



Response to QCA

Draft Decision

Revised Access Arrangement for Gas Distribution  
Networks:

Envestra Queensland

A submission by Origin Energy

27 February 2006

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## 1. Introduction

Origin Energy (Origin) welcomes this opportunity to comment on The QCA's draft Decision on Envestra's Revised Access Arrangement for its Queensland Gas Distribution Networks proposed to take effect from 1 July 2006.

This submission does not contain confidential information and may be published on the Authority's website.

Origin has over 2 Million gas and electricity customers in Queensland, New South Wales, Victoria and South Australia and has several years of experience in the gas industry. In particular, Origin has significantly more experience with Envestra's current Queensland Access Arrangement than any other retailer. Origin is therefore well placed to comment on the Envestra's revised Access Arrangement.

Origin is of the firm view that customers and the Australian economy as a whole are the key beneficiaries of vigorous competition in the energy industry. As real competition takes shape, customers receive the benefit from new entrants and incumbents competing for market share by offering cheaper and more innovative services.

While the gas industry is well established in QLD, gas retail competition is still developing in Queensland with Full Retail Contestability (FRC) starting on 1 July 2007. FRC implementation during this Envestra's access period makes it essential for customers, the gas industry and, to a certain extent the Queensland economy as a whole, that the QCA ensures that the gas networks operate in an efficient and effective manner and minimise barriers to entry. In light of this, Origin supports the great majority of the QCA's recommendations and we are happy to discuss each of these further if required. There are, however, some specific comments that we would like to make in response to a number of important issues raised in the Draft Determination.

Moreover, as a general comment, Origin encourages initiatives that, where possible, support consistency between Energy Distribution and Retailing across State jurisdictions and preclude preferential treatment between participants. Such outcomes not only enhance the efficiency of the industry as a whole but support the development of an effective competitive gas market in Queensland.

Origin has considered and generally supports the QCA in the stance it has taken in its draft decision in relation its treatment of depreciation, incentive mechanisms and redundant capital

## 2. Terms and Conditions

The QCA has made a number of amendments to Envestra's proposed terms and conditions, which have the effect of more appropriately sharing risk between the Envestra and the network user, and which ensure the accountability of Envestra.

### 2.1 Responsibility and Accountability of the Network Operator

In its submission of 11 November 2005 to the QCA, Origin proposed that a new Clause 2(a) be inserted into the Access Arrangement terms and conditions that Envestra be obliged to *"Operate and manage the Network in a manner consistent with a prudent network operator"*. We note that the QCA has rejected this proposal.

This inclusion was suggested to address terms proposed by Envestra such as Clauses 2.5, 13.2, 13.3 which state;

#### ***"2.5. Gas Balancing within Network***

*Envestra will have no responsibility to ensure that the Quantity of Gas delivered out of the Network to or for the account of the Network User is equivalent to the Quantity of Gas delivered into the Network by or for the account of the Network User. Envestra will have no liability to the Network*

*User in the event that, at any time, the Quantity of Gas delivered into the Network by or for the account of the Network User is more or less than the Quantity of Gas delivered out of the Network to or for the account of the Network User.”*

**“13.2. Exclusion of Liability**

*Envestra will not breach its obligations under the previous clause where its failure to comply with that clause is due to:*

*(a) the technical, practical and physical limitations of the Network;*

*(b) the fact that insufficient Gas is delivered into the Network; or*

*(c) the fact that Gas is delivered into the Network at pressures outside the limits specified from time to time by Envestra,*

*whether or not Envestra knew, or ought to have known, of those facts or matters at any time before, on or after the Start Date.”*

**“13.3. No Implied Obligation**

*Nothing in clauses 13.1 or 13.2 imposes any obligation on Envestra to take any steps to modify the technical, practical or physical limitations of the Network or to cause or procure the delivery of Gas into the Network or to ensure that Gas is delivered into the Network at pressures within the limits specified from time to time by Envestra.”*

While we believe it is unintentional, these clauses do appear to attempt to relieve Envestra of its responsibilities to act as a prudent network operator. We believe this to be an unreasonable arrangement that needs to be addressed.

Origin submits to the Authority that any appearance of attempting to avoid the responsibility of acting as a safe and prudent network operator is unreasonable.

## 2.2 Advance Payment of Network Charges

In both its current and revised Access Arrangement, Envestra requires users to make advance payment of two months of estimated network charges. In each subsequent month, Envestra retrospectively adjusts the advance payment of charges in line with the charges actually incurred by each user.

There are a number of reasons why this advance payment arrangement is inefficient and unreasonable, they are;

- Advance payment of network charges represents working capital that is currently being carried by Users. This working capital is more appropriately carried by the distributor since as a regulated entity with a lower risk profile, Envestra enjoys a lower Weighted Average Cost of Capital (WACC) than Users. The overall cost of carrying this working capital is therefore lower to the market if it is carried by Envestra.
- Origin submits that Envestra already protects itself adequately from bad-debt with a robust credit policy which seeks credit support from Users with poor credit ratings. We therefore believe it is unreasonable for Envestra to require, what amounts to a security deposit, from Users who enjoy a credit rating that exceeds Envestra’s minimum threshold.
- Advanced payment followed by subsequent monthly adjustments is a complex arrangement involving the risk of errors accompanied by disputes between the distributor and Users. As gas contestability increases and new retailers enter the market, more Users will be required to pay Envestra’s network charges in advance. This will inevitably lead to a further duplication of effort and an increased risk of error and disputes.

- Origin believes that Allgas operates in a similar environment to Envestra in Queensland and has not sought an advanced payment regime in its revised Access Arrangement. We therefore believe that it is inconsistent and unreasonable for Envestra to seek such an arrangement.
- Advanced payment is a barrier to entry since Users are required to set up unique settlement systems to cope with arrangements that are peculiar to Envestra's Queensland and South Australian Access Arrangements.  
Moreover, Users are required to pay network charges around two months before they can expect to be paid by their customers.
- Origin notes that the McLennan Magasanik Associates reports<sup>1</sup> commissioned by the QCA, confirm that retail margins are very low (even negative in some segments of the market) within the Envestra network.  
Origin submits that removal of prepayment would tend to ameliorate some of the losses suffered by gas retailers on the Envestra network. Origin considers that improved margins provide an incentive to other retailers to enter this network.

Origin notes that the QCA has proposed in its draft decision, a 12-month period starting 1 July 2006, in which Envestra would be entitled to seek an advanced payment of one-month instead of two. Origin strongly disagrees with this approach since both Envestra and Users will be required to set up or modify existing settlement systems and processes that would operate for a short time. These system and processes would then need to be modified again after twelve-months. Origin is concerned that this change process will introduce further risk of errors and disputes multiplied by an increasing number of Users inexperienced in Envestra's settlement processes. Furthermore, a one-month pre-payment continues to remain a barrier to entry and continues to be an unreasonable security deposit for Users with strong credit ratings.

While Origin disagrees with Envestra's entitlement to seek an advanced payment, in any form, except from Users with poor Credit Ratings, Origin concedes that it is appropriate that Envestra should be entitled to recover the appropriate cost of carrying this working capital in its distribution tariffs.

### 2.3 Invoicing

Origin supports the QCA Amendment 4.4 (all 3 points). It is important, especially under FRC, for the network provider to provide sufficient information to allow reconciliation of network charges at the individual customer level, and for timeframes for the rectification of invoices to be limited to the same timeframes as the retailer.

### 2.4 Overruns

QCA rejected both Energex's and Origin's proposed revisions to the Overrun arrangements. Origin has a number concerns in this regard:

- The QCA mentions that Users are entitled to renegotiate a lower MDQ should circumstances warrant it. Origin recommends that a formalised process of applying for, and granting, MDQ reductions be implemented.
- Origin supports Energex Retail's suggestion that Envestra notify a network user of a change in MDQ fourteen days before the change comes into effect. Network Users need adequate time to advise the customer and adjust their billing.

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<sup>1</sup> McLennan Magasanik reports "*Demand forecasts for Envestra*" and "*Demand forecasts for Allgas*" both dated 22 November 2005, Section 3.2.7; "Economics for Gas Retailers" in both reports.

Origin requests that, in the interests of efficient market operation, the QCA reconsider its position on this matter.

### 2.5 Meter Accuracy

The QCA rejected Origin's proposal for reciprocal arrangements regarding metering accuracy, although it suggested that the matter would be considered if circumstances change.

Since a number of Origin owned meter installations are already in place, Origin recommends that the QCA reconsider its position on this matter.

The amendment is simple and does not create a problem for Envestra.

## 3. Pricing Issues

### 3.1 Pricing of Shared Assets

Origin notes that the QCA has determined that significant pipeline extensions can be excluded from the covered assets. However, this must be based on QCA approval and a portion of the revenue allocated to shared assets as appropriate (this allows average prices for all users to decrease in the event of major new customers utilising some parts of the existing network). Origin agrees with this approach.

### 3.2 FRC Costs

Origin notes that the price path proposed by the QCA does not include an allowance for network FRC costs. However, once determined, the QCA has stated that FRC costs will be additional to Envestra's network price path. Origin supports the recovery of reasonable FRC costs by both of the networks and by Retailers.

### 3.3 Network Pricing Principles

Origin strongly supports the principle that the network price structure clearly signals (at a minimum) the incremental costs of gas supply to very small consumption customers, such as customers using a gas cooker only. Gas cooking is a "life-style choice", not an essential service, and it is critical that supply for this utilisation (particularly when not accompanied by other gas use in the home) is not subsidised by other existing network users.

In our view, the continued connection of very small gas customers at prices below their true costs, simply encourages economically inefficient investment in supply to small customers, the costs of which must then be borne by other customers. This in turn discourages utilisation of gas by customers where it is economically efficient to do so (if based on true costing).

However, the issues of principle highlighted above, are complicated by the lack of commensurate price signals in the gas retail price, or of an overarching jurisdictional strategy on efficient retail gas pricing in Queensland. Customers respond to the retail price not the network price, and currently, the gas retail price structure in Envestra's supply area is determined by the pricing regulator without any reference to the existing network price structure or the true costs of supply. This, combined with the statutory obligations to provide retail supply on request<sup>2</sup>, has exacerbated the trend to invest in new connections that are not economically viable even over the long term.

### 3.4 Cost Pass-Through

Origin has some concern that the QCA does not explicitly address the question of pass through of both increases and decreases in the relevant costs. Envestra's proposed Access Arrangement does suggest both increases and decreases will be passed through (Clause 4.3).

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<sup>2</sup> The *Gas Supply Act (2003)* removed the economic test for retail supply that existed in the previous *Gas Act (1965)*

Accordingly, Origin encourages the QCA to continue to ensure that both increases and decreases in relevant costs are passed through.

### 3.5 Rolling Forward the Capital Base

Origin notes that the QCA faced the same dilemma with respect to assessing the opening capital base for 2006 as other jurisdictional regulators have faced. That is:

- To decide whether, the distributor has under spent capital relative to its forecast capital expenditure in the first period of the current Access Arrangement;
- The distributor's forecast for the final year(s) of the current Access Arrangement shows a significant upward trend in capital expenditure;
- There is little transparency with respect to the basis of the historical or final year capital expenditure such that the regulator can determine if under spending reflects real improvements in efficiency versus reductions in actual investment in projects (compared to forecast) or cost cutting at the expense of service quality.

As there were no objective service performance measures for the 2001-2006 access period, the QCA is unable to assess whether the cut back in capex is due to efficiency improvements or due to underinvestment. Origin notes, for instance, that while UAFG in Envestra's network (Gas Losses) initially decreased, the losses appear to be now on an upward trend. This suggests the possibility of some decline in network performance over the period, a decline that might have been arrested if the allowed capex in mains renewal had been fully spent by Envestra. These differences are illustrated in Table below (note that mains renewal makes up the bulk of the stay in business capital).

#### Stay in Business Capital (\$M) First Access Period

|                            | 2001/02 | 2002/03 | 2003/04 | 2004/05 | 2005/06 |
|----------------------------|---------|---------|---------|---------|---------|
| Envestra Approved          | 6.9     | 7.0     | 6.8     | 7.0     | 6.6     |
| Envestra Actual & Forecast | 3.81    | 4.20    | 5.33    | 6.20    | 7.28    |

Sources: Envestra Approved: Final Determination 2001/02-2005/06, Table 14.5, page 186.  
Envestra Actual/Forecast: Draft Determination 2006/07-2010/11, Table 11.4, page 53.

Origin is also somewhat concerned that the QCA has allowed Envestra the \$2.6 Million in Major Projects for 2005-06 (as part of Growth Capital), when their own advisors have indicated that Envestra did not substantiate this expenditure plan for 2005-06. We recognise that the QCA has indicated that it will remove this "allowance" in the Final Determination in the event Envestra does not provide additional supporting information.

In Origin's view however, it would have been better to exclude the \$2.6 Million in the Draft Determination, reinstating it in the Final Determination only if the QCA is provided with a clear substantiation of the investment from Envestra. Such an approach would also provide a greater discipline on the distributors in terms of the completeness of the information provided to the regulators as part of their initial proposals.

We note here that Envestra's proposed Access Arrangement was provided in September 2005 and the Draft Determination was released in December, well into the 2005-06 financial year. It would be reasonable to expect therefore that any Major Projects for 2005-06 would have been identified and costed by Envestra prior to this time, and that the information would therefore be readily available for their submission and the QCA's review.

Origin also considers that any Major Projects will be associated with a significant capital contribution from the relevant customer. Origin submits that the QCA should ensure that the

forecast of capital contributions for 2005-06 takes into account, and is consistent with the forecast of Major Projects for 2005-06.

Origin is not in a position to comment in detail on the forecast capital expenditure programme. However, we note with some concern the significant increases in proposed capital expenditure by Envestra and question whether these increases are sustainable in the context of the Queensland gas market, particularly if they result in average network tariff increases of CPI+2%

Origin therefore supports the QCA's proposal to reduce the total forecast capital expenditure from \$102.5M proposed by Envestra to \$66.7 Million. We note that still represents a 32% increase compared to the actual expenditure in the previous five years, a sufficient increase to support an adequate renewal rate for mains, meters and services.

Moreover, we note that Envestra's proposal claims that much of the capex reductions (compared to forecast) in the first access period represent increases in efficiency in the 2001-2006 period. In that case, we would expect to see cost savings from enhanced operational efficiency rolling forward into the capex costs for 2006-2011. Instead, we see costs for customer connections and the like remaining at high and unsustainable levels.

For instance, Envestra suggests that the costs of each additional incremental domestic customer in a new area are made up of (pages 62 & 63 of the Draft Decision):

- \$38 per metre mains extension
- \$968 per customer inlets/services
- \$336 per customer meter costs.

If the average new customer typically requires 5 metres of mains extension, then the total incremental capex costs for connection of a new domestic customer will be some \$1,500 per domestic customer (that is, excluding any allocation of costs for usage of the existing pipelines). If this represents the true cost of a customer connection, then we suggest that the majority of new connections are not sustainable. For instance, the average annual DUOS charge for a 5 GJ customer (a cooker only customer) is \$125-\$130 per year (GST exclusive)<sup>3</sup> - this is unlikely to result in recovery of \$1,500 incremental costs and ongoing Capex and Opex expenditure.

### 3.6 Gas Marketing Expenditure

Origin strongly supports increased investment in gas marketing activities to at least \$600,000 by Envestra, as it is essential for the economics of gas utilisation that consumption per customer increases.

However, Origin recommends that Envestra's marketing plans are consistent with:

- The Queensland Government's Sustainability Housing policy which commences in March 2006, as this will clearly have a direct impact on the requirement for and the approach to marketing of gas hot water.
- The economics of gas supply to new and existing premises. The marketing plan should be clearly directed at activities that will have a substantial impact on the average \$ per GJ network cost, and therefore must also result in actions that are demonstrably above the incremental costs of supply (We note the MMA report, that the minimum here to recover the incremental cost of gas connection in a new residence is around

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<sup>3</sup> The full cost of this is not recovered in the retail price as noted previously.

10 GJ per year - any residential plans should clearly demonstrate an impact that results in consumption greater than 10 GJ per year<sup>4</sup>)

- Promote the utilisation of gas in commercial and industrial processes as a priority over residential customers where there is a greater opportunity to achieve average consumption levels significantly above the level of the incremental cost.

### 3.7 Demand Forecasts

The forecast trends in average consumption for residential customers are concerning, and will further add to the average network cost in \$ per GJ terms. For instance, if the annual fixed network supply charge is \$75 per customer, then a reduction in consumption from 10 GJ pa to 8.9 GJ pa results in an increase of over \$0.90c per GJ in average \$ per GJ network cost.

This conclusion further supports the urgent need to reform network (and retail) pricing to discourage gas connection for single gas appliance use and encourage multiple gas appliance utilisation. The Marketing Plan should be targeted around the same objectives.

A further difficulty in finalising the demand forecasts lies in the outcome of a number of key exogenous factors, the outcome of which will have significant impacts on the price to customers and, therefore, on the demand outcomes:

- Retail pricing reform: if retail pricing reform is implemented as recommended by Origin, the economics of gas utilisation will markedly change from a customer's perspective. A key component of Origin's recommended reform includes a direct pass through of "uncontrollable Retail costs (such as regulated network charges).<sup>5</sup>
- FRC Cost Recovery: FRC will add a number of new costs for mass market customers, which, if passed through to customers will increase prices at least in the short term to some segments (particularly those segments where there are zero or negative margins now).
- Introduction of demand based retail tariffs for large customers. Currently, many large customers between 10TJ and 100 TJ per annum "sit on"<sup>6</sup> throughput-based retail tariffs set by the Pricing Regulator (no MDQ component) and which distort the true cost signals. If these are unwound and retail prices reflect the true costs, then MDQ growth may be curtailed - in contrast to the MMA forecast of continuing growth in MDQ relative to annual load. However, the removal of embedded cross subsidies under the current tariffs is likely to see the average gas retail price for large customers with good load factors decline, an outcome which may encourage growth in annual load of this sector if not in MDQ. Again, the utilisation of the correct economic pricing signals is essential for the effective operation of the market.

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<sup>4</sup> However, we also note here the contradiction between a requirement for new customers to consume more than 10TJ/year and the demand forecast of declining average consumption (to a point below 10 GJ/year)

<sup>5</sup> Origin is recommending that retail prices set by the Pricing Regulator in Qld are set within the same analytic, cost-reflective framework as used by the South Australian regulator (ESCOSA) in determining gas retail tariffs 2005/06 - 2007/08. The regulated retail prices in SA were set based on the pass through of network charges plus an approved retailer cost allowance. See for example: ESCOSA, *Gas Standing Contract Price Path Final Inquiry Report and Final Price Determination*, June 2005, page 1.

<sup>6</sup> Under the *Gas Supply Act (2003)*, large customers up to 100 TJ have the right to stay on their current variable tariffs, and do not have to move to an MDQ based contract.

Given the sensitivities of the tariffs to these factors in such a small market, the impact of retail pricing reform on network demand (both MDQ and annual volume) may need further analysis.

### 3.8 Reference Tariffs and Tariff Paths

An overall price path (with side constraints) is acceptable in gas and electricity markets where cost reflective pricing is already in place. However, as noted by the QCA, there is a lack of empirically supported cost allocation and in all likelihood, some significant cross-subsidies between customers at the network pricing level<sup>7</sup>. Given this, Origin considers the discipline of separate price paths is more appropriate for the 2nd Access Arrangement period.

Origin is particularly interested in the QCA investigating the question of cost reflectivity not only between the volume and demand segments of the market, but within the volume and demand segments. We note here, for instance, that Envestra's proposed V tariff, the last step in the tariff is some 69% of the first step in the tariff<sup>8</sup>. The first step applies to small residential consumers while the last step in the tariff applies to commercial/industrial consumers using above 7 GJ/day (for the marginal unit of gas above that).

This ratio of 69% is considerably higher than the ratio between the first and last step in network tariffs in both Victoria and South Australia. For instance, in the main Victorian Envestra network tariff, the ratio is 18% with the last step applying to consumption all above 1.4 GJ per day<sup>9</sup>. There may be valid economic reasons for this difference, however, Origin is not in a position to assess these factors.

We believe strongly, however, that it is in the interests of the gas market as a whole that growth in demand from the larger V tariff customers should be encouraged, certainly in preference to the limited options available for and benefits of expanding residential gas supply.

## 4. Summary

In the interests of customers, the gas industry and the Queensland economy, it is essential that the QCA enforces Access Arrangements that include reasonable terms and conditions and tariff regimes that are cost reflective, encourage efficient gas use and minimise cross-subsidies. This is especially important as retail competition develops into full retail competition during this access period.

Origin Energy  
27 February 2006

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<sup>7</sup> We are using the term cross subsidy in its more common form, ie that different customer segments generate a different return on investment. This is different from the meaning in the Code where a cross subsidy exists only where prices for a segment sit outside the (broad) range of incremental costs up to stand-alone costs.

<sup>8</sup> Calculated from Table 15.5 as  $\$9.57/\$13.86 = 69\%$

<sup>9</sup> Calculated based on Envestra's Victorian Central Tariff for 2006 as  $\$0.87/\$4.73=18\%$ .