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QGDN Application
National Competition Council
GPO Box 250
Melbourne VIC 3001

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

APPLICATION FOR LIGHT REGULATION OF ENVESTRA'S QUEENSLAND GAS DISTRIBUTION NETWORK

Origin Energy Limited (Origin) welcomes the opportunity to comment on Envestra's application for light regulation of its Queensland Gas Distribution Network (QGDN).

Origin is Australia's leading integrated energy company focused on gas exploration, production and export, power generation and energy retailing. We are Australia's largest energy retailer servicing 4.3 million electricity, natural gas and liquefied petroleum gas (LPG) customer accounts across the east coast. Origin is an interested stakeholder in this consultation as we are a retailer in the QGDN. As such, we would like to ensure continued access to fair and reasonable price and non-price terms and conditions for the QGDN.

Broadly, Envestra's application details its case to move from full to light regulation of the QGDN on the basis that:

- it is not in a position to exercise market power with regard to the services provided on the QGDN; and
- light regulation offers a form of regulation that is as effective as full regulation but at a lower cost.

Origin does not consider Envestra has made a compelling case for moving the QGDN to light regulation. Specifically, Envestra's application overstates the degree to which its market power as a monopoly service provider is mitigated by opportunities for substitution given gas is a fuel of choice and competition amongst users. As Envestra notes, 86 percent of its volume is from large industrial customers, many of whom use gas as a feedstock and have little ability to substitute fuels. It also does not adequately demonstrate that light regulation can be as effective as full regulation at a lower cost because the relatively small cost saving from moving to light regulation does not outweigh the likely loss of benefits associated with full regulation.

Our submission provides further details on these issues to assist the National Competition Council's (NCC's) consideration of the application.

Should you have any questions or wish to discuss further any detail of this submission, please contact Lillian Patterson on lillian.patterson@originenergy.com.au or (02) 9503 5375.

Yours sincerely,

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1. Envestra's ability to exercise market power with regard to the services provided on the QGDN

The National Gas Law requires a consideration of the likely effectiveness of full and light regulation in promoting access to the pipeline services that are subject of the application. This entails ensuring the form of regulation is appropriate and proportionate to the degree of market power that is involved in the provision of the pipeline service.

Envestra considers it is not in a position to exercise market power, particularly because natural gas is a fuel of choice, there are readily available substitutes for natural gas that can be accessed at a low cost and natural gas has no clear competitive advantage over electricity or LPG in the Queensland energy market.

Origin makes some observations on this issue separately for residential customers[1] and industrial customers. It is the industrial customer base that accounts for 86 percent of Envestra's volume, a customer base with little opportunity to switch between gas and electricity and so with the greater exposure to the exercise of market power through higher network prices and more onerous terms and conditions.

a) Residential customers

i) Connection/disconnection trend

Envestra uses the low penetration rate and customer usage of gas in Queensland as evidence of a lack of market power. It gives the following penetration rates and gas usages for Queensland and for comparison, South Australia and Victoria:

	Queensland	South Australia	Victoria
Penetration rate	15%	75%	90%
Average annual residential consumption (2013-14)	8GJ	20GJ	50GJ

While the penetration rate and gas usage for Queensland are significantly lower than in the southern states this is because of the different market conditions in Queensland, especially given gas in Queensland is generally used for cooking and/or hot water rather than space heating. Origin would caution against a simplistic conclusion that the low penetration rate and gas usage indicate gas does not have a competitive position in Queensland and as such, Envestra is not in a position to exercise market power.

In assessing gas competitiveness, Origin suggests the NCC consider the change in the number of residential customers, both historically and forecast. This would give an indication of households' gas usage decision making, specifically if new households are actively connecting to gas and existing households are actively disconnecting from gas. Envestra's application gives the current penetration rate as well as the number of residential customers for 2013-14 but static figures do not give an indication of a trend.

We note in the Australian Energy Regulator's (AER's) Final Decision on Envestra's 2011-16 QGDN Access Arrangement, residential customer numbers were expected to increase by approximately 10.6 percent from 2011-12 to 2015-16 as follows:[2]

[1] While we focus on residential customers, the same arguments can be made for commercial customers.
[2] AER 2011, 2011-2016 *Envestra Access Arrangement Proposal for the Queensland Gas Network Final Decision,* p. 93

	2011-12	2012/13	2013/14	2014/15	2015-16
Residential customer numbers	82,921	85,180	87,459	89,576	91,752

This indicates that although gas is a fuel of choice, Envestra had previously anticipated new customer connections in excess of existing customer disconnections.

A continued increasing trend in residential customer numbers, coupled with Envestra's position as a natural monopoly service provider, may suggest a situation that is not conducive to light regulation given Envestra's market power position.

ii) Customer switching decision

Envestra suggests gas appliances for residential customers can be readily substituted with an electric or LPG equivalent at a low cost to customers given the low number of gas appliances used.

Origin has undertaken a high-level analysis of customer switching in the QGDN. This analysis is based on the assumption that given electricity is not a discretionary fuel and has a 100 percent penetration rate, if a customer were to switch its gas appliances its preference is likely to be to switch to electric appliances.

The primary use of gas in Queensland is for hot water. Using publicly available information on standing offer residential tariffs and gas consumption for household purposes,[3] the annual cost difference on the variable component of a customer's bill for using electricity rather than gas for hot water is approximately [redacted]. Including the fixed gas supply charge, the annual saving from switching to electric hot water is less than [redacted].

Envestra's application notes that one third of the QGDN customer base has only a gas cooker installed in their home. For such a household, the annual cost difference for the variable component of a customer's bill for using electricity rather than gas for cooking is approximately [redacted]. Including the fixed gas supply charge, the annual saving from switching to electric cooking is less than [redacted].

To replace either a gas water heater or gas cooker with an electric equivalent, the cost is upwards of approximately [redacted] for the purchase and installation of a new electric appliance and removal of the existing gas appliance and gas supply connection. The significant one-off switching cost compared against the potential annual cost saving from switching may not provide adequate incentive to switch a single gas appliance to an electric appliance.

Origin has not undertaken further analysis for households that use more than one gas appliance. However, the above argument holds for these households as it is reasonable to assume that the switching costs (both tangible and intangible in terms of effort) increase as the number of gas appliances increases.

Envestra has suggested that the competitiveness of gas compared to electricity is expected to worsen given projected increases in wholesale gas prices. Origin's analysis suggests potential increases in wholesale gas prices have little impact on Queensland customers given their already low gas usage and low retail gas bills. For example, if there was a $1/GJ increase in the wholesale gas price, given cost pass through this would result in a

[3] Independent Pricing and Regulatory Tribunal 2011, *Determinants of Residential Energy and Water Consumption in Sydney and Surrounds*

$8 per annum (p.a.) increase in the variable component on the average residential customer in the QGDN.[4] This is less than a two percent increase on the average residential customer's bill. This minimal change indicates that the costs even under increased wholesale gas prices are still unlikely to provide adequate incentive to switch to electric appliances.

The low incentives for customers to switch away from gas counter Envestra's view and again suggest a situation that is not conducive to light regulation given Envestra's market power position.

iii) Dual fuel decision

Full gas retail contestability and retail price deregulation were introduced in Queensland in 2007. As a result, there are now three retailers in the QGDN retail market – Origin, AGL and Alinta Energy (with Alinta Energy focusing on supplying large industrial customers).[5] It is important to note there is a potential for increased competition in the gas retail market as a result of the planned deregulation of retail electricity prices in South East Queensland from 1 July 2015.

For customers that use gas, the choice of energy retailer is typically a dual fuel decision as they often prefer to have their gas and electricity accounts with a single retailer. It is anticipated that electricity retail price deregulation may precipitate increased competition in the electricity sector. This may then flow on to the gas sector because of the customers' dual fuel decision. This increased competition may then lessen any perceived countervailing market power that existing retailers may have in negotiating terms and conditions of access to the QGDN.

Origin suggests a decision to move to light regulation of the QGDN is not appropriate at this time given this significant energy market change in Queensland next year and the resultant potential for increased gas competition.

b) Large industrial customers

Envestra notes there are several large customers consuming greater than 10TJ p.a. in the QGDN network. Representing approximately 86 percent of the delivered volume of gas in 2013-14 and accounting for the majority of its revenue recovery, these customers are a significant proportion of the QGDN network.

Envestra suggests that in the large industrial sector, industrial customers may be able to use electricity, LPG, diesel or coal as an alternate fuel source where gas is used mainly for heating. It also suggests large customers, particularly new customers or existing customers undergoing significant plant upgrade/renewal, also have the option of connecting to either:

- the adjacent transmission pipeline (i.e. the Roma to Brisbane Pipeline in Brisbane or the Queensland Gas Pipeline in Rockhampton and Gladstone); or
- for customers located in the Brisbane region, connecting to the neighbouring Allgas gas distribution network.

The switching argument for large industrial customers is less persuasive than for residential customers. Based on an assessment of Origin's own portfolio of customers in the QGDN, the

[4] Based on the average residential customer usage of 8GJ p.a. noted in Envestra's application and excluding margin and GST.

[5] We note there are actually six registered gas retailers in Queensland – Origin, AGL (which includes a separate registration for Australian Power & Gas), Alinta Energy, Dodo Power & Gas, Simply Energy and ERM Power – according to the Queensland Government's website. Available at: www.business.qld.gov.au/industry/energy/gas/gas-regulation-licensing/register-gas-retail-authorities

majority of large customers are in the manufacturing sector and use gas for more than just heating. These customers hold long-term gas contracts as gas is an important feedstock into their processes and as such, they are unable to switch to alternative fuels.

The option of connecting to the adjacent transmission pipeline or Allgas distribution network is also highly unlikely. Location is the primary determinant of the network to which a customer connects. The simplest and most cost effective option is to connect to the existing distribution network. For most large industrial customers, their location makes it impractical to connect to anything other than the QGDN. For an existing customer, even if its location made it possible, it is highly improbable it would make the significant long-term decision and assume the considerable costs to build a new pipeline to obtain gas from a supply source other than the QGDN. For a new customer, while it is possible that the choice of gas connection may be a factor in its location decision, there are more pertinent issues that would be expected to drive this decision.

The number and size of large industrial customers in the QGDN and their limited ability to move to an alternative fuel source or connect to an alternative gas supply source highlights that Envestra has countervailing market power in the provision of its service. Should it assist the NCC's consideration of Envestra's application, Origin would be happy to share further information on our large industrial customers with the NCC on a confidential basis.

2. Does light regulation offer a form of regulation that is as effective as full regulation but at a lower cost

a) Loss of potential benefits associated with full regulation

Envestra's application details that the cost of light regulation is expected to be around $4.6 million lower than full regulation over a five-year pricing period, which it equates to $65 per customer. Origin suggests that this saving, in particular the low per customer saving over the five-year period, is not of a sufficient size to justify moving to light regulation when weighed against the benefits provided by full regulation.

Full regulation centres on the preparation and submission of an Access Arrangement proposal with the AER on a periodic basis. The AER's assessment of the proposal is a multi-stage process with distinct steps that allow interested parties to provide feedback on the proposal. This open, transparent and consultative process ensures all interested parties, not just retailers who eventually undertake negotiations on access, of the robustness of the terms and conditions outlined in the Final Access Arrangement.

Envestra suggests it intends to continue to rely on similar methodologies to set prices under light regulation as it currently applies for full regulation and that it can continue to make certain parameters and pricing methodologies transparent to stakeholders where this would better facilitate an informed negotiation. With respect to non-price terms and conditions, it intends to continue to apply the most recent terms and conditions approved by the AER for the QGDN.

Origin is not confident these assurances are adequate to ensure a continued fair and reasonable bargaining position on access to the QGDN, particularly over the longer term. This is because the periodic determination process under full regulation releases a large amount of information about Envestra's operation of the QGDN that would be discontinued under a light regulation regime. Envestra suggests there will continue to be sufficient information available for a number of reasons including that there is a significant amount of historical information available because the QGDN has been subject to full regulation for the past 15 years and other gas distribution networks will continue to be subject to full

regulation thereby providing current related information. We do not consider this adequate. It is clear that past regulatory information will become less and less relevant over time and as circumstances change. In addition, information on other distribution networks cannot explain the underlying fundamentals that drive changes in the QGDN. There is a real potential that a weakening bargaining position over time will result in price increases and more onerous terms and conditions of access.

The full regulation process also allows interested stakeholders who do not have a direct relationship with Envestra to input into a monopoly service for which they cannot seek an alternative service. Consumer advocacy and representative groups are taking a greater interest in the pricing proposal process for distribution networks, as can been seen by the number of submissions lodged by these groups to the recent NSW Networks, Jemena Gas Networks and ActewAGL determination proposals. This opportunity will be lost under light regulation.

b) Saving to residential customers

Envestra's application gives a cost saving of around $4.6 million from moving to light regulation over a five-year period. In assessing the cost saving to customers, it is more appropriate to consider the cost saving by different classes of customer rather than as a single figure saving per customer. This is because the cost of regulation differs for a residential customer compared to a large industrial customer.

On a cost per GJ basis, the cost saving on $4.6 million is $0.30/GJ. This equates to a saving of $2.42 over the five-year regulatory period for a residential customer that consumes an average of 8GJ of gas each year. When compared with the risk of potentially higher prices and more onerous terms and conditions, the cost saving from light regulation does not appear to outweigh the benefits of full regulation.