28 May 2013

Ms Natalie Naylor
Legal Counsel
Wagga Wagga revocation
National Competition Council
Level 21, 200 Queen St
Melbourne VIC 3000

Submitted in hardcopy and by email: gas@ncc.gov.au

Dear Ms Naylor

APPLICATION FOR REVOCATION OF COVERAGE OF THE WAGGA WAGGA NATURAL GAS DISTRIBUTION NETWORK

Origin Energy Limited (Origin) welcomes the opportunity to comment on the application made by Envestra Limited (Envestra) for revocation of full coverage of the Wagga Wagga natural gas distribution network.

Origin Energy (ASX: ORG) is the leading Australian integrated energy company focused on gas and oil exploration and production, power generation and energy retailing. A member of the S&P/ASX 20 Index, the company has more than 5,800 employees and is a leading producer of gas in eastern Australia. Origin is Australia's largest energy retailer servicing 4.3 million electricity, natural gas and LPG customer accounts and has the country's largest and one of the most flexible generation portfolios with approximately 5,900 MW of capacity, through either owned generation or contracted rights. Origin's strategic positioning and portfolio of assets provide flexibility, stability and significant opportunities for growth across the energy industry. Through Australia Pacific LNG, its incorporated joint venture with ConocoPhillips and Sinopec, Origin is developing one of Australia's largest CSG to LNG projects based on Australia's largest 2P CSG reserves base

Envestra considers that revocation of the Wagga Wagga distribution network is justified on the basis that it does not satisfy criteria (a) and (d) of the section 15 of the National Gas Law. However, Origin is concerned that, in the absence of coverage, network users could be exposed to a monopolist network service provider that could be in a position to extract inefficient economic rents, both in terms of usage tariffs and other non-price terms and conditions of supply.

In contrast to transmission services, there is generally no alternative to distribution services for retailers and end users. This exacerbates the impact of an unrestrained monopolist supplier, as outlined in relation to the relevant coverage criteria below.

Promotion of competition (criterion (a))

Origin considers that maintaining access to the Wagga Wagga distribution network promotes a material increase in competition in the retail gas market. There is currently competition in retail gas services on the Wagga network. A price increase is currently projected for next year which will improve margins and we would expect competition to become more vigorous when retail price regulation is removed, as proposed by the AEMC

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in its recent draft finding.[1] However, a monopolist supplier of distribution services could function to stymie the development of such competition.

While Envestra's application focuses on monopoly pricing, the detrimental consequences of a monopolist service provider are not confined to the tariffs imposed under supply agreements. A monopolist service provider could also extract economic rents through onerous terms and conditions of supply. Such terms and conditions may function to transfer risk from the network operator to network users in a manner that is inefficient insofar as the network user is not as well placed to assess and, therefore, manage that risk. A poor allocation of risk ultimately leads to higher costs for network users and higher prices for end users.

The approval processes for access arrangements for Envestra's other regulated distribution networks provide examples of where the AER has decided against terms and conditions that could be considered onerous and a result of Envestra's monopolistic position. For example, the AER's final access arrangements for Envestra's networks in South Australia and Queensland functioned to restrain Envestra from imposing certain onerous terms and condition that were proposed in its original application. Here is a list of examples of how Envestra's proposed access arrangements for its South Australian and Queensland networks diverged from the access arrangements approved by the AER:[2]

- Envestra was required to amend imbalanced liability clauses that proposed that only the network user be liable for claims of economic or consequential loss, not Envestra.
- Envestra was required to amend clauses whereby Envestra's liability for death or injury would be capped at $100m whereas the network user's liability in these respects would be uncapped.
- Envestra was required to impose additional obligations on itself in relation to delivery of gas, gas specifications and receipt pressure, on the basis that it was the party best placed to monitor and manage the relevant risks.
- Envestra was required to amend its 'holding over' provisions so as to exclude network user liability to pay for gas that is not required but continues to be delivered due to the negligent act or omission on the part of Envestra.
- Envestra was required to amend the definition of 'maximum hourly quantity' to strengthen its obligation to deliver.
- Envestra was required to amend provisions regarding notice of gas specifications to clarify that it was required to give notice to network users, where Envestra had proposed that only the network user be required to provide such notifications.

Each of the terms originally proposed would have served to reduce Envestra's risk exposure in a manner that appears consistent with its commercial interests, but in no case was any operational justification provided for the imbalanced allocation of risk. The fact that comparable terms and conditions continue to be imposed on supply agreements

[1] Evestra Ltd, Wagga Wagga Network Revocation Submission, Public version, 1 May 2013, paragraph 48, available at http://www.ncc.gov.au/images/uploads/ReGaWWAp-001.pdf. The Australian Energy Market Commission (AEMC) has also recently noted the impact of non-cost reflective retail tariffs on the development of competition; AEMC, Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales, Draft Report, 23 May 2013, page 77, available at http://www.aemc.gov.au/Market-Reviews/Open/nsw-retail-competition-review.html

[2] See AER, Final decision, Evestra Ltd, Access arrangement proposal for the Qld gas network, 1 July 2011 – 30 June 2016, June 2011, pages 221-230, available at http://www.aer.gov.au/sites/default/files/Access%20arrangement%20final%20decision%20-%20Envestra%20%28Qld%29.pdf; AER, Final decision, Envestra Ltd, Access arrangement proposal for the SA gas network, 1 July 2011 – 30 June 2016, June 2011, pages 245-256, available at http://www.aer.gov.au/sites/default/files/Access%20arrangement%20final%20decision%20-%20Envestra%20%28SA%29%20-%20June%202011.pdf

for Envestra's unregulated networks (on which Origin is a network user) illustrates the likelihood that Envestra could impose onerous supply terms and conditions on an uncovered Wagga Wagga network.

It should also be noted that supply terms and conditions can lead to monopoly prices independent of the base tariff. In Origin's experience, monopolist network service providers may be able to structure supply agreements such that the cost of ancillary services effectively exceeds the base tariff. This results in network users paying monopoly prices for access overall. As with inefficient risk transfer, inefficient cumulative prices lead to higher prices for end users and do not promote the National Gas Objective.

Envestra's position as an unrestrained monopolist supplier of network services in Wagga Wagga could be exacerbated by the fact that there is no realistic alternative to distribution services for retailers and end users. Envestra argues that it would be restrained by the ability of customers to switch away from gas distribution (small customers to switch to electricity and LPG and large customers to bypass the distribution network and connect directly to the transmission network). However, Origin does not agree that customer switching will restrain Envestra in this way. Switching would require:

- small customers to purchase new appliances, including heaters and hot water systems, and to incur LPG conversion costs; and
- large customers to incur significant capital expenditure on new pipeline infrastructure.

Indeed, the customers that will be most affected by higher gas prices flowing from monopoly pricing of network services are likely to be least able to switch away from gas.

Envestra also highlights that any network user could reinitiate coverage should it deem this necessary. However, in reality this process involves significant cost and time such that price and service outcomes would need to deteriorate considerably before this course of action could be justified.

Not contrary to the public interest (criterion (d))

Origin considers that maintaining access to the Wagga Wagga distribution network would not be contrary to the public interest. In its application, Envestra's assessment of the public interest is inadequate insofar as it assumes there is no public benefit flowing from coverage. It confines its argument to the cost of regulation. In contrast, the onerous terms excluded from Envestra's access agreements in South Australia and Queensland (listed above) illustrate the tangible benefit of distribution network regulation.

While Origin agrees that public benefits should be weighed against the cost of regulation, we question Envestra's regulatory cost estimates. It claims that full access arrangement review costs are largely independent of the size of the network and that the regulatory costs for its other distribution networks cannot be shared with the stand-alone Wagga Wagga network. On this basis, Envestra claims that it will incur significant regulatory costs that will feed through to network tariffs, and ultimately end users.

In Origin's experience, a smaller network is likely to require a less onerous access arrangement application. This ought to be the case for Envestra insofar as the Wagga Wagga distribution network represents a less complex system and a smaller proportion of Envestra's overall business. This is illustrated by the different access arrangements in Queensland for Envestra and APT Allgas; both meet the requirements of a regulated network under the law, but with the latter has a significantly shorter and more straight forward access agreement, demonstrating that there is scope to simplify access arrangements.

In terms of cost sharing, while it may not be possible to align the Wagga Wagga access arrangement reviews with those of Envestra's other distribution networks, we would expect to see synergies across Envestra's business units. The reviews relate to similar subject matter and Envestra could utilise overlapping advice from external advisors. For example, advice regarding weighted average cost of capital (WACC) may well be independent of network size, but Envestra is unlikely to require separate consultants' reports regarding WACC for each distribution network that it owns. Similarly, it would seem unreasonable and imprudent for Envestra to obtain discrete, high-level legal advice on the AER's access arrangement process for each of its distribution networks.

Origin notes Envestra's estimates of its cost of regulating the network to be $2.3 million. This figure seems high since it represents incremental cost to spending already undertaken for the larger networks. For example, $2.2 million of these are labour costs. This would represent around 40 senior FTEs working at a cost of $800 a day for 70 days. This appears an unreasonable resource requirement for incremental work specific to a small and simple gas network.

Origin notes also that $2.3 million represents more than total capital expenditure on the network over the current regulated period, and over two thirds of the operational expenditure budget. It is hard to understand how it can be a commercial undertaking for Envestra to spend as much as the network's five year capital outlay solely on one regulatory application.

Envestra estimates the cost to the AER of regulating the Wagga Wagga network to be $0.5 million, which it assumes will be saved entirely if coverage is revoked. Origin doubts that the AER would reduce its personnel costs as a result of a revocation of coverage on the Wagga haulage network. Hence these savings may be overstated.

In terms of asserted benefits, Origin questions Envestra's claim that, in the absence of network regulation, it will restrict price increases to CPI over the next 5 years. Origin notes that while the Envestra estimates the cost of its regulating the network to be $2.3 million, it hopes to reduce revenues by only $1.2 million. Origin seeks to understand where the remainder of the saving would be directed. Envestra itself has drawn attention to a diminishing average consumption and, in this context Envestra can be expected to seek to recover capital expenditure over smaller volumes by increasing prices further. If the $1.1 million balance is to be directed towards restraining price increases to CPI, Envestra should make this explicit. Ambiguity about how the benefits of revoking coverage will be shared undermines Envestra's argument about public benefits in the absence of coverage.

Origin considers that the public benefits flowing from regulation of the Wagga Wagga distribution network to be significant, and the regulatory costs to be considerably less than those estimated by Envestra. This suggests that coverage would not be contrary to the public interest.

Conclusion

Origin appreciates the opportunity to put forward its reasons for not supporting revocation of coverage of the Wagga Wagga distribution network. As set out above, we consider coverage criteria (a) and (d) are both met in this case. In our view, revoking coverage would not be in the long term interests of gas consumers.

Should you have any questions or would like to discuss this submission further, please contact Hannah Heath (Manager, Wholesale Regulatory Policy) on (02) 9503 5500 or hannah.heath@originenergy.com.au.

Yours sincerely,

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