



Government of **Western Australia**
Office of **Energy**

GAS TARIFFS REVIEW

Interim Report



Office of Energy Report to the Minister for Energy

June 2009

GAS TARIFFS REVIEW – INTERIM REPORT

KEY MESSAGES

- The Office of Energy is undertaking a review of regulated gas tariffs, after a previous statutory review of the *Energy Coordination (Gas Tariffs) Regulations 2000* (Tariff Regulations) found that:
 - continued tariff regulation was required; and
 - the tariff caps were below costs.These findings were tabled in Parliament in November 2007.
- This Interim Report recommends a further interim adjustment in the retail gas tariff caps to take effect from 1 July 2009. This adjustment is over and above the increase to the tariff caps that took effect on 1 July 2008. A further more detailed review will be completed during 2009/10.
- The Tariff Regulations currently provide for the tariff caps to increase annually in line with the Consumer Price Index (CPI).
 - Increases above CPI for most tariff classes are again required for 2009/10 to continue to assist in moving the tariff caps towards cost-reflective levels, with cost increases mainly due to the significant gas commodity price increases. These higher gas costs are likely to be faced by new entrant retailers and retailers that are renegotiating contracts.
- A significant proportion of business customers consume more than the Gas Market Moratorium threshold of 0.18 terajoules of gas per annum. Consumers above this threshold can choose between two retailers – Alinta and Synergy, so they will not necessarily be impacted by any tariff cap increases.
- These tariff cap increases will help to ensure efficient operation of the gas market and contribute to maintaining viability of gas retailers. Further tariff cap increases may be necessary, pending the more detailed review to be completed by the Office of Energy. This detailed review has been delayed to allow for consideration of a number of factors impacting on the determination of appropriate gas commodity costs, including the outcomes of the current arbitration process between Alinta and North West Shelf Gas Pty Ltd. Future gas commodity costs are difficult to forecast as there is no forward market and prices are set under confidential long-term contracts.
- The tariff cap increases include an allowance for partial recovery of the additional costs incurred by Alinta in association with the Varanus Island gas disruption in the areas covered by the Tariff Regulations serviced by supply from this processing facility (i.e. excluding Albany).

INTERIM RECOMMENDATION

The Office of Energy recommends that the tariff caps specified under the *Energy Coordination (Gas Tariffs) Regulations 2000* (Tariff Regulations) should be adjusted from 1 July 2009 as per Table 1.¹

Table 1 – Recommended Interim Gas Tariff Cap Increases		
Tariff Cap (GST Inclusive)	Current Tariff Cap (from 1 July 2008)	Revised Tariff Cap (from 1 July 2009)
Mid-West/South-West Area – Residential Customers		
Supply Charge (cents/day)	12.12	14.54
First 12 units/day (cents/unit)	8.15	10.04
Over 12 units/day (cents/unit)	7.33	9.06
Mid-West/South-West Area – Non-Residential Customers		
Supply Charge (cents/day)	12.12	12.71
First 100 units/day (cents/unit)	8.51	9.19
Over 100 units/day (cents/unit)	6.77	7.36
Kalgoorlie-Boulder Area – Residential Customers		
Supply Charge (cents/day)	27.25	32.70
Energy Charge (cents/unit)	7.56	9.33
Kalgoorlie-Boulder Area – Non-Residential Customers		
Supply Charge (cents/day)	27.25	32.70
Energy Charge (cents/unit)	6.74	8.35
Albany Area – Residential and Non-Residential Customers		
Supply Charge (cents/day)	12.73	15.28
Extra Dwellings (cents/day)	6.35	7.62
Energy Charge (cents/unit)	9.26	11.11

¹ A unit of gas is equivalent to 3.6 megajoules (MJ).

Table 2 shows the percentage and dollar value increases to customers' bills that would result from the recommended tariff increases for consumers in each area (Mid-West/South-West, Kalgoorlie-Boulder, and Albany) and customer class (residential and non-residential), with consumption levels at the 25th, 50th, and 75th quartiles.²

Table 2 – Impact of Tariff Cap Increases on Customers (based on annual bills)									
Quartiles									
	25%			50%			75%		
	Cost increase	Gas Disruption Costs	Total	Cost increase	Gas Disruption Costs	Total	Cost increase	Gas Disruption Costs	Total
Mid-West/South-West Residential	\$47	\$6	\$53	\$78	\$11	\$89	\$118	\$18	\$136
	20.0%	2.2%	22.6%	20.0%	2.4%	22.9%	20.0%	2.6%	23.1%
Mid-West/South-West Non-Residential	\$15	\$8	\$23	\$78	\$47	\$126	\$243	\$164	\$407
	4.9%	2.5%	7.5%	4.9%	2.8%	7.9%	4.9%	3.2%	8.2%
Kalgoorlie-Boulder Residential	\$54	\$6	\$60	\$86	\$11	\$98	\$116	\$17	\$133
	20.0%	1.8%	22.2%	20.0%	2.2%	22.6%	20.0%	2.4%	22.8%
Kalgoorlie-Boulder Non-Residential	\$59	\$8	\$67	\$109	\$17	\$127	\$298	\$54	\$352
	20.0%	2.1%	22.6%	20.0%	2.6%	23.2%	20.0%	3.0%	23.6%
Albany Residential and Non-Residential	\$46	-	\$46	\$78	-	\$78	\$114	-	\$114
	20.0%		20.0%	20.0%		20.0%	20.0%		20.0%

² Quartiles divide a set of data into four equal parts. That is:

- A customer that has consumption at the 25th quartile consumes more gas than 25% of the customers, and less than 75% of the customers.
- A customer that has consumption at the 50th quartile consumes more gas than 50% of the customers, and less than 50% of the customers. The 50th consumption quartile is representative of the median level of consumption in each customer class.
- A customer that has consumption at the 75th quartile consumes more gas than 75% of the customers, and less than 25% of the customers.

1. BACKGROUND

1.1 Gas Tariff Regulations and Alinta's Tariffs

The *Energy Coordination (Gas Tariffs) Regulations 2000* (Tariff Regulations) apply to small use customers³ in the Mid-West/South-West area (including Geraldton and the Perth Metropolitan area), the Kalgoorlie-Boulder area, and the Albany area (Tariff Areas). The Tariff Regulations set price caps for two classes of small use customers – residential and non-residential.

For the Mid-West/South West area, Alinta's residential tariffs have a supply charge (cents per day) and consumption charges (cents per unit) that are structured into three steps – for the first 12 units per day, the next 24 units per day, and over 36 units per day; with the price per unit decreasing as the level of consumption increases. This is referred to as a “declining block tariff structure”. The Tariff Regulations limit annual tariff cap increases for the supply charge and for the first two steps of the consumption charge to the Consumer Price Index (CPI), and for the third step of the consumption charge to CPI+2%. With the interim tariff adjustment that took effect on 1 July 2008 the consumption charges for the second and third blocks were set at equivalent levels.

For the Kalgoorlie-Boulder area, Alinta's tariffs have a supply charge (cents per day) and single consumption charge (cents per unit) irrespective of the level of consumption. This is referred to as a “flat tariff structure”. The Tariff Regulations limit annual tariff cap increases for the supply charge and for the consumption charge to CPI.

For the Albany area, Alinta's tariffs have a supply charge (cents per day) and consumption charges (cents per unit) that were previously structured into two steps – for the first 100 units per day, and over 100 units per day, with similar arrangements also applying to non-residential customers in the Mid-West/South-West area. The Albany tariffs now have a flat consumption charge, regardless of the level of gas usage. The Tariff Regulations limit annual tariff cap increases for the supply charge and the consumption charges to CPI.

Allowing the tariff caps to increase annually in line with CPI effectively means that the tariff caps would remain constant in real terms.

1.2 Tariffs Regulations Review

The Office of Energy completed a review of the Tariff Regulations for the former Minister for Energy (Minister) in October 2007.⁴

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 Tariff Areas. These cost pressures may impact on the viability of gas retailers and may act as a

³ A small use customer is a customer that consumes less than 1 terajoule of gas per annum.

⁴ The review was completed in accordance with the requirement under Clause 8 of the Tariff Regulations.

barrier to entry in the gas retail market if the tariff caps are maintained at their current level.

The Tariff Regulations Review Report recommended that a more detailed investigation should be undertaken regarding the level and structure of the tariff caps; and that 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. This recommendation is the basis for the Gas Tariffs Review (the Review).

The Tariff Regulations Review Report was completed in October 2007 and tabled in Parliament by the former Minister for Energy on 21 November 2007, in accordance with the requirements of Clause 8(3) of the Tariff Regulations.

1.3 Gas Tariff Review

The Review is to assess the retail gas tariff cap arrangements in Western Australia, as recommended by the Tariff Regulations Review. The Office of Energy is responsible for completing the Review and preparing recommendations for consideration by the Minister.

The Review will consider the appropriate structure and level of the tariff caps for small use customers in the Tariff Areas. The Review will focus on the cost reflectivity of the tariff caps; the level of tariff caps necessary to promote competition for each customer class; and incentives for gas consumers to negotiate alternative supply arrangements.

The Review recommendations will consider:

- the timing for any necessary changes to the tariff caps, including the transition process in this regard; and
- the appropriate adjustment mechanism and arrangements for regular adjustments of the tariff caps in the future.

As part of the Review process, an Issues Paper was circulated for public comment in February 2008, and responses were received in March 2008. The non-confidential details of these submissions are posted on the Office of Energy website (www.energy.wa.gov.au).

Finalisation of a Draft Review Recommendations Report (Recommendations Report) addressing the terms of reference for the Review has been delayed to allow for consideration of a number of factors impacting on the determination of appropriate gas commodity costs, including the outcomes of the current arbitration process between Alinta and North West Shelf Gas Pty Ltd.

The Recommendations Report will include a more detailed set of recommendations and will be released for public comment prior to final recommendations being presented to Government. A Final Recommendations Report will be subsequently released detailing the finalised Review Recommendations, including any requirement for further tariff cap adjustments.

It is noted that until regulated retail tariffs are set at levels that reflect costs faced by new entrants, it is unlikely that new retailers will enter the retail gas market in Western Australia, which means that consumers will be unable to realise the benefits that competition and choice have delivered in other parts of Australia. These benefits include support for the development

of innovative products, providing choice for customers through a range of alternative price and service offerings and ultimately maintaining downwards pressure on prices, while encouraging the delivery of a higher quality of services to consumers.

Regulated tariff caps at cost reflective levels would also provide for the commercial viability of industry participants and support ongoing investment in the Western Australian gas industry.

1.4 2008 Interim Report

The 2008 Interim Report recommended an initial interim adjustment of the retail gas tariff caps which took effect from 1 July 2008 to provide for the sustainable operation of the small use gas retail market within the Tariff Areas. This increase was in place of, rather than in addition to, the regular adjustment of the tariff caps specified in the Tariff Regulations, and was implemented to move the tariff caps towards cost-reflective levels.

The interim tariff cap adjustments were proposed by Alinta and verified by the Office of Energy and Frontier Economics. The verification process undertaken by the Office of Energy and Frontier Economics is detailed in Section 4 of the 2008 Interim Report (available at www.energy.wa.gov.au).

1.5 2009 Interim Tariff Cap Increases

The interim tariff cap increases that are recommended to take effect from 1 July 2009 are presented in Table 1. These tariff cap increases are instead of the CPI-based increase that would normally occur in 2009/10 and continue to move the tariff caps towards cost-reflective levels. For the median customer the tariff cap increases are about 18% to 21% on top of what would have occurred under the CPI-based increase (excluding Mid-West/South-West small business customers).⁵

2. THE WESTERN AUSTRALIAN RETAIL GAS MARKET FOR SMALL CONSUMERS

Full retail contestability (FRC) in gas in Western Australia was introduced in May 2004, meaning that any gas retailer can enter the Western Australian market. Despite the introduction of gas FRC, there is still only limited competition in the Western Australian gas retail market.

An exception to gas FRC is that Synergy is restricted by the Gas Market Moratorium (the Moratorium) to only sell gas to customers that consume more than 0.18 terajoules (TJ) per annum.

The Moratorium was put in place because Synergy would have a competitive advantage over other gas retailers in the absence of electricity FRC, as Synergy would be able to apply economies of scope in retailing both electricity and gas. The Moratorium threshold was

⁵ The increase for the non-residential tariff caps in the Mid-West/South-West area represents an increase of about 5.4% on top of what would occur under the standard CPI adjustment. The increase for residential gas consumers in the Mid-West/South-West area will be about 20.4% on top of the CPI adjustment.

reduced to 0.18 TJ per annum on 1 July 2007 to give greater choice to energy consumers in Western Australia, and to provide parity on an energy equivalency basis with the current electricity contestability threshold of 50 megawatt hours (MWh) per annum.⁶

As a result, there are now two gas suppliers in the Mid-West/South-West area servicing customers that consume between 0.18 TJ per annum and 1 TJ per annum – Alinta and Synergy. It should also be noted that at least 50% of this segment's gas consumption in the Mid-West/South-West area is now sold under contract rather than under the regulated tariff.

Alinta is the sole supplier to customers in the Kalgoorlie-Boulder and Albany areas, and in the Mid-West/South-West area for customers with gas consumption less than 0.18 TJ per annum.

3. INTERIM FINDINGS

Information collected by the Office of Energy as part of the Review process has highlighted the need for a further interim adjustment of the tariff caps from the levels currently specified in the Tariff Regulations due to cost pressures in supplying gas to small use consumers. This adjustment to the tariff caps is required to continue to provide for the sustainable operation of the small use gas retail market within the Tariff Areas.

3.1 Interim Tariff Cap Increases

The interim tariff cap increases are presented in Table 1. These tariff cap increases are instead of the CPI-based increase that would otherwise occur in 2009/10.

The interim tariff cap adjustments were proposed by Alinta and verified by the Office of Energy and ACIL Tasman. The verification process undertaken by the Office of Energy and ACIL Tasman is detailed in Section 4.

The Office of Energy is still to complete its more detailed Gas Tariffs Review and is not bound by any parameters used in this interim process.

It is also noted that the proposed 2009/10 tariff adjustment also includes provision for partial recovery of costs incurred by Alinta in association with the Varanus Island gas disruption in the Tariff Areas serviced by supply from this processing facility (i.e. excluding Albany). It should be noted that it is intended that the allowance for the recovery of these costs will be limited to the 2009/10 period. Further discussion of the methodology for this cost allowance is in section 4.6.

Table 2 (page 3) shows the percentage and dollar value increases to customers' bills that would result from the recommended tariff cap increases for consumers in each of the Tariff Areas and customer classes (residential and non-residential), with consumption levels at the 25th, 50th, and 75th quartiles. It is noted that these impacts are presented on an annualised basis and that the changes to winter gas bills will be higher in dollar terms due to increased

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

consumption, although this impact will be moderated on an annual basis with reduced consumption in other periods of the year.

4. VERIFICATION PROCESS

The Office of Energy and ACIL Tasman have undertaken a comparative cost stack analysis to ensure that the tariff cap increases proposed by Alinta are reasonable.

The general method for constructing a tariff is by separately considering each cost that a retailer faces, plus an appropriate retail net margin, and adding these costs to derive the tariff charge to be applied. This is more commonly known as a “cost stack” analysis.

Alinta provided the Office of Energy with cost stack analysis to support the proposed adjustments to the tariff caps. The Office of Energy and ACIL Tasman have verified the calculations and the parameters that underlie the various components in these cost stacks and compared these figures against the proposed tariff increases. The following cost components were incorporated into the cost stack analysis:

- transmission costs (including imbalances/overruns);
- distribution costs;
- retail operating costs;
- retail net margin; and
- gas commodity cost.

In addition to these costs, an allowance was also made to provide for recovery of a portion of the additional unforeseen costs incurred by Alinta in maintaining the supply of gas to tariff customers during the Varanus Island supply disruption. These customers assisted by making voluntary reductions but supplies were maintained. This cost allowance is further discussed in section 4.6.

It should be noted that costs from the proposed Carbon Pollution Reduction Scheme (CPRS) were not considered under the cost stack analysis because the cost stacks relate to a proposed adjustment to the tariff caps for the 2009/10 period only. Whilst the Office of Energy intends to address CPRS costs in the more detailed analysis for the Review, estimated CPRS impacts have been prepared to illustrate the potential requirement for future increases in the tariff caps to cover these costs. This analysis is further detailed in section 4.7.

4.1 Transmission Costs

Gas is transported from the production fields to distribution areas via transmission pipelines. There are two main pipelines in Western Australia:

- the Dampier to Bunbury Natural Gas Pipeline (DBNGP), which connects the North West Shelf with the Mid-West/South-West area; and
- the Goldfields Gas Pipeline (GGP), which connects the North West Shelf with the Kalgoorlie-Boulder area.

While the DBNGP is a covered pipeline under the Gas Access Code,⁷ and there is an Access Arrangement in place for the DBNGP, current applicable charges for the DBNGP are stipulated under the terms and conditions of the DBNGP Standard Shipper Contract (Shipper Contract). Applicable charges will be determined under the Shipper Contract until 2016, when they are then expected to return to regulated rates.

Transmission costs for the Mid-West/South-West were based on the applicable rates in the Shipper Contract, and for the Kalgoorlie-Boulder area on the GGP Access Arrangement. These transmission costs are regulated by the Economic Regulation Authority.

The Shipper Contract and the GGP Access Arrangement provide for transmission costs to be escalated in accordance with annual CPI movements to each September quarter applied to the next calendar year.

Given that the cost stack analysis applied to the financial year 2009/10, for the cost-stack analysis for Mid-West/South-West business customers 2009 rates were used for the 1 July to 31 December 2009 period, and the 2009 rates were escalated by a forecast CPI applied to the period from 1 January to 30 June 2010. The Shipper Contract also included an additional charge to reflect the expected expenses for cost contributions associated with the Stage 5 expansion of the Dampier to Bunbury Pipeline (expected in the last quarter of 2009/10). This cost was also included in the cost-stack analysis.

In review of the calculation of the transmission costs applicable to gas supplied to non-residential customers in the Mid-West/South-West region, ACIL Tasman verified the transmission charges through a copy of a letter from DBP advising tariff adjustments for the 2009 calendar year, and also verified the calculations and CPI rates applied for an estimate of transmission charges for the first half of the 2010 calendar year.

In review of the transmission costs applicable to gas supplied to residential customers in the Mid-West/South region and all tariff customers in the Kalgoorlie-Boulder region (based on costs under the GGP Access Agreement), ACIL Tasman verified the CPI escalation for 2009/10 of charges calculated as part of the 2008/09 cost stack analysis (which were verified by Frontier Economics as part of the 2008 Interim Reset).

The transmission of LPG to the Albany area is reliant on road transport from Kwinana to feed the reticulated system. Assumptions relating to these transportation costs have been included with the cost of delivered LPG based on Alinta's actual costs, which were independently verified by Frontier Economics in 2008/09 through the review of invoices for the supply of LPG to the Albany area. For the purposes of the 2009/10 cost stack analysis these costs were escalated by CPI and ACIL Tasman has verified these calculations.

An additional cost component for the transmission of gas on the DBNGP is the recent addition of imbalance/overrun charges. Shippers on the DBNGP are required to maintain a balance between the gas that they inject onto the pipeline and take off of the pipeline, and are required to pay imbalance and overrun charges if they cannot maintain the balance within certain tolerances. As shippers on the DBNGP, retailers will not be able to maintain a perfect balance

⁷ The *Gas Pipelines Access (Western Australia) Act 1998* implemented the National Third Party Access Code for Natural Gas Pipeline Systems.

between pipeline injections and offtake, as the amount of their gas offtake will be dependent on their customers' actual consumption, which can be highly variable.

The imbalance/overrun charges included in the cost stacks were based on Alinta's actual imbalance/overrun costs. The calculation of these charges was verified by Frontier Economics for the 2008/09 tariff adjustment based on data provided by Alinta. Alinta indicated that this cost item did not require adjustment in the 2009/10 cost stack analysis.

4.2 Distribution Costs

Gas that is transported to customers in the Tariff Areas must then be transported from the outlet of the transmission pipelines to homes and businesses via distribution systems.

The distribution systems for the Tariff Areas are owned by WA Gas Networks, are operated by WestNet Energy, and are regulated by the Economic Regulation Authority.

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.

Distribution costs for all three Tariff Areas are based on the regulated rates determined by the Economic Regulation Authority. As for transmission charges, distribution network cost increases are limited to September to September CPI movements.

In review of the distribution costs applicable to gas supplied to tariff customers in all three Tariff Areas, ACIL Tasman verified the CPI escalation for 2009/10 of charges calculated as part of the 2008/09 cost stack analysis (which were verified by Frontier Economics as part of the 2008 Interim Reset).

4.3 Retail Operating Costs

Retail operating costs are the costs that retailers incur in acquiring and serving their customers, and include costs for billing and revenue collection systems, call centres, and related corporate functions. Factors that influence the cost to serve include customer location, regulatory obligations, other market administration costs (such as the fees associated with operation of the Retail Energy Market Company, Energy Safety, etc), and labour costs.

In considering retail operating costs, determinations in other jurisdictions can be viewed as benchmarks. However, issues specific to Western Australia need to be taken into account in estimating appropriate retail operating costs for incumbent and new entrant retailers in the State. In addition, retail operating costs for retailing gas or electricity should not differ to a great degree, given that the operating costs are independent of the type of fuel retailed.

The Electricity Retail Market Review benchmarked retail operating costs to be \$75 per customer in 2007/08 dollars for residential customers serviced by an efficient new entrant electricity retailer. It noted that other jurisdictions have made an additional allowance for FRC costs ranging from \$5 per customer. For the cost stack analysis in 2009/10, a figure of \$80 per customer was used for all customer classes in the Tariff Areas, with the exception of the non-

residential customers in the Mid-West/South-West area, and escalated by the appropriate CPI amount (to the mid-point of 2009/10) to bring it to a nominal figure in 2009/10 dollars.

For the non-residential customers in the Mid-West/South-West area, the Electricity Retail Market Review benchmark pointed to retail operating costs of \$150 per customer in 2007/08 dollars, recognising the different mix of small and large non-residential gas customers in the Mid-West/South-West area relative to businesses on contestable electricity tariffs. For the cost stack analysis in 2009/10, the benchmark retail operating cost for non-residential customers was escalated by the appropriate CPI amount (to the mid-point of 2009/10) to bring it to a nominal figure in 2009/10 dollars.

These higher retail operating costs for non-residential customers reflect the need for a larger cost allowance to cover the costs of increased customer service activity needed to manage these types of customers. Note that, although the retail operating costs are high on a per customer basis, given the higher consumption of non-residential customers, the cost per unit is actually lower than for the residential customers.

ACIL Tasman verified the calculations used for retail operating costs described above.

The Office of Energy will undertake a full review of the appropriate retail operating cost for all customer class in all Tariff Areas as part of its more detailed Gas Tariffs Review.

4.4 Retail Net Margin

The retail net margin is added to the cost stack to allow retailers to manage risks associated with servicing customers, and to allow retailers to make a profit on retailing gas. In its response to the Review Issues Paper, Alinta 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 also suggested that there is a case for a higher retail margin (at least 6%) 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 to the Review Issues Paper suggested that an appropriate retail margin would be at least 5%.

The 2008/09 cost stack analysis included a 5% net retail margin assumption for all customer classes in all three Tariff Areas. This assumption has been maintained in the 2009/10 cost stack analysis and ACIL Tasman has verified these calculations.

A 5% net margin is consistent with the margin accepted for contestable electricity tariffs, as determined under the Electricity Retail Market Review. The Electricity Retail Market Review utilised a benchmarking approach to setting the net retail margin based on determinations on retail margins in other Australian jurisdictions.

The Office of Energy will undertake a full review of the appropriate margin for all customer classes in all Tariff Areas as part of its more detailed gas tariffs Review to be completed during 2009/10. This review will consider the particular risks associated with retailing gas to small use customers in Western Australia.

4.5 Gas Commodity Cost

The natural gas commodity cost is the cost that retailers face for buying gas from upstream suppliers.

The natural gas commodity costs used by ACIL Tasman and the Office of Energy in assessing whether the tariff increases proposed by Alinta are reasonable are considered confidential as they may impact upon market price expectations.

In relation to the Albany distribution licence area, commodity costs for LPG for the 2008/09 cost stack analysis were verified by Frontier Economics at \$28 per GJ including delivery charges. For the purposes of the 2009/10 cost stack analysis this cost allowance was escalated by CPI and ACIL Tasman verified these calculations. ACIL Tasman also noted that this escalated price approximated the indicative cost faced by a new entrant in sourcing LPG supplies on the international market (including an allowance for transportation related charges for delivery to the Albany area), however it was also highlighted that the LPG cost allowance implied under the tariff cap proposed by Alinta would be significantly below this world parity LPG price.

4.6 Gas Supply Disruption Costs

The major gas supply disruption from the Varanus Island processing facility from 3 June 2008 reduced the supply of gas to Alinta and affected its operations in a number of ways.

Alinta attempted to maximise the amount of gas available by:

- making gas available that it would ordinarily use to generate electricity at its cogeneration facilities in Pinjarra and Wagerup (with the resulting requirement for the purchase of electricity from the Wholesale Electricity Market at prevailing market prices to meet contractual obligations); and
- purchasing additional quantities of gas to partially cover gas supply shortfalls, noting that these gas purchases were at a significantly higher cost than the contracted volumes and that supply shortfalls were unable to be fully covered.

In allocation of gas supplies, to the extent that demand for gas exceeded the amount available, Alinta allocated gas placing a high priority on the supply of gas to residential customers to minimise the potential for health impacts and disruption to the community.

As part of its proposal Alinta submitted that principles of efficient regulation support pass through of efficient costs that it incurred as part of the disruption, as these costs are outside of the foreseeable costs within the area of control of an efficient retailer.

Alinta has confirmed that the most appropriate estimates of the financial impact of the Varanus Island outage (on Alinta) are as reported as part of a Due Diligence Report prepared by Pricewaterhouse Coopers for the Babcock and Brown Power sale process (\$9.6 million for the 2007/08 financial year) and Babcock and Brown Power's Interim Financial Report for the half-year ended 31 December 2008 (\$18 million net of insurance proceeds), a total of \$27.6 million.

Alinta has also suggested that in principle costs associated with a particular policy should be allocated to the beneficiaries of these actions. It has provided evidence that during the gas disruption supplies to tariff customers were largely maintained. These customers assisted by making voluntary reductions, but supplies were maintained.

In recognition of these factors, Alinta has proposed that the gas supply disruption costs detailed above should be allocated to tariff customers in proportion to the level of contracted supplies directed towards servicing of the gas requirements of these customers. This is equivalent to a total of \$9.3 million recoverable from tariff customers, with the remaining amount of \$18.3 million to be borne by Alinta. This additional cost allowance represents an impost of 0.26 cents per unit (GST inclusive) based on 2009/10 forecast consumption, to be applied to the consumption component of all tariff caps other than those applied to the Albany area.

It also proposed that the amount collected through this measure be reviewed as part of any future tariff adjustment processes to ensure no over-recovery with respect to this cost allowance. On the basis of the arguments presented above the Office of Energy supports the inclusion of these costs in the tariff caps for both the Mid-West/South West and Kalgoorlie-Boulder areas for the 2009/10 period. The Office of Energy also notes that the flow-through of efficient unforeseen costs is usually termed as a pass-through event in respect of electricity and gas pricing determinations by independent regulators. These pass through charges are permitted to ensure that the regulated entity is placed in the same position as it would have been but for the occurrence of that event. Such determinations have been made to cover events such as unforeseen increases in network costs and impacts of extreme weather events.

4.7 Costs of the Carbon Pollution Reduction Scheme

As noted above, costs from the proposed CPRS were not considered under the cost stack analysis because the cost stacks relate to a proposed adjustment to the tariff caps for the 2009/10 period only and the CPRS is now intended to be implemented from 1 July 2011. Notwithstanding this, the Office of Energy requested that Alinta give consideration to the possible impacts of CPRS costs on the tariff caps in the interest of transparency and advance consideration of the magnitude of these cost pressures.

The Office of Energy intends to address CPRS costs in the more detailed analysis for the Review, and therefore the estimated CPRS impacts have been prepared only to illustrate the potential requirement for future increases in the tariff caps to cover these costs.

Alinta has indicated that the CPRS is expected to make it (or any other retailer) liable for the obligations of gas users it supplies that emit less than 25,000 tonnes of greenhouse emissions. As this obligation would include gas supplied to customers under the tariff caps, the level of the caps would need to increase to reflect the costs incurred in meeting the CPRS obligations.

As an indicative estimate, and based on a forecast price of \$26.76 per eligible emissions unit (EEU), Alinta estimates that the benchmark cost allowance for the CPRS obligations of customers in the Mid-West/South-West and Kalgoorlie-Boulder supply areas would need to be between 0.76 and 0.94 cents per unit. Based on these allowances, residential customers with median gas consumption could expect their annual gas bill to increase by between \$33 and \$41 per year as a result of the CPRS.

Due to the higher greenhouse emissions associated with LPG, Alinta estimates that the benchmark cost allowance for the CPRS obligations of customers in the Albany area would need to be between 0.89 and 1.09 cents per unit. Based on these allowances, residential customers in Albany would expect a similar magnitude increase in costs of between \$33 and \$41 (based on a differing level of gas consumption).

ACIL Tasman has verified these calculations noting that the figures provided are relatively conservative in terms of the allowances made for the level of upstream emissions that will be largely passed on by gas producers. It is also noted that the proposed commencement date for the CPRS has been delayed to 1 July 2011 and in the first year the price of each EEU is to be set at \$10.

5. TARIFF INCREASE ANALYSIS

Analysis by the Office of Energy has shown that some of the cost components in the cost stacks have increased above CPI over recent years, thereby providing upward pressure on the tariff caps beyond the regular annual tariff cap increases.

The main drivers of the cost pressures are the transmission costs and the gas commodity costs. Both of these costs have been increasing well above CPI levels, with gas commodity costs increasing significantly above CPI. The gas commodity pressure is discussed in more detail below.

5.1 General Discussion on Gas Commodity Costs

Natural gas commodity costs in the Western Australian domestic market have increased dramatically in recent periods, moving sharply away from historical prices in the \$2.50 per GJ range earlier this decade.

In its analysis provided to the Office of Energy, ACIL Tasman has indicated the view that gas prices have continued to increase beyond the above levels based on consideration of publicly available information relating to the signing of gas commodity contracts between Santos and Moly Metals Australia (for supply of gas from the John Brookes field to the Spinifex Ridge

molybdenum and copper mine in the Pilbara region) and also between Santos and CITIC Pacific's Sino Iron project (for supply of gas from the Reindeer gas project to a world scale magnetite mining project). ACIL Tasman has indicated that analysis of the public information on the Moly Metals Australia contract suggests an implied gas commodity price of \$6.70/GJ (in 2009/10 dollars), and for the CITIC Pacific contract, a price of \$7.80/GJ (in 2009/10 dollars).

ACIL Tasman has also indicated that it has analysed the long run marginal cost of gas in Western Australia based on reported costs by Santos and Apache to develop the Reindeer field and the Devil Creek gas plant, respectively. This analysis has suggested a gas commodity price between \$6.50/GJ and \$8.50/GJ.

In relation to the Albany distribution licence area, commodity costs for LPG have also increased over the longer term, however world propane prices have moderated with the more recent deterioration in economic conditions. ACIL Tasman's analysis has indicated that these prices average an estimated \$17.50 per GJ on a Perth delivered and stored basis.⁸ However adding in estimated indicative transport costs to the Albany region would take the delivered price into a range between an estimated \$24.30 to \$29.50 per GJ.

6. ASSISTANCE FOR HARDSHIP CUSTOMERS

As part of its submission Alinta has noted that certain residential customers may have limited options with respect to more efficient gas usage and managing future gas bills. The Office of Energy notes that these difficulties may be increased with any further adjustment of gas tariffs.

Alinta has noted that it actively promotes instalment payment plans as a convenient method for managing gas accounts. Customers that face payment difficulties are encouraged to enter into an instalment plan to pay their outstanding account and to assist in budgeting for future accounts over a 12 month period. These customers that elect to enter into an instalment payment plan are actively managed and communicated with on an ongoing basis.

Alinta has also advised that it has previously established the AlintaCARE program to assist residential customers facing genuine financial hardship. This program is managed and delivered by an independent financial counselling organisation on behalf of Alinta.

It is also noted that the Economic Regulation Authority has developed a Code of Conduct for the supply of gas to small use customers in consultation with industry stakeholders. This Code is to be similar to the existing Code of Conduct for the supply of electricity to small use customers. When introduced the Code will require that gas retailers have an explicit hardship policy to assist residential customers facing financial hardship in identification of the full range of assistance measures available to them.

⁸ This price is based on the Saudi Aramco LPG (propane) average contract price of A\$633 (US\$426) per tonne over the first five months of 2009. This compares to an average contract price of A\$871 (US\$768) for the 2008 calendar year.