Office of Energy
Government of Western Australia

GAS TARIFF REGULATIONS REVIEW REPORT

Report prepared by the Minister for Energy
the Hon Francis Logan MLA

on the

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

October 2007

CONTENTS

1 Executive Summary

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 annum ["TJ/a"]) in the areas covered by the Tariff Regulations. 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") carry out 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* (the "Amendment Regulations"). As the Amendment Regulations commenced on 18 October 2002, this means the review of the Tariff Regulations (the "Tariff Regulations Review") must be conducted by 18 October 2007.

The Tariff Regulations Review found that:

- The Tariff Regulations are still required in Western Australia.
- There are upward pressures on the cost to retail gas to small use customers in the areas covered by the Tariff Regulations. These cost pressures may impact on the viability of gas retailers and may act as a barrier to entry in the gas retail market if the tariff caps are maintained at their current level.

It is noted that, despite the introduction of gas full retail contestability ("FRC") in Western Australia in May 2004, there is a lack of alternative retailers in the small use customer market, very little customer switching behaviour, and limited exercise of market choice by customers.

- Alinta Sales Pty Ltd ("Alinta") is actively retailing to small use customers in all three of the areas covered by the Tariff Regulations.
- Synergy is licensed to trade gas in the areas overlapped by the South West Interconnected System, but is restricted by the Gas Market Moratorium to the larger part of the small use customer market (0.18 TJ/a to 1.00 TJ/a), and is actively trading gas only in the Perth metropolitan area.
- There are no active retailers other than Alinta and Synergy in the areas covered by the Tariff Regulations.
- There has been limited customer switching in the small use customer market in the Mid-West/South-West area, and none in the Kalgoorlie-Boulder or Albany areas.

The Tariff Regulation Review concludes that there are a number of factors that may represent barriers to entry for the State's gas retail market.

- Access to gas supply and transport may be difficult to secure in the current environment.
- The scope for product/service differentiation for gas retail products to small use customers in the gas distribution areas covered by the Tariff Regulations may be limited by the existing tariff structure.

It is noted that processes are currently underway at both the State and Commonwealth levels to address matters associated with the gas supply constraints currently being faced in Western Australia. Whilst addressing the causes and possible resolution of gas supply constraints is outside of the scope of the Tariff Regulations Review, resolution of these matters is important to the development of competition and therefore the need for continued tariff regulation.

It is recommended that more detailed investigation should be undertaken regarding the level and structure of the tariffs. Implications for differentiation of products and services, and the ability for customers to select appropriate products should be taken into account as part of this process.

A complete summary of the findings and recommendations from the Tariff Regulations Review is presented in Appendix 4 to this report.

2 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 TJ/a) in the areas covered by the Tariff Regulations. 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 carry out a review of the operation and effectiveness of the Tariff Regulations within five years of the commencement of the Amendment Regulations. As the Amendment Regulations commenced on 18 October 2002, this means the Tariff Regulations Review must be conducted by 18 October 2007.

Clause 8 of the Tariff Regulations provides that, in 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" – this report), and that the report be laid before each House of Parliament as soon as practicable after it is prepared.

3 Tariff Regulations Review

The Minister asked that the Office of Energy conduct the Tariff Regulations Review, having regard to the matters listed above. In assessing the need for continuation of the Tariff Regulations the Office of Energy focused on:

- An assessment of the level of competition in the retailing of gas in the areas covered by the Tariff Regulations. The level of competition in gas industry markets is central to the question of whether the interests of gas customers are promoted by continued tariff regulation. Where competition is effective, tariff regulation can be phased out without necessarily exposing customers to inappropriately high tariffs.
- An assessment of the appropriate level of the gas retail tariff caps (as specified in the Tariff Regulations). The legitimate business interests of retailers are generally

understood as being promoted by ensuring that tariffs are cost-reflective. Cost reflective tariffs also promote the interests of gas consumers by encouraging entry by efficient retailers.

- Consideration of other matters of relevance to the gas market, and therefore on the operation of the Tariff Regulations.

In addressing these matters, the Tariff Regulations Review Report comprises a review of the level of competition in the retailing of gas in the areas covered by the Tariff Regulations and other related issues, and makes preliminary findings on the appropriateness of the level of the gas tariff caps and their impacts on stakeholders.

The Tariff Regulations Review Report also notes and considers other matters of relevance to the Tariff Regulations Review, and where appropriate, details the existing and intended future actions by Government to address these matters.

4 Public Consultation Process

A "Tariff Regulations Issues Paper" was prepared by the Office of Energy that considered issues relating to:

- the level of competition in the gas retail market in Western Australia;
- the costs of retailing gas to small use customers in the areas covered by the Tariff Regulations; and
- the appropriateness of the level and structure of the tariff caps and their impact on competition and on consumers.

The Issues Paper was publicly released and made available on the Office of Energy website in September 2007, and interested parties were invited to make submissions over a 4-week period. Submissions were received from the following parties, and are posted on the Office of Energy website at http://www.energy.wa.gov.au/2/3241/64/gas_tariff_regu.pm:

- Alinta;
- Synergy; and
- the Western Australian Council of Social Services Inc. ("WACOSS").

A late submission was received from the Department of Treasury and Finance ("DTF"). While DTF's comments have not been canvassed in this Report, the Office of Energy considers that the views in DTF's submission are broadly consistent with the recommendations in this Report. The DTF submission is available at the above website

5 Gas Retail Market Competition

The aim of competition is to ensure that resources are allocated in a cost effective way to the uses that society values most. The introduction of competition does not preclude regulation on social policy and equity grounds, as regulation may be desirable to achieve or preserve social objectives even with cost reflective pricing under effective competition. Where competition is not fully effective, tariff regulation should provide arrangements that allow for efficiency outcomes similar to those that would be achieved in a situation of effective competition. In addition, such regulation needs to develop the pre-conditions for competition to be formed in the medium-term; as well as meeting any social policy objectives. This process inevitably involves tradeoffs between the desirability of cost reflectivity for different customer classes and meeting affordability requirements and other related social policy objectives.

In this context, the Tariff Regulations Review assesses the extent to which effective competition has been developed over the period of operation of the Tariff Regulations, and the extent to which the Tariff Regulations have met their objectives and managed the tradeoffs described above.

The competition assessment for the Tariffs Regulations Review is 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;
- customer switching behaviour;
- the exercise of market choice by customers;
- ability of suppliers to enter the market;
- differentiated products and services; and
- prices and profit margins.

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 various state and territory electricity and gas retail markets. 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 "Authority") is responsible for conducting a similar detailed competition review for both the electricity and gas markets no earlier than 2009, in accordance with the Australian Energy Market Agreement ("AEMA") requirements.[1]

6 Competition in the Western Australian Retail Gas Market

6.1 Background

Natural gas is a significant fuel source for Western Australia.

Western Australia holds about 80% of Australia's natural gas reserves and is a major gas producer, with about 66% of Australia's natural gas production.[2]

[1] Under the AEMA, 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 Authority is responsible for undertaking the review for Western Australia.

[2] Argonaut Securities Pty Limited, "The Western Australian Gas Market", September 2007, p.2.

Demand for natural gas in Western Australia has risen from less than 20% of national consumption of natural gas in the mid 1980s to a current level of around 35% of national consumption. This is a significant 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.[3]

Despite this significant amount of gas consumption and production, 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 seem to bear the trademarks of an effective competitive market. For instance, new entrants have no ability to make spot trades to mitigate gas commodity and transport risks.

In respect of domestic uses of natural gas, manufacturing, electricity generation and mining account for about 90% of gas consumption in Western Australia. Residential supply accounts only about 3% of total consumption in Western Australia, in comparison to about 13% of gas consumption across Australia. However natural gas usage by Western Australian residential customers has increased markedly in the past 20 years (average of 6.5% growth per annum).[4]

Choice of gas as an energy source in preference to other energy sources will be influenced by the level and structure of tariff caps. Any adjustment of the tariff caps or gas pricing arrangements relative to the cost of alternative energy sources will have implications for the desirability of gas as an energy option. This matter is considered further in section 6.2.

The Tariff Regulations cover the bulk of supply of reticulated gas to small use customers in Western Australia, and includes the Mid-West/South-West (including the Perth metropolitan area), Kalgoorlie-Boulder, and Albany areas. The Mid-West/South West and Kalgoorlie-Boulder supply areas have natural gas reticulation systems, while the Albany area is a reticulated liquid petroleum gas ("LPG") system.[5]

Gas FRC was introduced in Western Australia in May 2004. The achievement of gas FRC means that the legal and technical requirements are in place to allow new gas companies to enter the market. The Retail Energy Market Company Ltd. ("REMCo") currently has responsibility for operation of the gas retail market in Western Australia. The REMCo scheme covers the AlintaGas Networks distribution systems, and operates on a not for profit basis. Any future gas retail market schemes must be approved by the Authority.

A comprehensive customer protection framework also stipulates minimum standards for retailer conduct in dealing with small use customers. Appendix 1 provides details on the components of the small use gas customer protection framework, over and above the Tariff Regulations.

Under recent changes to the Gas Market Moratorium, which took effect from 1 July 2007, Synergy is now permitted to supply gas to customers using at least 0.18 TJ/a. This change is intended to give greater choice to energy consumers in Western Australia, and provides

[3] ABARE, "Energy in Australia 2006", 2007, pp.55; and Chamber of Commerce and Industry of Western Australia ("CCIWA"), "Meeting the Future Gas Needs of Western Australia – A Discussion Paper", May 2007, pp.38-41.

[4] CCIWA, pp.39-45.

[5] 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. 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.

parity on an energy equivalency basis with the current electricity contestability threshold of 50 megawatt hours/annum ("MWh/a").[6]

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. This lack of liquidity is present in the current limited access to wholesale gas supply, which reflects upstream issues (as detailed in section 6.3.1), that may act as a barrier to entry into the gas retail market.

6.2 Independent Rivalry in the Market, Customer Switching Behaviour, and Exercise of Market Choice by Customers

Despite the introduction of gas FRC, there are still relatively few gas retailers in Western Australia. Alinta has submitted that competition is well established and increasing in the industrial and in the mid to large commercial market segments, where customers consume more than 0.18 TJ/a.

Synergy has obtained approval from the Authority to trade gas (i.e. to retail gas to small use customers) in the area covered by the South West Interconnected System, which overlaps the areas covered by the Tariff Regulations.[7] This approval remains subject to the Gas Market Moratorium, which as noted above, prevents Synergy from retailing gas to customers who use less than 0.18 TJ/a.

At this time, it is apparent that Synergy has not commenced actively trading in the Kalgoorlie-Boulder or Albany licence areas in the small use customer market, and is competing with Alinta in the Mid-West/South-West area for customers larger than 0.18 TJ/a.

It clear that there is only limited customer switching between retailers in the gas retail market in Western Australia. Data provided by REMCo indicates that there has been a higher degree of customer switching in the large customer market (greater than 1 TJ/a), compared to the larger end of the small use customer market (between 0.18 TJ/a and 1.00 TJ/a). Even then, the switching in the small use market has only been in recent months, coinciding with the reduction in the threshold on Synergy under the Gas Market Moratorium, and only in the Perth metropolitan area. No alternative retailers have emerged in the smaller end of the small use customer market (less than 0.18 TJ/a).

Greater levels of competition in Western Australia might be expected should electricity FRC be introduced. As discussed later in this report, this competition would be expected with the increased opportunities for retailers to become dual fuel suppliers in the small user energy market. In this situation, the restriction on Synergy under the Gas Market Moratorium would also need to be reviewed.

It should also be noted that the AEMC has recently published its first draft report of the effectiveness of competition in the Victorian gas and electricity markets, and found that there is effective competition in these markets.[8]

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[6] The Western Australian Government reduced the electricity contestability threshold to 50 MWh/a on 1 January 2005, in conjunction with a range of other measures to reform the electricity industry in Western Australia.

[7] Synergy's gas trading licence and a map of the gas trading licence areas can be located at http://www.era.wa.gov.au/2/315/51/licence_holders.pm

[8] The AEMC's draft report on its assessment of the effectiveness of competition in the Victorian gas and electricity markets is available on the AEMC website: (http://www.aemc.gov.au/electricity.php?r=20071004.170645).

The Victorian gas retail market is in sharp contrast to the Western Australian gas retail market:

- While there are only two active retailers in the areas covered by the Tariff Regulations in Western Australia (Alinta and Synergy), Victoria has six licensed gas retailers (three incumbents – AGL, Origin Energy, and TRUenergy; and three second tier retailers – Australian Power and Gas, Simply Energy, and Victoria Electricity).[9]
- While there has only been limited customer switching in the large end of the small use customer market in Western Australia, there has been significant customer switching in Victoria (customer switching in Victoria has grown from a gross annual rate of about 12% for the year ended 30 June 2004 to about 21% for the year ended 30 June 2007).

Findings:

1. Despite the introduction of gas FRC in Western Australia in May 2004, there is a lack of alternative retailers in the small use customer market, very little customer switching behaviour, and limited exercise of market choice by customers:

- Alinta is actively retailing to the small use customer market in all of the areas covered by the Tariff Regulations. Synergy is licensed to trade gas in the areas overlapped by the South West Interconnected System, but is restricted by the Gas Market Moratorium to the larger part of that market (0.18 TJ/a to 1.00 TJ/a), and is actively trading gas only in the Perth metropolitan area. There are no alternative retailers to Alinta and Synergy in the areas covered by the Tariff Regulations.
- There has been limited customer switching in the small use customer market in the Mid-West/South-West area, and none in Kalgoorlie-Boulder or Albany.

6.3 Ability of Suppliers to Enter the Market

Importantly, retailers must back their potentially short-term retail customer contracts with long-term gas commodity and gas transport contracts. These commodity and transport 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, Synergy highlighted in its submission that new entrants may not have the benefits of the availability of a larger gas trading portfolio, purchasing power and pre-existing contracts with gas producers.

Alinta submitted that, due to the synergies of a combined industrial and small use customer base, it seems unlikely that a retailer could successfully compete without serving both market segments. Alinta also noted that the small use customer market represents a relatively limited proportion of Western Australia's domestic gas consumption.

6.3.1 Upstream Issues

The Western Australian gas market has historically been characterised by long-term bilateral contracts for gas and transmission capacity. The market also features a small number of producers and one pipeline – the Dampier to Bunbury Natural Gas Pipeline ("DBNGP") – accounting for the majority of pipeline capacity. There is no formal short-term or spot trading market, and as a result, the liquidity of the wholesale gas market is low. Transparency of information (particularly price) is limited, and there are barriers to the entry for new downstream users (particularly small users).

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[9] An additional company, Red Energy, also has a gas retail licence in Victoria, but is not actively trading gas.

Although there is greater diversity of gas field ownership in Western Australia than in the eastern states, the North West Shelf Joint Venture ("NWSJV")[10] 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.[11]

There are also growing reports from industry indicating that despite strong domestic demand for natural gas, including in the gas retail market, there is presently limited availability of new domestic gas supply. Reports also indicate that maximum terms for new gas supply contracts are becoming shorter (currently around five years).[12]

The current tight situation for new domestic supply is coincident with a focus on liquefied natural gas ("LNG") production. LNG is produced by cooling natural gas to allow it to be transported to export markets. About 70% of the gas produced in Western Australia is exported in the form of LNG, with the balance sold into the domestic market.[13] Increasing costs and complexity associated with petroleum production, and fully committed upstream infrastructure, would appear to have contributed to the current tight market for domestic supplies.

This current tight market may be alleviated over the short to medium-term with a number of gas fields, such as Reindeer, which is scheduled to come on line in 2010. There are also other fields that are known gas resources near to the coast and existing infrastructure, in relatively shallow water depths, which have the potential to be developed in the near term.

Recent industry reports have suggested that wholesale gas supply in Western Australia may continue to be constrained for the next few years, until a number of larger projects come on-stream.[14]

Alinta submitted the view that the "greatest barrier" for new retailers is undoubtedly access to upstream or wholesale gas. Alinta commented that the "…'tight' wholesale market, where there is the perception that supply is very much less than demand, makes market entry very difficult, if not impossible. Large industrial customers in particular are quite conscious of the risk attached to new entrant retailers, especially those with little brand equity at risk".

Having said this, Alinta also submitted that the current operations of the wholesale market present as many challenges to incumbent retailers as for new entrants. Synergy expressed the view that there would be no discernable changes in the availability of natural gas for the domestic market until at least 2010.

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

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[10] The NWSJV is made of six companies, including Woodside Energy, BP Developments Australia Pty Ltd, Chevron Australia Pty Ltd, BHP Billiton (North West Shelf) Pty Ltd, Japan Australia LNG (MMI) Pty Ltd and Shell Development Australia Proprietary Limited (Source: www.nwsg.com.au).

[11] CCIWA, pp.34-35.

[12] Authority, "Discussion Paper: Gas Issues in Western Australia", June 2007, p.5.

[13] Argonaut.

[14] Ibid, p.1: Argonaut states that it expects a dramatic shortfall of supply of natural gas for the domestic market for the next 2-3 years, until some larger projects (Reindeer and Macedon) come on-stream in 2010/2011 (at the earliest).

the reason that prices in this State have remained so low over time (the long term contracts currently expiring were set at a time of low prices). This compares with the larger markets overseas that have a higher frequency of trade and greater propensity to trade on commodity exchanges, which results in prices that are more volatile, and that more closely reflect current market conditions.[15]

The historic low prices have changed markedly in the last 12 months, as the domestic price of natural gas appears to have risen sharply, with reports of prices for new contracts being upwards of $6.00/gigajoule ("GJ"). Interestingly, the eastern states markets have not experienced increased gas prices to the same degree, 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.[16] It has also been claimed that the increased supply of gas from coal seam methane sources may have contributed to relatively stable prices in the eastern states.

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 gas producers and marketers. However, even at LNG netback prices[17] the supply of new domestic gas supply for long tenures is reportedly currently difficult to secure.

Domestic gas prices and the availability of natural gas will impact on the competitiveness of the gas retail sector in Western Australia. Incumbent retailers may have greater ability than new entrants to absorb cost fluctuations due to the availability of long-term contracts negotiated at lower historical prices.

There is also a lack of liquidity in relation to the supply of LPG in Western Australia, which may impact on the cost to reticulate LPG in the areas covered by the Tariff Regulations.[18] As for natural gas, this lack of liquidity is characterised by limitations in wholesale supply. Alinta currently retails LPG to small use customers in the Albany distribution licence area.

There are currently two major facilities extracting LPG from gas/condensate streams in Western Australia – the NWSJV, which is for export use, and the Wesfarmers plant at Kwinana. The Wesfarmers plant supplies most of the domestic LPG market by extracting propane and butane from the natural gas stream flowing from the NWS gas fields via the DBNGP. 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 benchmark known as the "Saudi Aramco Contract Price". This benchmark price, set by the world's largest producer, Saudi Arabia, is used as a basis internationally for pricing sales of LPG and is understood to have reached around $700/tonne in recent months. It is understood that local producers add a component equivalent to freight and insurance to develop a

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[15] CCIWA, pp.47-48.

[16] CCIWA, p.50.

[17] 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.

[18] 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.

price that an LPG supplier would be required to pay if it imported LPG. This figure is used to derive the wholesale price of locally produced LPG.[19]

6.3.2 Transmission Issues

Transmission capacity in Western Australia has historically been negotiated by way of long-term bilateral contracts, with shippers being entitled to transport gas to the extent that they have contracted for capacity on a take or pay basis. This market is also characterised by a relatively small number of shippers directly holding both supply contracts and gas transmission contracts.[20]

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 (i.e. 1-3 year) capacity is not generally available. Synergy has also commented that the pipeline owner only commits to additional capacity augmentation on a fully booked capacity basis.

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 AlintaGas Networks systems in this area is relatively limited compared with the significant industrial demand from mining and other industries.

6.3.3 Retail Issues

The incumbency of existing energy businesses based in Western Australia may act as a barrier to new entrant gas retailers in the small use customer market. Retailing energy to this customer segment requires commitment to capital expenditure on mass market customer information and billing systems, and long lead times to design and implement billing and other retail systems, (Synergy has expressed the view that this lead time is typically 24 to 36 months). Such systems are also required to meet regulatory compliance requirements and operational matters such as pricing, end to end sales processes, wholesale and retail market management, service order capability and relevant industry interfaces. Incumbent retailers also have the advantage of an established customer base, brand recognition, along with highly relevant marketing experience and knowledge of customer consumption profiles that may assist in retail contract development and marketing.

Synergy has submitted that energy retail systems are complex, costly, and may take time to implement; and note that "for the most part this means future competition is most likely to come from 'big established' players already active in retail energy markets elsewhere in Australia". The relatively small size of the Western Australian energy market may also naturally limit the potential number of retailers competing for small use customers in the State.

In addition, as noted earlier, Alinta has submitted that, due to the synergies of a combined industrial and small use customer base, it seems unlikely that a retailer could successfully

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

[20] Synergies Economic Consulting, "WA Gas Supply & Demand – The Need for Policy Intervention", July 2007.

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.

compete without serving both market segments, because the small use customer market represents a small proportion of Western Australia's domestic gas consumption. Further to this comment, Alinta and Synergy highlighted perceptions by potential new entrant retailers regarding limited retail margins within the small use gas retail market in the areas covered by the Tariff Regulations.

This situation may be addressed in the future through the potential introduction of electricity FRC, which may assist in making both the Western Australian electricity and gas retail markets more attractive to existing retailers in other Australian jurisdictions through access to greater market synergies in dual fuel retailing. The Office of Energy 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.[21] It should be noted that in Victoria and South Australia all gas retailers currently also retail electricity, and entered the energy market initially as electricity retailers.

Stakeholder submissions highlighted a divergence of views regarding the availability of capacity at transmission gate stations to the AlintaGas Networks distribution system, and the payment for such access. This may represent an additional form of barrier to participation in the gas retail market if such issues (or perceptions) are not resolved.

In terms of reduced barriers to entry, it should be noted that retailers are currently readily able to access the benefits of the established gas retailing regulatory arrangements in Western Australia. Whilst 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 and are now almost fully depreciated.

Alinta has submitted that experience in South Australia, which also operates under the REMCo retail market system, suggests that the retail market system will cope with large volumes of customers seeking to change retailer when an alternative gas retailer emerges. However, Synergy expressed the view that the technical systems available for facilitating gas FRC in Western Australia remain largely untested.

Findings:

2. There are a number of factors that may represent barriers to entry for the State's gas retail market. In particular, access to gas supply and transport may be difficult to secure in the current environment.

Recommendations:

1. Potential issues regarding access to gate station capacity and payment for such access should be fully explored to determine the need for any changes to existing regulatory requirements covering such access.

6.4 Differentiated Products and Services

Product and service differentiation may take various forms. Price differentiation may include situations where market contracts are offered which differ from the regulated tariff (e.g. discounted prices) and/or mechanisms such as loyalty rebates or discounts for

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[21] Further information on the Electricity Retail Market Review can be found at the Office of Energy website at www.energy.wa.gov.au/2/3240/64/electricity_mar.pm.

account payments within required timeframes. Non-price mechanisms may include bundling with other products/service offerings and labelling (e.g. "Green energy", "100% Australian owned", or bundled gas and electricity products).

Without sufficient competitive pressure in the areas subject to the Tariff Regulations, there will be limited incentive for product and service differentiation. It is understood that Alinta does not currently offer alternative pricing arrangements to the existing tariff cap structure to small use customers in the areas subject to the Tariff Regulations.

Alinta has submitted that "the current default or standard tariffs are a legacy and considerable scope exists to improve product service/differentiation". However, Alinta has also remarked that in Western Australia, products "are in general quite simple and easy to understand". The ability of consumers to understand product offerings and the impacts of these offerings on consumer behaviour, and in terms of affordability, are important issues. In this regard it should be noted that a general restriction on innovation in contract pricing structures may be the relative lack of interest on the part of consumers in devoting significant amounts of time to comparing various offers. In this context, a tariff that offers a simple discount off a regulated tariff might be easier for retailers to market as it is relatively simple to understand.

Synergy has commented that the lack of electricity FRC precludes energy retailers from creating products that package both gas and electricity to small use customers.

Findings:

3. The scope for product/service differentiation for gas retail products to small use customers in the areas covered by the Tariff Regulations may be limited by the existing tariff structure.

Recommendations:

2. More detailed investigation should be undertaken regarding the structure of the tariffs. Implications for differentiation of products and services, and the ability for customers to select appropriate products should be taken into account.

6.5 Prices and Profit Margins

It is important to consider the impact that competition has on prices and profit margins for retailing gas in Western Australia. There are strong linkages between competition and the cost to retail 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 Report.

6.6 Other Matters

The Western Australian Government is keenly aware of the gas supply constraints currently being faced by domestic gas users and retailers, 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 in the Ministerial Council on Energy and the Ministerial Council for Mineral and Petroleum Resources Joint Working Group on Natural Gas Supply (the "Joint Working Group"). The Joint Working Group was tasked with identifying barriers to domestic gas supply and developing strategies to overcome such barriers. The Joint Working Group has released a Report for public comment and will soon present final recommendations to both Ministerial Councils.[22]

Alinta has submitted that Government policy at both a State and Federal level needs to ensure that the upstream gas market is subject to a similar degree of scrutiny as the downstream market to ensure that supply costs are reflective of fair and reasonable costs.

Findings:

4. The gas supply constraints currently being faced in Western Australia are acknowledged as significant issues. Gas supply constraints may impact on the likelihood of retail entry, and the retail tariffs faced by consumers. These matters are complex and processes are currently underway at both the State and Commonwealth levels to address these matters. Addressing the causes and possible resolution of gas supply constraints is outside of the scope of the Tariff Regulations Review, but their resolution is important to the development of competition and therefore the need for tariff regulation.

6.7 Is there Sufficient Competition in the Retail Gas Market in Western Australia?

The information presented throughout Section 6 of this report (including the data provided by REMCo) indicates that there is clearly not sufficient competition in the small user segment of the Western Australian gas retail market to justify the removal of the Tariff Regulations. This view is supported by the submissions to the Tariff Regulations Review Issues Paper, with Alinta, Synergy and WACOSS expressing agreement that there is negligible competition in the small use gas retail market in Western Australia. It is recognised that this lack of competition could also be reflective of the fact that the current regulated tariff structure and tariff levels may be inappropriate.

Furthermore, Alinta acknowledged that “[p]rice regulation is a necessity whilst there is no real alternative for the vast majority of customers” and “in the mid term can act as a useful benchmark for customers against which competing offers can be judged”. Alinta also suggested that the tariff caps “can perform a default function which ensures that the most vulnerable in society have an appropriate safety net to rely upon”. This view was supported by WACOSS, who submitted that the gas tariff caps protect residential consumers from price increases and general price volatility.

Findings:

5. There is currently insufficient competition in the gas retail market in Western Australia to justify removal of the Tariff Regulations.

Recommendations:

3. In the absence of sufficient competition, the price of gas to small use customers in the areas covered by the Tariff Regulations should continue to be regulated by way of tariff caps.

[22] Ministerial Council on Mineral and Petroleum Resources/ Ministerial Council on Energy Joint Working Group on Natural Gas Supply, “Final Report”, September 2007 (available at www.mce.gov.au). Recommendations from the Report relate to acreage management, improving the operation of existing market structures, development of an annual national gas statement of opportunities and obtaining an understanding of new market developments.

7 Retail Tariff Caps

7.1 Tariff Regulations

Caps on gas tariffs for households and small business customers were introduced in 2000 as part of the privatisation of AlintaGas, with the requirement that the price of gas to existing small use customers would be capped under tariffs set out in the Tariff Regulations. This requirement also extended to any new small use customers.[23] The Tariff Regulations apply to any retailer that is licensed to supply gas to small use customers in the areas subject to the Tariff Regulations.

The tariff caps were intended to provide a "safety net" for customers, allowing for a sufficient margin for gas retailers, accounting for the risks faced by those retailers. It was originally intended that these tariff caps would cease to apply to small business customers as of 1 July 2002 and that residential tariffs would escalate at CPI+2% each year from this time.

Prior to the introduction of gas FRC in Western Australia, the Tariff Regulations were amended by this Government (under the Amendment Regulations) to reinstate the protection to small business, and to make the annual tariff cap adjustments more in line with inflation. The Amendment Regulations commenced operation on 18 October 2002.

In their current form, the Tariff Regulations allow retailers to set their tariffs for new small use customers as they wish, so long as they offer at least one form of tariff under the tariff cap arrangements.

The tariff caps for residential customers in the Mid-West/South-West area have a fixed daily charge component, and variable energy prices structured into three steps – for the first 12 units/day, the next 24 units/day, and over 36 units/day.[24] 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 Mid-West/South-West area, have a fixed daily charge component, and variable energy prices structured into two steps – for the first 100 units/day and over 100 units/day. The tariff caps for the Kalgoorlie-Boulder area have one daily usage charge and a separate fixed daily charge. The tariff caps for all of these customer categories are escalated on an annual basis in accordance with CPI.

Appendix 2 provides a summary of the tariff caps for 1 July 2003 to 1 July 2007 for each of the three areas covered by the Tariff Regulations, as well as the actual Alinta tariffs charged over this period.

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

There is growing evidence of cost pressures across the gas supply chain, acting to increase the costs of supplying gas to retail customers. This includes the small use customer market segment, where profit margins may be more limited and customers less attractive to retailers.

[23] This is in accordance with sections 5 and 6 of the Tariff Regulations.

[24] Section 4(1) of the Tariff Regulations defines a "unit" as being 3.6 megajoules.

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. The Office of Energy has conducted a preliminary study of the costs to supply gas to small use customers in Western Australia. The cost components taken into account in this process are discussed in detail below and include:

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

7.3 Gas Commodity Costs

As noted previously, natural gas commodity costs in the Western Australian domestic market have increased dramatically in the past 12 months, moving sharply away from historical prices in the $2/GJ range earlier this decade. Contracts for the domestic supply of natural gas are generally confidential. However, a recent paper by the Authority presenting a summary of findings drawn from a consultation process regarding domestic gas issues indicates that natural gas prices for new domestic contracts are in the $5.50/GJ to $6.00/GJ range.[25] Similar prices have also been quoted in other industry publications.

In addition, forecast growth for LNG globally is strong.[26] To the extent that domestic natural gas prices are related to global prices for LNG, this suggests that the domestic price of natural gas may continue to rise.

Commodity costs for LPG have also increased recently. As discussed in Section 6.3.3, the domestic price of LPG is based on oil import parity pricing. In relation to the Albany distribution licence area, it is understood that the national import parity price for LPG has been trending strongly upwards. The international benchmark price for propane has moved from around A$400/tonne to A$700/tonne since January 2004 – an increase of around 75%.

7.4 Transmission Costs

Western Australia is characterised by point-to-point transmission pipelines, with large distances between the points of production and consumption (see Appendix 3 for a 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; although, transmission costs are not believed to form a large portion of the overall costs of retailing gas. The cost of expanding or extending the pipeline to meet new demand is passed onto shippers, and is impacted by rising costs in the broader economy (e.g. labour and capital costs).[27]

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[25] Authority, "Discussion Paper: Gas Issues in Western Australia", June 2007, p.8.

[26] ABARE, "Australian Energy, National and State Projections to 2029-30", ABARE Research Report 06.26, December 2006, p.44.
See also: ABARE, "Australian Commodities", vol.14 no.3, September quarter 2007, p.458.

[27] Capital and labour costs have increased substantially in recent times:

While the DBNGP is a covered pipeline under the Gas Access Code,[28] and there is an Access Arrangement in place for the DBNGP, current applicable charges are stipulated under the terms and conditions of the DBNGP Standard Shipper Contract ("Shipper Contract"). The Shipper Contract will remain effective in its current form until 2016 and accordingly it is not expected that there will be significant changes in transmission costs over the short to medium-term, beyond the increases required as a result of the material costs associated with continued pipeline expansion.

7.5 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 AlintaGas Networks Distribution System Access Arrangement for the Mid-West and South-West Distribution System has been relatively stable over the past 5 years, and while this stability may continue into the future, there could be upward pressure on the cost of new gas distribution infrastructure. For instance, the popularity of solar water heaters, particularly in new residential subdivisions,[29] may decrease the profitability of distribution infrastructure. In a typical household, gas water heating accounts for around 65% of household gas consumption. Since the B3 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 AlintaGas Networks distribution systems will also face increased labour, materials and construction costs, which have 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 Access Arrangement for the Alinta Distribution System is in place until 2009. The Office of Energy estimates that distribution costs form about 40% of the cost to retail gas to small use customers in the Perth metropolitan area.

The distribution of LPG in Albany is reliant on road transport to feed the reticulated system. This contributes an additional cost pressure.

7.6 Retail Operating Costs

CRA International has identified a $90/customer fixed charge for the cost of retailing natural gas in Victoria (adjusted for CPI and productivity since 2003).[30]

- 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.

[28] The *Gas Pipelines Access (Western Australia) Act 1998* implemented the National Third Party Access Code for Natural Gas Pipeline Systems.

[29] 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.

[30] 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.

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 possible that economies of scale available to incumbents may result in smaller new entrants facing higher operating costs.

Synergy has expressed the view that costs to serve customers would probably be much higher for new entrants. Such new entrants would face costs associated with acquiring and retaining customers, which may not apply to incumbent retailers.

7.7 Retail Margin

There is considerable experience in the setting of retail margins in other Australian jurisdictions, which provide a basis for the setting of benchmarks for gas retail margins in Western Australia.

The Independent Pricing and Regulatory Tribunal ("IPART") of New South Wales has previously stated that a 2-3% net retail margin for gas retailing would be reasonable (margin on energy sales before interest and tax, but after all other costs, including retail costs).[31]

Alinta has submitted that the key factors that must be considered for supply of gas to small use customers include:

- Risk:
  - regulatory risk over the term of a pricing review;
  - financial exposures through energy markets;
  - financial exposure to end-customer debt; and
  - reputation risk around failure to supply.
- Commitment:
  - long-term gas purchase and pipeline capacity commitments;
  - scale of financial commitment;
  - size of customer base; and
  - average residential customer revenue.

Alinta submitted that the unit supply cost to a residential customer is higher on average than for business customers (including for small business customers) as a result of lower average consumption, a higher 'winter peak' usage capacity component, and a higher cost to serve through greater customer service activity. This view was generally supported by Synergy.

Alinta also suggested that there is a case for a higher retail margin (in the order of 6%) for residential customers due to higher risks associated with volatile energy prices, the risk associated with long-term pipeline capacity commitments, the small market size of only 580,000 customers, and low average residential customer revenue. Synergy's submission suggested that an appropriate retail margin would be at least 5%.

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

7.8 Findings on Appropriateness of the Level and Structure of the Tariff Caps

Preliminary analysis by the Office of Energy suggests that gas commodity costs may comprise around 25% of the total retailer costs for new entrants to retail gas to small use customers within the Mid-West/South-West area.

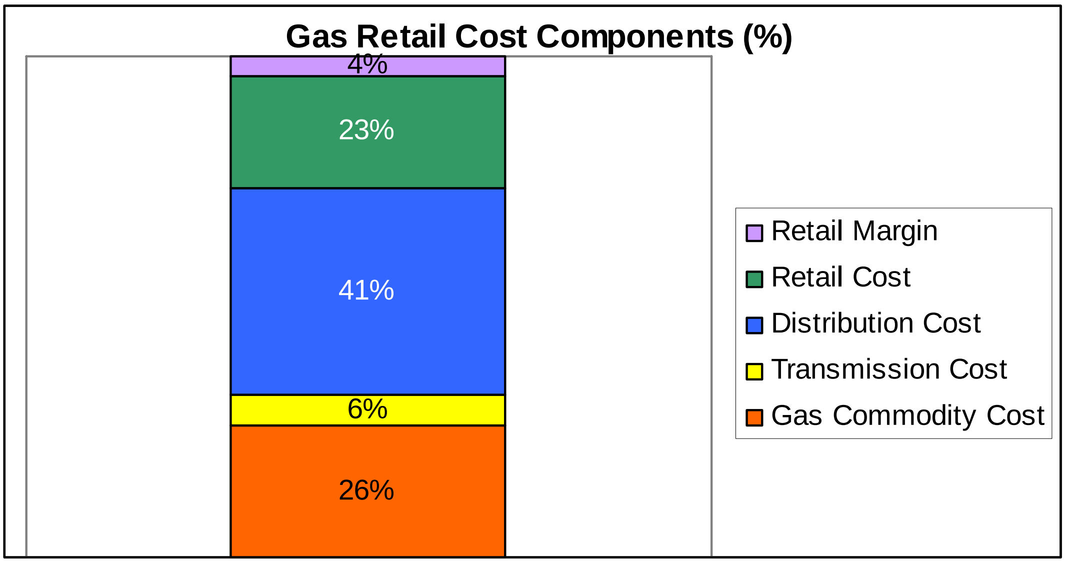
Distribution and transmission costs appear to have been relatively stable or declining for some years, but it is unclear whether this trend will continue in the longer term. This means that future possible price spikes in relation to the wholesale supply of gas will be likely to have a more prominent impact on the ability of new entrant retailers to recover an appropriate margin under the existing Tariff Regulation price caps.

Given the information outlined above, there are indications that the retail margin available to new entrant retailers under the current tariff caps may be eroded, particularly for servicing residential customers, if the wholesale supply costs remain at their current level or continue to rise in a similar manner to recent periods.

However, this analysis was based on publicly available information and did not use actual cost data. Therefore, these results are indicative only.

Alinta submits that there are negative margins in a number of tariffs in a number of gas trading licence areas, and that continuing this situation is not in the long-term benefit of either retailers or customers. In particular, Alinta and Synergy both cite concern regarding retail margins available under the tariff caps for residential customers. Synergy has expressed the view that negative margins are likely for any new entrant choosing to compete in the residential gas market in the supply areas covered by the Tariff Regulations.

The Office of Energy's preliminary analysis suggests that the components of gas retail costs should be approximately as follows:



Synergy and Alinta have both submitted that restructuring of the tariff caps is necessary. Synergy has suggested that a significant increase to the supply charge (see Appendix 2) is required, to alleviate the propensity for retailers to "cherry pick" customers based on high volume use and to permit retailers to recover fixed costs of servicing small volume customers.

Submissions also suggested that increases in tariff caps would have greater impacts for low income and/or disadvantaged households. WACOSS noted that pensioner households consume energy at a rate below the average household, but as a portion of their weekly expenditure, spend almost double the average amount. WACOSS submitted that the current tariff caps should be left unchanged and most definitely not be removed.

Synergy recommended that, to minimise the impacts of any price shocks from tariff restructuring, price changes should be transitioned over a period of about four years, after which tariffs should be subject to independent review. This would provide notice both to potential new entrants and to customers regarding anticipated future pricing.

Both Alinta and Synergy submitted that the Western Australian Government should approach hardship issues through additional policy initiatives, outside of the process of setting retail energy tariff arrangements. In this context, it is noted that the Office of Energy is leading an Inter-Agency Working Group to address issues associated with essential service hardship arrangements offered by energy utilities.

WACOSS submitted that there is a disparity between gas and electricity consumer protection in Western Australia, and has recommended the development of a Gas Customer Code for Western Australia to mandate minimum rights and protections afforded to consumers. WACOSS noted that it would be participating in a Gas Customer Code Reference Group being convened by the Authority. The Office of Energy will also take part in the Gas Customer Code Reference Group, and will be responsible for any legislative amendments required to allow for implementation of a Gas Customer Code (see Appendix 1 for further information on small use gas customer protection).

In summary, the views expressed in the submissions to the Tariff Regulations Review indicate that in general terms, the regulated tariff caps are not currently reflective of the costs for new entrant retailers to supply small use customers in the areas covered by the Regulations. As noted, such a situation has a negative impact on business viability and the longer term prospects for increased competition in this market segment.

As also noted previously, addressing these issues raises potential questions regarding social impacts of tariff restructuring in terms of affordability for particular low income groups. Restructuring of tariff arrangements to allow for price discrimination and increased flexibility in product offerings could enhance prospects for retailer entry. The issue of "cherry picking" of customers would become an issue for existing retailers only if they are forced to offer uniform prices across different customer groups marked by different costs to serve. Removal of such a requirement would facilitate competition, but would also give rise to social policy considerations, which would prompt a call for other complementary initiatives to meet these objectives.

Considering the above, it is concluded that a comprehensive and expert analysis needs to be undertaken by an independent consultant of:

- the costs to retail gas in the areas covered by the Tariff Regulations; and
- the appropriateness of the level and structure of the tariff caps.

The findings of the detailed review of gas tariff caps would be presented to the Minister for Energy for his consideration for potential changes to the Tariff Regulations.

Importantly, in assessing the appropriateness of the level and structure of the tariff caps, consideration would need to be given to principles of cost-reflectivity, the ability of the tariff caps to promote competition, and the impact of pricing arrangements on consumers. A reasonable transition path for consumers should be factored in for any changes to the level and structure of the tariff caps. The timing of any changes would need to take into account other relevant pricing review processes, including the timing for submission of the AlintaGas Networks draft access arrangement (by March 2009), and the Electricity Retail Market Review (including the potential timing for implementation of electricity FRC).

Importantly, as the costs to retail gas are not fixed over time, it will also be important to put a mechanism in place for independent reassessment of tariff caps in the future. It is appropriate that the review process considers the arrangements for future tariff adjustment mechanisms and the associated responsibility for undertaking such tariff setting processes.

Findings:

6. The publicly available evidence indicates that the cost of wholesale supply of gas is increasing. The cost of wholesale supply of gas is only one component in the overall cost to retail gas to small use customers in the areas covered by the Tariff Regulations. Pressure on wholesale supply costs will continue to the extent that the domestic market is linked to the international market for LNG, and may or may not be significant depending on whether there is sufficient available margin in the tariff caps to provide for an appropriate level of profit for new entrant retailers.

7. Increasing cost pressures are likely to impact on the cost retail gas in the future, particularly as Western Australia continues to enjoy strong economic conditions.

8. Strong upward trends in the costs to retail gas will impact on retailer margins in the future, particularly for potential new entrant retailers who would need to secure large volumes of wholesale gas supply at prevailing prices.

Recommendations:

4. Given the limited potential for competition in the short-term under existing arrangements, a more detailed investigation of the level and structure of prices under the Tariff Regulations should be undertaken.

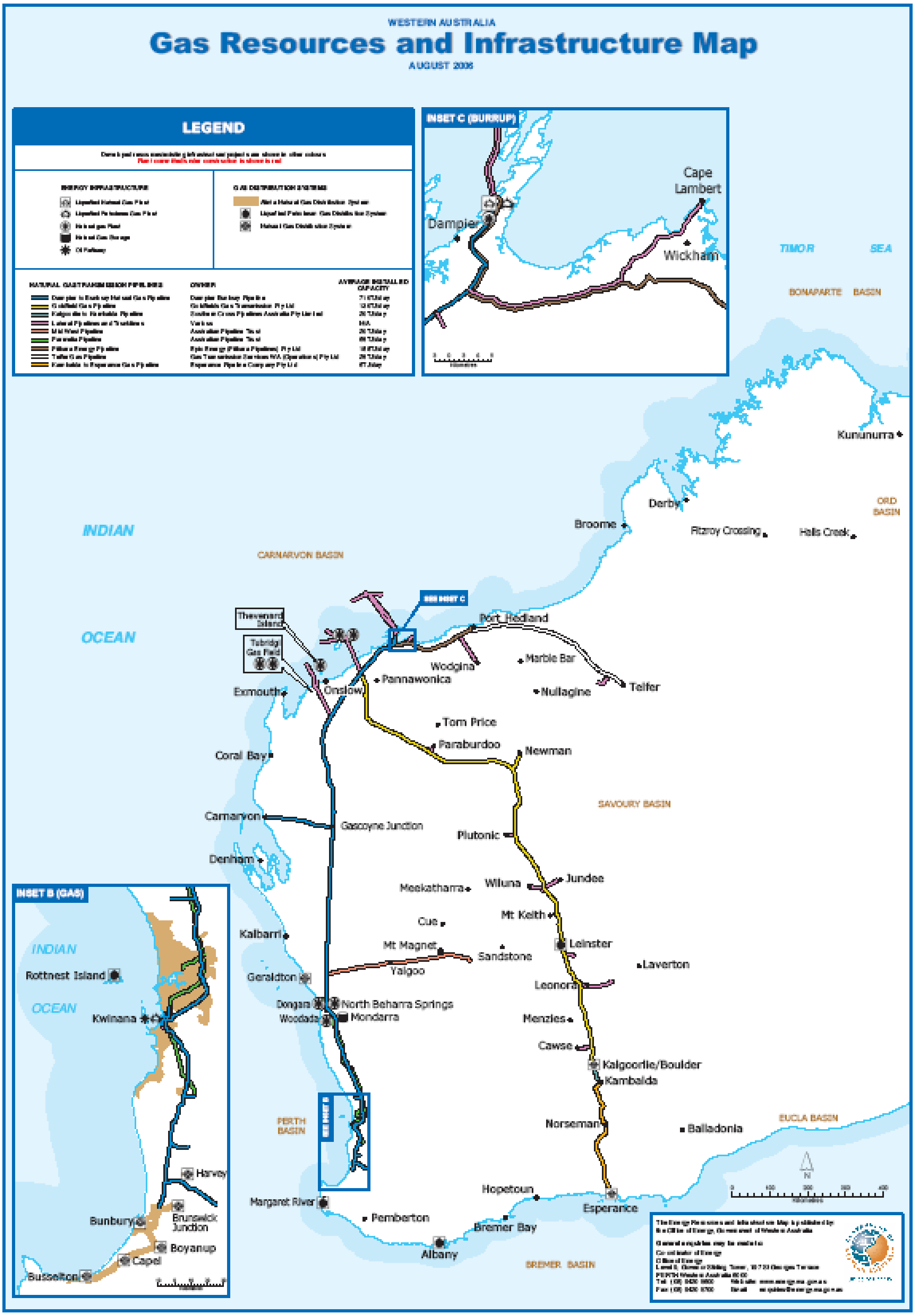
5. The more detailed review of gas tariff caps should be conducted by an expert consultant engaged by the Office of Energy, and would consider:

- the appropriate structure and level of tariff caps taking into account:
  - cost reflectivity;
  - ability of the tariff caps to promote competition (including impacts on whether customers choose gas over alternate energy supply options); and
  - impacts on consumers;
- incentives for gas consumers to negotiate alternative supply arrangements;
- timing for any necessary changes to the tariff structure, including the transition process for amendment of the tariff caps; and
- the appropriate mechanism for the adjustment of the tariff caps in the future, including:
  - criteria to be used in conducting regular reviews of the tariffs and the tariff adjustment mechanism;
  - the person or agency that should conduct the reviews; and
  - the timing for such reviews.

Customer Protection Measures
Gas Licensing Regime – A gas licensing regime was established in 2003 to provide uniform standards of conduct for the gas industry. – Responsibility for gas licensing was initially with the Coordinator of Energy and was subsequently transferred to the Authority in 2004.
Energy Industry Ombudsman Scheme – The Gas Industry Ombudsman was established in May 2004 to provide a free-to-customer complaint handling service to small use gas customers that have a problem with their gas provider. – The Gas Industry Ombudsman was extended to include small use electricity customers in September 2005 and is now known as the Energy Industry Ombudsman.
Gas Marketing Code of Conduct 2004 – This Code was implemented in May 2004 to specify the requirements and obligations on gas retailers in the marketing of gas to residential and small business customers. This Code covers matters such as access to customer information, promoting effective relationships between small use customers and their gas retailer, and privacy protection for small use customers.
Energy Coordination (Customer Contracts) Regulations 2004 – These Regulations were implemented in May 2004 to require gas retailers to have a standard form contract for small use customers, and set out the requirements for information to be included in these standard form contracts. – These Regulations also set out similar requirements associated with non-standard contracts.
Energy Coordination (Last Resort Supply) Regulations 2005 – These Regulations were implemented in March 2005 to allow for a gas Supplier of Last Resort ("SOLR") regime which provides for small use customers to be transferred to a SOLR in the event that their contracted gas retailer is unable to provide them with supply in the long-term.

The Authority is also working towards the development of a Gas Customer Code. This Code will effectively mirror the operation of the electricity industry's Code of Conduct for the Supply of Electricity to Small Use Customers (the *Electricity Industry (Code of Conduct) Regulations 2005*).

Tariff Caps and Actual Alinta Tariffs for 1 July 2003 to 1 July 2007										
		Tariff Cap 01/07/03	Actual Tariff 01/07/03	Tariff Cap 01/07/04	Actual Tariff 01/07/04	Tariff Cap 01/07/05	Actual Tariff 01/07/05	Tariff Cap 01/07/06	Actual Tariff 01/07/06	Tariff Cap 01/07/07
Mid-West/South-West										
Residential										
• Supply charge	¢/day	10.01	10.01	10.21	10.21	10.45	10.45	10.76	10.76	11.02
• First 12 units	¢/unit	7.09	7.01	7.23	7.10	7.40	7.30	7.62	7.62	7.81
• Next 24 units	¢/unit	4.59	4.55	4.68	4.61	4.79	4.75	4.93	4.93	5.05
• Over 36 units	¢/unit	3.44	3.44	3.58	3.58	3.74	3.74	3.93	3.93	4.10
Non Residential										
• Supply charge	¢/day	10.01	10.01	10.21	10.21	10.45	10.45	10.76	10.76	11.02
• First 100 units	¢/unit	7.32	7.32	7.47	7.47	7.65	7.65	7.88	7.88	8.07
• Over 100 units	¢/unit	5.83	5.83	5.95	5.95	6.09	6.09	6.27	6.27	6.42
Albany										
Residential										
• Supply charge	¢/day	10.50	10.50	10.71	10.71	10.96	10.96	11.29	11.29	11.57
• Supply extra dwellings	¢/day	5.24	5.24	5.34	5.34	5.47	5.47	5.63	5.63	5.77
• First 100 units	¢/unit	7.65	7.65	7.80	7.80	7.98	7.98	8.22	8.22	8.42
• Over 100 units	¢/unit	6.40	6.40	6.53	6.53	6.68	6.68	6.88	6.88	7.05
Non Residential										
• Supply charge	¢/day	10.50	10.50	10.71	10.71	10.96	10.96	11.29	11.29	11.57
• First 100 units	¢/unit	7.65	7.65	7.80	7.80	7.98	7.98	8.22	8.22	8.42
• Over 100 units	¢/unit	6.40	6.40	6.53	6.53	6.68	6.68	6.88	6.88	7.05
Kalgoorlie-Boulder										
Residential										
• Supply charge	¢/day	22.49	22.49	22.94	22.94	23.48	23.48	24.18	24.18	24.77
• Energy charge	¢/unit	6.25	6.25	6.37	6.37	6.52	6.52	6.71	6.71	6.87
Non Residential										
• Supply charge	¢/day	22.49	22.49	22.94	22.94	23.48	23.48	24.18	24.18	24.77
• Energy Charge	¢/unit	5.57	5.57	5.68	5.68	5.81	5.81	5.98	5.98	6.13


WESTERN AUSTRALIA
Gas Resources and Infrastructure Map
AUGUST 2006
LEGEND
INSET C (BURRUP)
Cape Lambert
Dampier
Wickham
TIMOR SEA
BONAPARTE BASIN
Kununurra
ORD BASIN
Derby
Broome
Fitzroy Crossing
Halls Creek
INDIAN
OCEAN
CARNARVON BASIN
SEE INSET C
Thevenard Island
Tubridgi Gas Field
Port Hedland
Marble Bar
Telfer
Wodgina
Pannawonica
Nullagine
Exmouth
Onslow
Tom Price
Paraburdoo
Newman
Coral Bay
SAVOURY BASIN
Carnarvon
Gascoyne Junction
Plutonic
Denham
Jundee
Meekatharra
Wiluna
Cue
Mt Keith
Kalbarri
Mt Magnet
Leinster
Sandstone
Yalgoo
Laverton
Geraldton
Leonora
Dongara
North Beharra Springs
Woodada
Mondarra
Menzies
Cawse
Kalgoorlie/Boulder
Kambalda
PERTH BASIN
SEE INSET B
Norseman
Balladonia
EUCLA BASIN
Hopetoun
Esperance
Margaret River
Pemberton
Bremer Bay
Albany
BREMER BASIN
INSET B (GAS)
INDIAN
OCEAN
Rottnest Island
Kwinana
Harvey
Brunswick Junction
Bunbury
Boyanup
Capel
Busselton
N

APPENDIX 4

SUMMARY OF FINDINGS AND RECOMMENDATIONS

Findings:

1. Despite the introduction of gas FRC in Western Australia in May 2004, there is a lack of alternative retailers in the small use customer market, very little customer switching behaviour, and limited exercise of market choice by customers:

- Alinta is actively retailing to the small use customer market in all of the areas covered by the Tariff Regulations. Synergy is licensed to trade gas in the areas overlapped by the South West Interconnected System, but is restricted by the Gas Market Moratorium to the larger part of that market (0.18 TJ/a to 1.00 TJ/a), and is actively trading gas only in the Perth metropolitan area. There are no alternative retailers to Alinta and Synergy in the areas covered by the Tariff Regulations.
- There has been limited customer switching in the small use customer market in the Mid-West/South-West area, and none in Kalgoorlie-Boulder or Albany.

2. There are a number of factors that may represent barriers to entry for the State's gas retail market. In particular, access to gas supply and transport may be difficult to secure in the current environment.

3. The scope for product/service differentiation for gas retail products to small use customers in the areas covered by the Tariff Regulations may be limited by the existing tariff structure.

4. The gas supply constraints currently being faced in Western Australia are acknowledged as significant issues. Gas supply constraints may impact on the likelihood of retail entry, and the retail tariffs faced by consumers. These matters are complex and processes are currently underway at both the State and Commonwealth levels to address these matters. Addressing the causes and possible resolution of gas supply constraints is outside of the scope of the Tariff Regulations Review, but their resolution is important to the development of competition and therefore the need for tariff regulation.

5. There is currently insufficient competition in the gas retail market in Western Australia to justify removal of the Tariff Regulations.

6. The publicly available evidence indicates that the cost of wholesale supply of gas is increasing. The cost of wholesale supply of gas is only one component in the overall cost to retail gas to small use customers in the areas covered by the Tariff Regulations. Pressure on wholesale supply costs will continue to the extent that the domestic market is linked to the international market for LNG, and may or may not be significant depending on whether there is sufficient available margin in the tariff caps to provide for an appropriate level of profit for new entrant retailers.

7. Increasing cost pressures are likely to impact on the cost retail gas in the future, particularly as Western Australia continues to enjoy strong economic conditions.

8. Strong upward trends in the costs to retail gas will impact on retailer margins in the future, particularly for potential new entrant retailers who would need to secure large volumes of wholesale gas supply at prevailing prices.

Recommendations:

1. Potential issues regarding access to gate station capacity and payment for such access should be fully explored to determine the need for any changes to existing regulatory requirements covering such access.

2. More detailed investigation should be undertaken regarding the structure of the tariffs. Implications for differentiation of products and services, and the ability for customers to select appropriate products should be taken into account.

3. In the absence of sufficient competition, the price of gas to small use customers in the areas covered by the Tariff Regulations should continue to be regulated by way of tariff caps.

4. Given the limited potential for competition in the short-term under existing arrangements, a more detailed investigation of the level and structure of prices under the Tariff Regulations should be undertaken.

5. The more detailed review of gas tariff caps should be conducted by an expert consultant engaged by the Office of Energy, and would consider:

   - the appropriate structure and level of tariff caps taking into account:
     - cost reflectivity;
     - ability of the tariff caps to promote competition (including impacts on whether customers choose gas over alternate energy supply options); and
     - impacts on consumers;
   - incentives for gas consumers to negotiate alternative supply arrangements;
   - timing for any necessary changes to the tariff structure, including the transition process for amendment of the tariff caps; and
   - the appropriate mechanism for the adjustment of the tariff caps in the future, including:
     - criteria to be used in conducting regular reviews of the tariffs and the tariff adjustment mechanism;
     - the person or agency that should conduct the reviews; and
     - the timing for such reviews.