QUEENSLAND COMPETITION AUTHORITY

Issues Paper

Review of Small Customer Gas Pricing and Competition in Queensland

May 2008

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SUBMISSIONS

Public involvement is an important element of the decision-making processes of the Queensland Competition Authority (the Authority). The Authority is releasing this Issues Paper as a first step in its Review of Small Customer Gas Pricing and Competition in Queensland. The Authority has identified a number of key issues that it will need to consider in accordance with the Terms of Reference for the review. The issues that have been identified are not exhaustive but are provided to assist stakeholders in preparing their submissions. The Authority will take account of all submissions received by the due date.

Written submissions should be sent to the address below. While the Authority does not necessarily require submissions in any particular format, it would be appreciated if two printed copies are provided together with an electronic version on disk (Microsoft Word format) or by e-mail. Submissions, comments or inquiries regarding this paper should be directed to:

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The **closing date** for submissions is 27 June 2008

For further enquiries contact Gary Henry on (07) 3222 0555

Confidentiality

In the interests of transparency and to promote informed discussion, the Authority would prefer submissions to be made publicly available wherever this is reasonable. However, if a person making a submission does not want that submission to be public, that person should claim confidentiality in respect of the document (or any part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available. It would also be appreciated if two copies of each version of these submissions (that is, the complete version and another excising confidential information) could be provided. Again, it would be appreciated if each version could be provided on disk. Where it is unclear why a submission has been marked "confidential", the status of the submission will be discussed with the person making the submission.

While the Authority will endeavour to identify and protect material claimed as confidential as well as exempt documents (within the meaning of the *Freedom of Information (FOI) Act 1989*), it cannot guarantee that submissions will not be made publicly available. As stated in s187 of the *Queensland Competition Authority Act 1997* (the QCA Act), the Authority must take all reasonable steps to ensure the information is not disclosed without the person's consent, provided the Authority is satisfied that the person's belief is justified and that the disclosure of the information would not be in the public interest. Notwithstanding this, there is a possibility that the Authority may be required to reveal confidential information as a result of an FOI request.

Public access to submissions

Subject to any confidentiality constraints, submissions will be available for public inspection at the Brisbane office of the Authority, or on its website at www.qca.org.au. If you experience any difficulty gaining access to documents, please contact the office (07) 3222 0555.

Information about the role and current activities of the Authority, including copies of reports, papers and submissions can also be found on the Authority's website.

PREAMBLE

The Queensland gas market was fully deregulated as from 1 July 2007. Since then, prices charged to small gas customers have increased significantly.

The Government has taken action to ameliorate the price increases for eligible seniors and pensioners.

The reasons behind the increases are not known with certainty, although it may simply reflect the removal of previous cross subsidies which held small gas customer prices artificially low.

The Minister for Mines and Energy has asked the Authority to undertake this review to assist the Government to determine whether any additional measures need to be combined with existing initiatives to improve competitive market outcomes for gas customers, incumbent retail market participants and new entrants.

In undertaking the review, the Authority is to consider and report on the following main issues in Queensland's small customer gas market:

- the current level of competition in the markets for reticulated natural gas and substitute fuels such as reticulated and bottled LPG;
- the impact on retail prices of prices and costs in the upstream gas market and whether current small customer retail prices are reflective of actual costs incurred in the upstream gas supply chain; and
- the extent of current small customer gas market activity, including consumer switching behaviour, impediments to small customers exercising informed choices regarding their retailer of choice and consumer perceptions of natural gas as a product of choice compared to other energy supply options.

The Authority is also required to:

- consider how each of these issues affects different categories of small gas customer;
- comment on differences in market competitiveness and cost reflectivity between regions within Queensland; and
- provide an analysis of differences in market competitiveness and cost reflectivity between Queensland and other Australian States or Territories.

If you are interested in participating in the review, your submission needs to be received by the Authority no later than 27 June 2008. The Authority will release a Draft Report in September 2008 at which time further comments will be sought. The Final Report is due to the Minister by 1 December 2008.

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1. INTRODUCTION

Under the relevant provisions of the *Gas Supply Act 2003* (the Act), the Minister for Mines and Energy (the Minister) has directed the Authority to review small customer gas pricing and competition in the Queensland retail gas market.

The review is to examine current market issues in the interests of gas customers, incumbent retail market participants and new entrants.

1.1 Purpose of the Review

Full Retail Competition (FRC) in Queensland energy markets commenced on 1 July 2007. At the commencement of FRC, the regulated prices for small reticulated natural gas customers (those consuming less than 1 terrajoule (TJ) per annum) were revoked with licensed retailers now responsible for setting prices for all their customers.

Prior to the commencement of FRC, natural gas retail prices for small non-market customers were set by the Queensland Government and, in general, escalated each year by the Consumer Price Index. These prices were often cross-subsidised and were generally below the cost of supply and, since the commencement of FRC and deregulation of gas tariffs, retailers active in the Queensland gas market have moved to restructure their gas prices to better reflect the costs of supplying reticulated natural gas to small customers in Queensland.

As a result of the structure of retail prices in the small customer market, some smaller residential customers have experienced significant price rises. The Government has taken action to ameliorate the price increases for eligible seniors and pensioners.

The Minister has directed the Authority to undertake this review to assist the Government to determine whether any additional measures need to be combined with existing initiatives to improve competitive market outcomes for gas customers, incumbent retail market participants and new entrants.

1.2 Terms of Reference

In undertaking the review, the Authority is to consider and report on the following main issues in relation to Queensland's small customer gas market:

- the current level of competition in the markets for reticulated natural gas and substitute fuels such as reticulated and bottled Liquefied Petroleum Gas (LPG);

- the impact on retail prices of prices and costs in the upstream gas market and whether current small customer retail prices are reflective of actual costs incurred in the upstream gas supply chain; and

- the extent of current small customer gas market activity, including consumer switching behaviour, impediments to small customers exercising informed choices regarding their retailer of choice and consumer perceptions of natural gas as a product of choice compared to other energy supply options.

The Authority is also required to:

- consider how each of these issues affects different categories of small gas customer;

- comment on differences in market competitiveness and cost reflectivity between regions within Queensland; and

- provide an analysis of differences in market competitiveness and cost reflectivity between Queensland and other Australian States or Territories.

The full Terms of Reference are shown in Attachment 1.

1.3 Process for the Review

In conducting this review, the Authority will undertake public consultations with stakeholders and provide opportunities for stakeholder input, including in response to the release of a Draft Report.

To assist stakeholders in preparing their submissions to this review, this Issues Paper sets out a range of matters about which the Authority is seeking information and comment. Written submissions will be welcomed by the Authority in response to this Issues Paper and later in the process following the release of a Draft Report.

The Authority is required to submit its Final Report to the Minister no later than 1 December 2008.

The currently proposed timetable for the review is as follows:

Action	**Indicative Timetable**
Release of Issues Paper and invite submissions	23 May 2008
Submissions on Issues Paper due	27 June 2008
Release Draft Report and invite further submissions	September 2008
Submission to Draft Report due	October 2008
Final Report to the Minister for Mines and Energy	By 1 December 2008

Details for making submissions can be found at the front of this paper. The closing date for receipt of initial submissions is 27 June 2008.

This Issues Paper lists a range of issues on which the Authority would welcome comment from interested parties. The list is not exhaustive and interested parties are invited to raise and discuss any other issues relevant to the Terms of Reference.

2. COMPETITION IN THE QUEENSLAND GAS MARKET

The Terms of Reference for this review require the Authority to assess the *level of competition* and the potential for *future competition* in the small customer segment of the Queensland gas market.

2.1 Defining "competition"

The Australian Energy Market Commission (AEMC) in its on-going jurisdiction by jurisdiction review of *Effectiveness of Competition in Electricity and Gas Retail Markets* has defined "competition" as a process of rivalry among firms, where the price and output decisions of each market participant are constrained by the actions of others.[1] Competition is not an absolute concept, as different types of competitive rivalry can exist depending on the nature of the market.

In economic theory, markets are generally considered to range from perfectly competitive to pure monopolies.

Perfectly competitive markets are characterised by a large number of buyers and sellers each producing a homogenous product, with perfect knowledge of the conditions of supply and demand. In such markets, the cost of entry is low and producers are free to enter and exit the market over time. Where these characteristics prevail, the degree of competition between suppliers is generally considered to be high. Producers are considered to be effectively price-takers as they have no real power to increase prices above marginal cost.[2]

In contrast, where markets are characterised by significant barriers to entry such as high up-front capital costs and economies of scale relative to demand, there may be only one producer supplying the entire market. However, where markets exhibit such natural monopoly characteristics and where customers have little bargaining power, it is possible for the monopolist to exert its market power by raising prices and limiting output so as to earn above-normal profits.

In reality of course, most markets fall somewhere in between the two theoretical extremes. For example, some markets may be characterised by high barriers to entry and only a few suppliers. Other markets may have relatively low barriers to entry and with a number of suppliers that produce differentiated products that are highly, but not perfectly, substitutable for one another. In each of these markets, firms can compete with one another in different ways. For example, in markets for the sale of a homogenous product, suppliers are likely to compete on the basis of price. In a monopolistic market, suppliers may compete by consistently developing new products over time in an attempt to maintain a price premium over other products or market share.

In undertaking its competition analysis, the Authority believes that it is important to distinguish between the type of competitive rivalry that can be observed in the market and the degree of competition between players in that market.

1 AEMC 2007, *Review of the Effectiveness of Competition in the gas and electricity retail markets,* Statement of Approach, 19 April 2007, p. 5.

2 Marginal cost refers to the cost of producing the last unit sold.

2.2 Framework for assessing the level of competition

In developing the framework for this assessment, the Authority has considered the approach adopted by other regulators in reviewing retail competition in their respective energy markets. [3]

The Authority notes that, more recently at the national level, the AEMC has begun its assessment of the effectiveness of energy retail competition in Australia on a jurisdiction-by-jurisdiction basis following a formal request from the Ministerial Council on Energy (MCE). The AEMC has already completed its review of the Victorian energy market[4] and is currently reviewing the South Australian market.[5]

The analytical framework adopted by the AEMC for assessing the level of competition includes assessing the level of:

- independent rivalry within the small customer market;
- ability of retailers to enter the market;
- the exercise of market choice by customers;
- differentiated products and services;
- prices and profit margins of retailers; and
- customer switching behaviour.

The Authority considers the analytical framework adopted by AEMC represents a useful approach for considering the level of competition in the Queensland gas market. However, the Authority recognises that, since FRC was only introduced in Queensland in July 2007, competition can not be expected to have fully matured in the small customer gas market as may be the case in other jurisdictions. However, if the conditions for competition are indeed present then it is likely that at least some if not all of the following observations can be expected to be made:

- 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.

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3 Essential Services Commission of Victoria, *Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity*, Final Report, 22 June 2004.
Essential Services Commission of South Australia, *Review of the Effectiveness of Energy Retail Market Competition in South Australia*, 2007, Phase 2 and Phase 3 reports prepared by NERA Economic Consulting for the Commission.
Western Australian Office of Energy, *Gas Tariff Regulations Review Report, Report prepared by the Minister for Energy on the Review of the Energy Co-ordination (Gas Tariffs) Regulations 2000*, October 2007.

4 AEMC 2007, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria*, First Final Report, 19 December 2007, and
AEMC 2008, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria*, Second Final Report, 29 February 2008.

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

In any event, the Authority intends to examine whether there are any clear signs that would suggest that competition may be constrained.

2.3 The reticulated natural gas market for small customers

For most gas customers, retailers provide the interface between producers and transmission and distribution pipeline owners and are therefore responsible for securing the supply of gas and entering into the transportation arrangements required to deliver the gas to the customer's location.

In order to supply gas to customers, retailers in Queensland effectively enter into bilateral contracts with each of the upstream supply chain participants. The structure of the Queensland reticulated natural gas industry is illustrated in Figure 1 below.

Figure 1 Structure of the Queensland Natural Gas Industry

Gas Producing Fields
Bowen/Surat, Cooper/Eromanga and Adavale Basins

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Transmission Pipelines

- Roma to Brisbane Pipeline (RBP) that extends from Roma to Brisbane
- South West Queensland Pipeline (SWQP) that extends from Ballera to Roma;
- Queensland Gas Pipeline (QGP) that extends from Wallumbia to Rockhampton; and
- Carpentaria Gas Pipeline (CGP) that Ballera to Mt.Isa.

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Distribution Network

Envestra

- Brisbane region (including Ipswich and suburbs north of the Brisbane river); and
- Northern region (Rockhampton and Gladstone)

APT Allgas

- Brisbane region (south of the Brisbane river)
- Western region (including the townships of Toowoomba and Oakey)
- South Coast region (including Gold Coast)

↓

Licensed Gas Retailers*

Active	***Inactive***
AGL Sales (Qld) Pty Ltd	AGL Sales Pty Ltd
Australian Power and Gas Pty Ltd	Dodo Power and Gas Pty Ltd
Origin Energy Retail Ltd	EnergyAustralia
	Origin Energy (Vic) Pty Ltd

*As at 31 March 2008. Dalby and Roma Town Councils each hold a retail authority that permits them to retail natural gas to customers within their specific distribution network area. Customers within these areas are currently excluded from retail competition.

To secure the supply of gas, retailers generally enter into a long term contract with gas producer(s) which specify the quantities to be purchased in each year of the contract.

Given the bilateral contractual nature of the gas industry, the ability of retailers to supply customers is limited by the availability of uncontracted gas reserves and the available capacity of both the transmission and distribution pipelines.

To facilitate effective competition in the retail market, the Queensland Government established an independent Gas Retail Market Operator (VENCorp) to oversee and administer the retail market rules in accordance with *Queensland Gas Market Retail Rules*. The purpose of these market rules is to facilitate the allocation of gas within the distribution networks between competing retailers to ensure that each retailer matches supply with its demand or pays a penalty for any imbalance between supply and demand.

Issues for comment

The Authority invites stakeholders to comment on the following issues:

- ***Are there features of the Queensland gas supply chain that have a bearing on the development of competition in the retail market?***
- ***To what extent do retailers compete with each other to acquire new customers and retain existing customers?***
- ***Are retailers able to recover their efficient costs at their current prices?***
- ***Are future expected profit margins likely to be sufficient to encourage new entry and increase competition or insufficient such that new entry is deterred?***
- ***Are there any barriers facing new, or existing, retailers that affect their decision to enter the Queensland market?***
- ***To what extent might retailers be expected to compete in the small customer market in the future?***

2.4 Small customer gas market activity

Market activity may be considered in terms of both retailer conduct and consumer conduct.

On the supply side, evidence of retailers aggressively marketing their product or service will help to inform the degree to which retailers are in fact competing with one another.

On the demand side, the most useful indicator of the effectiveness of competition may be the extent to which customers are responding to competitive offers either by switching retailers or entering into alternative contracts with their incumbent retailer. Switching may be viewed as an outcome of the effectiveness of retailer actions in motivating customer responses. The rate of customer switching is likely to be affected by:

- the extent to which retailers are actively promoting their market offers;
- the extent of differences in price and/or quality in market offers; and
- customers' awareness of the choices available to them, which will vary depending upon their receptiveness to the sales channels utilised by retailers.

In a competitive market, customers can be expected to be well informed about available offers and switch or retain their gas supply services with a retailer that offers the most favourable terms and conditions. However, customers may find the search for, and evaluation of such information, costly and time consuming. Effective competition therefore can be expected to motivate retailers to recognise these costs and undertake targeted marketing campaigns in order to make it easier for customers to make informed choices.

Currently, small gas customers are able to shop around with active retailers to find the deal that best suits their needs including combining their electricity and natural gas accounts with the same retailer in a “dual fuel” package.

Under the *Gas Industry Code*, active retailers are required to publish their prices to provide transparency and certainty to residential and other small customers. The Authority currently provides an online “price comparator” on its website to assist residential customers in comparing the prices from retailers who are offering negotiated contracts.

Issues for comment

The Authority invites stakeholders to comment on the following issues:

- ***Are retailers currently competing, or likely to compete, to acquire new customers and retain existing customers?***
- ***Are retailers currently responding, or likely to respond, to consumer taste by offering differentiated and better product packages?***
- ***What marketing strategies are retailers currently using to engage with potential customers? What marketing strategies do they propose to use in the future?***
- ***Are customers prepared to switch retailer and, if so, what are the reasons behind their choice?***
- ***Are customers able to make an informed choice to switch gas retailer or are there obstacles to customers effectively participating in the competitive market?***
- ***Is there sufficient information available to customers about their options and is this information easily accessible and able to be understood by them?***

3. COMPETITION IN THE SUBSTITUTE FUEL MARKET

The Terms of Reference also require the Authority to assess the level of competition in the reticulated and bottled LPG markets in Queensland as substitute fuels for reticulated natural gas.

Liquefied Petroleum Gas or LPG is a generic name for mixtures of hydrocarbons (mainly propane and butane). LPG is different from the natural gas piped into a reticulated gas network. LPG is generally kept in a liquid state because the propane and butane mixtures are more compact in liquid form than in gas form and therefore much cheaper and easier for transportation and storage. Natural gas, on the other hand, consists almost entirely of methane. LPG has higher energy content than natural gas and, as a result, LPG appliances generally can not be used with natural gas and vice versa, without conversion.

While alternative fuels may have cost and other advantages over reticulated gas, the Authority recognises that there may be a range of barriers to their use including:

- natural gas and LPG appliances are not directly substitutable, requiring conversion which may be costly. This cost may act as a barrier to uptake, even when alternative supplies are available; and
- the cost of appliances is often a significant portion of household budgets and, once purchased, households may not switch to another technology until the useful life of the appliance is exhausted.

3.1 Supply of LPG

Domestically, LPG is used for heating (water and homes) and cooking as well as for barbeques and camping stoves. There are other uses of LPG, including:

1. industrial and commercial use;
2. transport fuel (known as Autogas or automotive LPG); and
3. as feedstock by refineries and the petrochemical industry.[6]

The 2006 *Western Australian Government Taskforce inquiry into Bottled LPG Affordability* identified the following commercial participants in the LPG supply chain:

- *Producers* - who sell LPG at the petroleum refinery or LPG extraction plant gate, or at overseas terminals for transhipment to Australia;
- *Marketers* - who buy LPG in bulk from local producers, or from overseas markets, and sell to other marketers, distributors, retailers and/or to final consumers;
- *Transporters and distributors* - who truck bulk LPG to their regional depots, where it is stored in large pressure vessels, to be supplied to bulk customers by small tanker and to refill LPG cylinders, which are distributed to bottled gas retailers or consumers. The transporters and distributors may be integrated with a marketer, or may operate on contract to a marketer, or may be independent. Sub-contractors may also carry out any of the specific functions of distributors such as bulk haulage, depot operation, and/or cylinder filling and distribution. There may also be network operators who transport bulk LPG to the depots for supply by reticulation; and

[6] Western Australian Government Taskforce, *Bottled LPG Affordability Inquiry*, Issues Paper, November 2006, p 5.

- *Retailers* – who sell directly to end users, including the activities of sales and billing, and sometimes appliance retailing. These may be retail branches of a marketer, commission agent of a marketer, or else independent resellers who purchase and resell LPG in marketer owned and branded cylinders. [7]

3.2 Pricing of LPG

The price of domestically produced LPG is based on a national import parity price benchmark known as the *Saudi Aramco Contract Price*. This benchmark price, set by the world's largest producer, Saudi Arabia, is used as a basis internationally for pricing LPG.[8]

The Authority understands that local producers also add a component equivalent to freight and insurance to develop a price that an LPG supplier would be required to pay if it imported LPG. This figure is used to derive the wholesale price of locally produced LPG.[9]

Issues for comment

The Authority invites stakeholders to comment on the following issues:

- ***What is the extent of the reticulated and bottled LPG market in Queensland?***
- ***What issues should the Authority consider regarding the level of competition in the reticulated and bottled LPG market?***
- ***What is the level of competition in the reticulated and bottled LPG market in Queensland?***
- ***Does the current level of competition or concentration in the LPG market impact on retail prices paid by customers?***
- ***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?***

[7] Western Australian Government Taskforce, *Bottled LPG Affordability Inquiry*, Issues Paper, November 2006, pp.18-19.
[8] LPG Australia website http://www.lpgaustralia.com.au
[9] Western Australian Government Taskforce, *Bottled LPG Affordability Inquiry*, Issues Paper, November 2006, pp.18-19.

4. GAS PRICES FOR SMALL CUSTOMERS

Historically, retail gas prices paid by Queensland's residential and other small natural gas consumers were regulated by the Queensland Government and set at a level that did not necessarily reflect the full cost of gas supply.[10] The introduction of FRC in the Queensland gas market also coincided with the deregulation of gas prices. The regulated prices that applied to small customers prior to 1 July 2007 were revoked with licensed retailers subsequently responsible for setting prices for their products and services.

Unlike Queensland's retail electricity market and retail gas markets in other Australian jurisdictions, there are no longer any regulated or government controlled prices for small gas customers who do choose to enter market contracts. However, under the *Gas Supply Act*, the Queensland Government has retained the reserve power to regulate tariffs in the event competition is found to be not effective.

Since deregulation, there has been a substantial increase in the retail prices being offered to some small customers.[11] Possible explanations include that prices are now moving towards cost reflectivity after being kept artificially low by the Government prior to deregulation and/or that the market is experiencing increases in the cost of supply to customers. Alternatively, the increases could reflect a lack of competition and the resulting capacity of retailers to increase prices.

4.1 Cost of supply

As part of this review, the Authority is required to ascertain whether current retail gas prices faced by small customers are cost reflective. The cost components to be taken into account in determining the cost of supply include:

- Wholesale gas prices;
- Transmission costs;
- Distribution costs; and
- Retail costs.

There are different ways that retail prices could be assessed. These include an approach based on actual (or claimed) cost of supply submitted by the retailers, utilising external benchmarks from other jurisdictions, or a combination of both approaches.

The Authority anticipates using a benchmarking approach in assessing the cost of supply. This is because data on actual costs may be commercially sensitive and therefore not readily available given the bilateral contractual nature of the gas market. That said, the Authority recognises that benchmarking requires that the benchmarks from different jurisdictions are comparable and that there may be issues specific to the Queensland gas market that may need to be taken into account in estimating appropriate costs for incumbent and new entrant retailers in the State. For example, it is possible that economies of scale available to incumbents may result in smaller new entrants facing higher supply and operating costs.

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10 Department of Mines and Energy Fact Sheet: *Natural gas Prices – Deregulation*, 22 October 2007, available at: http://www.dme.qld.gov.au/zone_files/Gas/gas_price_deregulation_factsheet.pdf

11 See the Terms of Reference for this review.

Issues for comment

The Authority invites stakeholders to comment on the following issue:

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

Wholesale gas prices

The wholesale price component of the retail supply cost represents the upstream segment of the gas supply chain that encompasses both the exploration and production phases. The price of wholesale gas is generally determined by long-term supply contracts that establish minimum quantities that must be taken or paid for in each year by retailers. The "take or pay" provisions in effect operate as a minimum bill which must be met by a retailer even if actual demand is below the take or pay quantity. Viewed in this way, the minimum bill operates as a fixed cost for retailers. In addition to paying the ex-plant price of gas, retailers also incur negotiation and contracting costs.

The Authority notes that Coal Seam Methane (CSM) is also gaining an increasing prominence as an alternative source of natural gas, particularly in the Queensland gas market. Queensland's CSM industry has experienced significant growth in recent years and production is expected to continue to increase in the future.[12] The Authority intends to examine the impact of CSM development on a retailer's cost of securing supply.

Issues for comment

The Authority invites stakeholders to comment on the following issues:

- ***How should the wholesale cost of supplying natural gas be assessed?***
- ***What are the expectations regarding future natural gas costs?***
- ***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?***

Transmission

The transmission cost component of the gas supply cost relates to the pipeline systems used to transport gas from production facilities to the distribution systems that supply users.

Generally, gas retailers are able to negotiate transmission charges that vary with the retailer's capacity and load characteristics. While reference charges for a gas transmission pipeline may be set under an access arrangement approved by the by the Australian Energy Regulator, a retailer can still negotiate different price outcomes by managing its suppliers and demand load.

The Authority notes that, until recently, the Roma to Brisbane Pipeline (RBP) and the South West Queensland Pipeline (SWQP) were unregulated. However, the Australian Energy

[12] Department of Mines and Energy, *Queensland's coal seam gas – 2006-07 update*, available at: http://www.dme.qld.gov.au/zone_files/coal_pdf/new_csg_cc.pdf

Regulator (AER) has now reviewed the RBP access arrangements including the tariffs.[13] However, the SWQP will continue to be unregulated until 30 June 2016.[14]

Since transportation charges are predominantly capacity based, the transportation costs incurred by a retailer will be largely fixed. In addition to paying these transportation charges, retailers will also incur negotiation and contracting costs.

Issues for comment

The Authority invites stakeholders to comment on the following issues:

- ***What are the likely transmission costs of retailers in Queensland?***
- ***What transmission cost benchmark should apply?***

Distribution

The distribution pipe network transports the gas to end customers. The distribution networks in Queensland are owned by Envestra and APT Allgas. The access regime which applies to the distribution network is administered by the Authority and not within the control of retailers. Therefore, the Authority will determine these charges based on its own current regulatory decisions.

Retail Operating Costs

Retail operating costs are costs that retailers incur in acquiring and serving their customers. Typically, these include costs such as those associated with retailer billing and revenue collection systems, call centres and related corporate functions. Factors that influence these costs include customer location, regulatory obligations and other market administration costs.

Retail operating costs can be categorised into fixed costs (which do not vary with customer numbers or consumption) and variable costs (which do vary with customer numbers or consumption). The categorisation of retail operating costs is relevant to the allocation of these costs to a particular class of customer.

A large proportion of retail operating costs are likely to consist of wage payments to employees. Retail operating costs may also be influenced by any moves to introduce more complex billing arrangements (including changes to billing software and systems), particularly if the retailer is also active in the electricity market and offers dual fuel discounts to attract customers.

Issues for comment

The Authority invites stakeholders to comment on the following issues:

- ***What are the operating costs incurred by retailers in Queensland?***
- ***Do retail operating costs vary for customers with differing consumption levels within the small customer class and/or locations?***

13 AER 2008, *Revised access arrangement by APT Petroleum Pipelines Ltd for the Roma to Brisbane Pipeline*, Final Approval, 28 March 2007.

14 AER 2008, *Revised access arrangement by Epic Energy Queensland Pty Ltd for the Ballera to Wallumbilla Natural Gas Pipeline (South West Queensland Pipeline)*, Final Decision, 1 November 2006.

- ***What are the fixed and variable components of retail operating costs?***
- ***What are the likely operating costs of retailers in other jurisdictions? What retail operating cost benchmark should apply?***

Retail Margin

The retail margin is the increment above a retailer's actual costs to cover return on capital, depreciation, amortisation, taxes and profit. The margin is intended to compensate and reward retailers for their investment in the business and the risks they assume in order to provide retail services.

The retail margin is not only important for maintaining the financial viability of the retailer, but it is also important for the development of competition in the gas retail market.

Issues for comment

The Authority invites stakeholders to comment on the following issues:

- ***What is the most appropriate basis for assessing the retail margin for Queensland retailers?***
- ***Do retail margins vary for customers with differing consumption levels within the small customer class and/or locations?***
- ***Is there any consistency in retail margin allowance in other jurisdictions? What retail margin benchmark should apply?***

5. APPENDIX – TERMS OF REFERENCE

Background

Deregulation of natural gas tariffs coincided with the start of Full Retail Competition (FRC) in gas on 1 July 2007. Deregulation allowed gas retailers to further move towards cost-reflective pricing which had initially commenced in 2005 with a number of increases in gas tariffs higher than the consumer price index. The aim of these policies is to encourage further development of the State's natural gas market. Gas prices for small customers were cross-subsidised and generally well below cost prior to 1 July 2007.

The move to cost reflectivity affected individual consumers differently. Depending on location, some household consumers with a gas cook top and hot water system faced a cost increase, whilst other customers may have experienced reductions in their gas bills.

However, some smaller residential customers (for example those with a cooktop only) experienced more significant price rises. The price changes had a greater impact on small gas users because fixed charges (including network and retail costs) now make up a larger proportion of their total gas bill, as retailers move to reflect the structure of the costs they face in retail pricing. Also, because of the high proportion of fixed charges in their bills, there is little scope for smaller customers to mitigate the increase by lowering consumption.

Looking forward, the gas retailers have not provided any firm indication of the likely increases still required to achieve cost-reflectivity in natural gas tariffs, or the price changes that may take place later in 2008 or later.

To help alleviate the difficulties faced by some smaller customers, on 16 October 2007 the Government announced a $55 per year rebate for eligible seniors and pensioners who have reticulated natural gas. This rebate was targeted at meeting a substantial part of the increase in fixed charges borne by those affected small customers least likely to be able to absorb the increase.

A number of additional Queensland Government initiatives have been implemented to assist residential gas customers and grow the residential gas market. These include the Sustainable Housing Code, Queensland Residential Gas Installation Rebate Scheme and the phase-out of electric hot water systems.

These initiatives have the potential to reduce gas prices to customers by spreading distribution costs over a growing customer base. The Queensland Government anticipates that, as customer numbers grow and the utilisation of the system improves, the average cost to the consumer will reduce over time. In addition, growth in the residential market may attract additional retailers into Queensland, increasing competition and potentially lowering prices.

Significant residential areas in Queensland do not have access to reticulated natural gas and many current gas customers use Liquefied Petroleum Gas (LPG), either through a reticulated network, or more commonly bottles. The price of LPG is set at world prices. Given the growing demand for LPG internationally, it is understood that the price of LPG is also increasing beyond the consumer price index annually.

In this context, it is timely for the Queensland Competition Authority (QCA) to undertake a Review of Small Customer Gas Pricing and Competition in Queensland.

The Queensland Government is currently developing a Queensland Residential Gas Market Strategy. The objective is that the outcomes of this Review will determine whether any additional measures need to be combined with existing initiatives, to improve competitive market outcomes for gas customers, incumbent retail market participants and new entrants.

Head of Power

The *Gas Supply Act 2003* includes the provision to enable Direction by the Minister to investigate a number of areas in relation to pricing and retail competition within the gas industry in Queensland.

Under Chapter 3, Part 4, Division 1, Section 227A the Minister may, by gazette notice, give the Queensland Competition Authority (QCA) a written direction to:

- investigate the effectiveness of retail competition in the Queensland retail gas market; and

- give the Minister a report on the pricing investigation within a stated period.

Under Chapter 5, Part 3, Section 270K, the Minister may, by gazette notice, give the QCA a written direction to conduct a review into:

- any matter relating to the Queensland reticulated processed natural gas markets.

Objectives

As Minister, I wish to ensure that consumers of gas in Queensland benefit from competition and efficiency in the market place. This includes reticulated natural gas and its alternatives, reticulated and bottled Liquefied Petroleum Gas (LPG).

Accordingly, I direct the QCA to undertake a Review of Small Customer Gas Pricing and Competition in Queensland.

This review should examine current market issues in the interests of gas customers, incumbent retail market participants and new entrants.

Matters to be Considered

In undertaking the Review of Small Customer Gas Pricing and Competition in Queensland, the QCA is to consider and report on the following issues:

1. The level of competition in the reticulated natural gas market, and as a comparison, other substitute fuels including reticulated and bottled LGP in Queensland. This should include an assessment of the following components:
    - Current competition within the small customer gas market (Refer to point 3);
    - Changes is market competitiveness over time, and the potential for future competition within the small customer gas market;
    - Ability of retailers to enter the market, including barriers to entry across the gas market supply chain, and expansion of the gas retail market;
    - Relevant gas market supply constraints; and
    - The impact of competition in the small customer gas market on the profitability of the reticulated natural gas distribution areas.

2. The impact of movements in upstream gas costs on the current prices paid by small customers including an assessment of:

   - Wholesale gas prices;
   - Transmission costs;
   - Distribution costs;
   - Retail operating costs; and
   - Retail margin.

The QCA should consider movement of these costs over time, and the potential for future changes in costs.

Based on the above outcomes, the QCA should provide comment on whether current Queensland small customer prices are reflective of the actual costs incurred in the upstream gas supply chain. If the QCA considers that prices are not cost reflective, the QCA should comment on the price adjustments necessary to achieve cost reflectivity.

3. Current small customer gas market activity, including:

   - The exercise of market choice and switching behaviour by consumers and any technical or other barriers to this;
   - Any impediments to small customers being able to exercise informed choices regarding their retailer of choice; and
   - The perceptions of natural gas as a product of choice in the small customer market compared to other energy supply options.

4. The QCA should consider how each of these issues affects different categories of small gas customer, for example, small commercial customers, domestic customers with a gas cooker only and domestic customers with a gas cooker and gas hot water system.

5. Where relevant, the QCA should comment on differences in market competitiveness and cost reflectivity between regions within Queensland.

6. The QCA should provide analysis of differences in market competitiveness and cost reflectivity between Queensland and other Australian States or Territories. This should include consideration of other recent reviews of gas pricing and competition in other jurisdictions or nationally, where relevant to this Review.

Any other issues not explicitly mentioned here which arise during the course of the Review, and which impact on the Review's objectives or matters being considered, should, where relevant, be included in the report to the Minister.

Definitions

For the purpose of this Review, a "small customer" is consistent with that defined in the *Gas Supply Regulation 2007* as one consuming less than 1 terrajoule of gas per annum per connection.

Consultation

In conducting this review, the QCA is requested to invite submissions from stakeholders to the extent to which it considers necessary or desirable.

Reporting Period

The QCA must submit its report on its Review of Small Customer Gas Pricing and Competition in Queensland in its final form to the Minister no later than 1 December 2008.