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02 October 2007

Jason Banks  
A/Coordinator of Energy  
Office of Energy  
Gas Review Regulations Review  
Level 9 Governor Stirling Tower  
197 St Georges Terrace  
PERTH WA 6000

Dear Jason

**GAS TARIFF REGULATIONS REVIEW – ISSUES PAPER**

Thank you for giving Synergy the opportunity to comment on the *Review of the Energy Co-ordination (Gas Tariffs) Regulations 2000 Issues Paper*.

Please find to follow Synergy's response in relation to this Issues Paper.

Should you require any further information in relation to this, please contact me.

Yours faithfully

A handwritten signature in black ink, appearing to read "J. Mitchell", written in a cursive style.

**JAMES MITCHELL**  
**MANAGING DIRECTOR**

**Response to Review  
of the Energy Co-ordination  
(Gas Tariffs) Regulations 2000  
Issues Paper**

**October 2007**



## BACKGROUND

Since Full Retail Contestability (FRC) was achieved in retail gas in May 2004, all other gas retailers other than AlintaAGL and Synergy have exited the Western Australian gas market. Some of these retailers continue to service significant retail gas markets in the Eastern States. It is therefore reasonable to conclude either (or both) that:

- the WA gas market is simply not sufficiently commercially attractive to other retailers; and
- impediments or barriers to entry have prevented the arrival of new retail competitors into WA.

## SUMMARY OF GENERAL COMMENTS AND CONCLUSIONS

This paper concludes that there is a justification for tariff cap increases but that to avoid price shock, especially with respect to the residential segment a “glide path” approach should be taken toward “cost reflective tariffs”. The preceding comment is premised upon the establishment of a legitimate competitive environment active across all market segments in the region. Absent such an environment, AlintaAGL, despite FRC, remains a monopolist and in such circumstances tight regulatory control is not only reasonable and expected, but entirely justified to protect the interests of customers.

## RESPONSES TO THE ISSUES PAPER

### QUALIFICATION

Synergy's comments are restricted to retailers selling or contemplating selling gas within the reticulated natural gas system contained within the SWIS except where specifically otherwise noted.

#### **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?**

As of 1 July 2007, Synergy became the only “second tier” retailer to supply gas to customers using less than 1,000 GJ of gas per annum. Synergy is prevented from entering the residential and other small use customer market, due to a moratorium imposed by Government. Despite FRC in 2004, which permitted all retailers (other than Synergy) to supply gas to small use customers (including those consuming less than 180 GJ/annum), there has been no competing trading licences granted other than to Synergy within the SWIS.

While FRC was implemented to encourage and foster retail gas competition, Synergy is the only other competitor presently active in the market. Synergy believes that the lack of competition stems mainly from the structure and characteristics of the WA gas market including its commercial attractiveness. There are significant barriers that preclude prospective retailers entering the WA gas market (these are addressed in detail in item 4 herein).

Synergy has considered the residential market from the perspective of a new market entrant (having to secure gas at present price levels rather than rely upon historic long term commodity prices or contract rollovers) and has concluded that at current tariff levels, this segment is not profitable when burdened with the costs of advertising and promotion, establishing systems, regulatory and operational compliance accompanied by tariff discounting at rates necessary to create customer churn.

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

Technical systems theoretically capable of facilitating FRC remain largely untested so Synergy is unable to comment in this regard. Synergy is not aware of other barriers preventing customers switching to an alternative retailer, were any such retailer active within WA.

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

No alternative retailers exist in the residential market. Should an alternative retailer become active in this segment we see no obvious impediments to customers exercising choice, although there may be some technical constraints given that systems have not been subject to large scale customer churn (some ostensible capabilities remain untested in actual application).

For those customers that fall within the 180 GJ to 1 TJ tranche, a potential impediment to switching to an alternative retailer may be pre-existing contractual terms (price as well as arrangements associated with the network including tariff charges).

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

There are a number of significant impediments facing any potential new entrant into WA's retail gas market. Synergy believes these barriers must be addressed by Government in order to facilitate sustainable retail gas competition in WA. The State Government's initiatives in this regard should include a broader review of the functioning of the WA gas market. Specifically, these market entry barriers include:

- The lack of access to long term gas supply;
- The lack of access to economically viable gas - the incumbent gas retailer has access to cheap, secure long term gas supply, whereas new entrants will have to pay significantly higher gas commodity prices;
- Inefficient processes to gain access to pipeline and gate station capacity;
- The lack of a transparent spot market for short term gas supply and transport;
- The inability at present to create a broad product suite (for example packaging gas and electricity);
- Investment levels required in back office systems to support gas retailing and compliance with the market rules and industry codes;
- The low margin (limited headroom) which exists in the small use gas retail market, most especially in the residential segment;
- The incumbent retailer AlintaAGL effectively monopolises the market; and
- The existence of the Synergy moratorium.

Possible methods of resolving these barriers are discussed below.

**a. The lack of access to long term gas supply**

The availability of gas commodity supply (at the production stage) is currently constrained. Domestic Gas "reservations" from the North West Shelf Joint Venture are fully contracted by current gas participants and there is very limited quantities of domestic gas available to contract.

Synergy acknowledges that the Government is currently reviewing this situation and that it has responded with a range of policy initiatives. It is not presently believed that significant impact will be discernable until at least 2010.

**b. The lack of access to economically viable gas**

As a result of its smaller initial customer base, any new entrant to the retail gas market will require access to significantly smaller parcels of gas commodity than an established gas retailer such as AlintaAGL. The current commercial environment relating to gas availability suggests difficulty in securing any supplies of gas for several years. Presuming nevertheless that gas commodity does become available, sourcing smaller gas supply volumes at comparable and competitive costs contrasted against an established gas retailer (that has a significantly larger gas trading portfolio, purchasing power, and pre-existing contracts with gas producers) will be difficult.

This issue can be addressed to some extent by the development of a competitive gas supply market via the dissolution of joint marketing arrangements currently in place as well as encouraging investment in discovery of gas fields which would have a domestic gas supply focus. Development of a viable "spot" market in gas would also be of value in that it would provide both a risk hedge against balancing and other costs and a commodity "price signal".

It is worth noting for example that Woodside Petroleum Ltd's Managing Director has publicly indicated that Woodside would be prepared to make "cheap gas" available to residential (but not industrial) customers in WA<sup>1</sup>. It is not presently known how and under what circumstances such low cost gas might be sustained, however.

**c. Inefficient processes to gain access to pipeline and gate station capacity**

Transmission capacity on the DBNGP is currently fully contracted. The lack of pipeline capacity is further exacerbated in that the pipeline owner only commits to additional capacity augmentation on a fully booked capacity basis. This means, any new market entrant must contract for a high level of "take or pay" gas capacity for a term of fifteen years prior to construction of additional pipeline capacity. Even then, this new capacity is unlikely to become available for at least two years after the commitment is made.

New retail gas entrants are primarily seeking to acquire existing retail gas customers (already being supplied by the incumbent gas retailer) rather than new loads. This switching or churn suggests that new pipeline capacity is not technically required to support retail competition as existing pipeline capacity is obviously sufficient to service these customers.

Entering into long term gas transport arrangements is risky for any new or "would-be" market entrant that requires access to small, flexible, potentially rapidly changing levels of pipeline capacity. Pipeline capacity that fits this profile is nevertheless vital to increase competition in what is an inherently load variable customer segment.

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<sup>1</sup> Comments made by Don Volte at the 2007 Woodside Annual General Meeting

Possible solutions for access to pipeline capacity include:

- Migration from the current contract carriage framework to a market carriage<sup>2</sup> system:
  - for the entire transmission pipeline; or
  - for a portion of the transmission pipeline (5% - 15% capacity say 50 TJ/day), with capacity levels tailored to assist new retail gas entrants; or
- Introduction of a market carriage framework for all new capacity augmentations; and
- Less stringent peaking arrangements for gas transport intended for small use customers.

Currently, most gate station capacity is fully committed to established gas market players. This prevents new entrants from transferring gas from the transmission system to the distribution system which presents a further barrier to retail competition.

Access to gate station capacity for new retail gas entrants entail similar issues to those described above with respect to transmission pipeline capacity. As such, possible solutions for access to gate station capacity would include similar solutions based on a market carriage approach, or automatic capacity transfer for switching customers. These solutions need to apply especially to gate stations serving REMCo operated retail networks.

#### **d. The lack of a transparent spot market for short term gas supply and transport**

Due to the current capacity constrained nature of the gas supply and transport markets, new retail entrants need the flexibility to engage in spot trades or similar arrangements to manage their short term positions. These markets are extremely immature in WA.

Synergy notes that the Government is currently engaging stakeholders via Economic Regulation Authority's (ERA) review of the REMCo Gas Retail Market Scheme. Synergy believes that an effective outcome of that process would (amongst other things) be the development of a functional and reliable spot market and related pricing information systems and delivery mechanisms (both contractual frameworks and physical infrastructure).

#### **e. The inability at present to create a broad product suite (for example packaging gas and electricity)**

At present, new retail gas entrants are constrained in their ability to create innovative products to retail to potential customers, for example:

- The lack of an effective spot market for gas does not allow retailers to place a value on peak and off peak gas use and therefore retailers are unable to create products around this;
- The lack of FRC in the electricity market precludes energy retailers from creating products which package both gas and electricity to small use customers; and
- Different regulatory arrangements that apply to gas and electricity small use supply.

Synergy notes that another desirable outcome stemming from the ERA's review of the REMCo Gas Retail Market Scheme could lead to regulatory and market changes allowing innovative new gas retail product offerings.

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<sup>2</sup> 'Market carriage' is understood to be transportation capacity that would automatically convert in the event of a customer transfer in a similar fashion to how transmission capacity functions within the electricity network.

**f. Investment levels required in back office systems to support gas retailing and compliance with the market rules and industry codes**

New retail gas market entrants may face significant investment in developing systems (or adapting existing systems in the case of Eastern States utilities) and resources to both compete for and service residential and small business gas customers. Energy retail systems are complex, costly and take significant time to implement and 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. Issues surrounding these systems include:

- High development costs associated with electricity and/or gas customer information and billing systems;
- Long lead times required to design and implement billing and other retail systems (typically 24 to 36 months);
- Regulatory compliance and related matters to be addressed by these systems (gas and electricity retail market codes and rules, licensing, transfer market rules, metering codes, and reliability codes); and
- Operational matters addressed by these systems (pricing, end to end sales process, wholesale and retail market management, service order capability and industry interfaces).

In particular, advance notification of the timing of significant market changes is needed to ensure effective preparation by all participants. Amongst potential new entrants into the small use gas market in WA is Synergy once it has completed its “systems journey”. Synergy does not presently expect to have the systems capability to fully participate at the residential gas retail level before 2009/2010.

**g. The low perceived margin in the small use gas retail market**

The lack of interest by prospective energy retailers in the small use gas retail market can be attributed to low perceived retail margins. Indeed Synergy's calculations currently show negative margins are likely for any new entrant choosing to compete in the residential gas market. This is based on assumptions including:

- The current gas commodity pricing (\$4.00 to \$6.00 /GJ at the plant gate);
- The nature of gas commodity, pipeline and network costs (high fixed cost percentage coupled with ‘take or pay’ style contracts);
- The expectation that an entrant would need to price gas at levels most probably at least 10% lower than the current tariffs in order to incentivise customers to switch;
- Significant initial investment in back office set up costs, regulatory compliance costs, promotional and advertising expenses.

Only discounts from gazetted tariffs (or alternative competitive offers) have been successful at securing customer churn from incumbent energy retailers in other jurisdictions and it is likely that this trend will prove equally true in WA. In this regard, if prospective retailers are to find the small use gas market (especially residential segment) profitable, caps on tariffs will need be increased enough that a commercially attractive retail margin can be achieved after absorbing the additional costs involved in customer acquisition and allowing for the revenue reduction attributable to tariff discounting.

Over time, increased competition would encourage efficiency in the market. Synergy is of the view that sufficient head room above the current regulated tariff is required before “would-be” retail competitors will invest the risk capital, and time and effort to establish a position in the market, but that this must be done in a controlled fashion (i.e. glide path) to alleviate to the maximum degree possible the effects of price shock and dislocation.

Once tariffs are “cost reflective” Synergy recommends that tariffs thereafter be subject to independent review. Standardisation of market rules across Australia would also make it easier for Eastern States retailers to enter the WA market. Economies of scale and reduced requirements to adhere to new processes would reduce the cost to serve for such a retailer potentially further improving margins and competitive position.

**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?**

All new market entrant retailers (and to some degree even the incumbents) need to address and overcome the barriers described above.

Synergy has an additional limitation placed on it in the form of a government imposed moratorium preventing it from serving customers consuming less than 180 GJ/annum of gas. It is important to note that merely revoking the moratorium without addressing critical market entry barriers and increasing tariff caps from present levels will result in minor (if any) impact on the level of gas retail competition in WA.

**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 scope for product differentiation for AlintaAGL and Synergy in relation to gas for small use customers is minimal. The two major energy retailers active in the SWIS have both positioned themselves as dual fuel (gas and electricity) retailers.

From the perspective of new entrant gas retailer, it may be even more difficult to establish a market niche or differentiate its product and service offerings from the existing players. This ability is further compounded by prescriptive regulation.

In addition to the above, new entrants may lack (or have to adapt) the following generally possessed by incumbents:

- Intelligent billing systems and back office systems;
- Customer service functions;
- IT systems to interact with other market participants;
- Established customer base;
- Brand identification;
- Marketing (including customer acquisition) experience; and
- Have a portfolio of energy products.

**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**

The small use customer market generally perceives gas to be a more convenient, efficient and environmentally friendly fuel than coal, wood and many other alternative energy sources. Gas is also perceived, in most instances to be more economical than electricity.

Gas is often also considered to be more reliable (fewer supply interruptions) when compared to electricity especially by the small use customer segment.

**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?**

Synergy perceives these impacts to be negligible provided the distribution network operator is able to pass on additional costs associated with churn (additional meter reading, data input and processing etc). Synergy's understanding is that mechanisms to allow the "pass through" of such costs already exist.

**9. Are current retail prices to small use customers reflective of supply and retail costs for the respective gas distribution license 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.**

Synergy deems small business tariffs to be sufficient to cover supply and retail costs at this point in time<sup>3</sup>, however this will change should the commodity price of gas continue to increase at its current rate.

Synergy's calculations on residential tariffs show that due to the high costs involved in implementing competition in the residential market, tariff caps will need to be increased significantly to create enough headroom for competition. Of most significance are the standing fees which cover only a small portion of the cost incurred to serve a customer and cover the standing network charges which must be paid irrespective of a customer's annual take. A new retailer would incur losses in this market segment assuming; gas supply at \$4.00 at the plant gate (most probably below any presently achievable contract today), an \$80 annual cost of serve<sup>4</sup>, and offering a 10% discount to existing tariffs in order to attract customers.

For reasons earlier noted Synergy believes that restructuring tariffs and increasing the cap so as to raise revenues by perhaps as much as 20% will be required to make the small use residential market segment attractive to new entrant retailers. Most important are changes to the "structure" of the tariff. A significant increase in the standing charge is required to alleviate the propensity to "cherry pick" customers based on high volume use and to permit retailers to recover costs of servicing small volume customers.

To minimize the impact of price shock, and other dislocation affects, Synergy recommends that this be carried out over a period of about 4 years with a predictable glide path (target) after which tariffs should be subject to independent review. This will provide notice both to potential future market entrants and to customers respecting anticipated future pricing.

**10. What is considered to be an appropriate retail margin for retailing natural gas in Western, Australia and is this different for LPG?**

Synergy perceives an appropriate retail margin to be at least 5%. LPG margins may need to be even greater as capital may need to be committed to gas storage vessels, truck fleets etc which are not required for retailers serving customers within a reticulated system.

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<sup>3</sup> Should plant gate commodity prices increase beyond \$6.00/GJ, which now certainly seems possible, even this assumption may be challenged.

<sup>4</sup> While AlintaAGL appears to have a cost to serve of only about \$55 per customer presently this cost would be expected to increase perhaps by as much as 20% should significant customer churn occur. Synergy's calculations are that a new retailer would likely incur a gas cost to serve of at least \$75 (lean and efficient operation) were they to establish a viable retail gas business in WA.

**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?**

While load factor and seasonality are somewhat different for these customer classes, there is no compelling cost justified basis for substantially differing tariff structures.

**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 area? Will impacts change over time.**

Should the existing tariff cap adjustment mechanism continue into the future the small business market (above very small volumes) will likely remain attractive barring further commodity gas price increases. The residential market is significantly different. While the incumbent retailer enjoys comfortable margins based upon historic gas contracts from serving residential customers (perhaps in the order of 15% on average) new entrants could not profitably serve this segment after covering the additional costs involved in customer acquisition and offering discounts necessary to create churn.

In both segments, however, the standing portion of the tariff needs to be increased to permit a retailer to cover fixed infrastructure related costs incurred in servicing a customer irrespective of commodity consumption levels.

Assuming an \$80 per annum retail cost to serve and standing network charge of \$26 (net of GST) a more appropriate retail standing charge would be perhaps as much as three times the present level for small use customers.

While small business customers remain attractive from a commercial perspective for new entrant retailers, customer numbers are too small to create enough incentive to enter into this market. Increasing tariff caps to levels required to entice interest in WA's retail gas markets, absent policy changes addressing the other impediments however, is unlikely to attract competitors to this region.

Synergy considers if appropriate for Government to consider an alternative price escalator opposed to CPI given the material change in gas (industry cost structure in recent years).

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

While price regulation may provide a positive price outcome for customers in the short to medium term, present headroom levels do not permit competitive entry of new retailers. This situation, unrectified, would inhibit the potential benefits of competition and choice in the longer term.

Customers are, however, clearly interested in paying the lowest amount possible for necessary services such as energy. While most customers will ultimately agree that tariffs must eventually be cost reflective they will not respond positively to price increases. For this reason Synergy recommends cost reflective pricing as an ideal be approached progressively through a predictable "glide path" intended to mitigate the negative impacts attributable to price shock.

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

Synergy believes that the long term gas retail prices will need to track supply costs to ensure that the current levels of supply security are maintained and are therefore likely to trend upwards. In any event, once tariffs are cost reflective they should be subject thereafter to independent review to insure that they remain cost reflective going forward.

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

The key criteria that a customer uses to evaluate energy products are price, product characteristics and service from the retailer. The introduction of effective competition in the small use gas market segment would incentivise retailers (both incumbent and new) to package products/services in new and novel ways to best deliver value to customers.

Section 4 above describes and discusses a range of barriers that a new market entrant faces (in addition to tariff levels, which are presently not cost reflective). Barriers need to be overcome, and tariffs restructured if sustainable competition is to be achieved.

**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)?**

Any proposed increase in tariff caps beyond CPI will need to be carefully monitored to minimise the impact on customers who have a reduced ability to absorb large utility cost increases.

The government may need to consider additional policy initiatives for handling special hardship situations and managing the potential negative social welfare ramifications which could result. This should be done outside of the business of retail energy sales via the implementation of suitable programs to assist low income earners or economic hardship cases unable to pay higher tariffs.

**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?**

Given the increases in gas and oil prices world wide, customers undoubtedly already expect to pay higher prices for gas.

Synergy and most other "would-be" retailers will require two to three years of preparation before being in a position to compete to any significant manner in the residential market; therefore, a three to five year "glide path" is the obvious and appropriate regulatory response.

Increasing tariff caps progressively during the next three to five years would provide notice to, and time for future retail entrants to develop the systems necessary to enter this market while preventing customers from facing large "one-off" price increase.

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

No other matters of significance have been identified at this point.