the need for any changes to appliances or equipment used at the premise. While reticulated LPG offers some benefits over bottled LPG, consumers will always have the ability to benchmark these benefits over alternative arrangements.

LPG competes with a range of substitute fuels²¹ and energy sources for various applications in Queensland households and small businesses. Origin recognises the importance of LPG as a fuel capable of offering greenhouse abatement opportunities to the extent that it replaces higher emission energy sources.

4.1.3 What is the level of competition in the reticulated and bottled LPG market in Queensland?

Origin has been a long term participant in the supply of LPG in Queensland and has established significant infrastructure in order to efficiently supply this market. Competition exists and as mentioned above there are at least five active suppliers of LPG in Queensland with each implementing their own strategies for market growth. Origin is aware of additional LPG terminal infrastructure constructed in the Sunshine Coast, Townsville and Cairns by another retailer in the past 2 years which indicates an increasing interest in this market. Unlike some other jurisdictions demand for LPG in Queensland is growing in the traditional²² market.

There are several LPG suppliers operating LPG distribution systems in Queensland and property developers are increasingly showing interest in installing more distribution systems in “Greenfield” projects. The installation and operation of LPG distribution systems is not limited to LPG suppliers as any gas pipeline operator or infrastructure provider could readily compete in this market.

4.1.4 Does the current level of competition or concentration in the LPG market impact on retail prices paid by customers?

Electricity and natural gas markets across Australia have been undergoing significant reform over the past 12 years with the aim of achieving competitive markets where consumers can readily choose their preferred retailer, energy product and service offering. Effective competition has been achieved in many jurisdictions to such an extent that prices are no longer regulated and customers are largely paying their true cost of supply.

The bottled LPG market in Queensland and for that matter all jurisdictions have been operating under this paradigm for some time. Competition has allowed the market to thrive without cross subsidies and with consumers continually subjected to dynamic market based pricing.

Competitive market pricing for reticulated LPG customers will always be assessed using comparisons to the most viable alternative which comes from bottled LPG. There is vigorous competition between bottled LPG suppliers supported by 5 active suppliers in Queensland. An ongoing vibrant and competitive bottled LPG market ensures that efficient market based pricing is maintained in the reticulated LPG market.

²¹ LPG is often a close substitute for coal, electricity, natural gas, oil and wood.

²² The use of LPG in applications other than transport is referred to as the traditional market.

Origin is happy to discuss its views on LPG pricing on a confidential basis to the QCA.

The LPG retail prices (along with electricity) exert competitive pressure upon natural gas pricing. LPG and electricity are recognised substitutes for natural gas suppliers. Residential and commercial users can replace natural gas appliances with those using alternative fuels, in particular in the medium term.

The competitive pressure exerted by electricity (and/or LPG) is ongoing, because although individual customers might be locked into using gas appliances for around 10-15 years, around 7 per cent of consumers change appliances every year. Customers can make decisions regarding substitute products when selecting or updating their capital equipment or appliances. This is particularly the case with new extensions where households are choosing their energy source and can trade off costs and benefits of alternative sources of energy. At any time this may affect some 7 per cent of consumers who are new households or are replacing equipment and may provide some constraint on electricity and gas pricing.²³

With regard to the wholesale cost, LPG is an internationally traded commodity, with contract prices set monthly in the Middle East (Saudi CP). This pricing is posted by the industry body LPGA on their web site which also contains an extensive history of these price movements. Australian suppliers and customers of LPG have little influence over the price of this commodity.

4.1.5 Are there any barriers to entry into the Queensland LPG market? How do they impact on competition in the State's natural reticulated gas market and how might barriers to entry be addressed to promote competition in the market?

Origin considers that barriers to entry are minimal in the Queensland LPG market given that there are currently around five LPG retailers and many authorised dealers and resellers.

With regard to the impact that barriers to entry in the LPG market may have on competition within the State's natural gas market, Origin sees little relevance between the two fuels. While bottled LPG could be seen as the most viable alternative to natural gas, competition within the natural gas market is best achieved by different retailers of natural gas. LPG is likely to be priced at a premium to the natural gas commodity and although there are significant fixed costs of supplying natural gas in Queensland, in most cases where there is a reasonable load, LPG will unlikely be able to compete with natural gas on a price basis.

²³ Productivity Commission, Review of the National Gas Regime, Report No. 31, 11 June 2004, p.48

5. Gas Prices for Small Customers

5.1 Cost of Supply

Wholesale gas supply is purchased by Origin and other market participants as two distinct products; Base Load supply referred to in this submission as “Wellhead Supply” and Peak Load supply referred to in the submission as “MDQ Supply”.

Base Load Supply contracts are characterised by a flat daily supply of gas with negligible tolerance between the maximum and minimum daily quantity. Base Load Supply contracts are characterised by a maximum daily volume, a yearly maximum volume and a yearly minimum volume. Gas that is not taken up to the contract minimum volume constraint must be paid for and is either forfeited or banked and taken in ensuing years at additional cost.

Peak Load Supply contracts are required to augment the Base Load contracts on high demand days to allow the Gas Retailer to maintain supply and comply with regulatory requirements. Peak Load contracts are characterised by a maximum daily volume and a fixed yearly capacity payment. Retailers such as Origin with significant mass market loads are obliged to provide for the capacity to meet this forecast demand, in advance, based on forward projections of an extreme year rather than actual peak demand

A mass market retailer must comply with prudent risk strategies to manage their exposures to extreme demand conditions. These include obtaining physical hedges to meet peak demand.

Origin’s approach to both annual supply and peak day supplies seeks to:

- comply with our regulatory and legal obligations as the incumbent retailer in Queensland; and
- as a prudent retailer act in accordance with appropriate commercial risk management policies to limit exposure in the market.

5.1.1 How should the retail cost of supplying natural gas in Queensland be assessed?

Origin’s actual cost of gas supply is determined by bundled and unbundled legacy contracts that cannot readily be provided because of the confidential nature of these contracts.

However, Origin agrees with the QCA that a benchmarking approach to the cost of supply will be the most practical in this situation. Origin will endeavour to provide actual cost information where possible, on a strictly confidential basis, where required.

5.2 Wholesale gas prices

5.2.1 How should the wholesale cost of supplying natural gas be assessed?

Wholesale gas supply is purchased by Origin and other market participants as two distinct products; Base Load supply referred to in the submission as “Wellhead Supply” and Peak Load supply referred to in the submission as “MDQ Supply”.

Wellhead price for annual contract quantity ('ACQ')

Origin determines its forecast gas supply charges for Mass Market and Industrial customers less than 1 TJ per year based on legacy contracts. Historically gas has been supplied to Brisbane from the South West Queensland Cooper Basin and long term legacy contracts commenced with SWQ Producers in 1995 for delivered supply to Brisbane and Wallumbilla. The SWQCB contracts are used to supply all Retail customers less than 1 TJ.

- The contract for Brisbane supply is priced delivered to Brisbane, the contract price consists of a variable and fixed charge.
- The contract for Gladstone / Rockhampton supply is priced delivered to Wallumbilla; the contract price consists of a variable and fixed charge.
- Contracts have been subject to escalation and Price review.

As such Origin's actual cost of gas supply is determined by bundled and unbundled legacy contracts that cannot readily be provided because of the confidential nature of these contracts.

Origin agrees with the QCA that a benchmarking approach to the cost of supply will be the most practical in this situation. However, Origin will endeavour to provide actual cost information where possible, on a strictly confidential basis.

Origin would advise that as a benchmarking exercise, the QCA cannot simply collate a \$/GJ benchmark as an indicative cost of supply. As mentioned above and discussed in further detail below, any examination of wholesale gas cost needs to consider both the cost benchmark for base "Wellhead Supply" and peak "MDQ Supply". In addition it is important that any benchmark should reflect a firm supply with sufficient term to underpin a significant retail position within Queensland.

Wellhead MDQ

The supply of wellhead MDQ required over the price path period is based on the total portfolio of contracts required to ensure an appropriate level of security for non-interruptible customers.

The total MDQ commodity cost is allocated to customer segments based on their contribution to the peak day demand (similar to the contribution to transmission costs - see below). This is represented by the "load factor" for each market segment, that is, the ratio of the segment peak day demand to the average daily demand of the segment.

The residential market has a higher load factor meaning that this segment contributes to a higher proportion of the peak demand day requirements than to a retailers annual demand requirements.

Origin supplies Wellhead MDQ from our gas storage facility located at Newstead, near Wallumbilla.

The market price of MDQ has increased faster than ACQ in recent years reflecting some key changes in the Queensland gas and electricity supply market and competing demands from interstate buyers, generators etc.

Market based benchmarks for MDQ may be established based on a variety of MDQ sources including interstate sources such as (but not only) the price published by TRU Energy for underground storage. Other suggested sources include:

- load shedding prices for large customers;
- imbalance Charges on gas transmission pipelines

- cost of running Generation on substitute fuels such as fuel oil; and
- spot gas purchase prices.

5.2.2 *What are the expectations regarding future natural gas costs?*

Origin's view on future ACQ and MDQ prices is based on the following factors:

- reduced flexibility in Coal Seam Gas supply contracts. The need to obtain specific peak shaving contracts has increased in recent years, with these peak contracts being priced at a premium over flat (load factor 1.0 or less) contracts;
- the increase of the electricity / gas convergence. The increase of gas fired generation units in Queensland has compounded these trends as generators compete for limited intra day balancing and other short term gas supplies. Similarly, overall gas demand volatility and 'peakiness' increases;
- reduced flexibility with respect to contractual linepack rights ('imbalance') on the Roma to Brisbane pipeline, Ballera to Wallumbilla pipeline and the Wallumbilla to Gladstone pipeline as these pipelines are approaching throughput capacity; and
- the extended drought across much of the eastern states has also resulted in a dramatic tightening of the gas supply due to the expanded reliance on gas generation.

5.2.3 *To what extent are the current prices expected to persist, and what is the likely impact of the availability of gas from new sources on these prices?*

The direction of future gas prices is very difficult to predict at this point in time as there are multiple factors at work.

On the one hand, there is a significant proving up of coal seam gas reserves in Queensland which greatly enhances the overall gas supply position. On the other hand, there are major challenges on both the supply and the demand side. These include such interrelated factors as:

- Increasing gas production costs;
- Growth in gas fired generation for peak, intermediate and base load;
- Impact of the expanded MRETS, the Emissions Trading Scheme and the ongoing 13% gas Scheme in Queensland;
- The potential for large scale LNG processing developments in Queensland;
- Growth in energy intensive industries in Queensland;
- Water scarcity and its impact on coal usage and costs for generation; and
- Investment decisions in gas transmission pipelines and electricity transmission systems, which impact directly and indirectly on the cost of delivered gas.

In Origin's view, predicting the net outcomes of all these factors on future domestic Australian gas prices is very difficult. This in turn is one of the reasons why price regulation should be avoided, the market place will drive efficient pricing far more effectively than any regulatory process could.

5.3 Transmission

5.3.1 *What are the likely transmission costs of retailers in Queensland?*

The transmission system in Queensland comprises three major transmission pipelines: Ballera to Wallumbilla; Wallumbilla to Brisbane; and Wallumbilla to Gladstone / Rockhampton. In addition there is a lateral pipeline extending from Gladstone to Wide Bay.

Gas transmission costs consist largely of fixed capacity costs with a smaller variable component (depending on the pipeline). Any methodology to assess the costs of transmission must take into account the complexity of allocating fixed costs over varying levels of demand and efficient utilisation of the pipelines, as well as the seasonal/peak demand features of the load.

5.3.2 *What transmission cost benchmark should apply?*

Determining a transmission cost benchmark for gas supply to the various regions of the state is extremely difficult. It involves understanding the fixed and variable cost relationships, the annual volumes, the peak capacity requirements of the overall load - and the allocation principles for establishing costs relevant to particular market segments (as each segment has their own profile characteristics).

In addition, there are issues of equity and stranded asset investment. In this context it should be noted that certain contracts were effectively imposed on gas retailers by previous Queensland governments in order to encourage the development of gas in Queensland. These contracts are still afoot, yet are potentially above prices that could be negotiated right now (although perhaps not in the future).

If a regulator underestimates these costs as they apply to a particular segment for a particular retailer with a particular portfolio, then competition will never emerge. As an example, it is important that the QCA understand that the Access Arrangement for the Roma to Brisbane pipeline is not a realistic benchmark for the wholesale cost of delivery of gas from Wallumbilla to Roma.

Currently there is no capacity available under the Access Tariff and all capacity is contracted under long term arrangements at prices considerably above the determination. These long term rates were contracted to current retailers at bundled rates determined by the government when the pipeline was originally commissioned. In addition any expansions of the Roma to Brisbane pipeline are not subject to the Access Arrangement pricing.

Origin has previously provided evidence of typical transmission rates to the Queensland Government on a confidential basis.

5.4 Retail Operating costs

5.4.1 *What are the operating costs incurred by retailers in Queensland?*

Origin Energy incurs retail costs for its mass market gas retail business across all of Australia. Consequently, the cost to serve information reflects economies of scale and scope that are gained from operating businesses other than solely the provision of small use gas customers in Queensland. However, the cost to serve does vary

across jurisdictions as business synergies cannot be maximised due to regulatory differences.

Origin has traditionally applied a lower operating cost for Queensland gas customers compared to interstate gas customers and electricity customers, reflecting the low level of investment in the past in growing this market (given the lack of cost-reflective pricing).

However, following the introduction of FRC, the increase in the regulatory burden with FRC, and the need to manage customer losses effectively, the differences between Queensland gas customer costs and the retail operating costs for gas customers in other states has been much reduced.

Generally, we are of the view that actual costs should be considered in the context of widely available benchmarks, noting however, the limitation that various benchmarks have with respect to the components of the retail operating cost considered and the inclusion of retail FRC costs.

5.4.2 Do retail operating costs vary for customers with differing consumption levels within the small customer class and/or locations?

Operating costs do vary with different consumption levels. The driver of this is whether the customer is “account managed” and/or has complex billing arrangements in place. In general, the operating cost for small customers (ie with consumption below 1TJ) in Queensland is consistent. Consequently, the operating cost submitted by Origin in its recent price reviews for South Australia is based on any mass market gas customer in Eastern Australia and equally applies to Queensland customers.

5.4.3 What are the fixed and variable components of retail operating costs?

Retail operating costs have a large fixed cost component of about 70%.

5.4.4 What are the likely operating costs of retailers in other jurisdictions? What retail operating cost benchmark should apply?

In terms of benchmarking retail operating costs, Origin believes the use of benchmarking can be fraught with difficulties. Nevertheless, if used in conjunction with other measures, its utilisation may be valid under certain conditions as noted previously. For benchmarking to be an appropriate guide to operating costs, then the following conditions must apply:

- The relevant components of retail operating costs are clearly defined;
- The data is provided in a consistent manner by the relevant retail entities;
- The data represents properly allocated retail costs from businesses that are separated from or fully ring fenced from a distribution business;
- Benchmarks themselves are current and reflect the increasing complexity of energy markets including increases in regulation costs and wholesale market operation costs; and
- The explicit identification of costs directly associated with implementation of retail contestability. This includes costs such as amending billing systems and

wholesale systems to comply with market rules but excluding customer retention and acquisition marketing costs.

- There is a logical and consistent allocation of costs between costs captured in the retail operating costs and costs “captured” in the retail margin. For instance, it must be clear where the costs of bad debt (an increasing issue in a competitive market) are allocated.

5.5 Retail Margin

5.5.1 *What is the most appropriate basis for assessing the retail margin for Queensland retailers?*

There is no standard approach used by state regulators in assessing an appropriate margin especially for default customers in a competitive market segment. Origin prefers to take a simple percentage return on revenue approach. Even so, jurisdictions differ significantly in their perceptions of a reasonable return on revenue. What is important to Origin is that the margin is commercially realistic and consistent with the risks of the retail operation. This includes:

- Retail risk, including customer churn, bad debt, market failure and weather variations that impact on cash flows;
- Financial risks, impact of working capital of the network payment schedules, the market settlement arrangements etc;
- Market trends: a shift in Queensland gas demand with growth in the very high volume end and decline or stagnation in other segments;
- The wholesale settlement arrangements, including the wholesale market balancing regimes and the impact of this on cash flow, costs and financial risk exposures; and
- Particularly in the case of Queensland, the absolute value of the retail margin (in terms of \$/customer).

Origin considers pricing levels should adopt a 5 per cent net margin which is conservative and the minimum acceptable for Origin’s legitimate business interests.

5.5.2 *Do retail margins vary for customers with differing consumption levels within the small customer class and/or locations?*

Historically in Queensland the retail margins varied across the consumption levels. The previous structure of the regulated prices did not align with the fixed costs of supply and hence the retail margin was not consistent across customer levels or location. These discrepancies were largely resolved in the progressive rebalancing of the tariff structure for the commencement of competition.

Retail margins between customer classes have been rebalanced and are now largely consistent, including customers supplied at different locations. However, as demonstrated by the different price levels in regions there is a clear difference in the transport costs to service customers supplied via the different distribution pipelines in Brisbane as well as customers located in Wide Bay and Northern regions.

5.5.3 Is there consistency in retail margin allowance in other jurisdictions? What retail margin benchmark should apply?

As noted, there are quite different views on how to approach retail margin and what the appropriate retail margin is in a contestable market. In general, there has been a slowness to recognise that the gas wholesale market has changed over the last few years, with more complex supply contracts, tighter contract terms and, in particular, much more restrictive and expensive gas balancing regimes.

Given the different supply conditions there is no expectation the retail margin will continue to remain consistent across jurisdictions, particularly given the continuance of different, state specific wholesale balancing and settlement systems, regulatory regimes and market transfer systems - all of which reduce the synergies available for national retailers.

As the retail market further develops in Queensland the impact upon Origin's business may change and perhaps the business strategy will require enhancement. It is recognised that while a low margin will have a direct impact on a retailer's market competitiveness, a higher margin is less likely to benefit the retailer with additional returns as it may incentivise dormant retailers to enter the market. Accordingly, an appropriate margin is a balancing exercise to allow a retailer to maintain its market share.

Origin recognises investment analysis provides a useful means of validating existing retail margin benchmarks. However, benchmarks may provide some guidance for retailer margin yet consideration of the different commercial risks associated with the electricity and gas market is necessary to take account of unique market conditions.