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Gas Tariff Regulations Review  
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## **GAS TARIFF REGULATIONS REVIEW – ISSUES PAPER**

Dear Matthew

Please find attached Alinta Sales response to the Gas Tariff Regulations Review – Issues Paper.

Please note that section 9 is confidential at this stage of the process. All other sections of the submission are to be treated as public information.

Yours faithfully

**Donald MacKenzie**  
**Chief Executive Officer**  
**Alinta Sales Pty Ltd**

## Alinta Sales Response to Review of Energy Coordination Regulations

### 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.**

To date in Western Australia (“WA”) no alternative gas retailer has emerged in any of the gas distribution licence areas to compete with the incumbent retailer, Alinta Sales, in either of the residential and small commercial (<180 GJ) market segments.

Competition is well established and increasing in the industrial and in the mid to large commercial market segments where customers consume more than 180 GJ per annum with Synergy steadily growing market share. This is expected to continue as customers exercise their right to choose supplier and customers, including small-use customers, select the product option that best suits their situation.

When full retail contestability is introduced to the WA electricity market, there will be at least two competing gas and electricity retailers in the small-use energy market. The increased size of the energy market is then likely to attract other competitors. This is best evidenced by the number of new entrants competing for customers in the industrial and mid to large commercial segments of the electricity market.

### 2. **Are there technical or other barriers to customers switching, where an alternative retailer may exist?**

The WA retail gas market system appears to be operating as intended and functionally there are no barriers or impediments to switching retailer. Customer switching has no upfront charge, unlike in the > 50 MWh electricity market, as the gas market system has a profiling option which avoids the need to meter consumption hourly or daily. The WA retail market system has been, and continues to be, almost entirely funded by Alinta Sales.

Experience in South Australia, which also operates using the REMCo retail market system, suggests that when an alternative gas retailer emerges the retail market system will cope with large volumes of customers seeking to change gas retailer.

### 3. **Are there impediments to small use customers being able to exercise informed choices regarding their choice of retailer?**

In WA, experience to date has shown that gas retailers are ‘playing by the rules’ and customers are able to make well-informed decisions. Products are in general quite simple and easy to understand.

There has been no repeat to date of the poor customer experiences which have tarnished the introduction of retail competition in other States. At this stage of competition, it is likely that this reflects the size and cultures of the competing entities, Alinta Sales and Synergy, rather than a broader interpretation that implies that the consumer protection rules are adequate.

#### 4. What barriers are there, across the gas market supply chain, to entry, expansion and exiting the gas retail market?

Capacity at transmission gate stations or access to unused gas transmission capacity has been cited by some alternative retailers as a potential barrier to entry. This is a potential concern as it misrepresents the situation.

##### *Gate Station Capacity*

Capacity at gas transmission gate stations is not in Alinta's view the issue. The fundamental issue is who underwrites the capital and operating costs of multi-user gate stations particularly where these gate stations serve industrial loads as well as a large number of small-use customers.

This issue is not new. It has existed from the beginnings of a competitive market as capital costs are generally not considered in calculating fair standard or default tariffs. Therefore, cost recovery is difficult.

Alinta Sales has recently funded an upgrade of the Rockingham gate station which serves a large number of small-use customers in the Rockingham to Mandurah growth corridor. The gate also serves some industrial loads in Kwinana, either as a primary gas source or as a back-up source of gas.

Complicating factors in cost allocation are, the:

- Variability of small-use customer demand with changing weather events;
- Variability of industrial demand as back-up arrangements are utilised at times of system stress or system peak therefore driving a capacity expansion requirement; and
- Consequences of a failure to supply large numbers of small-use customers driving higher redundancy expectations.

Alinta Sales, as the largest shipper at the gate station, was under most pressure to fund this particular upgrade as the risks around small-use customer supply are huge. Alinta Sales had little choice but to fix the problem and argue about who pays at a later date. Supply failure does not sit well within a first-world economy.

Further work is certainly warranted by regulators to coordinate an economically efficient method of funding gas transmission gate stations and allocating costs fairly to gas consumers. As the market evolves, in the absence of the issue being addressed, it will find a higher profile as small-use customer supply reliability is compromised.

##### *Gas Transmission Capacity*

The critics of the existing gas transmission capacity system ie. contract carriage, ignore an important fact; that the small-use consumer market is only 4% of the State's domestic gas consumption. 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.

Indeed, as there are synergies associated with serving both industrial and small-use customers, advocates of a market carriage system for the small-use segment run the real risk that new rules actually increase the cost of serving small-use customers as synergies in gas transportation are dismantled.

## *Domgas*

The greatest barrier to entry for new retailers is undoubtedly access to upstream or wholesale gas. The 'tight' wholesale market, where there is a 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.

When the wholesale market returns to a more normal balance between supply and demand, this constraint will ease and new entrants will present less of a risk to customers. New entrants will find market entry an easier prospect.

### **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?**

The 'tight' wholesale market dominates other perceived constraints. The operation of the wholesale market presents as many challenges to the incumbent as it does to new entrants. In a sense, it is the lowest common denominator and other advantages that an incumbent would expect to have are secondary.

The comments in the review paper around the Domgas Alliance misinterpret the impacts of the wholesale market factor in practice. The formation of the Domgas Alliance is recognition that all participants are impacted equally, whether they are new entrant or incumbent.

### **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.**

The current construction of the default or standard tariffs is a declining block, that is increased gas use is rewarded by a reduced unit price.

When the five components of cost associated with supply to small-use customers (page 12 of the discussion paper) are reviewed, there is little doubt that the current default or standard tariffs are a legacy and that considerable scope exists to improve product/service differentiation and to reflect a carbon-constrained world where energy efficiency is a social imperative, not just an economic driver.

The largest component of the current cost structure, the AlintaGas Networks ("Networks") distribution tariff, being a declining block mechanism is also constructed to encourage greater gas consumption. This tariff is independently regulated by the Economic Regulation Authority.

The Networks tariff can be amended in 2010; however the draft access arrangement must be submitted by March 2009. As small-use customer tariffs are a factor that must be considered, changes to the retail tariff from July 2008 are practically the optimum date from a regulatory perspective.

### **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.**

Natural gas has been heavily promoted by Alinta and its predecessors for 20 years with a strong emphasis on the cost or value of the product.

Recent changes in the wholesale price of natural gas do change the relative merit of natural gas when compared to other energy sources. Proposed legislation to include a cost of carbon and improvements to product performance should lead consumers to seriously consider the

alternatives to gas as a primary source of energy for water heating such as gas-boosted solar hot water systems.

A change away from gas for hot water heating should in theory be a positive feedback loop, as the fixed cost of a distribution network is carried by fewer consumers, thereby accelerating the economic driver for change.

**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?**

Gas market development is undoubtedly aided by vertical integration including that of the distribution network owner. However, in Western Australia, this ownership structure has not existed for many years. Despite strong growth in customer numbers, the market is essentially quite mature.

As the gas market currently operates with distributor and retailer/s as independent parties, increased competition will have minimal impact upon the profitability of reticulating gas.

It could be argued that the profitability (for a distributor) of reticulating gas should improve with increased retail competition if such competition translates into lower prices driving higher volumes through the distribution network. With a high fixed cost base, increased utilisation of the assets, particularly if the increased competition changed usage patterns to something less peaky, may lead to better than regulated returns.

**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?**

The default or standard gas tariffs in all gas distribution areas do not reflect current costs.

In each gas distribution area, and for each tariff, a unique cost situation exists as there are different costs associated with supply to different market segments within each distribution area.

Note that the tariffs in Table 1 of the discussion paper are inclusive of GST whereas most input costs are generally quoted exclusive of GST.

*Costs*

Confidential component of submission

**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?**

A review of the purpose and function of a retail gas margin is needed prior to determining the quantum as regulators around the country differ widely in views as to the quantum. Key factors which must be considered for supply to small-use customers are:

- Risk:
  - Regulatory risk over the term of the review;
  - Financial exposures through energy markets;

- Financial exposure to end-customer debt; and
- Reputational risk around failure to supply,
- Commitment:
  - Long term gas purchase and pipeline capacity commitments; and
  - Scale of financial commitment,
- Size of the customer base; and
- Average residential customer revenue.

Given these key factors, the case for a higher retail margin of more than 6% is compelling due to:

- higher risks associated with volatile energy prices;
- the risk associated with long-term pipeline capacity commitments;
- the market size of only 580,000 customers; and
- an average residential customer revenue of just \$370 (ex GST).

**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?**

In general, there are few differences between supply to residential and non-residential customers. Indeed, some residential customers have a larger, commercial-size meter and consequently coastal distribution costs mirror that of commercial customers with a fixed component of \$210 per annum.

From a cost perspective, the unit supply cost to a residential customer is on average higher as a result of:

- Much lower average energy consumption;
- A higher 'winter peak' capacity component; and
- A higher cost to serve through greater customer service activity.

- (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?**

The existing tariff cap gives little incentive for new entrants to enter the market as there are clearly negative margins in a number of tariffs in a number of gas trading licence areas. Continuing this situation is not in the long-term benefit of either retailers or customers.

- (c) What impact will price regulation have on customers and on competition in the market, in the short- and long-term?**

Price regulation is a necessity whilst there is no real alternative for the vast majority of customers. In the short-term, price regulation should satisfy customers that in the absence of competition, the retailer is earning a fair return and customers are receiving a fair price.

In the mid-term, price regulation can act as a useful benchmark for customers against which competing offers can be judged.

Tariffs should ultimately be removed altogether when the competitive environment allows it.

**(d) Are gas retail prices consistent with customer needs and expectations?**

It can be argued that current gas prices do not meet customer needs as prices are 'too cheap' and encourage customers to be profligate in their use of energy.

Whilst world oil prices have risen dramatically over the past ten years, local wholesale gas prices have remained steady until recently. Dramatic increases in wholesale costs over the last two years make current tariff prices uneconomic.

**(e) What barriers or policies should be addressed to reduce pressure on the cost to supply to small use customers?**

Government policy at both a State and federal level needs to ensure that the upstream gas market is subject to the same degree of scrutiny as the downstream market to ensure that cost of supply is reflective of fair and reasonable costs.

Recent increases in domestic gas prices at a wholesale level undermine confidence in the entire system.

**(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)?**

Customers who experience hardship and struggle to pay energy bills generally have more significant issues with other service providers. Alinta has consistently tried to play its part in alleviating this hardship through schemes which identify those most in need.

Alinta contends that hardship is a broader issue than just energy which requires more direct action, not a piecemeal approach and that such funding is best channelled through Emergency Relief Agencies.

Where customers are on limited incomes and are conserving energy to save money, cost increases on the first step of the tariffs should be minimised.

Whilst price regulation is not perfect, it can perform a default function which ensures that the most vulnerable in society have an appropriate safety net to rely upon. Alinta supports the retention in the mid-term of price regulation.

**(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?**

Environmental expectations of customers mean that incentives to consume more through cheaper prices should be removed. This implies that cost increases should be directed to customers with higher consumption by immediately removing the discount that residential

customers receive for consuming large amounts of energy. Phasing in changes merely prolongs the period when customers are not faced with cost-reflective prices and encourages the inefficient use of gas.

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

There are no further issues at this stage which Alinta Sales considers require consideration.