



Office of Energy
Government of Western Australia

Review of the
Energy Co-ordination (Gas Tariffs) Regulations
2000

Issues Paper

September 2007

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Table 1 – Alinta Retail Tariffs (1 July 2007)

Appendix 1 – Gas Resources and Infrastructure Map (2006)

Appendix 2 – Summary of Issues Raised

1 Energy Co-ordination (Gas Tariffs) Regulations 2000

The *Energy Co-ordination (Gas Tariffs) Regulations 2000* (the “Tariff Regulations”) cap the retail price of gas to small use customers (households and small business customers using less than 1 terajoule of gas per year) in the gas distribution licence areas to which the Tariff Regulations apply. This includes the Mid-West/South West (including the Perth metropolitan area), Albany, and Kalgoorlie-Boulder areas.

Clause 8 of the Tariff Regulations requires that the Minister for Energy (the “Minister”) conduct a review of the operation and effectiveness of the Tariff Regulations within five years of the commencement of the *Energy Co-ordination (Gas Tariffs) Amendment Regulations 2002* (“Amendment Regulations”). As the Amendment Regulations commenced on 18 October 2002, this means the required review of the Tariff Regulations (the “Tariff Regulations Review”) must be conducted by 18 October 2007.

Clause 8 of the Tariff Regulations also provides that during the course of the Tariff Regulations Review, the Minister must give consideration to the need for continuation of the Tariff Regulations, having regard to:

- a) the importance of competition in gas industry markets;
- b) the interests of gas customers generally or of a class of gas customers;
- c) the legitimate business interests of the holders of trading licences;
- d) the effectiveness of the Tariff Regulations in achieving appropriate consumer protection outcomes; and
- e) any other matter that the Minister considers relevant.

The Tariff Regulations also require that the Minister prepare a report based on the review (the “Tariff Regulations Review Report”), and that the report be laid before each House of Parliament as soon as practicable after it is prepared.

2 Tariff Regulations Review

The Minister has requested that the Office of Energy (“OOE”) conduct the Tariff Regulations Review having regard to the matters listed above. For this purpose, the OOE considers that these matters essentially relate to:

- an assessment of the level of competition in the retailing of gas in the distribution licence areas covered by the Tariff Regulations (items (a) and (b) above);
- an assessment of the appropriate level of the retail gas tariff caps (as specified in the Tariff Regulations) in meeting consumer protection outcomes and the business interests of licence holders (items (c) and (d) above); and
- consideration of other matters of relevance to the operation of the Tariff Regulations (item (e) above).

To address these matters it is intended that the Tariff Regulations Review Report will comprise a review of the level of competition in the retailing of gas in reticulated systems in Western Australia and other related issues, and will also address the findings of a desktop study of the appropriateness of the level of gas tariffs and their

impacts on stakeholders. The Tariff Regulations Review Report will also note and consider the other matters of relevance to the Tariff Regulations Review, and where appropriate, will note the existing and intended future actions by Government to address these matters.

It is recognised that gas is supplied to small use customers in Albany by way of a reticulated liquefied petroleum gas (“LPG”) system, whereas natural gas is reticulated to customers in the other Alinta gas trading licence areas.¹ There are some different factors to take into account in respect of the pricing structure for reticulated LPG, in contrast to the supply of reticulated natural gas.

The Tariff Regulations Review needs to address the cost of supplying reticulated gas to residences and small business for each of the distribution licence areas covered by the Tariff Regulations (including the Albany area), and also assess the level of competition in each of these areas.

It is intended that stakeholders consider each of the distribution licence areas covered by the Tariff Regulations in providing comments on the issues raised in this Paper.

In the event that the Minister determines that the tariff caps under the Tariff Regulations should be retained, the OOE will engage an economic consultant to provide assistance in undertaking a more detailed study of the retail gas tariff caps for small use customers (“Gas Tariffs Review”). It is intended that this study would consider the:

- appropriate structure and level of the retail tariff caps;
- timing for any changes to the tariff cap structure, including the transition process for amendment to the tariff caps;
- appropriate adjustment mechanism for tariff caps in the future;
- criteria to be used in conducting regular reviews of the tariff adjustment mechanism;
- person or agency that should conduct the regular reviews; and
- timing for such reviews.

Should the Gas Tariffs Review be undertaken, the findings of this review will be presented to the Minister for his consideration.

¹ LPG is a mixture of hydrocarbons (mainly propane and butane) extracted from petroleum reservoirs in association with natural gas or produced as a by-product of petroleum refining. Natural gas is primarily methane, extracted from underground reservoirs and either piped to the point of use, or compressed (in the form of compressed natural gas) or cooled (as liquefied natural gas), for transport and storage.

3 Information Requirements

As part of the Tariff Regulations Review, the OOE intends to request information from key stakeholders (for instance, Alinta, Synergy, the Retail Energy Market Company [“REMCo”] and upstream producers) relating to both the level of competition in the gas retail market and the level of gas tariffs. The review will also consider relevant sources of publicly available information.

A series of issues are also raised in this Paper for comment by stakeholders and members of the public. The issues raised below are categorised in accordance with the intended structure of the Tariff Regulations Review Report.

4 Lodging a Submission

The OOE invites submissions on this Issues Paper **by close of business 2 October 2007**. Electronic submissions are preferred and should be emailed to Gas.Tariffs.Review@energy.wa.gov.au

Comments are encouraged on the matters raised in this Issues Paper, as well as on any other issues considered to be of relevance to the Tariff Regulations Review. The format of submissions should not be confined to the structure of this Paper, noting that many issues overlap.

Any queries on the Tariff Regulations Review should be made to Mr Matthew Martin, A/Senior Manager - Markets Branch, Office of Energy on 9420 5683.

5 Confidentiality

Stakeholders should clearly specify where data and information they provide is confidential or commercial in confidence (and where possible separate from other non-confidential information).

The OOE will aggregate data and information where necessary to meet confidentiality requirements in reporting on a public basis (i.e. to Parliament). Confidential information will not be released to third parties without permission.

Submissions will be published on the OOE website (excluding any material specified as confidential).

Requests for access to information relating to the Tariff Regulations Review will be treated in accordance with the *Freedom of Information Act 1992 (WA)*.

6 Gas Retail Market Competition

6.1 Scope of Review

The competition assessment for the Tariffs Regulations Review will be based on the criteria proposed by the Australian Energy Market Commission (“AEMC”) for evaluating energy market competition in other states and territories, which includes:

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

The purpose of the AEMC retail competition reviews is to provide advice to each jurisdiction on the appropriateness of retaining, removing or reintroducing retail energy price controls in the electricity and gas retail markets in that jurisdiction. The scope of the advice to be provided by the AEMC to jurisdictions is to include:

- an assessment of the effectiveness of competition in the electricity and gas retail markets; and
- recommendations on ways to phase out price controls if competition is found to be effective; or
- recommendations on ways to promote competition where competition is found to be less than effective.

For Western Australia, the Economic Regulation Authority (the “ERA”) is responsible for conducting a detailed review for both electricity and gas markets no earlier than 2009, in accordance with the Australian Energy Market Agreement requirements.²

Whilst it may be determined that the tariff caps are still required, it is recognised that there are upward pressures on the cost to retail gas to small use customers within reticulated systems. These cost pressures may impact on the viability of gas retailers and may act as a further barrier to entry in the gas retail market if the tariff caps are maintained at their current level. The Tariff Regulations Review will examine these tensions in addressing the interests of gas customers, incumbent retail market participants, and new entrants.

² Under the Australian Energy Market Agreement, dated 2 June 2006, the Ministerial Council on Energy agreed that the AEMC will be requested to review the effectiveness of retail competition in electricity and gas retail markets in each jurisdiction (except Western Australia).

The ERA is responsible for undertaking a similar review in Western Australia. The AEMC has commenced review of the retail gas and electricity markets of Victoria, to be completed by end of February 2008.

For further information see <http://www.aemc.gov.au/electricity.php?r=20070315.165531>

6.2 Competition in the Western Australian Retail Gas Market

6.2.1 Background

Gas full retail contestability (“FRC”) was introduced in Western Australia in May 2004. Achieving gas FRC means that the legal and technical requirements are in place to allow new gas companies to enter the market. In Western Australia, REMCo has responsibility for operation of the gas retail market on a not for profit basis, and any future gas retail market schemes must be approved by the ERA. A comprehensive customer protection framework also stipulates minimum standards for retailer conduct with small use customers.

In addition, the Minister has endorsed changes to the Gas Market Moratorium, which took effect from 1 July 2007. The amendments to the Moratorium allow Synergy to supply gas to customers using at least 0.18 terajoules per annum. This change is intended to give greater choice to energy consumers in Western Australia.

However, the gas retail market in Western Australia lacks liquidity, which is symptomatic of the structure of the gas market across the supply chain in this State. The structure and characteristics of the Western Australian gas market are discussed throughout section 6.

6.2.2 Independent Rivalry in the Market/Customer Switching Behaviour

Despite the introduction of gas FRC, there are still relatively few gas retailers in Western Australia and, until recently, there has been only a single retail supplier in each of the distribution licence areas subject to the Tariff Regulations. These limited supply options in the gas retail market are largely symptomatic of the structure and characteristics of the Western Australian gas market as a whole.

Although Western Australia is a major gas producer (with about 66% of Australia’s natural gas production) and consumer (about 35% of Australian natural gas consumption)³; the gas market in this State is relatively immature compared with some markets interstate (e.g. Victoria) and overseas (e.g. Canada, United States of America and the United Kingdom), and does not appear to bear the trademarks of a fully competitive market.

1. Comment is sought on opportunities for small use customers to switch to a second tier retailer in the gas distribution licence areas covered by the Tariff Regulations.
2. Are there technical or other barriers to customers switching, where an alternative retailer may exist?
3. Are there impediments to small use customers being able to exercise informed choices regarding their choice of retailer?

³ ABARE; Department of Industry, Tourism and Resources, “Energy in Australia 2006”, pp.35 and 55.

6.2.3 Ability of Suppliers to Enter the Market

The Western Australian gas market is historically characterised by long-term bilateral contracts for gas and transmission capacity, a small number of producers, and transmission capacity to the South West market dominated by the Dampier to Bunbury Natural Gas Pipeline (“DBNGP”). There is no formal short-term or spot trading market, and as a result the liquidity of gas trading is low. Transparency of information (particularly price) is limited and the opportunity for entrance by new downstream users (particularly small users) is restricted.

Although there is greater diversity of gas field ownership in Western Australia than in the eastern states, the North West Shelf Joint Venture (“NWSJV”) currently accounts for around 65% of total domestic supply and 90% of all developed gas reserves in the State. The remaining 35% of domestic gas supplies are made up by smaller projects, operated by a number of entities including ARC Energy, BHP Billiton, Santos Limited, Apache Corporation and Origin Energy.⁴

There are also growing reports from industry indicating that maximum terms for new gas supply contracts are becoming shorter (currently around 5 years).⁵ Despite strong domestic demand for natural gas, including in the gas retail market, there is presently limited availability of new domestic gas supply occurring due to a focus on liquefied natural gas (“LNG”) production, increasing costs and complexity associated with petroleum production, fully committed upstream infrastructure, and other factors.

The domestic price of natural gas has risen sharply in the last 12 months, with reports of prices for new contracts being upwards of \$6.00/GJ. Interestingly, the eastern states markets have not experienced the same degree of price increases, in spite of increased overall demand and smaller reserves. This may be due to a lesser reliance on natural gas for electricity generation and industrial processing compared with the Western Australian economy, and lack of connectivity of the eastern states market to the global LNG market.⁶ It has also been claimed that the rise of coal seam methane supply sources may also have had some influence in this regard.

Some analysts have argued that price constraints on domestic gas supply, as a result of suppliers being contractually locked into long-term domestic arrangements, may act to limit the availability of gas to local users. The argument is that if there was parity between domestic and global gas prices (i.e. LNG market) then the domestic market would become more attractive for producers and gas marketers. However, even at LNG netback prices⁷ the supply of new domestic gas supply for long tenures is reportedly currently difficult to secure.

The Western Australian gas market is also characterised by a lack of liquidity downstream. The majority of gas use in Western Australia is by a relatively small

⁴ Chamber of Commerce and Industry of Western Australia (“CCIWA”), “Meeting the Future Gas Needs of Western Australia – A Discussion Paper”, May 2007, pp.34-35.

⁵ ERA, “Discussion Paper: Gas Issues in Western Australia”, June 2007, p.5.

⁶ CCIWA, p.50.

⁷ The LNG netback price is the price of LNG sold to foreign markets, less the costs to get the LNG to those markets. This is effectively the wellhead price for LNG sold to the foreign market.

number of shippers that directly hold both gas transmission and supply contracts (i.e. bundled contracts).⁸

Transmission capacity has historically been negotiated by way of long-term bilateral contracts, with shippers entitled to transport gas to the extent that they have contracted for capacity on a take or pay basis. Transmission in the South West is dominated by the DBNGP, which has limited interconnection with the State's remaining transmission and distribution pipelines. Whilst the DBNGP continues to expand, such expansions have only occurred in response to contracted demand, so short-term (e.g. 1-3 year) capacity is not generally available.

The Kalgoorlie distribution network services customers in Kalgoorlie-Boulder from gas transported by the Goldfields Gas Transmission Pipeline. The demand for gas by small use customers within the Alinta network in this area is relatively small, compared with the significant industrial demand from mining and other industries within this region.

There is also a lack of liquidity in relation to the supply of LPG, which may impact on the cost to reticulate LPG in the distribution licence areas covered by the Tariff Regulations⁹.

There are currently two major facilities in Western Australia extracting LPG from gas/condensate streams - the NWSJV, which is for export use, and the Wesfarmers plant at Kwinana. The Wesfarmers plant extracts propane and butane from the natural gas stream flowing from the NWS gas fields via the DBNGP, and is used to supply most of the domestic LPG market. BP's Kwinana refinery also produces LPG as a by-product of the oil refining process.

The price of locally produced LPG is based on a national import parity price. The benchmark used by local LPG producers is known as the "Saudi Aramco Contract Price". This price, set by the world's largest producer, Saudi Arabia, is used as a basis internationally for sales of LPG. Local producers add in a component equivalent to freight and insurance to come up with a price that an LPG supplier would be required to pay if it imported LPG. That figure is used to derive the wholesale price of locally produced LPG.¹⁰

⁸ The downstream market is dominated by major gas users (and prospective users) and gas infrastructure investors that make up the DomGas Alliance. The DomGas Alliance includes Alcoa of Australia, Alinta, Synergy, Dampier Bunbury Pipeline, ERM Power/NewGen Power, Newmont Australia Ltd, Fortescue Metals Group, and Perth Energy. Verve Energy is another major domestic gas user.

The DomGas Alliance collaboratively contract around 80% of the State's gas transmission capacity and domestic gas consumption. It is estimated that about 80% of gas transported to the south west region, by either the DBNGP or Parmelia Pipeline, is used directly by parties holding contracts with, and taking delivery of gas directly from, the pipelines.

⁹ It is noted that the Office of Energy assisted in the State Government Inquiry into the affordability of bottled LPG for household use in Western Australia. The Inquiry Report was tabled in Parliament on 30 August 2007.

¹⁰ Western Australian Government Taskforce, "Bottled LPG Affordability Inquiry: Issues Paper", November 2006, pp.18-19,

4. What barriers are there, across the gas market supply chain, to entry, expansion and exiting the gas retail market?
5. What is the significance of these barriers and are they different for new entrant retailers in comparison to retailers seeking to expand market share?

6.2.4 Differentiated Products and Services

Importantly, it is recognised that retailers must back their retail customer commitment with long-term gas transport and gas commodity contracts. These commitments are financially significant, and the lack of a liquid market for trading commodity and transportation requirements adds to the risk of entering the market, and makes it harder to exit the market should that become necessary. While incumbent energy retailers also face these risks, they may be able to deal more efficiently with these requirements.

The market advantages enjoyed by existing energy businesses may amount to a further barrier to new entrant gas retailers, and therefore the potential scope for product and service differentiation. Retailing energy to small user customers requires commitment to capital expenditure on mass market billing systems, customer service functions, and information technology (“IT”) systems to interact with other market participants. Incumbent retailers also have the advantage of an established customer base, brand recognition, and highly relevant marketing experience.

The relatively small size of the Western Australian energy market may also naturally limit the potential number of retailers competing for small user customers in the State. It is noted that any move to introduce electricity FRC may make the Western Australian electricity and gas retail markets more attractive to eastern states companies, and provide greater market synergies. The OOE is currently reviewing the possible implementation of electricity FRC as part of a separate review process, in conjunction with a review of electricity tariffs and the roll-out of electricity smart meters. Further information on the Electricity Retail Market Review can be found at www.energy.wa.gov.au/2/3240/64/electricity_mar.pm.

On the other hand, it may be considered that barriers are sufficiently low such that retailers are readily able to enter or expand their place in the market. For instance, while there is a requirement for gas retail market participants to comply with market rules and industry codes, gas retailers must become members of REMCo and are able to influence the operation of the Western Australian gas retail market scheme. In addition, the costs of establishment and operation of the REMCo scheme have largely been borne by the incumbent gas retailer for supply to small use customers.

6. Comment is sought on the availability and scope for product/service differentiation in relation to the reticulation of gas in Western Australia, particularly in relation to small use customers.

6.2.5 Exercise of Market Choice by Customers

Natural gas is a highly significant fuel source for Western Australia. Demand for natural gas in Western Australia has risen from around 20% of national consumption of natural gas in the mid 1980s to around 33% of national consumption currently. This is a considerable share considering that the net amount of energy consumed in Western Australia each year accounts for only 14% of total energy consumption in Australia. Furthermore, natural gas accounts for about 41% of total energy consumption in Western Australia, compared with 20% nationally.¹¹

In Western Australia, manufacturing, electricity generation and mining accounts for around 90% of gas consumption in Western Australia. Around 13% of gas supplies across Australia are currently consumed by residential sources, in comparison to about 3% in Western Australia. While small in terms of overall demand, natural gas usage by Western Australian residences has increased markedly in the past 20 years (average of 6.5% growth per annum).¹²

Historically, the price of natural gas as a commodity in Western Australia has been relatively low. The tendency for gas to be sold via long-term contracts, due to the economy being project driven and transactions involving longer supply horizons, is arguably part of the reason that prices in this State have remained fairly low over time. This compares with the larger markets overseas with their higher frequency of trade and greater propensity to trade on commodity exchanges, which may result in prices being higher and more volatile, and may also make prices more closely reflect current market conditions.¹³

7. Comment is sought on the perceptions of natural gas as a product of choice in the small use customer market compared to other energy supply options.

6.2.6 Prices and Profit Margins

It is important to consider the impacts that market competition can have on prices and profit margins of reticulated gas in Western Australia. As discussed above, there are strong linkages between competition and the cost to reticulate gas to small use customers. Issues of profitability and cost reflectivity of the gas tariff caps are discussed in more detail in Section 7 of this Issues Paper.

8. What are the impacts of competition in the gas market on the profitability of reticulating gas in the distribution licence areas covered by the Tariff Regulations?

¹¹ CCIWA, pp.38-41.

¹² Ibid., pp.39-45.

¹³ CCIWA, pp.47-48.

6.2.7 Other Matters

As noted above, consideration of barriers to entry (expansion and exit) with respect to the reticulation of gas to small use customers in Western Australia is an important component of the competition assessment to form part of the Tariff Regulations Review Report (see section 6.2.3). However, it should be recognised that the OOE does not intend to undertake a detailed review of barriers to gas retail market entry as part of the Tariffs Regulations Review, as other processes are currently underway for review and policy development concerning such barriers.

In particular, the Western Australian Government is keenly aware of the gas supply constraints currently being faced by the downstream market and is actively working towards addressing barriers to domestic gas supply. Aside from its commitment to the domestic gas reservation policy, the Western Australian Government is participating on the Ministerial Council on Energy and the Ministerial Council for Mineral and Petroleum Resources Joint Working Group on Natural Gas Supply, which is tasked with identifying barriers to domestic gas supply and developing strategies to overcome such barriers. The Joint Working Group is expected to publish its deliberations around September 2007 and will seek public comment at this time.

7 Retail Tariff Caps

7.1 Background

The caps on gas tariffs for households were maintained as part of the privatisation of AlintaGas. The Tariff Regulations were also subsequently amended to reinstate the protection of small business and so that annual tariff cap adjustments would be more in line with inflation.

These tariff caps were instituted prior to the introduction of gas FRC in Western Australia and are intended to provide a “safety net” for customers, allowing for sufficient margin for gas retailers, accounting for the risks faced by those retailers. The Tariff Regulations apply to any retailer that is licensed to supply gas to small use customers in the gas trading areas subject to the Regulations (i.e. the Mid-West/South-West, Albany, and Kalgoorlie-Boulder areas).

The Tariff Regulations allow retailers to set their tariffs for small use customers as they wish, so long as they fall under the tariff caps. The tariff caps for residential customers in the Perth metropolitan area are structured into three steps – for the first 12 units/day, the next 24 units/day, and over 36 units/day, along with a fixed daily charge component. The Tariff Regulations limit the annual tariff cap increases applicable to these customers for the first two steps to CPI, and for the third step to CPI + 2%.

The tariff caps for all small use customers in the Albany area and non-residential customers in the Perth metropolitan areas are structured into two steps – for the first 100 units per day and over 100 units per day, along with a fixed daily charge component. The tariff caps for the Kalgoorlie-Boulder area have one daily usage charge and a separate fixed daily charge component. The tariff caps for all of these customer categories are escalated on an annual basis in accordance with CPI movements.

The current tariff levels for residential and small business customers in the gas distribution licence areas covered by the Tariff Regulations are set out in Table 1.

7.2 Tariff Caps - Retailer Costs for Supply to Small Use Customers

There is growing evidence of increasing cost pressures across the gas market chain impacting on the costs to retail gas to customers, including small use customers, where profit margins may be smaller and less attractive to retailers.

The Tariff Regulations Review necessitates an understanding of the impact of supply cost movements on gas retailer profitability in the small use customer market segment, and related impacts on competition in the gas retail market. The primary objective of this part of the review is to ascertain whether the existing tariff caps adequately cover supply costs and an appropriate retail margin. As noted previously, the OOE will be conducting a desktop study of the costs to supply gas to small use customers in Western Australia. The cost components to be taken into account in this process are discussed below and comprise the various costs involved in supplying gas, including allowance for a retail margin, as follows:

- gas commodity costs;
- transmission costs;
- distribution costs;
- retail operating costs; and
- retail margin.

As noted previously, should the Minister determine that the tariff caps under the Tariff Regulations are to continue, a Gas Tariffs Review will be undertaken. This will involve a more detailed assessment of existing and forecast costs of gas supply to small use customers in the gas distribution licence areas covered by the Regulations, taking into account both firm specific and industry wide (e.g. new entrant) costs.

7.2.1 Gas Commodity Costs

Natural gas commodity costs in the Western Australian domestic market have increased dramatically in the past 12 months. Contracts for the domestic supply of natural gas are generally confidential. However, a recent paper by the ERA presenting a summary of findings drawn from a consultation process regarding domestic gas issues indicates that natural gas prices for new domestic contracts are around \$5.50-\$6.00 per GJ.¹⁴ The “Energy Quarterly” publication by EnergyQuest also estimates that currently Western Australian domestic natural gas contracts are over \$5.00 per GJ.¹⁵ In addition, forecast growth for LNG globally is strong,¹⁶ which

¹⁴ “Discussion Paper: Gas Issues in Western Australia”, ERA, June 2007, p.8.

¹⁵ EnergyQuest, “Energy Quarterly”, May 2007.

¹⁶ ABARE, “Australian Energy, National and State Projections to 2029-30”, ABARE Research Report 06.26, December 2006, p.44.

indicates the likelihood that the domestic price of natural gas may continue to rise. As discussed in Section 6, the domestic price of LPG is based on import parity pricing.

Domestic gas prices and the availability of natural gas will impact on the competitiveness of the gas retail sector in Western Australia. As indicated above, incumbent retailers may have greater ability than new entrants to absorb any cost increases.

7.2.2 Transmission Costs

As indicated above, Western Australia is characterised by point-to-point transmission pipelines, with large distances between the points of production and consumption (see Appendix 1, Gas Resources and Infrastructure Map).

The retailing of natural gas to small use customers in Western Australia is heavily reliant on the transmission of gas on the DBNGP and on the Goldfields Gas Transmission Pipeline. Transmission costs form a large portion of the overall costs of purchasing gas. The cost of expanding or extending the pipeline to meet new demand is passed onto shippers and pipeline users, and is impacted by rising costs in the broader economy (e.g. labour and capital costs).¹⁷

While the DBNGP is a covered pipeline under the Gas Access Code and there is an Access Arrangement in place for the DBNGP, charges are stipulated under the terms and conditions of the DBNGP Standard Shipper Contract.

Transmission costs are also assumed to impact on the cost to reticulate LPG to Albany (including related transportation costs), given that the Wesfarmers extraction plant supplies the bulk of the domestic LPG market from gas transported down the DBNGP.

7.2.3 Distribution Costs

As is the case for transmission, the natural gas distribution networks are characterised by limited interconnection and sub-networks are typically supplied by a single transmission pipeline, although the Metro North sub-network in the Mid-West/South-West area is connected to both the DBNGP and the Parmelia Pipeline.

Although the B3 Tariff under the Alinta Gas Networks (“AGN”) Distribution System Access Arrangement for the Mid-West and South-West Distribution Systems has been relatively stable over the past 5 years, there is likely to be upward pressure on the cost of new gas distribution infrastructure. For instance, the popularity of solar water heaters, particularly in new residential subdivisions,¹⁸ may decrease the profitability of distribution infrastructure. In a typical household, gas water heating

¹⁷ Capital and labour costs have increased substantially in recent times:

- average weekly earnings in Western Australia have increased by 19% since February 2004;
- crude oil prices have increased by 217% from 2002 to 2006;
- iron ore prices have increased by 67% from 2002 to 2006; and
- commodity prices have generally increased by 60% from 2002 to 2006.

¹⁸ Sustainable Energy Development Office statistics from the solar water heater subsidy show that the top five areas where solar water heaters were installed were in new subdivisions.

accounts for around 65% of household gas consumption. Since the B3 distribution tariff contains a variable charge dependent on gas consumption, a dramatic decrease in consumption of gas from water heaters can have an impact on the revenue collected through the distribution tariffs and the payback on the infrastructure.

Expansion of the distribution systems will also face increased labour, materials and construction costs, which have all been subject to increasing price pressure in the State's current economic environment. These increased costs will need to be passed on to gas retailers via the distribution tariffs.

The distribution of LPG is also reliant on road transport to feed reticulated systems which contributes an alternative cost pressure.

7.2.4 Retail Operating Costs

A previous report prepared by CRA International identified a \$90/customer fixed charge for the cost of retailing natural gas in Victoria (adjusted for CPI and productivity since 2003).¹⁹

Jurisdictional specific issues would need to be taken into account in estimating appropriate retail operating costs for incumbent and new entrant retailers in Western Australia. As indicated above, it is recognised that average weekly earnings are subject to upward pressure, and this would appear to directly impact on retail operating costs. It is also noted that retail operating costs for incumbents would most likely be significantly lower than for new entrants due to operational efficiencies and economies of scale, for instance in IT and billing systems.

7.2.5 Retail Margin

The Independent Pricing and Regulatory Tribunal ("IPART") of New South Wales has previously stated that a net retail margin (margin on energy sales before interest and tax, but after all other costs, including retail costs, have been accounted for) of 2-3% for gas retailing would be reasonable.²⁰

¹⁹ CRA International, "Electricity and Gas Standing Offers and Deemed Contracts (2004-2007)", submitted to Victorian Department of Infrastructure Energy and Security Division, December 2003, p.28.

²⁰ IPART, "Review of Gas and Electricity Regulated Retail Tariffs, Issues Paper", October 2003, pp.10-11.

9. Are current retail prices to small use customers reflective of supply and retail costs for the respective gas distribution licence areas covered by the Tariff Regulations? If not, to what extent are costs not covered, and by how much would tariff caps need to be increased to recover costs?
10. What is considered to be an appropriate retail margin for retailing natural gas in Western Australia, and is this different for LPG? Is this different for alternative customer types, or for new retailers/retailers seeking to expand their business?

7.2.6 Impacts of Price on Competition

As noted above, the Western Australian Government has provided for Synergy to expand its gas retailing activities to the small use customer market with amendment of the Gas Market Moratorium. This will provide for some benefits to customers via competition, which should place downward pressure on prices. The tariff caps should operate as a price ceiling and must include a margin that provides a sufficient return for incumbent and new entrant retailers across the different market segments, or else the tariff caps will stifle competition.²¹

The level of the tariff caps may act as a barrier to market entry and may impact on retailer viability, if they are not cost reflective. Also, any dampening effect of tariff caps on profit margins for new entrants may be more sharply felt in supplying households with low gas consumption, where retail costs may be higher.

11. Input is sought from stakeholders on, but not limited to, the following areas:
 - (a) Are there significant differences to be taken into account regarding the costs of supply to residential versus non-residential classes across each of the gas trading licence areas?
 - (b) If the existing tariff cap adjustment mechanism continues into the future, will this impact on the ability of retailers to retail to small use customers in each of the gas trading licence areas? Will impacts change over time?
 - (c) What impact will price regulation have on customers and on competition in the market, in the short- and long-term?
 - (d) Are gas retail prices consistent with customer needs and expectations?
 - (e) What barriers or policies should be addressed to reduce pressure on the cost to supply to small use customers?
 - (f) What impacts would changes to, or the removal of, tariff caps have on small use customers, particularly vulnerable or disadvantaged customers

²¹ The AEMC, "Review of the Effectiveness of Competition in Gas and Electricity Retail Markets - Issues Paper", 2007, p.12 states:

- "It is noted that the Essential Services Commission of Victoria found that retail competition in gas and electricity supply was generally effective for those groups where sufficient profit margin existed, but that offers made to low margin customers were not attractive relative to the standing offer price. These profitable sub-markets accounted for almost 40% of customers, and typically encompassed customers who consumed more than 50GJ of gas or 6MWh of electricity per annum, operated dual fuel accounts, and were located in metropolitan and large regional centres."

(e.g. low income users)?

- (g) If adjustment to the level of the tariff caps is required to implement more cost-reflective arrangements, what transitioning process should be adopted in moving to these new tariff caps?

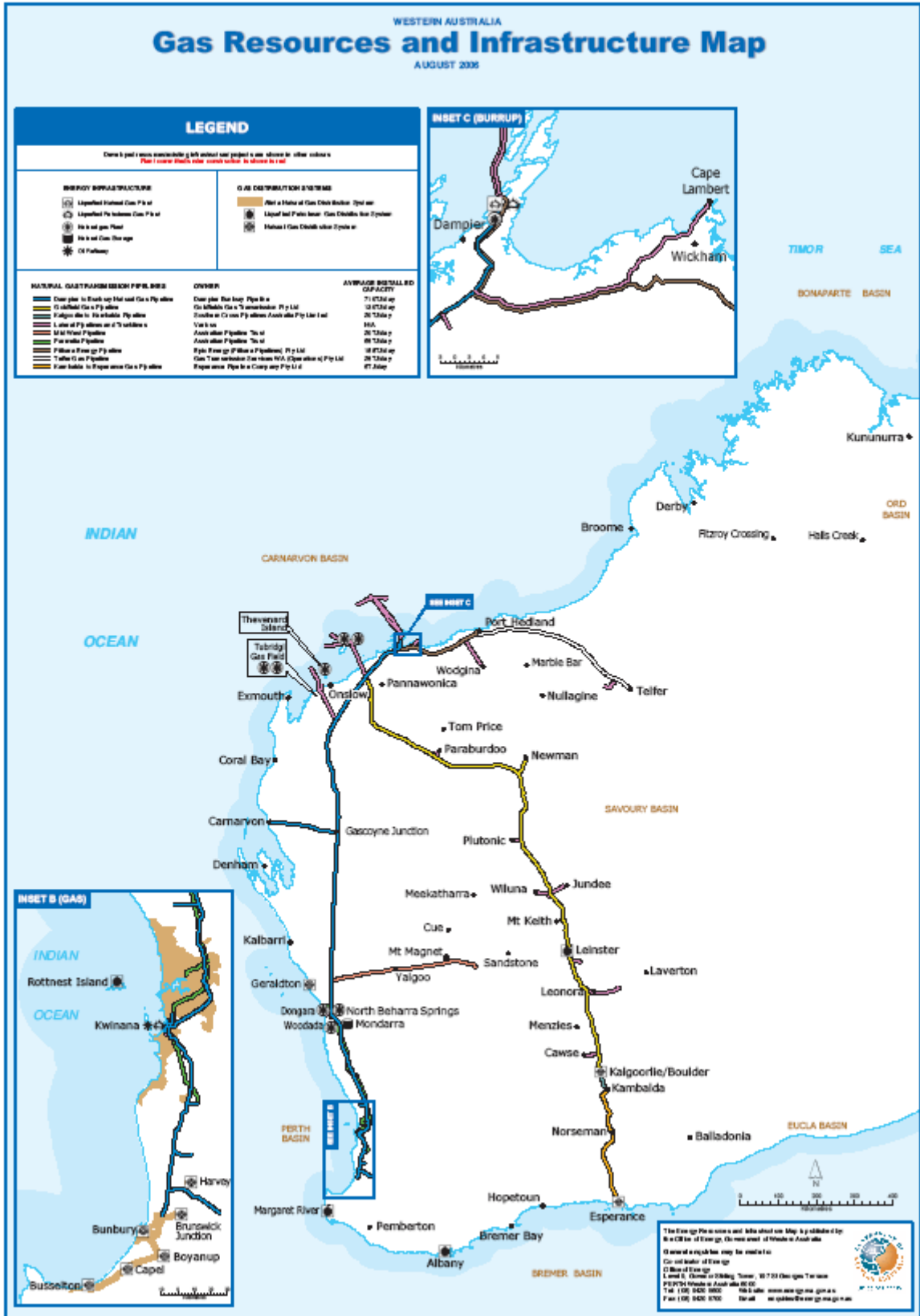
8 Additional Matters

As noted above the Tariff Regulations Review requires that consideration must also be given to any other matter that the Minister considers relevant to the need for continuation of the Tariff Regulations. In development of this paper the OOE has canvassed the issues that it considers relevant in the text above. Comment is welcomed on any other issues that are not mentioned in this paper, but are considered pertinent to the considerations under this review.

12. Are there any other matters that require consideration in the Tariff Regulations Review?

TABLE 1

ALINTA RETAIL TARIFFS (1 JULY 2007)					
Residential Tariff			Non Residential Tariff		
Coastal [Metropolitan] Licence Area					
Supply charge	c/day	11.02	Supply charge	c/day	11.02
First 12 units	c/unit	7.81	First 100 units	c/unit	8.07
Next 24 units	c/unit	5.05	First 100 units	c/unit	6.42
Over 36 units	c/unit	4.10			
Albany Licence Area					
Supply charge	c/day	11.57	Supply charge	c/day	11.57
Supply charge extra dwellings	c/day	5.77	First 100 units	c/unit	8.42
First 100 units	c/unit	8.42	Over 100 units	c/unit	7.05
Over 100 units	c/unit	7.05			
Kalgoorlie-Boulder Licence Area					
Supply charge	c/day	24.77	Supply charge	c/day	24.77
Energy charge	c/unit	6.87	Energy charge	c/unit	6.13



SUMMARY OF ISSUES RAISED

1. Comment is sought on opportunities for small use customers to switch to a second tier retailer in the gas distribution licence areas covered by the Tariff Regulations.
2. Are there technical or other barriers to customers switching, where an alternative retailer may exist?
3. Are there impediments to small use customers being able to exercise informed choices regarding their choice of retailer?
4. What barriers are there, across the gas market supply chain, to entry, expansion and exiting the gas retail market?
5. What is the significance of these barriers and are they different for new entrant retailers in comparison to retailers seeking to expand market share?
6. Comment is sought on the availability and scope for product/service differentiation in relation to the reticulation of gas in Western Australia, particularly in relation to small use customers.
7. Comment is sought on the perceptions of natural gas as a product of choice in the small use customer market compared to other energy supply options.
8. What are the impacts of competition in the gas market on the profitability of reticulating gas in the distribution licence areas covered by the Tariff Regulations?
9. Are current retail prices to small use customers reflective of supply and retail costs for the respective gas distribution licence areas covered by the Tariff Regulations? If not, to what extent are costs not covered, and by how much would tariff caps need to be increased to recover costs?
10. What is considered to be an appropriate retail margin for retailing natural gas in Western Australia, and is this different for LPG? Is this different for alternative customer types, or for new retailers/retailers seeking to expand their business?
11. Input is sought from stakeholders on, but not limited to, the following areas:
 - (a) Are there significant differences to be taken into account regarding the costs of supply to residential versus non-residential classes across each of the gas trading licence areas?
 - (b) If the existing tariff cap adjustment mechanism continues into the future, will this impact on the ability of retailers to retail to small use customers in each of the gas trading licence areas? Will impacts change over time?
 - (c) What impact will price regulation have on customers and on competition in the market, in the short- and long-term?
 - (d) Are gas retail prices consistent with customer needs and expectations?
 - (e) What barriers or policies should be addressed to reduce pressure on the cost to supply to small use customers?
 - (f) What impacts would changes to, or the removal of, tariff caps have on small use customers, particularly vulnerable or disadvantaged customers (e.g. low income users)?

- (g) If adjustment to the level of the tariff caps is required to implement more cost-reflective arrangements, what transitioning process should be adopted in moving to these new tariff caps?
- 12. Are there any other matters that require consideration in the Tariff Regulations Review?