



27 October 2008

Queensland Competition Authority  
GPO Box 2257  
Brisbane Qld 4001

[gas@qca.org.au](mailto:gas@qca.org.au)

By email

### **Review of Small Customer Gas Pricing and Competition in Queensland: Draft Report**

The Queensland Competition Authority (QCA) has been directed by the Minister for Mines and Energy to conduct a review into the effectiveness of retail competition and natural gas prices for small gas customers in Queensland.

As part of its process, the QCA released its *Review of Small Customer Gas Pricing and Competition in Queensland: Draft Report* (Draft Report) in October 2008.

Origin Energy (Origin) has been a natural gas retailer in Queensland since the start of the Brisbane Gas Company in the 1860s and now supplies electricity, natural gas and LPG to more than three million customers in Australia and the Pacific. As such, Origin is well placed to comment on the effectiveness of retail competition in the Queensland gas market and welcomes this opportunity to respond to the Draft Report.

Origin is pleased that the initial findings of the QCA's review recognise that:

- although gas prices have increased significantly, many small gas customers still pay less than cost of supply;
- there is evidence of competition between host retailers in Qld;
- the major impediment to competition by new entrants is the low profitability of current retail gas prices; but
- a competitive market is emerging as retailers' transition prices to levels with suitable profit margins.

Origin understands that the purpose of the review is to determine whether additional measures are necessary to improve competitive market outcomes for natural gas customers, incumbent retail market participants and new entrant retailers.

Full retail contestability (FRC) in the Queensland natural gas market only commenced on 1 July 2007 and due to the relative immaturity of the market, it is premature to make final judgement regarding the future state of competition. However, Origin fully supports the QCA's view that the Queensland gas market is exhibiting signs of a competitive market and strongly believes that the reintroduction of any regulated pricing arrangements would create further 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 utilisation of the network to the long term detriment of consumers.

As Origin concurs with the key findings and with the analyses conducted by the QCA and its consultants, McLennan Magasanik and Associates (MMA), this submission does not restate the arguments made in Origin's previous submission to the QCA's Issue Paper. Instead, this submission focuses on several conclusions that Origin feels need further clarification.



## 1. Competitive Assessment Framework

The QCA has based its assessment framework on that adopted by the AEMC in assessing the level of competition in Victoria and South Australia<sup>1</sup>.

It doing so, it has focussed on observing the:

- number of retailers competing in the market;
- change in market share since FRC was introduced;
- level of customer participation as identified by customer switching between retailers; and
- emergence of differentiated products and services within the market.

Such analysis provides a useful indicator of developments in the Queensland retail gas market but would be flawed if considered alone because of the immaturity of the market. However, the Draft Report has rightly noted that these indicators are but a snapshot of competition and been forward looking by focussing on the competitive signs and expected future developments.

The QCA has also tried to take into account the various unique factors that impact on the Queensland gas market including the:

- history of regulated retail prices being below the cost of supply;
- small size of the residential market;
- inefficient utilisation of the natural gas distribution networks because of the lack of heating load;
- structural limitations in transmission pipelines; and
- range of Government policies for natural gas and other energies including the impact of low off-peak electricity prices for controlled hot water.

Origin is therefore supportive of the approach undertaken by the QCA to assess competition.

## 2. Competitive Market outcomes for Small Gas Customers in Queensland

Table 1 outlines the QCA's conclusions of the set of indicators used to assess competition. It also contains comments by Origin on these findings.

---

<sup>1</sup> AEMC, Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria, Second Final Report, 29 February 2008. Review of Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia, Issues Paper, 14 March 2008.



Table 1: Competitive Outcome Indicators

Indicator	QCA Finding	Origin Comment
Number of Gas Retailers	<p>There are 3 new licensed retailers in addition to the host retailers, Origin and AGL.</p> <p>Only one new retailer has been active and only for a short-period of time.</p> <p>A distinct lack of alternate retailers.</p>	<p>Origin concur that new entrants have failed to enter the market. This is partially due to low profitability of gas customers. For competition to exist, prices must be at economically efficient levels and contain a retail margin to encourage entry by other participants. This is of particular significance to the Queensland market as the retail prices have been historically low.</p> <p>Origin would highlights that the lack of new entrants may also be due to the reduced profitability of regulated electricity tariffs. The QCA notes that retailers market to gas customers as dual fuel packages to minimise acquisition cost. Consequently, new entrant retailers will only seek to enter the gas market if they are active in the electricity market. This is not currently the case as many new entrants have ceased activity in the electricity market given the lower retail margins and the additional risks and costs being imposed on retailers.</p> <p>However, Origin notes that a new entrant retailer can quickly become licensed and enter the market, as shown by APG, which continues to provides competitive threat.</p>
Changes in Market Share	<p>The gas market is concentrated between the two host retailers.</p> <p>Competitive rivalry exists in metropolitan areas but not regional areas.</p>	<p>Agreed. The lack of new entrants has meant that competition is currently limited to the host retailers but Origin highlights that competition is readily observable from the customer transfer numbers.</p> <p>As noted above, profitability of electricity is also important to activity in the gas market so a major limitation on gas competition in regional areas is that these customers' electricity tariffs are not cost-reflective. Gas marketing must be pursued individually for regional customers and this is recognised as not being cost-effective.</p>
Customer Participation	<p>Since the commencement of gas FRC, the gross switching rate for 12 months is 5.8%. This is a reasonable initial rate but limited to metropolitan areas.</p>	<p>Agreed. The rate of customers switching retailer or entering into market contracts is quite significant in South East Queensland despite the small number of market participants.</p> <p>Active competition in regional areas is limited by the low profitability of both electricity and gas prices and the small number of customers. However, competitive forces ensure that prices for regional customers are increased above cost reflective levels.</p>
Price and Product Differentiation	<p>Price diversity and non-price product differentiation is evident in the Qld gas market in metropolitan areas but not in regional areas.</p>	<p>Origin agrees that price and product diversity is clearly observable and will continue to increase as Origin makes further energy products available to Qld customers.</p> <p>Again, Origin would highlight that it does not offer dual fuel benefits to regional gas customers because their regulated electricity tariffs are well below the cost of supply.</p>



### 3. Gas Prices for Small Customers

Origin has retail authority areas in Brisbane, Ipswich; Gladstone, Rockhampton and Wide Bay that were subject to regulated retail tariffs until 30 June 2007.

As acknowledged in the Draft Report, Queensland’s regulated retail gas prices have not kept pace with the rising costs of supply and previously resulted in significant losses to retailers supplying Queensland residential and small business customers. Accordingly, when price regulation was removed on 1 July 2007, significant price increases were applied to small customers, not as a result of a lack of competition, but as an inevitable consequence of aligning prices with the cost of supply.

Origin is encouraged to note that the detailed analysis performed by MMA, clearly demonstrates this.

In its consultant’s report, MMA has taken the approach of estimating the likely cost to a new entrant of supplying small gas customers in two ways. The fully allocated cost (long-run average cost) and a marginal cost whereby a retailer does not recover any retail margin or contribution to fixed costs.

Origin is fully supportive of the MMA approach as it clearly identifies and supports the submissions made by Origin that:

- it has increased gas tariffs for the purpose of bringing pricing for small customers into line with cost reflective levels by raising them above marginal cost; and
- the retail margins derived from these increased gas prices are still below the levels expected by an energy retailer for its fully allocated cost.

**Table 2: Comments on MMA’s Estimation of Cost Components**

Cost Component	Origin Comment
Wholesale Gas Price	<p>The wholesale gas costs used by MMA for both 2008-09 and 2012-13 are reasonable.</p> <p>However, Origin note that future gas prices are difficult to estimate because of many supply and demand factors such as:</p> <ul style="list-style-type: none"> <li>• increasing gas supply and production costs;</li> <li>• growth in gas fired generation;</li> <li>• the Carbon Pollution Reduction Scheme; and</li> <li>• the potential for LNG processing developments.</li> </ul>
Transmission Cost	<p>Origin understands why MMA has assumed transmission costs equivalent to those within the Access Arrangement for the RBP.</p> <p>Origin believes these are reasonable for this exercise but would again caution that these tariffs are not available and retailers are required to negotiate with the pipeline operators for actual transmission prices.</p>
Distribution Charges	<p>MMA have used the average tariff increase for the customer class which is appropriate but distribution charges for residential customers can differ greatly from this average.</p>
Retail Cost and Margin	<p>For this exercise, Origin agrees with the use of operating cost of \$100 per customer and retail margin of 6.5% of sales for domestic households.</p>



#### **4. Substitutes for Natural Gas**

The QCA has concluded that the opportunities for substituting energy are limited by the relative price differences and because of the costs of converting between energy sources.

Although Origin concurs in general with the QCA's findings on energy substitutes in the Draft Report, it believes that further consideration should be given to several of the issues raised.

1. Although conversion costs from LPG to natural gas and vice versa are significant, it should be noted that the competitive pressure exerted by other fuels (eg. LPG and electricity) is ongoing because appliances have a limited lifespan (10-15 years). Therefore, a percentage of consumers are continuously making the choice of which energy source to use when selecting or updating their capital equipment or appliances. This is particularly the case with new extensions where households can trade off costs and benefits of alternative sources of energy;
2. The QCA rightly identifies that natural gas is cheaper than LPG for all customers apart from the smallest users of gas (cooking only). However, the smallest cost of conversion from natural gas to LPG will be for cooking only customers so there be competitive pressures on this customer class;
3. The consideration of Government policies is appropriate but should include the rebate schemes for solar panels which directly compete with natural gas for hot water customers; and
4. The MMA analysis for electric hot water tariffs is revealing and indicates that policies that keep prices artificially low for one purpose can have far reaching consequences. Origin would like to see the inclusion of tariff 33 in the analysis. Furthermore, MMA should be cognisant of the fact that other appliances (such as pool heaters) that natural gas competes with electricity for also utilise tariffs 31 and 33 so the impact may be more significant than identified.

#### **5. Retail Contestability Outcomes in Other Jurisdictions**

Origin is pleased to see the QCA's examination of gas retail markets in other jurisdictions and comparison with Queensland is mindful of the relative immaturity of the Queensland market.

Despite this immaturity, the QCA's assessment highlights that the number of retailers licensed and operating in the Queensland market is comparable to other small gas markets such as the ACT and Tasmania.

It is also revealing to see that monthly customer switching rates in Queensland are at a similar level to the start of the Victorian, South Australian and New South Wales markets despite the inherent differences in the Queensland gas market.

These differences are clearly revealed by MMA's comparison of retail gas costs between jurisdictions. The MMA analysis demonstrates effectively that the relative higher cost of gas in Queensland is primarily being driven by the low consumption rates of residences and consequently, the high cost of gas distribution.

Origin agrees with this analysis as due to the warm climate, the reticulated gas market in Queensland does have fewer customers using smaller quantities of gas which leads to the high average cost of gas distribution given the large fixed costs of installing gas infrastructure.



## 6. Future of Gas Retail Competition Development in Queensland

The QCA has identified the two primary barriers to gas retailing in Queensland as being:

- capacity constraints on the Roma to Brisbane Pipeline (RBP); and
- that tariffs that are below cost reflective levels with low retail margins.

Origin agrees that these factors can limit competition but would highlight that:

- retailers can access capacity on the RBP in the short-term and that capacity is increasing on the RBP in the future. Both these facts were acknowledged by the QCA; and
- Origin has stated that it has been transitioning retail tariffs to cost-reflectivity and expects gas prices to be at levels that provide retail margins commensurate with other jurisdictions in the near future.

Clearly, the current customer switching rates indicate that retailers are motivated to compete and consumers are willing to enter the market. The emergence of new entrant electricity retailers initially contributed to a reasonable level of rivalry in the electricity market and if this market activity was maintained, then it is expected that these retailers will move to acquire gas customers as and when the opportunity arises.

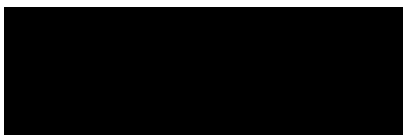
Therefore, Origin believes that the QCA is correct in assuming that there is potential for the development of further competition within the retail gas market in the future.

To encourage such development, industry participants must ensure:

- continued network expansion, capital works and encouragement of new connections within distribution areas;
- that pricing signals for gas and other competitive energy sources, such as the regulated electricity tariffs for off-peak hot water, are cost-reflective; and
- that Government policies aid industry by encouraging the penetration and utilisation of gas and do not interfere with efficient pricing signals in the energy markets.

If you have any questions with regard to this submission, please call me on (07) 3867 0620 or Madonna Mead on (07) 3867 0617.

Yours sincerely



Patrick Whish-Wilson  
Energy Regulation Manager