

REPORT TO  
ENVESTRA LIMITED

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15 JULY 2013

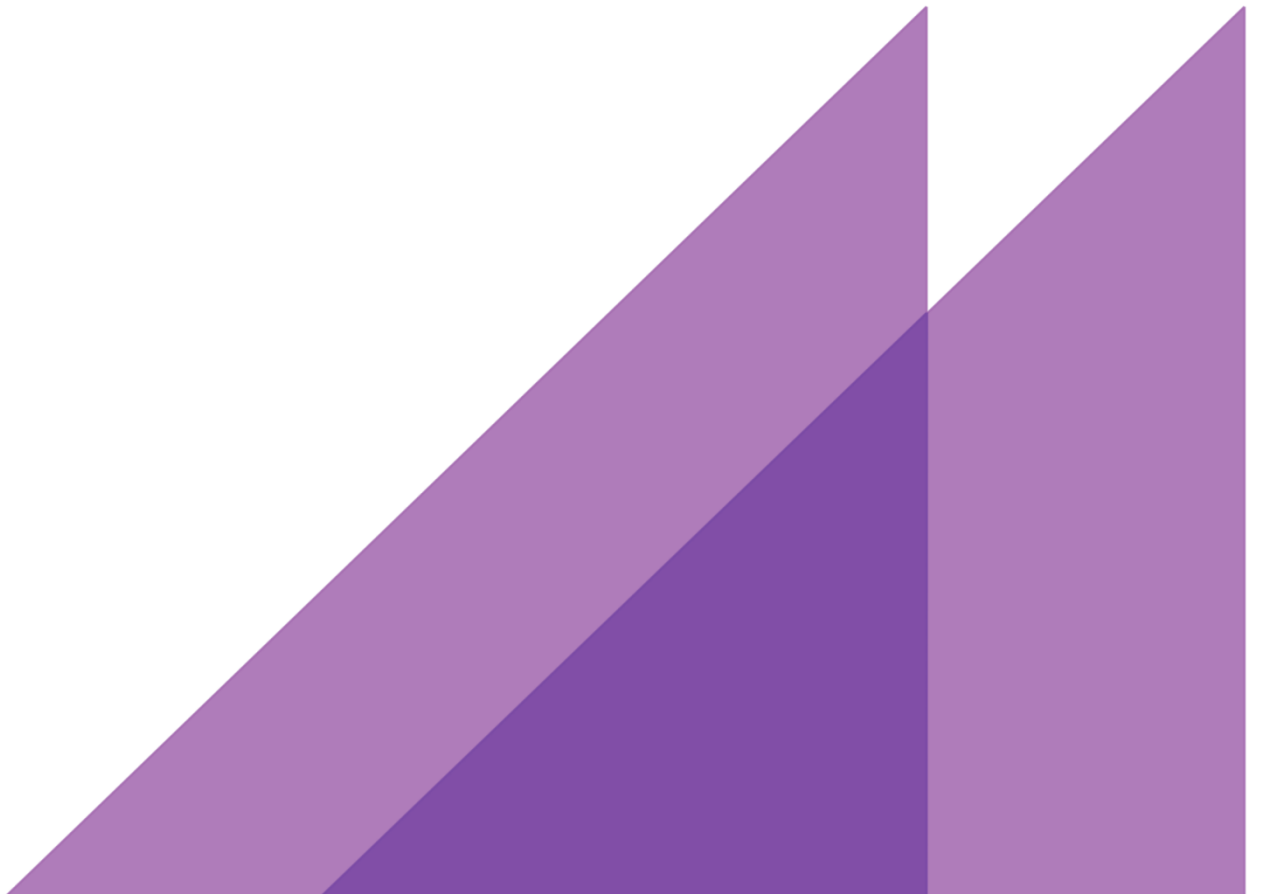
# REVOCATION OF COVERAGE

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WAGGA WAGGA GAS  
DISTRIBUTION NETWORK

FINAL REPORT





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# 1 Introduction

1. On 1 May 2013, Envestra Limited (Envestra) applied to the National Competition Council (the Council) under section 102 of the National Gas Law (the Law) for revocation of coverage of the Wagga Wagga Gas Distribution Network (WWGDN).
2. The WWGDN distributes gas within the city of Wagga Wagga and the neighbouring town of Uranquinty. In 2011-12, the network delivered approximately 1.7 PJ of gas to just over 20,000 end users. The network is 690 km in length. It is connected to the Moomba to Sydney pipeline via the Young to Wagga Wagga lateral and is also connected to the Victorian Transmission System via 'the Interconnect'. Both of these transmission pipelines are owned and operated by the APA Group.<sup>1</sup>
3. On 17 June 2013, the Council released its draft recommendation that the four pipeline coverage criteria, as set out in the Law, are met in relation to the WWGDN and therefore it should recommend to the New South Wales (NSW) Minister for Energy and Resources that coverage of the WWGDN not be revoked.
4. Envestra submitted, and the Council agreed in its draft recommendation, that pipeline coverage criteria (b) and (c), which relate to the diseconomies of duplicating infrastructure and to safety, are satisfied.
5. Envestra submitted that pipeline coverage criteria (a) and (d), which relate to competition and public benefits, are not satisfied. In its draft recommendation, the Council advised that it disagreed.
6. ACIL Allen Consulting (ACIL Allen) has been engaged by Envestra to review and assess the arguments made by the Council in relation to pipeline coverage criterion (a), which relates to competition. The rest of this report is structured as follows:
  - Section 2 provides background information on pipeline coverage criterion (a).
  - Sections 3 to 8 consider the arguments made by the Council in its draft recommendation in relation to:
    - The potential impact of revoking coverage of the WWGDN on the removal of price regulation in NSW
    - The risk that any cost reductions arising from revoking coverage of the WWGDN are not passed through by Envestra
    - The costs and risks associated with entry to the Wagga Wagga gas retail market
    - Automation of interfaces between Envestra and retailers
    - Pass through of cost reductions arising from revoking coverage of the WWGDN to consumers; and
    - Threat of fuel switching as a constraint to price increases.
  - Our conclusions are summarised in section 9.

<sup>1</sup> National Competition Council, *Application under the National Gas Law for a revocation of coverage determination for the Wagga Wagga Gas Distribution Network – Draft Determination*, 17 June 2013, paragraph 2.2

## 2 Background

7. The Law provides that a person may apply for a determination that a covered pipeline should no longer be covered. This is referred to as an application for revocation.
8. When deciding whether to approve an application for revocation, pursuant to section 105(1) of the Law, the Council must:
  - give effect to the pipeline coverage criteria
  - in doing so, have regard to the National Gas Objective.
9. The pipeline coverage criteria are set out in section 15 of the Law. They are:
  - a) that access (or increased access) to pipeline services provided by means of the pipeline would promote a material increase in competition in at least 1 market (whether or not in Australia), other than the market for the pipeline services provided by means of the pipeline;
  - b) that it would be uneconomic for anyone to develop another pipeline to provide the pipeline services provided by means of the pipeline;
  - c) that access (or increased access) to the pipeline services provided by means of the pipeline can be provided without undue risk to human health or safety;
  - d) that access (or increased access) to the pipeline services provided by means of the pipeline would not be contrary to the public interest.
10. The National Gas Objective, which is set out in section 23 of the Law, is:
 

to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.
11. ACIL Allen has been engaged by Envestra to consider pipeline coverage criteria (a), that is, whether access (or increased access) to pipeline services provided by means of the WWGDN would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the pipeline services provided by means of the WWGDN.
12. The Council agreed with Envestra's definition of the relevant (downstream) dependent market as "a market for gas sales in the Wagga Wagga and Uranquinty area serviced by the WWGDN" (Wagga Wagga retail gas market).<sup>2</sup>
13. The Council is of the view that competition in that market is limited. It notes that<sup>3</sup>:
  - the majority of customers in the market buy gas from one retailer
  - the only other retailer that currently supplies customers has a very small number of customers
  - there has been no new entry.

<sup>2</sup> The Council notes that most of the contentious issues raised in the application and in submissions are not related to markets upstream of the WWGDN. However, for completeness, the Law requires that the Council considers the impact in all dependent markets. Envestra accepts the Council's conclusion that there is no prospect that pipeline coverage criterion (a) is not satisfied in relation to upstream markets. Therefore, upstream markets are not considered in this report.

<sup>3</sup> National Competition Council, *Application under the National Gas Law for a revocation of coverage determination for the Wagga Wagga Gas Distribution Network – Draft Determination*, 17 June 2013, paragraph 4.25

14. This finding is consistent with the facts set out in Envestra's application. Among other things, Envestra demonstrates that the limited level of competition in the Wagga Wagga retail gas market shows that coverage of the pipeline has not promoted competition in that market. That is, even though the pipeline is covered, competition is very limited, with one retailer controlling 98 per cent of the market, despite full retail competition being in existence for the past 10 years. Therefore, in Envestra's submission, one of the key arguments was that coverage has not promoted competition, and as such, pipeline coverage criterion (a) is not satisfied in respect of the WWGDN.
15. The Council accepts that competition in the Wagga Wagga gas retail market is limited. However, it does not accept that, in and of itself, this shows that pipeline coverage criterion (a) is not satisfied.
16. On the contrary, the Council has identified a number of factors that, in its view, suggest that pipeline coverage criterion (a) is satisfied in respect of the WWGDN. Specifically, the Council is concerned that, if coverage of the WWGDN was revoked, the following factors would reduce the scope for additional competition in the area served by the WWGDN and elsewhere:
- the NSW Government would be dissuaded from removing retail price regulation
  - Envestra might increase the price of distribution services to retailers, which retailers would then pass through to customers
  - the costs and risks of entering the Wagga Wagga retail gas market for retailers, particularly small retailers, would be greater because the conditions for access to the WWGDN would not be known in advance<sup>4</sup>
  - Envestra would be less likely to participate in any future process to standardise and automate the interface between gas Distribution Network Service Providers (DNSPs) and gas retailers.
17. Envestra submitted that, if the WWGDN was not covered, its behaviour would be constrained by the countervailing power of retailers and, more importantly, the possibility that end users could switch to electricity, thereby using less of the distribution services Envestra provides. The Council considered that:
- Retailers would have the countervailing power to resist any price increase Envestra proposed. However, they would not have the incentive to do so. Rather, they would prefer to pass any such price increase on to end users and would be able to do so.
  - The threat of fuel switching would not constrain Envestra's behaviour because fuel switching is not costless for end users (regardless of the significant extent of allowed/forecast increases in retail gas prices).
18. Each of these points is considered in the following sections.

<sup>4</sup> If the WWGDN was covered, those conditions would have been determined in advance by the Australian Energy Regulator (AER) under the Law.

### 3 Removal of price regulation in NSW

19. Paragraphs 4.45 and 4.46 of the Council's draft recommendation states:
- ... the Council is concerned that revocation of coverage at this time might affect the scope for removal of retail price regulation of gas sales in NSW.
- The Council is aware that the [Australian Energy Market Commission] AEMC is to report to the NSW Government on competition in electricity and gas markets in NSW including whether and how price caps should be removed. The AEMC has published a draft report (AEMC 2013) and is seeking additional submissions before making its final report and recommendations in September. The Council believes that were the revocation of coverage of the WWGDN (perhaps as a precursor to other revocation action) to discourage removal of retail price regulation the scope for additional competition in the area served by the WWGDN and more widely would be significantly reduced. In such circumstances continued coverage would materially promote competition including in the relevant dependent market.
20. The AEMC has been tasked with reviewing the effectiveness of competition in the NSW small customer retail markets for electricity and natural gas. The purposes of the review include to<sup>5</sup>:
- assess whether competition in NSW energy retail markets is promoting effective choices for customers at a price and with the quality of service that is consistent with competitive market outcomes
  - provide recommendations on removing price regulations and what mechanisms may be required to improve the effectiveness of competition, if competition is found not to be effective.
21. The AEMC considers that<sup>6</sup>:
- ... where competition is providing customers with a choice of energy products and efficient prices, price regulation is more likely to inhibit competition than promote it.
22. In assessing the effectiveness of competition in the NSW energy markets, the AEMC has considered<sup>7</sup>:
- Market definition – a definition of the relevant market.
  - Market structure – a consideration of customer demand, aspects of independent rivalry related to the structure of the market, and the ability of suppliers to enter the market.
  - Market conduct – the behaviour of individuals and entities participating in the market, that is, whether there is independent rivalry such that retailers are competing strongly with each other to attract and retain customers, and customers are active in the market.
  - Market performance – a reflection of both its structure and the collective conduct of the participants acting in the market, that is, whether retailers are making profit margins that are consistent with a competitive market, and customers are satisfied with outcomes in the market.
23. Importantly, and contrary to the above concern raised by the Council, the AEMC provided no indication in its recent draft report on the review of competition in the

<sup>5</sup> Australian Energy Market Commission (AEMC), *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales, Draft Report*, 23 May 2013, page 1

<sup>6</sup> AEMC, *op cit*, page 119

<sup>7</sup> AEMC, *op cit*, pages 8-13



NSW energy markets that the coverage of the WWGDN, or any other natural gas pipeline, would be a factor in its recommendation on the deregulation of retail prices in NSW. This is despite the AEMC releasing its draft report around three weeks after Envestra applied to the Council for coverage of the Wagga Wagga network to be revoked.

24. The AEMC recognised differences between the level of competition in the electricity and gas markets. However, it stated that<sup>8</sup>:  

We did not find significant barriers to entry, exit and expansion. There are currently twelve active electricity and five active gas retailers operating in the market. ... Retailers are able to source electricity and natural gas supply to their customers. This is easier in electricity, where retailers can source electricity and manage spot price risk through hedges. In gas, we found it harder to access gas and pipeline capacity with a small customer base.
25. The AEMC identified the following challenges for small retailers to enter the NSW gas market<sup>9</sup>:  

... difficulties in negotiating supply agreements with producers and pipeline owners, and the relatively inflexible nature of these contracts for a growing business.
26. However, it concluded that<sup>10</sup>:  

... since Australian Power & Gas and Lumo have recently entered the gas market and are winning customers, these issues are not insurmountable.
27. Further<sup>11</sup>:  

While the gas market is providing less choice for gas customers, both in terms of gas retailer and product choice, the market is still providing efficient outcomes.
28. The AEMC also considered the difference in the level of competition between urban and rural areas as some stakeholders had commented that competition is not yet sufficient in rural areas for price caps to be removed. It concluded that<sup>12</sup>:  

While competition is less effective in rural areas than urban areas, we consider competition to be sufficient to enable these customers to benefit from the removal of price caps. Retailers in NSW have customers across the state and the majority of retailers have market offers in rural areas. Amongst customers, the awareness of the ability to switch and switching rates are similar between urban and rural areas.
29. Accordingly, the AEMC's draft recommendation is that<sup>13</sup>:  

Price caps be removed for all customers at the same time so that all customers have an equal opportunity to benefit from increased competition and product choice.
30. Any decision the NSW Government might make about removing retail price regulation would, we presume, be made based on the AEMC's final recommendation and the Government's view as to the best interests of NSW consumers. That is, and as reasoned by the AEMC, the relevant factors that will influence a decision by the NSW Government to remove retail price regulation is the extent of competition in the retail market and not how distribution networks are regulated (which matter was not considered to be a relevant factor for consideration by the AEMC).

<sup>8</sup> Australian Energy Market Commission (AEMC), *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales, Draft Report*, 23 May 2013, page ii

<sup>9</sup> AEMC, op cit, page 157

<sup>10</sup> AEMC, op cit, page ii

<sup>11</sup> AEMC, op cit, page 85

<sup>12</sup> AEMC, op cit, pages ii-iii

<sup>13</sup> AEMC, op cit, page iii

31. Given its commitments at the Council of Australian Governments in December 2012 and in the Australian Energy Market Agreement in 2004 to deregulate retail energy prices, we would expect that the NSW Government will remove retail price regulation, as the South Australian and Queensland Governments have recently done, when it is satisfied that removing retail price regulation will be in the best interests of NSW consumers.
32. Given the draft recommendations of the AEMC, the Independent Pricing and Regulatory Tribunal's support for price deregulation<sup>14</sup>, and the interests of NSW consumers more broadly, the Council's assertion that revocation of the WWGDN, which supplies a relatively small proportion of NSW consumers, would dissuade the NSW Government from removing retail price regulation is highly speculative. The Council's assertion would appear particularly speculative given that network regulation was not considered by the AEMC to be a relevant factor in making its draft recommendation to the Minister.
33. We note from paragraph 4.46 of the draft recommendation that the Council appears concerned that revocation of coverage of the WWGDN might be a precursor to revocation of coverage of other pipelines. This suggests that the Council's true concern is that the NSW Government would not remove retail price regulation if more customers were connected to distribution pipelines that were not covered.
34. Again this is highly speculative. In this regard, we note Envestra's assurance that it has no intention of seeking revocation of coverage of its Albury network given the existence of certain factors that are specific to that network.<sup>15</sup>
35. Each application for revocation of coverage of a pipeline for a particular market should be considered on its merits. The Council's decision on Envestra's application for revocation of coverage of the WWGDN should not be influenced by any further applications for revocation of other pipelines that may or may not occur.

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<sup>14</sup> Refer paragraph 107

<sup>15</sup> Letter from Envestra to the Council dated 5 June 2013, page 4

## 4 Risk of price increases

36. In this chapter, the following concerns of the Council are considered:
- Envestra does not pass through the reduction in regulatory costs resulting from the revocation of coverage of the WWGDN
  - The risk that Envestra will impact competition in the WWGDN area by increasing prices
37. Energy Australia's comment regarding price decreases in Victoria is also considered.

### 4.1 Pass through reduction in regulatory costs

38. In its application, Envestra has indicated that, if coverage of the WWGDN is revoked, it intends to pass through the reduction in regulatory costs to its customers. Pending the time of approval, Envestra intends to<sup>16</sup>:
- a) not apply the approved 2.5% real increase in regulated network tariffs that is otherwise scheduled to occur on 1 July 2014 (but to adjust prices by the Consumer Price Index (CPI) only)
  - b) to limit any further price increases to be no greater than the CPI over the following five year period
  - c) to continue with marketing incentives (such as appliance rebate programs) to enhance gas usage and/or connections.
39. In paragraph 4.35 of its draft recommendation, the Council has stated that while it has:
- Little reason to doubt the bona fides of Envestra's stated intentions to return some of the savings in regulatory costs to customers, limit future price increases and engage with retailers in relation to access terms, these intentions can only be given limited weight given difficulties that would arise in enforcing such promises in relation to an uncovered pipeline.
40. There is a significant reputational risk for Envestra if it does not act in accordance with the intentions set out in its revocation application. Envestra is a long term player in the Australian energy market with assets in NSW, Queensland, South Australia, Victoria and the Northern Territory. It is not in the long term interests of Envestra to put its reputation at risk, particularly for a network the size of Wagga Wagga (which Envestra has submitted accounts for around 2 per cent of its business)..
41. However, if there is any evidence that Envestra is increasing its prices above an efficient level then, under section 92 of the Law, any person may apply for a determination that the WWGDN be covered.
42. Origin has raised concerns regarding the significant time and cost associated with applying for such a determination.<sup>17</sup> However, it is noted that the direct cost for making an application is \$7,500, which is minimal relative to the market capitalisation of Origin (\$14 billion). Even if the total costs incurred by Origin are \$100,000, this is less than 0.001 per cent of Origin's market capitalisation.

<sup>16</sup> Envestra, *Wagga Wagga Network Revocation Submission*, 1 May 2013, paragraph 136

<sup>17</sup> Origin, *Submission to the Council on Envestra's application for revocation of coverage of the WWGDN*, 28 May 2013, page 3

43. If the Council remains concerned that Envestra will not have sufficient incentive to pass back the regulatory costs that would be saved by revoking coverage of the WWGDN, the Council could recommend that revocation of coverage of the WWGDN be subject to Envestra entering into an undertaking with the Minister or with the relevant retailers that the regulatory costs would be passed back.

## 4.2 Will Envestra impact competition in the WWGDN area by increasing prices?

44. In paragraphs 4.31 and 4.32 of its draft recommendation, the Council raises concerns regarding the incentive for Envestra to price services on the WWGDN above efficient costs if coverage was revoked:

The Council also accepts in principle Envestra's contention that the nature of the capital and operating costs associated with a distribution pipeline and the availability of spare capacity make additional throughput desirable and this may constrain Envestra's access pricing. However, the strength of that constraint depends on the prospects for increasing throughput and the relative contribution to Envestra's profits from reducing (or limiting) prices to attract additional throughput or raising prices to existing users.

It is not clear to the Council that the prospects for attracting additional throughput are such that access prices will be constrained in the absence of coverage.

45. All retailers need access to gas distribution services to be able to operate in the retail gas market.
46. If the distributor increased (or decreased) price equally for all retailers and if it is assumed that all retailers passed the price increase (decrease) through to customers, the impact on competition in the dependent market would be negligible. It would be comparable to the impact of any other broad general cost change, such as a change in the cost of labour. That is, if Envestra increased (or decreased) prices for the WWGDN equally for all retailers, there would not be a material impact on competition in the retail gas market in the WWGDN area.
47. However, if Envestra increased (or decreased) prices for the WWGDN in a discriminatory way by increasing (or decreasing) the price for some retailers but not others, it would give the retailers for which price was not increased (or decreased) a competitive advantage. The impact on competition in the WWGDN area would depend on the particular circumstances.
48. If the distributor had retail interests, it might conceivably increase price for those retailers in which it had an interest *less* (or decrease price) and increase price for other retailers *more*. This would place the retailers in which the distributor had an interest at a competitive advantage to other retailers. Such an action would therefore be expected to have a material impact on competition in the Wagga Wagga retail gas market.
49. The Council has accepted Envestra's position that its lack of involvement in gas retailing removes any incentive to leverage the market power it has through ownership of the WWGDN.<sup>18</sup>
50. Therefore, Envestra's pricing would only impact competition if Envestra charged retailers on a discriminatory basis for some reason other than to advantage its own gas retail interests. If Envestra did this, it would place one arbitrary group of retailers at a competitive advantage to others.

<sup>18</sup> Council's draft recommendation, paragraph 4.30

51. However, there is no incentive for Envestra to engage in discriminatory pricing (nor is there any evidence demonstrating that Envestra has acted in this way in Wagga Wagga or any other market).
52. As the Council notes in paragraph 4.31 of its draft recommendation, Envestra's incentive is to maximise throughput on the WWGDN. By arbitrarily increasing price to some retailers and not others, the best outcome for Envestra would be no change in throughput (if customers switched away from the "high price" retailers to other retailers). However, there is also a risk that customers would not switch to a "lower priced" retailer, but would switch fuel instead, reducing throughput on the WWGDN. This is discussed further in section 8.
53. This type of discriminatory pricing would not be in the interests of the "high price" retailers. These retailers would have a strong incentive to resist Envestra's attempt to increase price in a discriminatory way.
54. There are only two retailers currently operating in the Wagga Wagga area – Origin and Energy Australia. As the Council accepted in paragraph 4.42 of its draft recommendation, these two retailers have "some countervailing power due to their experience and knowledge of the gas sector".
55. Envestra indicated in its revocation application that the main retailer, Origin, has demonstrated its willingness to exercise its strong negotiating position. As the sole retailer in Envestra's uncovered Mildura network, Origin has not agreed to any increase in price that is in excess of the CPI.<sup>19</sup>
56. Even if Envestra sought to increase price in a discriminatory fashion, regardless of the lack of incentive to do so, it would not necessarily be able to do so.

### 4.3 How do network price increases compare on regulated versus unregulated pipelines?

57. In raising its concerns that Envestra will use its market power to price above efficient costs if the WWGDN is not covered, the Council notes a comment by Energy Australia<sup>20</sup>:
- ... querying whether gas distribution network prices should be falling as they are said to have done recently in Victoria (rather than rising in line with CPI).
58. The Australian Energy Regulator (AER) is the economic regulator for distribution gas pipelines in Victoria and in New South Wales. Its most recent determination on the revenues to be earned by Envestra for the WWGDN applies for the 2010-15 period and its most recent determination on the revenues to be earned by the three Victorian gas Distribution Network Service Providers (DNSPs) applies for the 2013-17 period.
59. The price control formula is applied to determine the adjustment that may be made to network tariffs from one year to the next. The price control formula, also referred to as the CPI-X formula, includes an X-factor which is the average real increase in network tariffs applicable. Where the X-factor is negative, there is a real increase (on average) in network tariffs and where the X-factor is positive, there is a real decrease (on average) in network tariffs.
60. The X-factors for the three Victorian gas DNSPs for the 2013-17 period, as determined by the AER, are as set out in Table 1. It should be noted that:

<sup>19</sup> Envestra, *Wagga Wagga Network Revocation Submission*, 1 May 2013, paragraph 84

<sup>20</sup> Council's draft recommendation, paragraph 4.36

- the X-factors for 2013 apply only from 1 July 2013 and therefore are higher than they would have been had they applied for the full year from 1 January 2013
- the X-factors do not take into account the outcomes of any appeals of the final determination, noting that MultiNet was recently successful in an appeal on its opening regulatory asset base, which will increase its revenue during the 2013-17 regulatory control period
- the X-factors do not take into account any pass through amounts arising from additional capital expenditure on mains replacement above a threshold.

Once these factors have been taken into consideration, the real price decreases in the early years may be completely offset by real price increases in the later years.

**TABLE 1 X-FACTORS FOR THE VICTORIAN GAS DNSPS, 2013-17 (EXCLUDING IMPACT OF APPEALS AND PASS THROUGH MECHANISMS)**

	2013	2014	2015	2016	2017
Envestra	0.17%	-1.5%	-2.0%	-3.0%	-3.0%
MultiNet	13.3%	5.0%	-2.0%	-2.5%	-2.5%
SP AusNet	17.4%	6.0%	-1.0%	-2.0%	-3.0%

SOURCE: RELEVANT AER REVENUE DETERMINATIONS

61. The X-factors for the WWGDN for the 2010-15 period, as determined by the AER, are as set out in Table 2.

**TABLE 2 X-FACTORS FOR THE WWGDN, 2010-15**

	2010/11	2011/12	2012/13	2013/14	2014/15
Envestra	-12.81%	-3.16%	-2.5%	-2.5%	-2.5%

SOURCE: RELEVANT AER REVENUE DETERMINATION

62. Prior to the inclusion of the outcome of appeals and the mains replacement pass through mechanism, the network tariffs in Victoria have decreased in real terms only for Envestra in the second half of 2013 and for MultiNet and SP AusNet in the second half of 2013 and in 2014. In the other years, gas network tariffs increase in real terms.
63. Contrary to the comment by Energy Australia, Table 1 demonstrates that the gas network tariffs are not decreasing in all Victorian gas distribution areas and in each year of the current revenue determination.
64. Of more relevance is a comparison of gas network tariffs for pipelines that are regulated to gas network tariffs for pipelines that are not regulated.
65. In its application for revocation of coverage of the WWGDN, Envestra compared the annual average price increases across its regulated pipelines<sup>21</sup> to the annual average price increases across its unregulated pipelines<sup>22</sup>. Figure 5 in Envestra's application shows that the real annual price decreases for its unregulated pipelines (of 0.1 per cent) have been 4.8 per cent lower than for regulated networks (which increased by 4.7 per cent)<sup>23</sup>.
66. This evidence does not support any inference that price increases are higher on unregulated pipelines than on regulated pipelines. To the contrary, the evidence suggests that it is most likely that price outcomes will be lower if coverage of the

<sup>21</sup> In South Australia, Queensland, Victoria, and Albury

<sup>22</sup> In Mildura and regional NSW (including areas surrounding the regulated Wagga Wagga network)

<sup>23</sup> Envestra, *Wagga Wagga Network Revocation Submission*, 1 May 2013, paragraph 127

network is revoked, which is consistent with Envestra's forecast of future prices set out in its application.

## 5 Costs and risk of entry to the Wagga Wagga gas retail market

67. In paragraph 4.43 of its draft recommendation, the Council states that it:

... considers that the costs and risks of competing in the market for gas sales in the area serviced by the WWGDN, especially for smaller second tier gas retailers, are likely to be lower if the conditions for access to the WWGDN (and the basis for the determination of these in the future) are known in advance. The ex ante regulation associated with a covered pipeline seems more likely to allow this, and also provides some certainty to retailers in deciding to enter a new market, than would be the case for an uncovered pipeline (or indeed a pipeline subject to light regulation).

68. In this chapter, we consider the range of issues to be considered by retailers entering a new gas market and the specific terms and conditions for the WWGDN if coverage is revoked.

### 5.1 Retailer entry to a new gas market

69. As identified by Energy Australia in its supplementary submission to the Council, there are a range of issues to be addressed by a retailer before entering a new gas market<sup>24</sup>:

- Registration and certification with AEMO (Australian Energy Market Operator)
- Obtaining transmission haulage to the network receipt points
- Obtaining distribution system haulage
- Procuring suitable gas supply from producers
- Procuring/managing gas supply hedges to offset risks in the wholesale gas market
- Establishing the business to business protocols including new connections and other service orders
- Building suitable tariffs and tariff structures to manage distribution network tariffs and retail risks
- Building processes and protocols to manage network billing
- Establishing new connection processes
- Ensuring customer contracts and terms address regulatory obligations and distribution processes
- Educate operational staff on the market issues of each network including emergency management

70. In addition to the above, it would be reasonably expected that retailers would need to incur marketing costs in order to attract customers in a new gas market.

71. Retailers thus need to take on significant cost and risk to enter new (including small) markets, most of which are not related to the distribution pipeline, with little potential benefit for entry to small retail markets such as the WWGDN area. While many of these costs and risks are common for entry to each electricity and gas market, there are significantly greater costs and risks associated with entry to small gas markets, particularly in NSW, Queensland and South Australia, which operate on a contract carriage model.

<sup>24</sup> EnergyAustralia, *Response to Envestra's Application for Revocation of Coverage – Wagga Wagga Gas Distribution System: Supplement 1*, page 1



72. The wholesale gas market operates very differently from the wholesale electricity market.
73. In electricity, wholesale trade takes place on the National Electricity Market (NEM), which is highly transparent and is accompanied by highly developed secondary markets for derivatives that can be used to manage risk. Further, buyers of wholesale electricity do not need to enter into separate bilateral contractual arrangements for transmission or distribution of that electricity.
74. There are two models operating in the Australian gas market – a “market carriage model”, which operates in Victoria, and a “contract carriage model”, which operates in the other states, including NSW, Queensland and South Australia.
75. Under a contract carriage model, the majority of wholesale trade is done on a confidential, bilateral basis between producers and retailers.<sup>25</sup> Having purchased gas from a producer, retailers then need to make separate arrangements with a shipper to ‘deliver’ their gas to the appropriate distribution network.
76. Therefore, before a retailer could supply small customers in Wagga Wagga (or elsewhere) with gas it would need to negotiate two contracts:
- a wholesale gas supply contract
  - a shipping contract.
77. There is substantial risk and cost associated with both of these contracts as was noted by the AEMC<sup>26</sup> in its draft report on its review of competition in the NSW energy markets. The AEMC noted that:
- Wholesale gas and pipeline capacity is generally traded through long term bilateral contracts. For a retailer to enter the gas market, it must negotiate directly with a gas producer and pipeline owner.<sup>27</sup>
  - The physical properties of transporting gas involve retailers nominating the volumes they require the day before delivery. As forecasting is uncertain, daily imbalances occur. Pipeline owners offer services to store or supply incremental gas to manage these imbalances.<sup>28</sup>
  - New entrant retailers noted that it is difficult to purchase small amounts of gas from producers.
  - Access to transmission pipeline capacity is predominately negotiated on a commercial basis between the pipeline owner and gas retailer. This is because the major transmission pipelines supplying Sydney are either unregulated or lightly regulated.<sup>29</sup>
78. Under the market carriage model, a new retailer can access the required wholesale gas and pipeline capacity through a market administered by the Australian Energy Market Operator.
79. In its submission to the AEMC’s review of competition in the NSW energy markets, Momentum Energy outlined the higher costs and risks for a new entrant retailer

<sup>25</sup> Or between producers and other participants in the wholesale market such as large industrial users.

<sup>26</sup> AEMC, *Draft Report Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales*, 23 May 2013, page 75

<sup>27</sup> AEMC, *op cit*, page 153

<sup>28</sup> *ibid*

<sup>29</sup> AEMC, *op cit*, page 155

associated with the contract carriage model, which operates in NSW, as compared to the market carriage model, which operates in Victoria<sup>30</sup>:

While there may be rivalry between the big three retailers, the NSW retail gas market is in practice largely limited to just them. This absence of actively competing gas retailers is due to the barriers to entry being high. There are three principal reasons for this are:

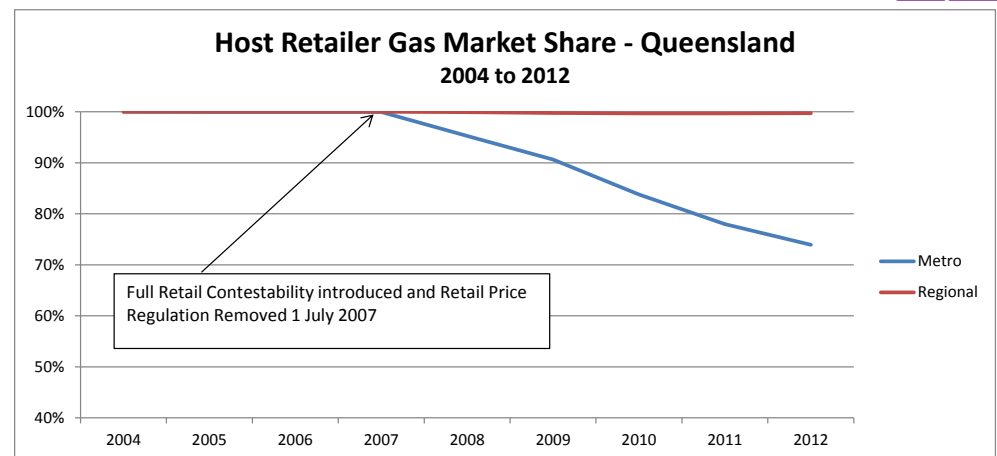
- Procuring wholesale gas is more difficult in NSW than Victoria;
- There are less supply and transportation options in NSW, and;
- Gas retailers rely heavily on bi-lateral contracts rather than purchasing from the market.

Gas is now transacted through the STTM at the Sydney Hub, but this gas is primarily used for balancing purposes.<sup>31</sup> When smaller retailers are seeking reliable longer term contracts, gas producers generally demand a higher price for gas from such a lower volume purchaser, combined with more onerous take or pay arrangements and less flexibility in daily cash flow arrangements<sup>1</sup>. Consequently, for second tier retailers, price and volume are unlikely to be sufficiently certain to back the provision of gas to their retail customers.

80.

The impact that the market structure has on the level of competition is demonstrated in the following graphs of the market share of the “host retailer” on Envestra’s pipelines in Queensland (Figure 1) and South Australia (Figure 2), which operate on a contract carriage model, and in Victoria (Figure 3), which operates on a market carriage model.

FIGURE 1 MARKET SHARE OF “HOST RETAILER” ON ENVESTRA’S PIPELINE IN QUEENSLAND

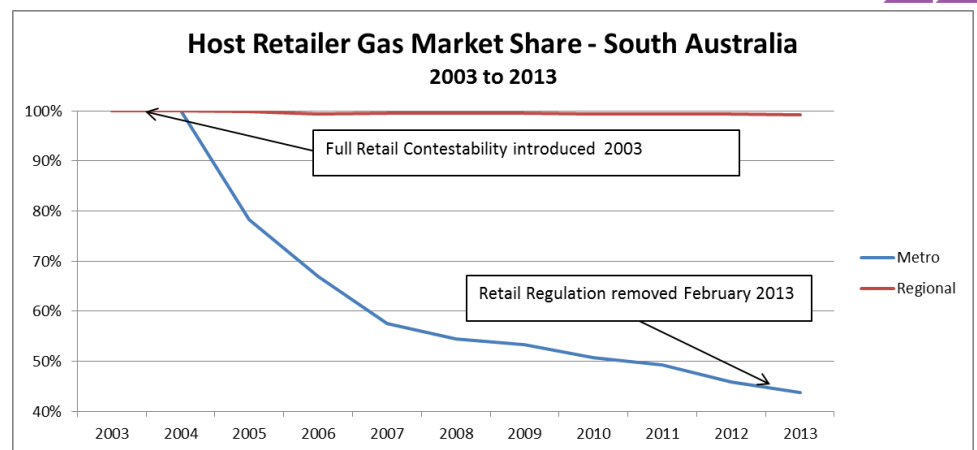


SOURCE: ENVESTRA

<sup>30</sup> Momentum Energy, Submission to the AEMC’s Issues Paper on the Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales, 15 February 2013, page 2

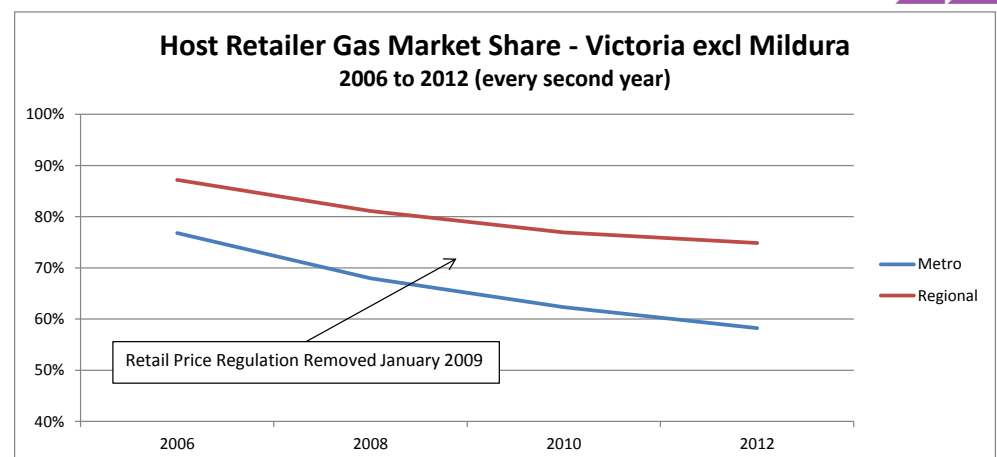
<sup>31</sup> The Sydney hub operates in relation to imbalances on the Moomba to Sydney pipeline and the Sydney to Longford pipeline, but not imbalances on the transmission pipelines that connect to the WWGDN – the Young to Wagga Wagga lateral and ‘the Interconnect’ to the Victorian Transmission System

FIGURE 2 MARKET SHARE OF “HOST RETAILER” ON ENVESTRA’S PIPELINE IN SOUTH AUSTRALIA



SOURCE: ENVESTRA

FIGURE 3 MARKET SHARE OF “HOST RETAILER” ON ENVESTRA’S PIPELINE IN VICTORIA, EXCLUDING MILDURA



SOURCE: ENVESTRA

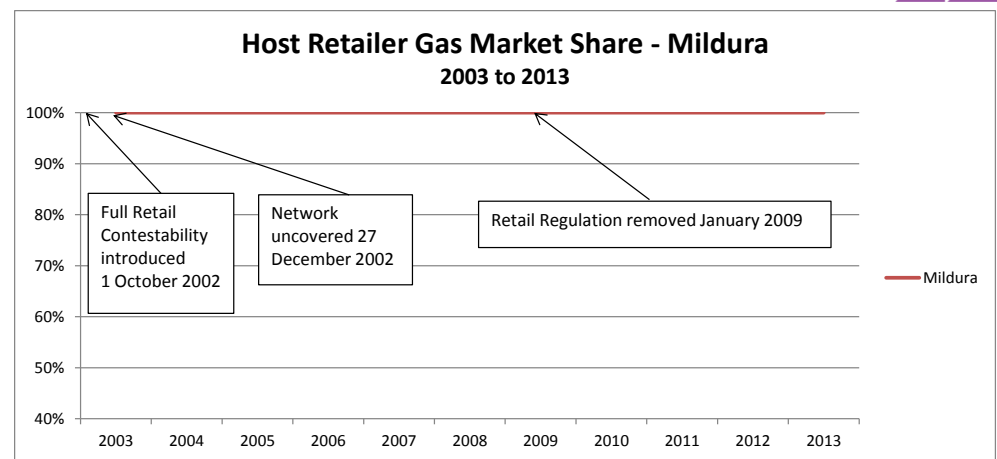
81. Figures 1 to 3 illustrate that the market share of the “host retailer” in those states operating under a contract carriage model, is higher than in Victoria (other than Mildura), which operates under a market carriage model. This is due to the additional costs and risks associated with negotiating the required wholesale gas contract and shipper contract under a contract carriage model. Retailers are required to enter into long term wholesale gas contracts and shipper contracts before winning new customers. The fixed costs under these contracts are incurred regardless of the actual customer base.
82. Figures 1 to 3 also illustrate that the market share of the “host retailer”<sup>32</sup> in regional areas is significantly higher than in metropolitan areas. This is due to the higher cost per customer relative to the potential benefits incurred by a new entrant retailer, particularly in the smaller regional areas, to address the issues identified by Energy Australia in paragraph 69, including to negotiate the required wholesale gas contract and shipper contract. That is, regional areas are associated with high costs and risk

<sup>32</sup> The “host retailer” is the retailer that operated in a market in a particular area prior to the commencement of Full Retail Competition.

for little benefit, due to their small size, which facts have led to the observed low levels of competition across all regional retail markets in which Envestra operates.

83. The higher level of cost and risk associated with a contract carriage model, particularly in regional markets, vis a vis a market carriage model will be faced by new entrant retailers, regardless of whether the WWGDN is covered or not.
84. This is evident from the market share of the “host retailer” in the Mildura area. The gas distribution pipeline in the Mildura area, which is uncovered, is supplied from South Australia under a contract carriage model, rather than from Victoria under a market carriage model. The “host retailer” has 100 per cent of the market share in the Mildura area, as illustrated in Figure 4.

FIGURE 4 MARKET SHARE OF “HOST RETAILER” ON ENVESTRA’S PIPELINE IN MILDURA



SOURCE: ENVESTRA

## 5.2 Terms and conditions for the WWGDN

85. In paragraph 4.43 of its draft recommendation, the Council has indicated that one of the benefits of coverage is the certainty as to the terms and conditions that will apply to the WWGDN.
86. In its supplementary submission to the Council:
- Envestra has proposed that the Wagga Wagga network will apply the most recent AER approved terms and conditions, which in this case is for our Albury network and is embodied in the haulage Agreements with retailers in that market, as an appropriate starting point for negotiation. This approach is consistent with our intention to have nationally consistent terms and conditions across all of our networks.<sup>33</sup>
87. Nationally consistent terms and conditions across all Envestra pipelines would provide the level of certainty that the Council is of the view that new entrant retailers require. This is because a new entrant retailer could review the most recent terms and conditions approved by the AER for Envestra’s regulated networks. It would be most likely that the potential retailer would operate in the other networks owned by Envestra, and as such, have a high level of familiarity with Envestra’s terms and conditions.

<sup>33</sup> Letter from Envestra to the Council dated 5 June 2013

88. However, in paragraph 4.35 of its draft recommendation, the Council appears to place little weight on these assurances:
- While the Council has little reason to doubt the bona fides of Envestra's stated intentions to return some of the savings in regulatory costs to customers, limit future price increases and engage with retailers in relation to access terms, these intentions can only be given limited weight given difficulties that would arise in enforcing such promises in relation to an uncovered pipeline.
89. There is a significant reputational risk for Envestra if it does not act in accordance with the intentions set out in its revocation application. Envestra is a long term player in the Australian energy market with assets in NSW, Queensland, South Australia, Victoria and the Northern Territory. It is not in the long term interests of Envestra to put its reputation at risk, particularly in respect of a network the size of Wagga Wagga (which Envestra has submitted accounts for around 2 per cent of its business).
90. However, if there is any evidence that Envestra is not engaging with retailers on access terms then, under section 92 of the Law, any person may apply for a determination that the WWGDN be covered.
91. As discussed in paragraph 42, Origin has raised concerns regarding the significant time and cost associated with applying for such a determination.<sup>34</sup> However, it is noted that the direct cost for making an application is \$7,500, which is minimal relative to the market capitalisation of Origin (\$14 billion). Even if the total costs incurred by Origin are \$100,000, this is less than 0.001 per cent of Origin's market capitalisation.
92. If the Council remains concerned that Envestra will not have sufficient incentive to use national consistent terms and conditions for the WWGDN, the Council could recommend that revocation of coverage of the WWGDN be subject to Envestra entering into an undertaking with the Minister or with the relevant retailers that national consistent terms and conditions be used for the WWGDN.

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<sup>34</sup> Origin, Submission to the Council on Envestra's application for revocation of coverage of the WWGDN, 28 May 2013, page 3

## 6 Automation of interfaces between DNSPs and retailers

93. Paragraph 4.47 of the Council's draft recommendation states that:
- ... Council is also concerned that the costs associated with the transactional interfaces between gas retailers and distribution pipeline operators are significant. Unlike the electricity sector where most of these processes have been standardised and automated, in the gas sector many pipeline appears (sic) to have bespoke requirements and retailers have to interface with each different system. There appears to be significant scope for these costs to be reduced and for competition to be enhanced as a result. The Council understands that some initiative may be under way in this regard. However, it appears to the Council that any such initiatives, and positive developments in this regard more generally, are more likely to flourish within a regulated environment than where a pipeline is uncovered.
94. Similar concerns were raised by the AEMC in its review of competition in the NSW energy markets. Two retailers suggested that the absence of<sup>35</sup>:
- ... real Business to Business (B2B) procedures ... can make it difficult to acquire a customer.
95. Conversely, in its submission to the AEMC's Issues Paper, Jemena considers that the absence of B2B procedures reduces the barriers to entry<sup>36</sup>:
- The current NSW gas retail market design has provided a ready means for retailers to enter and compete in the gas retail market for small gas customers.
- Unlike other jurisdictions, retailers are able to choose the level of automation they wish to invest in to operate within the market. They may commence operations in NSW with only a rudimentary market interfacing capability by utilising third party suppliers to meet market system requirements and by gaining remote self service access to [Jemena's] own distribution IT system for managing customer sites. Then, as the volume of transactions warrants, they may upgrade these systems to utilise interfaces with higher levels of automation.
- This flexibility allows retailers to avoid the high entry cost of investing in high volume automation, yet transition to automated systems when economically efficient to do so.
96. The B2B arrangements that have evolved in the energy markets since the commencement of Full Retail Competition (FRC) have been driven by economic efficiency. Prior to FRC, a relatively small number of customers could change retailers and the costs associated with manually transacting any customer transfers were small relative to the customer's energy bill. However, with the commencement of FRC, a very large number of customers could change retailers and the costs associated with manually transacting any customer transfers were high relative to the customer's energy bill. For example, if the cost for manually transacting a customer transfer is \$100, this may be small relative to an annual bill of say \$1 million for a larger energy user, but large relative to a small customer's annual bill of say \$2,000.
97. There is a substantial cost associated with automating the transactions between DNSPs and retailers. With the introduction of FRC, these costs were justified in those markets with a high number of transactions. B2B processes were therefore automated in the larger retail energy markets.

<sup>35</sup> AEMC, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales: Draft Report*, 23 May 2013, page 156

<sup>36</sup> Jemena, *Response to AEMC's Issues Paper – Review of Competition in the Retail Electricity and Natural Gas Markets in NSW*, 8 February 2013, pages 1-2

98. In smaller markets, such as those served by the WWGDN, the number of customers changing retailers is relatively small. As a result, the cost to introduce automated transactions between Envestra and the retailers cannot currently be justified.
99. In 2010, AEMO commenced investigating the need for standardised B2B transactions across the gas retail markets. The aim was to determine whether aligning the NSW/ACT processes with those in the South Australian, Victorian, Western Australian and Queensland gas retail markets would deliver industry benefits.
100. The Board of AEMO ceased work on the project following a January 2013 cost benefit assessment for the project. The cost benefit assessment identified:
- the costs to industry of the project to be approximately \$40-50 million
  - there is no consensus from industry on the need for, and value of, the program
  - the absence of a positive net present value or policy decision on the project.
101. In particular, the cost benefit assessment estimated that the cost of the B2B project to be “an order of magnitude higher” than \$6 per customer for customers in the Wagga Wagga area.<sup>37</sup>
102. However, Envestra has an incentive to automate B2B transactions when/if the number of transactions increases or when/if the cost to automate B2B transactions is reduced such that the benefits of the investment exceed the costs. Envestra has this incentive regardless of whether the WWGDN is covered.
103. There is a risk of an inefficient outcome if the WWGDN continues to be covered as a means to impose automated B2B transactions on participants that operate in that area which would otherwise not be justified through a cost-benefit analysis. To this end, such an investment would not be permitted under the National Gas Rules, which requires a cost-benefit test to be satisfied before expenditure is added to the regulatory asset base.

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<sup>37</sup> Nous Group, NSW/ACT Gas Market Reform – Cost Benefit Analysis, 15 March 2013, page 3

## 7 Pass through of price increases

104. Section 4 provided evidence that price increases on unregulated pipelines have been less than on regulated pipelines, and argued that, if the WWGDN is not covered, Envestra does not have an incentive to increase prices above efficient costs, in part due to the countervailing power of the significantly larger retailers operating in the Wagga Wagga retail gas market.
105. However, in paragraph 4.42 of its draft recommendation, the Council states that:
- ... the strength of such countervailing power of any retailer cannot necessarily be expected to benefit end users and, in particular, households. Under current regulatory arrangements gas retailers are generally allowed to pass through distribution cost increases, which limits the incentive for retailers to resist such increases. As such the application of any countervailing power by a retailer may be an inadequate response to any possible anticompetitive conduct affecting end users.
106. ACIL Allen agrees that, under the current regulatory arrangements in NSW, network prices are treated as a pass through cost in determining retail gas prices. However, it cannot be assumed that retail gas prices will continue to be regulated. Indeed, despite the concern that energy prices will not be deregulated in NSW if coverage of the WWGDN is revoked, much of the Council's reasoning appears to be based on an assumption that retail prices will be deregulated in NSW.
107. As indicated in paragraph 29, the AEMC is currently reviewing competition in the NSW energy markets and has made a draft recommendation that retail prices be deregulated. Additionally, in its recent decision on gas retail prices for 2013-16, the Independent Pricing and Regulatory Tribunal (IPART) concluded that<sup>38</sup>:
- Based on our analysis for this report, we consider it likely that competition in the market is now effective enough to provide sufficient protection to customers, as well as offering more choices and better price and service outcomes. Only 28% of small gas customers now remain on regulated prices in NSW, below the proportion of small electricity customers remaining on regulated prices (around 40%). We also consider that a competitive market is best placed to manage the uncertainties that are emerging in the wholesale gas market and note that other States have removed formal price regulation of retail gas.
108. Within the existing regulatory environment, the retailers have demonstrated that they do not necessarily pass through all costs. In its proposal to IPART's recent review of gas retail prices, Origin Energy noted that the retail margins in the Wagga Wagga retail gas market area were negative, despite IPART approving the retail gas prices proposed for that market for 2010-13. However, it also noted that it was<sup>39</sup>:
- very much aware of the cost of living pressures facing its customers. Origin has therefore sought to establish a price increase that strikes an appropriate balance between addressing this under-recovery [of costs] and the impact customer (sic) on consumers.
109. Origin Energy originally proposed a real annual increase in the R (retailer cost) component<sup>40</sup> of 4.9 per cent.

<sup>38</sup> IPART, *Review of regulated retail prices and charges for gas*, June 2013, page 6

<sup>39</sup> Origin Energy, *Submission to the Independent Pricing and Regulatory Tribunal on the review of regulated gas retail tariffs and charges from 2013 to 2016*, November 2012, page 2

<sup>40</sup> The retail price consists of an R component, N component and C component. The R component reflects the controllable costs retailers incur in supplying gas to customers, including wholesale and gas transmission costs, retail operating costs and a retail margin. The N component is the pass through of network costs and the C component is the pass through of carbon costs.



110. Conversely, IPART was of the view that a real annual increase of between 18.9 and 21.4 per cent in the R component appropriately balanced<sup>41</sup>:
- Efficient cost recovery and the need to protect customers from prices that are higher than efficient levels in the short term, and
  - The interests of customers in the long term by setting regulated retail prices that create sufficient incentives for retailers to compete and customers to participate in the market.
111. IPART ultimately agreed with Origin Energy's proposed increase in the R component for 2013/14 but will allow them to propose a change, as part of the annual review process that captures new information on wholesale gas costs and other related costs, including the retail margin.
112. Origin's choice not to increase prices to the maximum extent permitted by IPART suggests that Origin considers that it would not be profitable to do so. This implies that Origin is concerned that, if it did increase the R component of the retail gas prices by around 20 per cent, it would lose customers. This issue is discussed further in the next section.
113. As the only substantial dual fuel retailer in Wagga Wagga, Origin has an incentive to prevent customers from switching away from gas. If customers replace their gas appliances with electricity appliances, it would be easier for them to switch retailer. If this happened in large numbers, there would be an increased incentive for other retailers – Origin's competitors – to pursue electricity customers in Wagga Wagga.
114. Whether retail prices are regulated or deregulated, Origin's actions imply that it is sensitive to increases in retail gas prices. With the competitive threat from fuel switching, it has demonstrated that, if coverage of the WWGDN is revoked, it will not necessarily pass through increases in network costs to its consumers.

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<sup>41</sup> IPART, *Review of regulated retail prices and charges for gas*, June 2013, page 41

## 8 Threat of fuel switching

115. Envestra has argued that, with coverage of the WWGDN revoked, any ability it may have to price above efficient costs is constrained by the availability of alternative fuels – particularly electricity and to a lesser extent LPG.
116. In its draft report on the competitiveness of the NSW retail energy market, the AEMC recognised the threat of fuel switching<sup>42</sup>:
- Among other things, competitive pressure arises in gas where customers have the potential to change from gas to electricity, such as in heating and cooling.
117. Consistent with Envestra’s application to the Council, the AEMC identified that there is less regulatory intervention in gas than electricity as<sup>43</sup>:
- ... it is feasible to substitute away from gas to electricity. While it is difficult to completely replace electricity with gas (for example electricity is required for lighting and the majority of appliances), it is possible to replace gas with electricity (although we note that this may be at some expense, for example if appliances needed to be replaced). This ability for customers to use an alternative fuel to gas has been viewed as a market mechanism for keeping some control on prices and hence to justify a lighter-handed form of regulation.
118. The AEMC concluded that<sup>44</sup>:
- ... customers’ greater ability to switch away from gas to electricity ... provides pressure to keep gas retailers’ prices and service quality similar to outcomes expected in a competitive market.
119. In contrast, in paragraph 4.39 of its draft recommendation, the Council states that:
- ... while in principle the matters outlined above could be expected to constrain the ability of Envestra to use market power and thereby adversely impact on competition in the relevant dependent market, the feasibility of such matters must be taken into account. The purported alternatives for users are not without costs. Installing new appliances or machinery that use an alternative source of fuel to gas requires expenditure by the user. Similarly, assuming that it is even possible, configuring existing appliances or machinery to use an alternative fuel source also comes at a cost. The Council considers that in both the domestic and industrial contexts such costs are likely to be substantial, allowing exploitation of significant market power without triggering significant switching.
120. As outlined in section 4.2, it is not clear how Envestra could/would use any market power to “adversely impact on competition”.
121. That issue aside, ACIL Allen notes that gas is mainly used by domestic customers for space and water heating and, in relatively small volumes, for cooking. All of these functions can readily be performed by electric appliances. Therefore, from a functional perspective, electricity and gas are substitutes for use by small customers.
122. An economically rational consumer will assess the lowest cost form of space and water heating and cooking. In response to changes in the price of electricity or gas, an economically rational consumer will consider the cost of switching fuels by considering the upfront cost to switch and the life time costs.

<sup>42</sup> AEMC, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales: Draft Report*, 23 May 2013, page ii

<sup>43</sup> AEMC, *op cit*, page 70

<sup>44</sup> AEMC, *op cit*, page 85

123. An economically rational consumer will also consider the benefits associated with purchasing options to be able to more readily switch fuels in response to price changes. For example:
- once a premise has been connected to gas, the incremental cost of installing gas appliances is reduced (noting that all houses have an electricity connection)
  - if, at the time of purchasing a new cooling appliance, a reverse cycle air conditioner is chosen, the consumer has the option of using that electric appliance for heating as well as cooling<sup>45</sup>.
124. An economically rational consumer is more likely to consider these options in an environment where there is significant **uncertainty** regarding future prices of electricity (with the impacts of a carbon price and other government policies) and of gas. In its recent decision on retail gas prices for NSW for the 2013-16 period, IPART noted that<sup>46</sup>:
- ... the 2013 to 2016 regulatory period is characterised by an unprecedented level of uncertainty in domestic gas markets.
- In the longer term, we expect gas prices to rise towards international levels, increasing the costs of supplying gas to retail customers. However, this process of price transition is unlikely to be smooth with changing market dynamics having the potential to lead to increasing levels of price uncertainty in the gas market in the medium term.
125. The threat of fuel switching is also exacerbated by the likely future wholesale prices of the two fuels. As noted by IPART, it is likely wholesale gas prices are projected to increase by 50 per cent in 2014/15 and then remain at that level. This is consistent with approximately a 15 per cent increase in the total gas bill of small customers. By contrast, the outlook for retail electricity prices is that they will decline by around four per cent between 2013/14 and 2015/16.
126. An economically rational customer will be forced to consider whether to switch fuels when a gas appliance needs to be replaced.
127. It is reasonable to assume that many of the gas customers in the WWGDN area use gas for water and/or space heating and that most of the gas they use is accounted for by these appliances.<sup>47</sup>
128. According to the Australian Taxation Office depreciation schedules, the useful life of gas water and space heaters is as shown in Table 3.

TABLE 3 USEFUL LIFE OF GAS APPLIANCES

Appliance	Useful life (years)	Average annual replacement rate
Water heater	12	8.3%
Space heater	15	6.7%
Ducted space heater	20	5%

SOURCE: [TAXATION RULING TD 2012/2](#), AVAILABLE FROM [HTTP://ATO.TAXRATES.INFO/TAX-DEDUCTIONS/ATO-DEPRECIATION](http://ATO.TAXRATES.INFO/TAX-DEDUCTIONS/ATO-DEPRECIATION),  
 ACCESSED 28 JUNE 2013

129. This suggests that approximately eight per cent of Envestra's customers will consider replacing their water heater each year and between five and seven per cent will consider replacing their space heater.
130. Of course some customers will replace an old gas appliance with a new gas appliance. However, with replacement at this rate, it is not difficult to conceive of a

<sup>45</sup> Nearly 80 per cent of coolers installed in New South Wales are reverse cycle (refer ABS Catalogue Number 4602.0.55.001, Table 16)

<sup>46</sup> IPART, *Review of regulated retail prices and charges for gas*, June 2013, page 34

<sup>47</sup> The only other common use of gas is cooking, which uses a relatively small volume in the domestic context.

situation where a significant increase in the price of gas would lead to a large number of customers replacing gas appliances with electric appliances every year, particularly as they will already have an electricity connection. Indeed, this is a significant factor driving the observed decline in average annual customer consumption in the Wagga Wagga network explained in section 3.5 of Envestra's application.

131. Further, this type of switch is inherently long lived. That is, once a customer has decided to replace a gas appliance with an electric alternative, Envestra could not expect to 'win them back' until the replacement appliance fails or their house is next renovated. That is, the customer is lost for another 12 to 20 years. There is the risk with a loss of load, particularly heating load, that the customer will choose to disconnect their gas service in order to avoid the supply charge (which becomes relatively high as consumption charges decline).
132. As the Council notes in paragraph 4.31 of its draft recommendation, Envestra is strongly incentivised to maximise throughput on its assets. Its assets are also long lived. An ongoing, long term loss of even one per cent of customers each year would be damaging for Envestra's business. It would place upwards pressure on network prices, with a significant proportion of Envestra's costs of a fixed nature which would need to be recovered from a smaller volumetric base. This would in turn place greater pressure on consumers to consider switching fuels. Through this process, the threat of fuel switching is a much more meaningful constraint than appears to be acknowledged by the Council.
133. In conclusion, the future relativity between gas and electricity prices suggests that Envestra will be under significant pressure to retain customers and, given the long life of Envestra's assets and commitments, will act as a further constraint against increasing distribution prices, regardless of coverage of the WWGDN.

## 9 Conclusion

134. In response to an application by Envestra to revoke coverage of the WWGDN, the Council has identified a number of factors that, in its view, suggest that pipeline coverage criterion (a) is satisfied in respect of the WWGDN and that therefore coverage should not be revoked.
135. Specifically, the Council is concerned that, if coverage of the WWGDN was revoked, several factors would reduce the scope for additional competition in the area served by the WWGDN and elsewhere. The following sets out the key factors referred to by the Council as potentially limiting the scope for retail competition and summarises ACIL Allen's response to those factors/arguments:
- a) The NSW Government would be dissuaded from removing retail price regulation – however, this is highly speculative given the AEMC's draft recommendation in its review of competition in the NSW retail energy markets, and IPART's conclusion in its determination of retail gas prices for 2013-16, to remove price regulation. In assessing whether prices should be deregulated, the AEMC and IPART focused on the effectiveness of competition in the retail markets. Coverage of the gas distribution network was not considered by either the AEMC or IPART as a relevant factor in influencing the effectiveness of retail competition and therefore deciding whether retail price regulation should be removed.
  - b) Envestra might increase the price of distribution services to retailers, which would then pass that price increase on to customers – however, competition in the WWGDN area will only be impacted if Envestra increases prices to retailers in a discriminatory manner. Envestra has no incentive to do so given it has no retailing interests. If coverage of the WWGDN is revoked, Envestra has made a number of commitments in relation to future price increases. There is a reputational risk if it does not act in accordance with these commitments and any party can apply for the WWGDN to be covered again, which, contrary to the assertions made in the retailer submissions, would appear to be a credible threat. If the Council requires further certainty, it could recommend, as a condition of revocation, that Envestra enter into some form of undertaking with the Minister or contract with the retailers.
  - c) The costs and risks of entering the Wagga Wagga retail gas market for retailers, particularly small retailers, would be greater because the conditions for access to the WWGDN would not be known in advance – however, the most substantial costs and risks associated with entering the Wagga Wagga retail gas market are associated with the small size of the network and the resultant costs and risks of the contract carriage model which requires new retailers to enter into long term bilateral contacts for wholesale gas and pipeline capacity. There is a requirement to enter into these contracts, regardless of whether the WWGDN is covered. The high costs/risk and low expected benefits explains the empirical evidence that retailer competition is lower in gas retail markets which operate on a contract carriage model (New South Wales, Queensland and South Australia) rather than a market carriage model (Victoria), particularly in regional markets such as Wagga Wagga. If coverage of the WWGDN is revoked, Envestra has committed to nationally consistent access terms and conditions, consistent with Envestra's current practice for its other uncovered networks. There is a reputational risk if it does not act in

accordance with these commitments and any party can apply for the WWGDN to be covered again. If the Council requires further certainty, it could recommend, as a condition of revocation, that Envestra enter into some form of undertaking with the Minister or contract with the retailers.

- d) Envestra would be less likely to participate in any future process to standardise and automate the interface between gas Distribution Network Service Providers (DNSPs) and gas retailers – however, there is an incentive for Envestra to automate B2B procedures if it was economically efficient to do so. AEMO recently ceased a project to investigate automating B2B transactions in NSW on the basis of the current high cost and absence of a positive net present value or policy decision on the project. If the WWGDN continues to be covered as a means to impose the automation of B2B procedures, there is a risk that there will be an inefficient outcome. Such inefficient investment in the case of small regulated network would not be permitted under the National Gas Rules in any event.

136. Envestra submitted that, if the WWGDN was not covered, its behaviour would be constrained by the countervailing power of retailers and the possibility that end users could switch to electricity, thereby using less of the distribution services Envestra provides. The Council considered that:

- a) While retailers would have the countervailing power to resist any price increase Envestra proposed, they would not have the incentive to do so but would prefer to pass any such price increase on to end users and would be able to do so. However ACIL Allen notes that, in the setting of retail gas prices for 2013-16, Origin has demonstrated that it will not necessarily pass through the full costs incurred in retailing gas to customers in the WWGDN area.
- b) The threat of fuel switching would not constrain Envestra's behaviour because fuel switching is not costless for end users. However ACIL Allen notes that, with the uncertainty of future gas prices and forecast significant increases in gas prices relative to electricity prices, the economically rational consumer will be continually assessing the lowest cost form of water and space heating (in terms of the upfront switching cost and operating costs), and options to facilitate a low cost switch. Additionally, consumers will be forced to consider whether to switch fuels as gas appliances are replaced, with approximately eight per cent of water heaters and between five and seven per cent of heaters replaced each year and all customers already having an electricity connection.

137. For these reasons, ACIL Allen is of the view that the Council has not demonstrated that pipeline coverage criteria (a) has been satisfied. That is, the Council has not demonstrated that access (or increased access) to pipeline services provided by means of the WWGDN would promote a material increase in competition in at least one market (whether or not in Australia), other than the market for the pipeline services provided by means of the WWGDN.

138. Indeed, such a conclusion is counter to the significant factual evidence set out in this report. This evidence shows low levels of retail competition in all markets with a contract carriage model (New South Wales, Queensland and South Australia), particularly in regional areas such as Wagga Wagga. In nearly all cases, the relevant regional gas distribution networks are covered. This strongly suggests that network coverage is not likely to, nor has it, promoted a material increase in competition in the dependent retail markets. Rather, the high cost and risks, particularly associated with the contract carriage model, relative to the potential benefits explain the limited competition in regional markets operating within a contract carriage model.

139. For the reasons set out in this report, ACIL Allen is of the view that pipeline coverage criterion (a) is not satisfied such that coverage should be removed from the WWGDN.