Australian Energy Market Commission

Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia

First Final Report

19 September 2008

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About the AEMC

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy markets. The AEMC is responsible for Rules and policy advice covering the National Electricity Market and, from 1 July 2008, concerning access to natural gas pipeline services and elements of the broader natural gas markets. It is a statutory authority. Its key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council as requested, or on AEMC initiative.

Foreword

The energy industry has been the subject of widespread reforms over the last eighteen years. At the start of the last decade, the industry was characterised by discrete State and Territory-based markets with predominantly government owned vertically integrated monopolies responsible for a number of aspects of the energy supply chain. The lack of interconnection between markets, coupled with the performance inefficiencies and the absence of effective competition, prompted the Council of Australian Governments (COAG) to implement a wave of structural and market reforms designed to facilitate the development of a competitive national energy market operating under a consistent regulatory framework.

A second wave of energy-specific reforms commenced in 2003 following an independent review of energy reform by the Ministerial Council on Energy (MCE). While this review acknowledged that substantial progress in market reform had been achieved, it identified a number of impediments that were limiting the extent to which further benefits could be achieved. In response to the findings of the review, COAG committed to a range of reforms designed to reduce regulatory costs, encourage investment and facilitate effective competition.

The Australian Energy Market Commission (Commission) is playing an important role in fostering the development of effective competition. In February this year, it completed its first review of retail competition, finding that electricity and gas retailing in Victoria is effectively competitive and advising on ways to phase out retail price regulation in the State.

The Commission has now completed the first stage of its review of the South Australian energy retail sector. The Commission's finding that competition in electricity and gas retailing is effective (although relatively more intense in electricity than in gas), and its identification of the risks facing the industry going forward, make an important contribution to the policy discussion about the future direction of energy retailing in South Australia.

In preparing this report, the Commission sought and obtained substantial information from a range of stakeholders. The Commission thanks those stakeholders who assisted it in its information gathering processes and encourages all interested parties to continue to participate in the public consultation processes as we enter the next phase of the South Australian Review.

John Tamblyn
Chairman
for and on behalf of the
Australian Energy Market Commission

Contents

Abbreviations and Glossary

2007 Electricity Price Path Review	ESCOSA, *2007 Electricity Price Standing Contract Price: Final Inquiry Report and Final Price Determination*, November 2007
2008 Gas Price Path Review	ESCOSA, *2008 Gas Standing Contract Price: Final Inquiry Report and Final Price Determination*, June 2008
ACCC	Australian Competition and Consumer Commission
AEMA	Australian Energy Market Agreement
AEMC	see Commission
AER	Australian Energy Regulator
AGL	AGL Energy
ASX	Australian Stock Exchange
COAG	Council of Australian Governments
COTA	Council on the Ageing
Commission	Australian Energy Market Commission
Consumer Survey	A representative telephone survey of 1,200 residential and 650 small business energy customers in South Australia, and eight focus groups undertaken by McGregor Tan Research on behalf of the Commission
Consumer Survey Report	McGregor Tan Research, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets*, June 2008
CPRS	Carbon Pollution Reduction Scheme
CR4	The four-firm concentration ratio
ECC	Energy Consumers' Council
Electricity Act	*Electricity Act 1996* (SA)
Energy Marketing Code	*Energy Marketing Code*, made by ESCOSA under section 28 of the *Essential Services Commission Act 2002*
Energy Ombudsman	Energy Industry Ombudsman of South Australia
Energy Price Disclosure Code	*Energy Price Disclosure Code*, made by ESCOSA under section 28 of the *Essential Services Commission Act 2002* (SA)
Energy Retail Code	*Energy Retail Code* made by ESCOSA under section 28 of the *Essential Services Commission Act 2002* (SA)
ERIG	Energy Reform Implementation Group
ESIPC	Electricity Supply Industry Planning Council
ESC	Essential Services Commission (Victoria)

ESC Act	*Essential Services Commission Act 2002* (SA)
ESCOSA	Essential Services Commission of South Australia
First Draft Report	AEMC 2008, *Review of the Effectiveness of Competition in Electricity and Gas Markets in South Australia – First Draft Report,* 4 July 2008, Sydney
First Final Report	AEMC 2008, *Review of the Effectiveness of Competition in Electricity and Gas Markets in South Australia – First Final Report,* 19 September 2008, Sydney
FRC	Full retail competition
Gas Act	*Gas Act 1997* (SA)
GJ	Gigajoule
Guideline No 2	*Energy Regulatory Information: Energy Retail Code Retailer – Energy Industry Guideline No. 2*, made by ESCOSA under section 8 of the *Essential Services Commission Act 2002*.
HHI	Herfindahl-Hirschman Index
Host retailer	A retailer that is a Tier 1 retailer being, in South Australia, AGL in respect of electricity and Origin Energy in respect of gas
IPART	Independent Pricing and Regulatory Tribunal (NSW)
Issues Paper	AEMC 2008, *Review of the Effectiveness of Competition in Electricity and Gas Markets in South Australia – Issues Paper*, 14 March 2008, Sydney
MAPS	Moomba to Adelaide Pipeline System
MCE	Ministerial Council on Energy
MWh	Megawatt hours
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
NERA	NERA Economic Consulting
NERA Report	NERA, *Review of the Effectiveness of Energy Retail Competition in South Australia – Phase 2 Report for ESCOSA*, July 2007
New retailer	A retailer that is not a host retailer
NMI	National Metering Identifier
Origin	Origin Energy
PJ	Petajoule
REES	Residential Energy Efficiency Scheme
REMCo	Retail Energy Market Company
Request for Advice	MCE's request for advice dated 13 December 2007 in relation to the review of effective competition in the electricity and gas retail markets in South Australia

Retailer Survey	Survey of retailers participating in energy market in South Australia undertaken by LECG on behalf of the Commission
Retailer Survey Report	LECG, *Survey and interviews with South Australian electricity and gas retailers*, 18 June 2008
RMR	The Retail Market Rules established under the *Gas Act 1997* which facilitates the operation of the gas retail market in South Australia (and Western Australia)
RoLR	Retailer of Last Resort
SACOSS	South Australian Council of Social Service
SAFF	South Australian Farmers Federation
SEAGas Pipeline	South East Australian Gas Pipeline
Second Draft Report	AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Markets in South Australia – Second Draft Report*, to be published in October 2008
SESA Pipeline	South East South Australian Pipeline
South Australian Review	Review by the Commission of the effectiveness of competition in electricity and gas retail markets in South Australia
Statement of Approach	AEMC, 2007 *Review of the Effectiveness of Competition in Gas and Electricity Retail Markets – Statement of Approach,* 19 April 2007, Sydney
TIPS	Torrens Island Power Station
TJ	Terajoule
Victorian Review	Review by the Commission of the effectiveness of competition in electricity and gas retail markets in Victoria

Executive Summary

Full retail competition (FRC) was introduced for electricity customers in South Australia in January 2003 and, in practical terms, for gas customers in July 2004. The objective of retail energy competition is to deliver efficient prices and services to energy customers, and to give customers the opportunity to choose amongst competing retailers and their various price and service offerings. Rivalry between retailers and the exercise of choice by customers maintains competitive pressure on retailers to manage their input costs effectively, to offer more cost-reflective prices and to improve and diversify the retail services they offer in order to better satisfy customers' preferences. To safeguard the interests of customers during the transition to a competitive environment, the introduction of FRC was accompanied by consumer protection arrangements and a statutory mechanism to set the price for energy sold under a standard retail contract.

Energy, particularly electricity, is an essential service for modern day living. Consumers expect reliable and secure energy supply. Therefore, energy market regulatory arrangements include obligations and incentives to that end. However, energy is also a homogeneous service which is treated as a relatively low involvement commodity by most energy consumers rather than a high value, differentiated product that justifies extensive market search and analysis. This consumer reality has an important influence on the development of the competitive environment for electricity and gas for both customers and retailers.

The Australian Energy Market Commission (Commission), in accordance with the terms of the Australian Energy Market Agreement (AEMA) and the request for advice from the Ministerial Council on Energy (MCE), is reviewing whether competition in electricity and gas retailing in South Australia is effective for small customers (South Australian Review). If competition is found to be effective, the Commission is required to provide advice to the South Australian Government and the MCE on ways to phase out retail price regulation. Where competition is found not to be effective, the Commission's advice is required to identify ways to develop effective competition.

The Commission's finding is that competition is effective for small electricity and small natural gas customers in South Australia, although competition is relatively more intense in electricity than in gas. However, in making this finding the Commission has identified some structural limitations that are affecting the ability of small gas customers in regional areas to access the full benefits of competition. Of the total number of gas customers located throughout South Australia (around 375,000[a]), approximately 4.5 per cent are located in regional areas.[b] In preparing its

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[a] Office of the Technical Regulator, *Annual Report of the Technical Regulator: Gas 2006-07*, p. 7. There is a small difference between the figure reported by the Office (374,990) and the total number of gas customers reported by ESCOSA (375,391): ESCOSA, *2006-07 Annual Performance Report: Performance of South Australian Energy Retail Market*, November 2007, p. 65.

[b] *Id*. The gas customers recorded as located in regional areas include customers whose annual consumption is unmetered or greater than 1TJ (i.e. a large customer). However, this is unlikely to affect the percentage materially as the total number of unmetered or large customers located

draft advice on ways to phase out retail price regulation, the Commission will consider options to address these structural limitations. The Commission has not identified any regional distinctions for the 775,000[c] small electricity customers in South Australia.

In the short time since the introduction of FRC, the supply of retail energy services to small customers in South Australia by two single fuel host retailers has been replaced by competition between four large dual fuel retailers and several smaller, mostly electricity-only, retailers. The retailers who are currently licensed to supply retail energy services are set out in Table i below.

Table i Licensed retailers supplying retail energy services to small customers in South Australia

Retailer	Electricity		Gas	
	Licence	Sale to small customers	Licence	Supply and sale to small customers
AGL Energy (including Powerdirect)	✓	✓	✓	✓
Aurora Energy	✓	✓	×	×
Australian Power & Gas	✓	×	✓	×
Country Energy	✓	✓	✓	×
Dodo Power & Gas	✓	×	✓	×
EnergyAustralia	✓	×	✓	×
Jackgreen International	✓	✓	✓	×
Momentum Energy	✓	✓	✓	×
Origin Energy	✓	✓	✓	✓
Red Energy	✓	✓	×	×
Simply Energy	✓	✓	✓	✓
South Australia Electricity	✓	✓	✓	×
TRUenergy	✓	✓	✓	✓

Data source: ESCOSA and Retailer Survey Report.

There has been strong rivalry between energy retailers as they seek to gain customer share by offering customers alternative price, product and service combinations. Large numbers of electricity and metropolitan gas customers have been willing and able to respond to competitive offers and to exercise choice between the available offers when approached by retailers and given sufficient incentive. Market structure and the entry and expansion of new retailers have generally fostered competition,

throughout South Australia is small (2,974): ESCOSA, *2006-07 Annual Performance Report: Performance of South Australian Energy Retail Market*, November 2007, p. 65.

c ESCOSA, *2006-07 Annual Performance Report: Performance of South Australian Energy Retail Market*, November 2007, p. 65.

however recent changes in the energy market (described further below) have increased the risk of entry into, or expansion within, energy retailing.

The Commission's finding that competition is effective in electricity and gas retailing is supported by evidence of consumer behaviour. While small customers are unlikely to actively seek out competitive market offers, they demonstrate a clear willingness to participate in the competitive retail market if approached directly by a retailer. Approximately 66 per cent of electricity customers and 59 per cent of gas customers are now supplied under a market contract.[d] Customers exhibit a high willingness to switch retailers, especially in response to lower prices, and are confident in selecting an energy product that best suits their needs. Brand loyalty and switching costs do not appear to be significant deterrents. As competition between retailers continues to grow, it is expected that the proportion of customers supplied under market contracts will continue to increase. Regional gas customers will also have the opportunity to switch between retailers to the extent that the structural limitations can be alleviated.

The Commission's finding is also supported by evidence of strong retailer rivalry. Retailers face a strong incentive to overcome customers' lack of engagement with basic energy products which they do by marketing their products and services directly to customers, primarily through door-to-door sales and telemarketing. Consistent with the view that energy is a homogenous commodity, there is evidence that a large proportion of customers are unlikely to actively search for superior energy contract arrangements in the absence of such an active approach to marketing. As a result of competition, new retailers now supply 42 per cent of small customers in South Australia (see Figure i below).[e]

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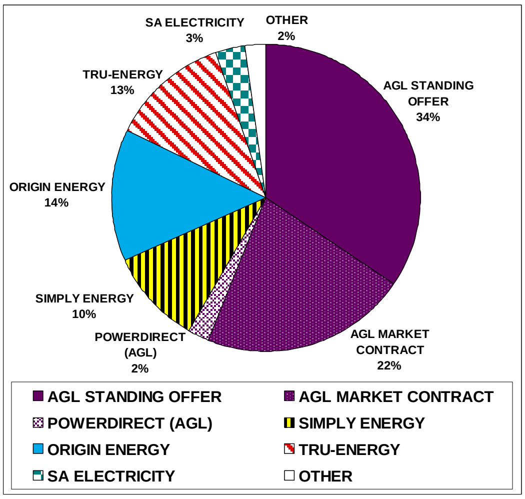
[d] Data reported under Guideline No 2.

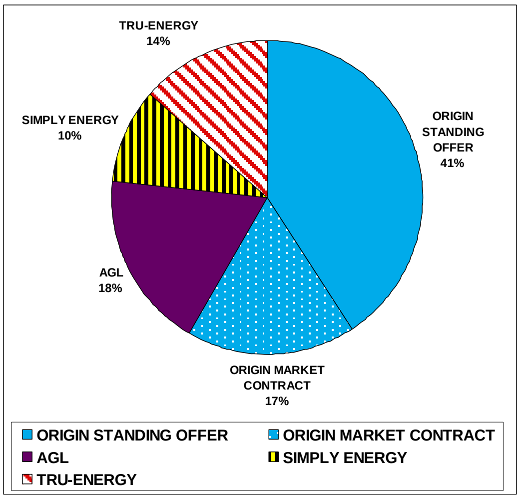
[e] *Id*. The new retailers' share of customers does not include Powerdirect, which is a wholly owned subsidiary of AGL.

Figure i Retailer customer shares: electricity and gas

Electricity



Gas



Note: Electricity retailers listed as "Other" are those with one per cent or less of the total share of customers. For a complete list of retailers currently selling electricity to small customers in South Australia, refer to Table i.
Data source: ESCOSA Data reported under Guideline No 2.

Retailers principally compete on the basis of discounts from the standing contract prices. Up-front discounts of up to 7 per cent are available under electricity market contracts, with lower up-front discounts available to gas market customers. Retailers also offer a range of non-price incentives in an effort to retain existing and secure new customers. Some retailers also offer more innovative products.

The history of entry into and expansion within the energy retail sector to date supports the Commission's preliminary finding about the effectiveness of competition. There has been substantial entry into electricity retailing, where small scale entry with few sunk costs has been viable and other entry requirements are limited. Entry into electricity retailing has been characterised by a combination of small scale pure retailers and larger vertically integrated dual fuel "gentailers". This has created a credible threat of competition from actual or potential new retailers constraining the price and output decisions of existing retailers. As at 1 January 2008, ten retailers were offering to sell electricity to small customers.

Some submissions to the Issues Paper and First Draft Report, suggested that AGL, as a result of its acquisition of the Torrens Island Power Station (TIPS), has sufficient power at the wholesale level to enable it to impact on the competitiveness of electricity retailing. Since the publication of the First Draft Report, the Commission has conducted further investigation and analysis on this issue. While the Commission's analysis is set out in detail in Appendix E, it notes that the recent wholesale outcomes were due to a combination of transitory circumstances and unexpected market events which should not impact adversely on the effectiveness of competition at the retail level.

However, there are emerging indications of competitive risks and pressures in the small customer electricity sector that were not evident in the last few years. The recent tightening of the supply/demand balance in the wholesale electricity market has contributed to increases in spot and contract prices, which have in turn increased prudential obligations and working capital requirements. These changes in wholesale market conditions, in the presence of unchanged standing contract prices with which retailers must compete, have made entry and expansion more difficult for smaller retailers. While the Commission's analysis of profit margins indicates that the margins earned by retailers appear to have fallen within the range expected in a competitive market and are sufficient to encourage entry, the recent increases in wholesale costs have undermined these margins and have prompted a number of retailers to temporarily cease actively marketing to prospective new customers until such time as margins improve.

Looking to the future, the Commission recognises that the electricity industry is entering a period of transition associated with the need for new investment to address the tightening supply/demand balance and adapting to the impacts of increases in intermittent generation. There will also be a period of adjustment to the cost structure changes that are expected to result from the introduction of the Carbon Pollution Reduction Scheme (CPRS) and other future policy responses to climate change. Effective retail competition can be expected to accommodate changes in the real cost of inputs as long as the standing contract and/or market contract prices are able to adjust to provide competitive retail margins. If this does not occur, the margin sensitivity analysis undertaken by the Commission suggests that retail margins could fall to levels that place the ongoing viability of retailers and effective competition at risk.

New retailers have also entered gas retailing, with three new retailers now offering to supply and sell gas to small customers in South Australia. Although smaller in number, these new retailers have competed effectively with the host retailer, generally through dual fuel marketing strategies, and now service more than 40 per cent of small retail gas customers, mainly those located in metropolitan Adelaide. Unattractive profit margins have limited the opportunities for new retailers to compete for South Australian gas customers. As a result, some gas retailers have temporarily ceased actively acquiring customers while other prospective retailers have deferred their plans to enter indefinitely. Looking forward, however, as long as standing contract and/or market contract prices offer sufficient margins, effective gas competition is likely to continue in metropolitan areas.

New retailers appear to have been discouraged from offering to sell and supply gas to small customers in and around Whyalla, Port Pirie, Riverland, Murray Bridge and Mt Gambier due to structural limitations affecting the ability of retailers to access firm transmission haulage services on the Moomba to Adelaide Pipeline System (MAPS) laterals and competitively priced haulage services on the South East South Australian (SESA) Pipeline. Currently the transmission haulage capacity on the MAPS laterals and the SESA Pipeline is contracted to the host retailer under legacy contracts. However, the Commission understands that some of these contracts are expected to expire in the near term, which is likely to improve access to transmission haulage services. An additional factor that may be discouraging new entry is the relatively low retail margins available to new retailers in South Australia which have been at or below the bottom of the range required for entry, particularly in regional areas where consumption volumes by small customers may be low. Minimum volumes, including some larger industrial or commercial customers, may also be required to support carriage contracts once access to the pipelines becomes available.

Notwithstanding the conclusion that competition is effective and serving the interest of most consumers, as noted above, the Commission recognises that gas customers located in regional areas of South Australia (representing approximately 4.5 per cent of small gas customers) do not currently have access to the full benefits of choice among the price/service offerings of a number of competing retailers. Although regional gas customers are currently exercising choice between the standing contract and market contracts, the market offers they are able to choose between are currently limited to those available from the host retailer, Origin Energy (Origin). Origin states (and the Commission has verified in its analysis set out in Appendix C) that it offers regional customers equivalent market contract offers to those offered to Adelaide customers. To the extent that Origin's market offers to Adelaide customers reflect the incentives and constraints imposed by competition from other gas retailers, Origin's regional gas customers are the indirect beneficiaries of competition in Adelaide. However, noting the continuing constraints on access to transmission haulage capacity on gas pipelines servicing regional South Australia in the short to medium term, the Commission will give further consider the availability of options to improve the access of regional customers to the competitive gas retail contracts. If appropriate, the Commission will outline its proposals as part of its draft advice on ways to phase out retail price regulation.

South Australia has successfully developed a competitive environment for energy retailing. The South Australian Government, in consultation with retailers and consumer groups, has developed and implemented a range of innovative strategies to foster the development of competition, including important mechanisms to safeguard the interests of energy consumers. The success of these policies and programs is facilitated by the work of independent bodies such as the Essential Services Commission of South Australia (ESCOSA) and the Energy Industry Ombudsman of South Australia (Energy Ombudsman). In combination, these advances provide a robust platform for the future transition and further development of energy retailing in South Australia.

1 Purpose of the First Final Report

The Australian Energy Market Agreement (AEMA) requires the Australian Energy Market Commission (Commission) to review and publicly report on the effectiveness of retail competition in the energy markets of each jurisdiction participating in the National Electricity Market (NEM). Where the Commission finds competition is effective, it must provide advice on ways to phase out retail price regulation. Where competition is found not to be effective, the Commission's advice must suggest ways to improve competition. The policy and legislative framework for the review by the Commission of the effectiveness of competition in electricity and gas retail markets in South Australia (South Australian Review) is discussed in greater detail in Chapter 2.

1.1 Report publicly on the effectiveness of competition

The primary purpose of this report, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – First Final Report* (First Final Report) is to set out the Commission's analysis and findings about the effectiveness of competition in electricity and gas retailing in South Australia. In summary, it details the Commission's responses to the following questions:

- Is competition in the retail sale of electricity to small customers in South Australia effective?
- Is competition in the retail sale and supply of natural gas to small customers in South Australia effective?

In answering these questions, the Commission has had regard to potential differences in the experiences that different classes of customers in different locations may have had.

The Commission's findings and the key supporting evidence is set out in Chapter 3 of the First Final Report. The detailed evidence underpinning the Commission's findings and its analysis of this evidence is contained in Appendices C-F.

1.2 Input from stakeholders

The Commission's assessment of the effectiveness of retail competition directly influences the nature of the advice it will subsequently provide to the South Australian Government and the Ministerial Council on Energy (MCE) concerning the future of retail price regulation. Given the significance of these recommendations, it is necessary for the Commission to test its analysis and conclusions through a process of open and informed public consultation.

To this end, the Commission invited public comment on its preliminary findings as set out in the *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia - First Draft Report* (First Draft Report) and the evidence supporting them. The Commission encouraged submissions to critique its preliminary findings, the supporting evidence and any other matter considered pertinent to the Commission's analysis of the effectiveness of competition.

The Commission received 15 submissions from a range of stakeholders, including retailers and consumer groups as well as regulatory bodies and industry groups. In addition, some stakeholders also provided confidential material for consideration. The Commission has published each submission on its website, subject to claims for confidentiality. The Commission's approach to confidential information is explained in Section 4.4 of the Statement of Approach.

2 Framework for Analysis

This Chapter summarises the analytical and methodological approach used by the Commission in the South Australian Review. It begins by describing the policy underlying the Review and summarises the terms of reference that apply to it. Chapter 2 then outlines the general analytical framework used by the Commission to assess whether competition is effective, which is the framework the Commission applied in reaching its findings (which are contained in Chapter 3). This Chapter concludes by setting out the information gathering and consultation processes undertaken in the lead up to the publication of the First Final Report.

2.1 Policy and legislative framework

The commitment of the Commonwealth, State and Territory governments to introducing important changes to the structure and operation of the Australian energy markets is reflected in the AEMA. One of the key commitments made by each of the signatories to the AEMA is to phase out retail price regulation for electricity and gas where effective retail competition can be demonstrated. In this context the Commission was accorded the role of reviewing and publicly reporting on the effectiveness of competition in the retail supply of electricity and gas in each NEM jurisdiction. The AEMA further requires the Commission to provide advice on ways to phase out retail price regulation when competition is found to be effective. In circumstances where competition is found not to be effective, the Commission must provide advice on how competition could be promoted.

In conducting each retail review, the Commission is required to follow the framework provided for in clauses 14.10- 14.16 of the AEMA. This requires, amongst other things, the Commission to base its assessment of the effectiveness of competition on criteria developed by the MCE in consultation with the Commission and other interested parties (MCE criteria).[1] The MCE criteria are:

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

On 13 December 2007, the MCE formally requested the Commission to provide advice on the state of competition in, and retail price oversight for, electricity and natural gas retailing in South Australia (Request for Advice). Consistent with the

1 AEMA, clause 14.11(a)(i).

AEMA, the Request for Advice requires the Commission to apply the MCE criteria in providing its advice. The Request for Advice is available on the Commission's website at www.aemc.gov.au.

The Request for Advice also requires the Commission to use the methodology and approach detailed in Parts 2 and 3 of the *Review of the Effectiveness of Competition in the Gas and Electricity Retail Markets – Statement of Approach* (Statement of Approach).[2] The Statement of Approach outlines the Commission's approach to conducting the retail reviews, including the method of applying the MCE criteria, and the Commission's consultation process.

The Request for Advice requires that the South Australian Review focus on "small customers"; that is, customers who consume less than 160MWh of electricity per annum or less than 1TJ of gas per annum.[3] In submissions received to the Issues Paper and the First Draft Report, consumer groups noted that the effectiveness of retail competition for large customers should be assessed as part of this South Australian Review on the basis that competition cannot be effective for small customers unless it is effective for large customers.[4] The Commission notes that large customers form a separate class of consumers to small customers due to the different natures of their energy requirements. Large customers are also able to implement a range of risk management strategies in managing their energy requirements.[5] As such, the Commission has focused on small customers as required by the Request for Advice.

Accordingly, the Commission's role in the South Australian Review is to assess and publicly report on whether competition is effective for small customers and, based on this assessment, provide advice to the MCE about the future of retail price regulation in South Australia.

2.2 Commission's framework for assessing competition

The central notion underpinning the South Australian Review is the concept of competition and the circumstances in which it is considered to be effective. This section discusses the importance of competition in delivering efficiently priced goods and services to customers and summarises the Commission's views about what constitutes "effective competition".[6]

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2 The Statement of Approach can be downloaded from the Commission's website at www.aemc.gov.au.

3 MCE Request for Advice, clause 5.

4 Including in the submission to the First Draft Report from Uniting*Care* Wesley, August 2008, pp. 16-17.

5 For example, as noted by AGL in its supplementary submission to the First Draft Report, some large customers may chose to manage their energy requirements by taking risk exposure on the wholesale market.

6 The Commission's views about what constitutes "effective competition" are explained in further detail in Chapter 3 of the Statement of Approach. The Statement of Approach is available from the Commission's website at www.aemc.gov.au.

In assessing whether competition in energy retailing in South Australia is effective, the Commission has also considered the nature of demand for energy services and the role of the retailer within the energy supply chain. This section discusses each of these issues in turn.

2.2.1 The importance of competition

At its most elementary, competition between sellers of goods and/or services implies that sellers act in an independent manner to attract and retain customers on the basis of price, product and/or service delivery. In the absence of collusion or coordination, sellers' decisions about how much they charge and how much they produce will be constrained by the competitive responses of actual and potential rivals and by the exercise of informed choice by customers. In the presence of these competitive conditions, no seller will be able to exert market power by raising prices above efficient costs or restricting output. The prices paid for products supplied in such a market will be economically efficient; that is, prices will reflect the efficient costs of supply.

One of the principal benefits of competition is that it gives businesses an incentive to pursue economic efficiency. In simple terms, this means a business will produce goods and services at least cost while directing resources toward the production of goods and services that are valued most highly by consumers. Over time, a business will respond in a timely manner to changes in consumer tastes and to changes in production techniques and technology.[7] Because the ultimate beneficiaries of economic efficiencies include consumers and the broader community, the principal objective of competition policy is to maximise economic efficiency.

Where competition is effective in promoting economic efficiency, there is generally no need for price regulation. Regulated prices will almost always be an imperfect substitute for prices determined by competitive processes and are likely to impose costs and distortions not present in a competitive market. Because regulators have imperfect information, regulated prices will generally either be set too low, deterring investment and innovation, or too high, to the detriment of consumers. Further, regulated prices often lack the flexibility of market prices. The distortions price regulation causes and the administrative costs it imposes are likely to be higher, and the benefits lower, where prices are regulated in a competitive market than in a market which is not competitive.[8]

Price regulation is only justified where markets are not effectively competitive, where regulation can improve market outcomes, and the benefits exceed the costs. This view is reflected in clause 14.11(a) of the AEMA, which requires jurisdictions to phase out retail price regulation where competition is demonstrated to be effective. This is not to say, however, that other regulatory frameworks are not required in

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[7] Economists often refer to these as production (or cost), allocative and dynamic efficiencies: Hilmer Committee, *National Competition Policy: Report by the Independent Committee of Inquiry*, August 1993, p. 4.

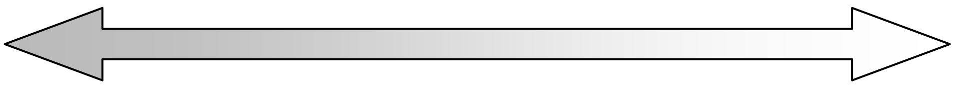
[8] Professor George Yarrow, *Report on the Impact of Maintaining Price Regulation*, Oxford, January 2008. This is a report prepared for the Australian Energy Market Commission.

order to overcome other market failures and thereby support competitive market processes and outcomes, e.g. prudential regulation and consumer protection provisions.

2.2.2 What is "effective competition"?

The extent of competition will vary between markets. As the Commission observed in the Statement of Approach, different levels of competition may also exist within a single market over time as it evolves and moves away from, at one extreme, a monopoly towards, at the other extreme, a perfectly competitive market.[9] The development of competition over time is illustrated in Figure 2.1 below.

Figure 2.1 Progression of competition



Monopoly → Oligopoly → Monopolistic competition → Perfect competition

Source: Australian Energy Market Commission, *Review of the Effectiveness of Competition the Gas and Electricity Retail Markets – Statement of Approach*, April 2007, p. 6.

A market that is considered to be "effectively competitive" need not have reached a state of perfect competition. Where markets are effectively or workably competitive, there is sufficient rivalry between business to ensure that they strive to deliver the goods and services consumers demand at least cost, and for product and process improvement. Effective competition will also ensure resources move relatively freely between and within markets in response to consumer demand and price signals.[10] Consumers in an effectively competitive environment will also have access to a reasonable degree of information to allow them to make choices and participate in the market. Businesses in an effectively or workably competitive market may have a degree of market power[11] associated with product differentiation or innovation, but that market power will not be substantial or sustainable and will be subject to competitive erosion over time. At any particular point in time, resources may not be employed in their most valuable use, prices may deviate from costs and technologies can deviate from the most efficient ones available. However, over time, effective

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9 Australian Energy Market Commission, *Review of the Effectiveness of Competition in Gas and Electricity Retail Markets – Statement of Approach*, April 2007, pp. 5-6.

10 See, for example, Maureen Brunt, "Legislation in Search of an Objective", in J.P. Nieuwenuysen (ed.) *Australian Trade Practices: Readings*, 1970, Melbourne, Cheshire, p. 238, and "Market Definition Issues in Australian and New Zealand Trade Practices Litigation", *Australian Business Law Review*, 1990, vol 18, no 2, p. 101.

11 Market power is essentially the inverse of competition. Market power is the ability of one or more suppliers in a market to sustain prices above long run costs, including a return on capital and accounting for risk, without margins being eroded by the competitive activity of rivals and/or entry.

competition will drive the market towards efficient outcomes. Businesses will continuously strive for competitive advantage against actual and potential rivals, they will seek out new profit opportunities to deliver the goods and services consumers want, and the market may always appear to be in a state of disequilibrium and change. This is the very essence of real world dynamic competition.

As the Supreme Court of Western Australia observed:

> "…with workable competition market forces will increase efficiency beyond that which could be achieved in a non-competitive market, although not necessarily achieving theoretically ideal efficiency." [12]

While economic models of competition can help inform our understanding of real world markets, the Commission's approach to evaluating effective competition draws on the approach adopted in relation to the development and application of competition law and policy (see Box 2.1 below). For any given market, an assessment of whether competition is effective will be a fact-based exercise, which assesses all of the relevant structural, behavioural and performance characteristics and their interaction.

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12 *Re: Dr Ken Michael; ex parte EPIC Energy (WA) Nominees Pty Ltd & Anor* [2002] per Parker J at 128.

Box 2.1 Defining effective competition

The Commission's approach to evaluating effective competition is guided by the approach adopted in the development and application of competition law and policy. The following definition of effective competition has been applied by the Australian Competition Tribunal:

> "As was said by the U.S. Attorney General's National Committee to study the Antitrust Laws in its report of 1955 (at p. 320): 'The basic characteristic of effective competition in the economic sense is that no one seller, and no group of sellers acting in concert, has the power to choose its level of profits by giving less and charging more. Where there is workable competition, rival sellers, whether existing competitors or new or potential entrants in the field, would keep this power in check by offering or threatening to offer effective inducements…'." [13]

Conversely, the Hilmer Committee identified the characteristics of markets in which effective competition does not exist:

> "Where the conditions for workable competition are absent – such as where a firm has a legislated or natural monopoly, or the market is otherwise poorly contestable – firms may be able to charge prices above the efficient level for periods beyond those justified by past investments and risks taken or beyond a time when competitive response might reasonably be expected. Such 'monopoly pricing' is seen as detrimental to consumers and to the community as a whole." [14]

While businesses in an effectively competitive market may exhibit transient market power, the (expected) competitive response of actual and potential rivals will constrain the exercise of that market power. The response of consumers to rival offers is also critical for establishing effective competition. As long as there are enough customers in the market that are willing and able to switch to another supplier in response to a price increase or equivalent deterioration in quality or service, and the business is unable to identify and discriminate against those customers that are not willing to switch, businesses within the market will be constrained in their pricing, output, service and quality decisions.[15] Over time, an

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13 *Re Queensland Co-operative Milling Association; Re Defiance Holdings* (1976) 25 FLR 169 at 188.

14 Hilmer Committee, *National Competition Policy: Report by the Independent Committee of Inquiry*, August 1993, p. 269. This passage was referred to by the Full Court of the Supreme Court of Western Australia in *Re Dr Ken Michael AM; ex parte EPIC Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 at 144.

15 If a firm increases its price above the competitive level (or equivalently reduces the quality of its product or service) the firm's marginal customers will switch to another product or supplier, thereby reducing the number of units the firm sells. Although the firm gains margin on the retained sales (the sales it makes to non-switchers at the higher price), it loses margin on the lost sales (the sales it would have made to the switchers). As long as the firm cannot identify switchers and non-switchers and charge them different prices, a profit maximising firm will not increase price above a

effectively competitive market would be expected to reflect the economic efficiencies discussed above.

In their joint submission to the First Draft Report, the Council on the Ageing (COTA) and the South Australian Council on Social Service (SACOSS) expressed the view that an oligopoly existed in the South Australian retail energy markets and questioned whether effective competition could exist in such an environment. They supported this view by referring to the four-firm concentration ratio (CR4) and Herfindahl-Hirschman Index (HHI) calculations.[16] As outlined in the Statement of Approach to this review and the Victorian Review First Final Report, the CR4 and the HHI can be useful tools in competition assessments but these indices alone are not conclusive indicators of the presence or absence of effective competition.[17] Such measures must be considered in combination with other relevant information including evidence of the ability of retailers to enter and exit the market and the extent of retailer rivalry. If sufficient rivalry exists between firms and there is sufficient threat of new entry, a market with a small number of firms can be effectively competitive. As noted by the European Union, "market shares and concentration levels provide useful *first indicators* of the market structure and the competitive importance of both the merging parties and their competitors" (emphasis added).[18]

In evaluating the effectiveness of competition, it is important to take a forward rather than backward looking approach. Clearly, regard must be had to evidence of what has actually been happening in a market but the most important question is: what is likely to happen going forward? The past is only relevant to the extent that it is a guide to the future. It is in the future that any regulatory changes consequent to the Commission's findings will be implemented. It is therefore necessary (and appropriate) to consider the likely state of competition with and without such regulation and whether past trends are likely to continue. As noted above, the Commission has been guided in its analysis by the forward-looking approach of the High and Federal Courts of Australia and the Australian Competition Tribunal (and its predecessor) in competition law analysis (see Box 2.2 below).

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level that would cause it to lose enough switchers so as to make the price increase unprofitable. Both switchers and non-switchers will accordingly be protected.

[16] COTA & SACOSS, Submission on the First Draft Report, August 2008, p. 5.

[17] Statement of Approach, published on 19 April 2007, p. 21; Victorian Review First Final Report, pp. 33-34 and 167-169. Available at www.aemc.gov.au.

[18] Guides on the assessment of horizontal mergers under the Council Regulation on the control of concentration between undertakings, Official Journal of the European Union, 5.2.2004 C31/5 – C31/18, paragraph 14.

Box 2.2 Forward-looking approach to competition analysis

The Trade Practices Tribunal identified the benefits of analysing competition using a forward-looking approach:

> "In our judgment, given the policy objectives of the legislation [the Trade Practices Act], it serves no useful purpose to focus attention upon a short-run, transitory situation… This does not mean we seek to prophecy the shape of the future – to speculate upon how community tastes, or institutions, or technology might change. Rather, we ask of the evidence what is likely to happen to patterns of consumption and production were existing suppliers to raise price or, more generally, offer a poorer deal. For the market is a field of actual or potential rivalry between firms." [19]

In his submission to the First Draft Report, the South Australian Minister for Energy suggested that the Commission consider the potential for existing retailers to merge in the future.[20] The Commission acknowledges that possible outcomes of effective competition may include the merging of companies and inefficient firms exiting a market. Although the Commission has taken a forward looking approach in relation to the structural conditions within the framework of analysis for this review, given the uncertainties that would be involved, it has not considered it appropriate to extend its analysis to the consideration of potential mergers. Future mergers that may affect the competitive environment will be appropriately addressed under the existing legislative provisions of the *Trade Practices Act 1974*.

In summary, the Commission's analysis in the South Australian Review is guided by the characteristics of effective or workable competition identified above and the factors which are most likely to combine to deliver those outcomes. The process adopted by the Commission to assess the effectiveness of competition is to identify those characteristics and to examine the extent to which they exist, and are likely to continue to exist going forward, in energy retailing in South Australia. The Commission's process is explained further in the following section.

2.2.3 Assessing competition in South Australia

Markets and competitive forces are dynamic processes and, as such, any assessment of the effectiveness of competition must recognise that competition is an interactive process between market participants not a state or outcome.[21] There is no single criterion or set of criteria that can be used to assess the effectiveness of competition.

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19 *Re Tooth & Co Ltd and Tooheys Ltd* (1979) 38 FLR 1 at 38-39.

20 Minister for Energy, submission to the First Draft Report, September 2008, p. 3.

21 *Re Queensland Co-operative Milling Association; Re Defiance Holdings* (1976) 25 FLR 169 at 188, 189. In that case, the Tribunal said:
"Competition expresses itself as rivalrous market behaviour… In our view effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and there should be independent rivalry in all dimensions of the price-product-service packages offered to consumers and customers."

Further, it is of little utility focusing on short-run, transitory forces.[22] Rather, it is necessary to consider a range of specific quantitative and qualitative factors and to understand the manner in which they combine to deliver effective competition in the longer term, taking a forward looking approach. Accordingly, the Commission has used an integrated and dynamic analytical framework to assess the effectiveness of competition in energy retailing in South Australia.

2.2.3.1 Three key analytical strands

In considering the application of the MCE criteria (set out in section 2.1 above) to the South Australian Review, the Commission has identified three key analytical strands that have informed its approach to the assessment of effective competition. These strands, which encompass the MCE criteria and mirror the approach adopted for the review of the effectiveness of retail competition in the retail sector in Victoria in 2007 (Victorian Review), derive from the Commission's understanding of effective competition (as articulated above).

For competition to be effective, a retail energy market needs to be characterised by:

- informed and active consumers willing and able to respond to offers for the supply of energy products, at prices and on other terms and conditions of supply which best meet their needs;
- rivalrous conduct between retailers (and/or the threat of entry by new retailers) to offer the products, services, prices and other conditions of supply which are most attractive to consumers; and
- freedom of movement for resources into and out of the market(s) in pursuit of profit opportunities, thereby eroding any excess profits over time and allocating resources to supply the goods and services most valued by consumers.

These three core characteristics of effective or workable competition underpin the three analytical strands adopted in the Commission's assessment of energy retailing in South Australia:

- consumer behaviour, attitudes and information requirements in relation to the purchase of energy products and services;
- the nature and extent of rivalrous behaviour between energy retailers; and
- conditions for entry into and expansion in energy retailing in South Australia.

Each of the three analytical strands includes a number of more specific elements that are relevant to an analysis of the effectiveness of competition. While it is important to consider how a single element interacts with the others, identifying individual elements can assist in developing the analytical framework. To this end, the Commission has obtained and analysed evidence relating to a number of factors

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22 *Re Tooth & Co Ltd and Tooheys Ltd* (1979) 38 FLR 1 at 38.

within each of the key analytical strands. These factors mirror those applied in the Victorian Review and are consistent with the indicators identified in Chapter 3 of the Statement of Approach. Through its analysis, the Commission reached an informed view about the materiality of each factor to the assessment of competition. In addition, the Commission was able to evaluate the interactions between each of the factors in order to reach an overall view about competition in energy retailing to small customers in South Australia.

The first of the Commission's analytical strands considered the behaviour of customers in exercising retailer choice. In conducting this part of its analysis, the Commission had regard to indicators of the presence (or absence) of informed customer choice and switching behaviour that is likely to exert competitive pressure on retailers. These indicators included:

- the extent to which customers are aware that they can choose their energy supplier and are relatively knowledgeable about the types of products and service offerings available in the market;

- the extent to which customers are exercising choice by entering into market contracts and changing retailers in response to the price and service offers available to them;

- customers' willingness to act on market information to choose those energy retailers and products which best meet their needs;

- customers' ability to access and understand information enabling them to compare products and service offerings, and their preparedness to undertake such investigations;

- customer attitudes to retail energy brands and their willingness to try new retailers; and

- the impact of regulation in assisting or deterring the exercise of effective consumer choice in relation to retail energy products.

The second strand of the Commission's analysis examined the nature and extent of rivalrous behaviour between retailers. The factors considered by the Commission included:

- price rivalry between retailers;

- differentiation of products and services between retailers to better meet customer requirements than their rivals;

- proactive and defensive marketing strategies by retailers to obtain new customers and retain existing ones;

- differences in business and marketing models (e.g. between the host and new retailers) to attract customers, manage customer churn and remain viable in a volatile market environment;

- the ability of retailers to identify and discriminate between groups of customers in their price, product and service offers;

- the impact of regulation on retailers' competitive activities, including marketing, price, product and service offerings;

- indicators of compliance and non-compliance with regulatory obligations and customer complaints about retailer service; and

- price and profit levels and trends across and between retailers.

The final strand of the Commission's analysis assessed the impact of entry, expansion and exit conditions on competition, including:

- the conditions for entry and expansion in energy retailing, including access to and the cost of contracts for energy supply and risk management facilities, the presence of economies of scale and scope, and the sunk costs of customer acquisition and retail operations; and

- the impact of regulatory requirements such as licensing, retail price regulation and customer service obligations on entry costs and risks.

Uniting*Care* Wesley proposed that a fourth strand of analysis should be incorporated to assess the effectiveness of competition at the wholesale level. [23] As outlined above, in assessing the impact of conditions for entry and expansion on retail competition the Commission has examine wholesaled current conditions in relation to access to energy supply and risk management products. In any event, a broader assessment of the effectiveness of competition in the wholesale sector is outside the terms of the MCE Request for Advice.

The key findings arising from Commission's analysis of these three key strands are explained in Chapter 3. A detailed discussion of the factors that underpin the key analytical strands and the materiality of their impact on the effectiveness of competition is contained in Appendices C-F of the First Final Report.

2.2.3.2 The role of the energy retailer and the nature of energy demand

In assessing the effectiveness of retail competition in terms of the three analytical strands discussed above, it is important to remain cognisant of the intermediary role played by retailers and the effect of customer attitudes towards energy products. These two dynamics can have an important influence on the development of an effectively competitive retail market.

Retailers contract with residential or small business customers to sell delivered energy at specified prices. Retailers purchase wholesale energy to meet the needs of these customers at prices which can fluctuate over the short-term. Therefore, the central role of an energy retailer in any Australian jurisdiction is to act as an

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[23] UnitingCare Wesley, submission to the Issues Paper, April 2008, p. 11; submission to the First Draft Report, August 2008, p. 6.

intermediary between the entity who produces the energy (i.e. the electricity generator or the gas producer) and the end use customer. In performing this role, the retailer manages the price and volume risk faced by the customer in exchange for a risk premium which is incorporated into the retail price of the energy. The efficient management of this risk is a key area in which retailers can compete.

The electricity retail function was described by the Federal Court of Australia in the following way:

> "The retail function in the NEM does not refer to any underlying physical delivery of electricity from retailer to customer. The electricity flows from generators through transmission and distribution lines to the end users. That flow is not controlled by the retailer. The retail function rather describes the assumption, by the retailer, of liabilities to the generator in respect of electricity for which the retailer is paid by the consumer." [24]

A gas retailer operates in a similar manner and assumes both the liabilities and risks of purchasing gas directly from producers and, in selling gas to the customer, charges a price for the energy and an appropriate return for the assumption of risk.

The retail price for each unit of electricity or gas comprises the wholesale price of energy, the charges for transporting energy from the place of production to the consumer's location, the variable costs incurred by the retailer in supplying retail energy services, a contribution towards its fixed costs, taxes and other levies, and a margin for risk and profit. The quantum of these price components will be affected by any regulatory intervention and by the effectiveness of competition between suppliers of the component goods or services.

The demand for any good or service, including in the energy retail sector, is a function of consumer tastes, the price, quality and variety of available products, the availability of substitutable products and the availability and price of any goods or services consumed in conjunction with the primary product or service. Demand is also reflective of the income of consumers and the transaction, switching and search costs associated with selecting one product or service over another. It may also reflect perceptions of the seller's brand or reputation. The nature of demand for energy retail products will affect the extent to which customers are willing to participate in a competitive energy market and, potentially, the effectiveness of competition.

Energy is an essential service and consumers place a high priority on it being reliable. The reliability and security of supply incentives and obligations that apply in the NEM and the safety obligations that apply to the transportation and supply of gas normally deliver the high levels of energy reliability that customers require.

Electricity and gas supply are homogenous services. Although retailers can differentiate energy services on the basis of price, service, expertise and non-price

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24 *Australian Gas Light Company (ACN 052 167 405) v Australian Competition and Consumer Commission (No 3)* (2003) ATPR 41-966 at 47,647.

incentives, consumers generally regard energy supply as an undifferentiated commodity. There is some substitutability between gas and electricity (e.g. in cooking, water heating and space heating) where both fuels are available, but for the majority of uses there is no alternative to electricity. Further, there is an increasing number of electricity-dependent appliances and the price of these appliances is falling. This, coupled with economic growth and rising household incomes, is increasing demand for energy. These characteristics of energy demand are reflected in a relatively low price elasticity of demand for energy, and for electricity in particular, where an increase in price normally results in a less than proportionate reduction in demand.[25] Furthermore, according to the International Energy Agency, the cost of energy in Australia is low by international standards, partly due to the effectiveness of competition reforms in the NEM as well as the abundance of low cost fuels for electricity generation. [26]

Notwithstanding its essential nature, a large proportion of customers view energy as a low involvement commodity which implies that the retailer it is purchased from is of little importance. This is partly due to the fact that, despite increasing consumption, the level of energy expenditure by small customers is low and generally represents a relatively small percentage of household expenses and small business costs.[27]

These features of energy demand can contribute to a perception on the part of some customers that the search and transaction costs associated with actively seeking out and acquiring the most suitable energy product are likely to outweigh the benefits of switching. However, actual or perceived search and switching costs are likely to be less of a deterrent as energy consumption increases or as energy prices increase. Retail energy customers may also exhibit "status quo bias", remaining with their existing retailer even in the presence of potential net gains from switching.[28] This may be particularly prevalent in recently de-regulated markets, previously supplied by government monopolies, but is likely to erode over time. However, low levels of interest amongst customers create incentives for retailers to reduce customers' search costs by using direct marketing to present customers with relevant information and comparisons which allow them to exercise choice at low cost with a minimum sacrifice of time and effort.

The low involvement nature of energy means that retailers play a key role in promoting competition. Given the limited emphasis placed on energy products by end use customers, retailers have a strong incentive to be pro-active in seeking and retaining customers in competition with their rivals by communicating the price and

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25 See, for example, National Institute of Economic and Industry Research, *The own price elasticity of demand for electricity in NEM regions*: *A report for the National Electricity Market Management Company*, June 2007; Australian Bureau of Agricultural and Resource Economics, *Price Elasticities of Australian Energy Demand*, September 1996.

26 International Energy Agency, *Energy policies of IEA Countries: Australia, 2005 Review*, 2005, p. 11.

27 Australian Bureau of Statistics, *Household Expenditure Survey 2003-2004*, February 2006, p. 6.

28 C. Camerer, S. Issacharoff, G. Lowenstien, T. O'Donoghue and M. Rabin, "Regulation for Conservatives: Behavioural Economics and the Case for 'Asymmetric Paternalism'", *University of Pennsylvania Law Review*, 2003, Vol 151 No 121, p. 1,224. The authors cite W. Samuelson and R. Zeckhauser, "Status Quo Bias in Decision Making", *Journal of Risk and Uncertainty*, 1988, Vol 7.

non-price advantages of their service offerings directly to customers. The Commission views the role of retailers and the attitudes of end use customers as important influences on the ability for effective competition to develop. Accordingly, it has considered these matters in the course of assessing the effectiveness of retail competition in South Australia.

2.2.3.3 Future of energy retailing in South Australia

The energy sector is entering an important period of transition. Over the last few years, indications of competitive risks and pressures in the small customer electricity sector have emerged that were not previously evident. The recent tightening of the supply/demand balance in the wholesale electricity market has contributed to increases in spot and contract prices, which have in turn increased prudential obligations and working capital requirements. There are also signals that future policy responses to climate change are expected to require changes to the cost structures facing energy retailers.

Important changes are also facing the gas industry. Rising domestic demand for gas, including for fuel for electricity generation, and a strong export market for liquefied natural gas are likely to alter wholesale gas pricing.

The Commission notes that these changes in wholesale market conditions, in the presence of regulated standing contract prices with which retailers must compete, alter the environment in which energy retailers in South Australia are required to operate. While the Commission has been mindful of these developments throughout the South Australian Review, it expects that effective retail competition can accommodate these changes in the real cost of inputs as long as the standing contract and/or market contract prices are able to adjust to provide competitive retail margins.

2.2.3.4 Information gathering and consultation

An integral input to the Commission's analysis is gathering information and testing it through consultation with stakeholders. The information gathering exercises and the consultative processes undertaken by the Commission are outlined in this section.

To ensure the Commission's assessment of the effectiveness of retail energy competition in South Australia is robust, it engaged in a range of information gathering exercises, including a variety of consultative processes.

The Commission's first formal consultation process commenced on 14 March 2008 when it released an issues paper calling for submissions on a number of matters concerning retail energy competition and the experiences of energy customers specific to South Australia (Issues Paper). The Commission received 13 submissions which it considered in the course of preparing the First Draft Report.[29]

On 14 March 2008, the Commission also released two reports it commissioned from NERA. One of the reports outlines the structure of the upstream gas market, its competitive environment and potential implications for competition at the retail level, and the other outlines these issues in relation to the wholesale electricity market. These reports were originally commissioned as part of the Victorian Review and were updated to reflect recent developments in the energy industry.

The Commission also undertook specific data and information gathering exercises to inform its analysis of competition.

The Commission engaged McGregor Tan Research (McGregor Tan) to conduct a representative telephone survey of 1,200 residential and 650 small business energy customers located throughout South Australia (Consumer Survey). The objective of the Consumer Survey was to obtain quantitative data to assist the Commission to assess whether competition is effective for small customers. To gain a deeper understanding of small customers' experiences of the energy market, McGregor Tan held a total of eight focus groups in Whyalla, Mt Gambier and Adelaide. McGregor Tan prepared a report for the Commission setting out the results of the telephone survey and the focus groups.

To understand energy retailing from the retailers' perspectives, the Commission invited retailers to participate in a survey (Retailer Survey). The Commission engaged LECG to undertake the survey on its behalf and report the results.

The Retailer Survey provided each retailer with the opportunity to provide focused and comparable information on specific issues that the Commission considered were relevant to the South Australian Review. At the completion of the written survey, officers of the Commission and representatives of LECG met with each retailer. Facilitated by McGregor Tan, each meeting sought the retailer's views about trends and specific issues arising from responses to the survey and, where necessary, elaboration on the views expressed in the retailer's written survey response. LECG collated the written responses and additional information provided during the follow-up meetings and prepared a report for the Commission.

An important input to the Commission's analysis of the effectiveness of retail competition has been the data collected by the ESCOSA via its *Energy Regulatory Information: Energy Retail Code Retailer – Energy Industry Guideline No. 2* (Guideline No 2). The statistical information provided in response to Guideline No 2 has informed the Commission's analysis of retailer rivalry and customer participation. The Commission supplemented this information by issuing a data template to each

29 Submissions to the Issues Paper were received from AGL Energy, Australian Power & Gas, Business SA, Council on the Ageing (SA), Energy Consumers' Council, Energy Industry Ombudsman of South Australia, Energy Retailers Association of Australia, Energy Supply Association of Australia, Origin Energy, Simply Energy, South Australian Farmers Federation, TRUenergy and Uniting*Care* Wesley.

retailer seeking quantitative data about customer numbers and transfers, revenue, and costs and margins.

The Commission's analysis of the prices and profits margins was made possible by access to information about market contracts for residential customers contained in the ESCOSA's on-line Estimator. The data template issued to retailers sought information about retailers' market offers to small business customers but the varying completeness of the responses meant the information provided was insufficient to undertake any robust analysis.

Following the publication of the First Draft Report, the Commission conducted a public forum in Adelaide on 17 July 2008. The forum was an opportunity for stakeholders to provide comments on the Commission's preliminary findings and participate in an open discussion. The discussions at the forum have provided an important input to the First Final Report.

Consultation on the First Draft Report commenced on 4 July 2008 where the Commission encouraged submissions to critique its preliminary findings and the supporting evidence. The Commission received 15 submissions which it considered in the course of preparing the First Final Report.[30]

Throughout the South Australian Review, the Commission has maintained an ongoing dialogue with various stakeholders, including representatives of the South Australian Government, ESCOSA, retailers, and community and welfare groups.

30 Submissions to the First Draft Report were received from the AER, AGL Energy, Alternative Technology Association, The Corporate Rate Group, Council on the Ageing (SA) & South Australian Council of Social Service (joint submission), Energy Retailers Association of Australia, Energy Supply Association of Australia, Electricity Supply Industry Planning Council, South Australian Minister for Energy, Origin Energy, Simply Energy, South Australia Electricity, South Australia Farmers Association, TRUenergy, Uniting*Care* Wesley.

3 Findings

The objective of competition in energy retailing is to deliver efficient prices and services to energy customers, and to give customers the opportunity to choose amongst competing retailers and their various price and service offerings. The purpose of the South Australian Review is for the Commission to assess and publicly report on the extent to which competition is effective and, accordingly, meeting these objectives for small energy customers. In this Chapter, the Commission sets out its findings and presents the key supporting evidence.

In reaching its findings, the Commission has had regard to the following sources of information:

- submissions made by interested parties in response to the Issues Paper, First Draft Report and to the Draft Statement of Approach[31];
- comments from stakeholders raised at a public forum on the First Draft Report held in Adelaide on 17 July 2008;
- results of the Consumer Survey and the Consumer Survey Report;
- results of the Retailer Survey and the Retailer Survey Report;
- reports prepared by NERA on wholesale energy markets and energy transportation in eastern Australia;
- data collected by ESCOSA via Guideline No 2, and switching data provided by NEMMCO and REMCo;
- reports published by ESCOSA; and
- reports commissioned by ESCOSA, including NERA's report of the effectiveness of retail competition in South Australia (NERA Report) and the surveys of small energy customers conducted by McGregor Tan Research in 2003, 2004 and 2007.

The Commission has also had regard to such other information as is relevant to the South Australian Review.

3.1 Commission's findings

Having considered the evidence before it in the context of the analytical framework set out in Chapter 2, the Commission's findings are that competition is effective for small electricity and small natural gas customers in South Australia, although competition is relatively more intense in electricity than in gas. However, in making its findings the Commission has identified some structural limitations in relation to

[31] The Draft Statement of Approach was published on 15 March 2007 and the final Statement of Approach was published on 20 April 2007. Submissions can be viewed on the Commission's website at www.aemc.gov.au.

the ability for gas retailers to access firm transmission haulage services. These limitations are affecting the ability of regional small gas customers to access the full benefits of competition with market contract offers available to these customers being limited to those provided by Origin. Of the total number of gas customers located throughout South Australia (around 375,000[32]), approximately 4.5 per cent are located in regional areas.[33] The Commission has not identified any regional distinctions for the 775,000 small electricity customers in South Australia.[34]

In the short time since the introduction of full retail competition (FRC), the supply of retail energy services to small customers in South Australia by two single fuel host retailers has been replaced by competition between four large dual fuel retailers and several smaller, mostly electricity-only, retailers. As at 1 January 2008, ten retailers were offering to supply retail energy services to small electricity customers, including four who also supply these services to small customers. These retailers are identified in Table 3.1 below.

32 The Office of the Technical Regulator estimates that there are 374,990 gas customers in South Australia: Office of the Technical Regulator, *Annual Report of the Technical Regulator: Gas 2006-07*, p. 7. There is a small difference between this figure and the total number of gas customers reported by ESCOSA (375,391): ESCOSA, *2006-07 Annual Performance Report: Performance of South Australian Energy Retail Market*, November 2007, p. 65.

33 *Id*. The gas customers reported as located in regional areas include customers whose annual consumption is unmetered or greater than 1TJ (i.e. a large customer). However, this is unlikely to affect the percentage materially, as the total number of unmetered or large customers located throughout South Australia is small (2,974): ESCOSA, *2006-07 Annual Performance Report: Performance of South Australian Energy Retail Market*, November 2007, p. 65.

34 ESCOSA, *2006-07 Annual Performance Report: Performance of South Australian Energy Retail Market*, November 2007, p. 65.

Table 3.1 Licensed retailers supplying retail energy services to small customers in South Australia

Retailer	Electricity		Gas	
	Licence	Sale to small customers	Licence	Supply and sale to small customers
AGL Energy (including Powerdirect)	✓	✓	✓	✓
Aurora Energy	✓	✓	×	×
Australian Power & Gas	✓	×	✓	×
Country Energy	✓	✓	✓	×
Dodo Power & Gas	✓	×	✓	×
EnergyAustralia	✓	×	✓	×
Jackgreen International	✓	✓	✓	×
Momentum Energy	✓	✓	✓	×
Origin Energy	✓	✓	✓	✓
Red Energy	✓	✓	×	×
Simply Energy	✓	✓	✓	✓
South Australia Electricity	✓	✓	✓	×
TRUenergy	✓	✓	✓	✓

Source: ESCOSA and Retailer Survey Report.

There has been strong rivalry between energy retailers as they offer customers alternative combinations of price, product and service. Large numbers of electricity and metropolitan gas customers have been willing and able to respond to competitive offers and to exercise choice between the available offers when approached by retailers and given sufficient incentive. Market structure and the entry and expansion of new retailers have generally fostered competition, however recent changes in the energy market (described further below) have increased the risk of entry into or expansion within energy retailing.

The remainder of this Chapter provides an overview of the evidence supporting the Commission's assessment of the effectiveness of competition in terms of customer participation, retailer rivalry, the ease with which retailers can enter, expand within or exit from energy retailing and the profit margins earned by retailers.

3.2 Customer participation

The ability and willingness of customers to respond in an informed manner to price and service quality differentials across product offerings is an essential condition for effective competition. Where enough consumers respond to price or quality differences by switching to products that better meet their needs, suppliers will be encouraged to respond to these signals or risk losing patronage and customer share. In the absence of consumer-based competitive pressure, suppliers may develop a degree of market power which, if exercised, may result in consumers being adversely affected by higher prices, reduced output and/or lower service quality.

The Commission's findings that competition is effective is supported by evidence of consumer behaviour. A more comprehensive analysis of the evidence and information before the Commission that underpins its views about customer participation is contained in Appendix D.

3.2.1 Awareness of FRC

Awareness of FRC amongst residential and small business energy customers in South Australia is high. Of those customers surveyed, over 82 per cent of residential electricity customers and 84 per cent of residential gas customers were aware that they could select their own retailer. The rates of awareness were only slightly lower amongst small business customers, with 70 per cent of small business electricity customers and 78 per cent of small business gas customers aware of their ability to select their own retailer.[35]

3.2.2 Switching rates

Although an awareness amongst customers that they can choose their energy retailer is an important pre-condition for competition, retailers will not be exposed to competitive pressure unless customers participate in the competitive process by switching, or by being prepared to switch, between retailers. While South Australia's small energy customers are unlikely to actively seek out competitive market offers, they demonstrate a clear willingness to participate in the competitive retail market if approached directly by a retailer.

Large numbers of small electricity and metropolitan gas customers have responded to competitive offers and exercised choice between the available offers when approached by retailers and given sufficient incentive. Approximately 66 per cent of small electricity customers and 59 per cent of small gas customers have switched to a market contract.[36] As noted above, a significant proportion of these customers are supplied by new retailers. The switching rates of small electricity customers to June 2007 resulted in South Australia being ranked as the third "hottest" electricity market in the world. While the gas switching rates were lower, it was nevertheless classified as an "active" market.[37]

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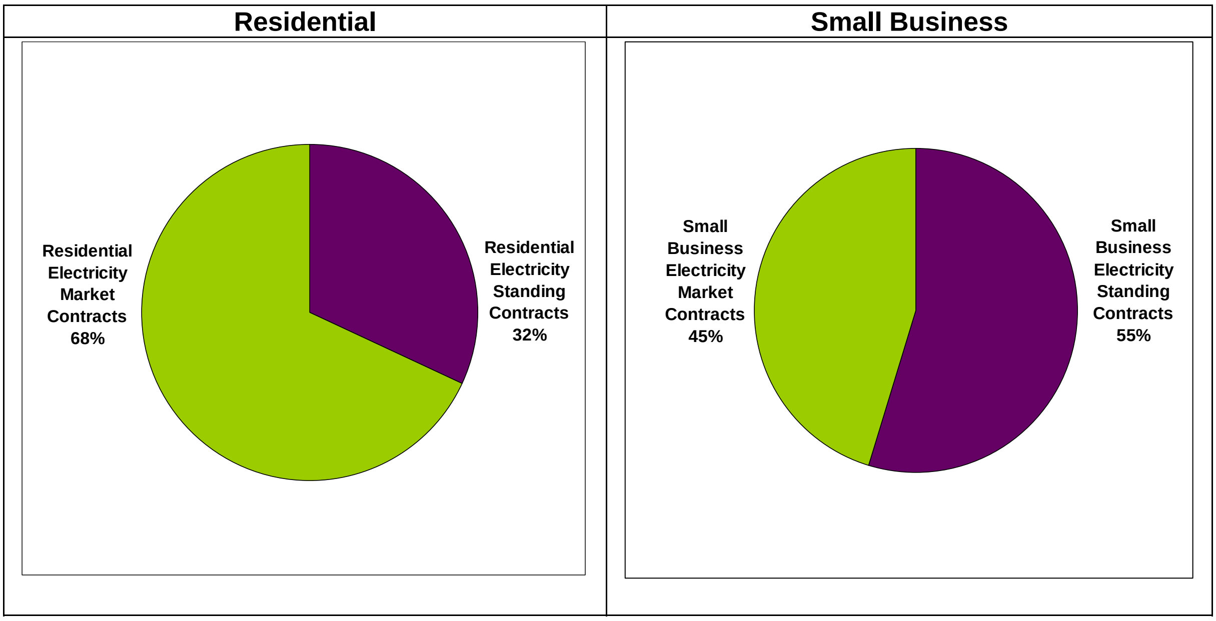
35 McGregor Tan, *Consumer Survey Report*, pp. 21 and 71.

36 *Ibid*, pp. 33, 43, 82 and 91.

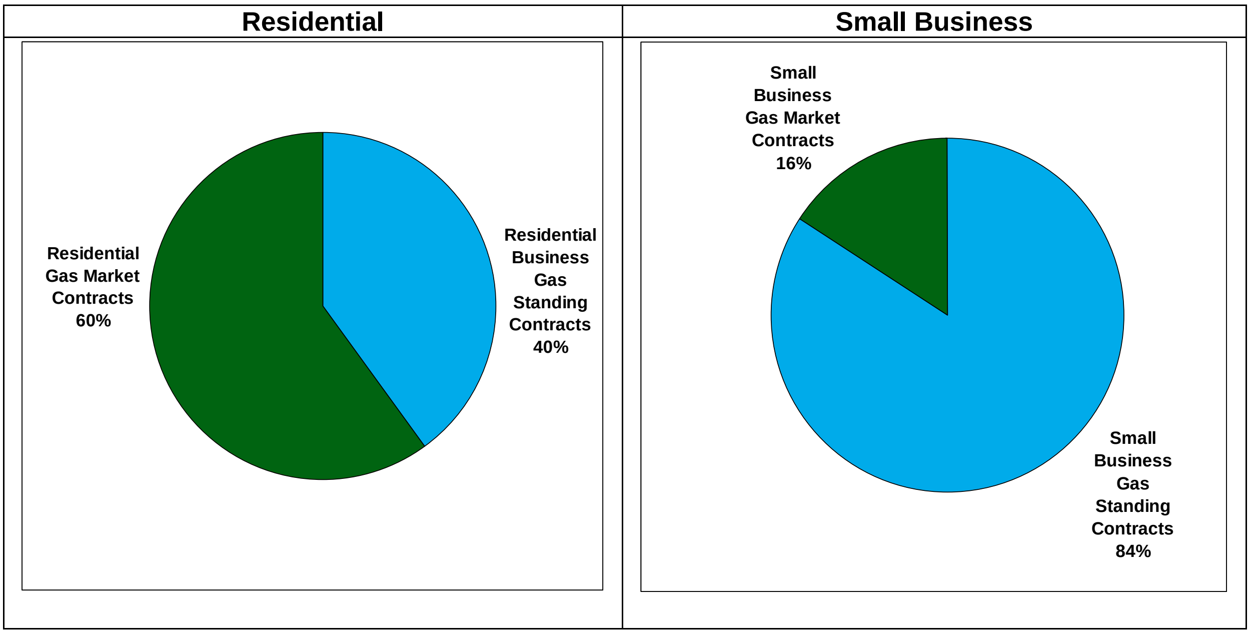
37 First Data Utilities and VaasaETT, Utility Customer Switching Research Project, *World Energy Retail Market Ranking*, 3rd edition, July 2007.

Figure 3.1 Market versus standing contracts: electricity



Data source: ESCOSA data reported under Guideline No 2.

Figure 3.2 Market versus standing contracts: gas



Data source: ESCOSA data reported under Guideline No 2.

Proportionately fewer small business customers have moved from the standing contract to a market contract. Evidence before the Commission suggests this is, in part, due to the higher opportunity costs faced by businesses in researching market offers themselves and/or responding to direct marketing approaches by retailers. Further, because energy is not a significant expenditure for many small businesses, the search costs facing many respondents outweigh (or are perceived as outweighing) the likely benefits of switching. The Retailer Survey also indicated that retailers had greater difficulty accessing the decision makers in small businesses and so marketing was more time-intensive than is generally the case for residential customers. Overall, it appears that while small businesses are less likely to participate than their residential counterparts, there are no structural factors impeding their participation in the market. Small business customers have demonstrated a willingness to engage with retail energy market competition in relation to electricity products, where the perceived benefits relative to search and switching costs are greater, and can be expected to respond in a similar way to competitive gas offers, given sufficient price incentive.

The switching data also indicates that the incidence of switching is also substantially lower for small gas customers located in regional areas than those observed in Adelaide. ESCOSA's *2008 Gas Standing Contract Price Path: Final Inquiry Report & Final Price Determination* (2008 Gas Price Path Review) noted that the switching observed in regional areas "almost exclusively" relates to switching from an Origin standing contract to an Origin market contract, rather than to a market contract offered by a new retailer.[38] This switching behaviour reflects structural features that are limiting the ability of regional gas customers to access the full benefits of competition, which are described further in section 3.2.4.

3.2.3 Reasons for switching

Most small customers that have switched to a market contract have done so in response to the direct marketing initiatives of retailers. While few customers initiate contact with a retailer, over 64 per cent of electricity and 19 per cent of gas customers surveyed by the Commission had been contacted directly by a retailer either in person, by phone or by some other means since the commencement of FRC.[39]

Of those residential or small business customers surveyed, the principal motivation for switching to a market contract was to reduce energy costs (71 per cent). The opportunity to have the same retailer for both electricity and gas (7 per cent) or to purchase green energy (7 per cent) also motivated some residential and small business customers to enter into market contracts. Very few customers who switched to a market contract indicated that the offer of a free gift was a primary motivator for switching (1 per cent). Similarly, loyalty bonuses or discounts for prompt payment were not considered to be significant for most customers in their decision to switch.[40] The proportion of customers who have switched to a market contract indicates that switching costs do not appear to be a significant deterrent to customer participation.

The majority of customers who chose not to switch to a market contract reported that they were either happy with their current retailer or "couldn't be bothered" switching.[41] This is consistent with customer attitudes towards energy, reflecting

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38 ESCOSA, *2008 Gas Standing Contract Price Path Inquiry: Final Inquiry Report & Final Price Determination*, June 2008, p. A-25.

39 McGregor Tan, *Consumer Survey Report*, pp. 27 and 77.

40 *Ibid*, pp. 36, 46, 85 and 92.

41 *Ibid*, pp. 9 and 13.

either a lack of interest in energy products, status quo bias and/or the perception of significant search and/or switching costs among a proportion of customers.

3.2.4 Accessing and understanding information about energy offers

Notwithstanding the relatively high levels of awareness of their ability to choose a retailer, the Consumer Survey reported that many small customers had not approached retailers to obtain, or to obtain information about, a market offer. This is in keeping with the Commission's observations that energy is treated as a relatively low involvement commodity by many energy customers. Of those who had actively sought out information about energy offers (10 per cent), the most common sources were the internet (46 per cent) or the retailer (30 per cent).[42]

Survey respondents were asked what sources of information they used when making a decision regarding changing their electricity or gas supply arrangements.[43] Approximately 65 per cent of respondents indicated that the information they had used came either from a retailer or a representative of a retailer. The internet was the second most common source of information (12 per cent).[44]

Respondents who actively sought or were provided with information generally agreed that the information was easy to obtain, useful and easy to understand.[45] Levels of agreement were generally higher amongst residential customers and generally lower amongst small business gas customers.

The Consumer Survey indicated that customers felt they had access to enough information to enable them to make an informed decision about the product that was best for them. Approximately 43 per cent of all electricity respondents and 53 per cent of residential gas respondents indicated that the information provided was "fine as is" and did not require improvement.[46]

However, there appears to be some incongruence between the results of the telephone survey and the observations by focus group participants about the availability of information. Notably, focus group participants stated that they did not have access to sufficient information to enable them to identify competing retailers, compare the price and non-price terms of competing market offers, or understand how the energy market works.[47] The Commission notes that much of this information is already available. ESCOSA publishes a Consumer Toolkit, which contains a number of fact sheets and other helpful materials aimed at small customers. Further, ESCOSA's on-line Estimator provides an important service to residential customers interested in comparing competing energy offers, and this has

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42 *Ibid*, pp. 55 and 98.

43 Respondents to this question included customers who had actively sought information, as well as those who had been given information by a retailer.

44 McGregor Tan, *Consumer Survey Report*, pp. 61 and 102.

45 *Ibid*, pp. 58 and 100.

46 *Ibid*, pp. 62 and 92.

47 *Ibid*, p. 172.

been complimented by an estimator service that allows small business customers to compare offers. At least two other on-line comparator services are now also accessible by South Australian energy consumers.[48]

3.2.5 Satisfaction with full retail competition

The Consumer Survey revealed high levels of satisfaction amongst those small customers who had switched energy retailer. Approximately 81 per cent of residential and 76 per cent of small business electricity customers, and 86 per cent of residential gas customers were quite or very satisfied that their new gas retailer had delivered what they were looking for.[49] High levels of satisfaction were reported by similar proportions of electricity customers who remained with the same retailer but had changed their supply arrangements (67 per cent of residential customers and 79 per cent of small business).[50] Given that the main motivator for switching for the majority of customers was to achieve a price or cost saving, this suggests that customers participating in the competitive market are experiencing the benefits of price-based competition.

One submission to the Issues Paper suggested that multiple switching can be indicative of market failure or the absence of effective competition.[51] However, the level of retailer rivalry observable in energy retailing in South Australia and the absence of evidence of widespread or systemic mis-selling suggests that multiple switching is reflective of, and consistent with, the competitive process. Customers exercise choice among competing retailers and their available products and services, exerting pressure on retailers to offer price, product and service combinations that best suit customers' needs.

Further, the preparedness of customers to switch retailer indicates that people find the switching process relatively easy and are willing to participate in order to put in place more suitable arrangements for the supply of energy.

A number of submissions received on the First Draft Report expressed the view that the Commission had erroneously relied on customer awareness and churn rates as strong indicators of market effectiveness.[52] To support this view, these submissions referred the Commission to consider a study of UK consumer experiences by Wilson

48 GoSwitch.com.au at www.goswitch.com.au and uSwitch at www.uswitch.com.au.

49 McGregor Tan, *Consumer Survey Report*, pp. 38, 87. The number of responses given by small business gas customers is too small to draw conclusions about their attitudes.

50 *Ibid*, p. 47. The number of responses given by gas customers is too small to draw conclusions about their attitudes.

51 Council on the Ageing (SA), submission to the Issues Paper, April 2008, p. 5.

52 See for example, the submissions to the First Draft Report from the Alternative Technology Association (pp. 1-2); COTA & SACOSS (pp. 6-7); Uniting*Care* Wesley (pp. 21-26); South Australian Minister for Energy (p. 3).

and Price where it was found that consumers do not always select the best offer available.[53]

The Commission considers that customer awareness and churn rates are components that contribute to the overall assessment of customer participation, which forms one of three strands of the Commission's analysis. The Commission also notes that large proportions of the customers in the Wilson and Price study had either realised perfect gains or been as well, if not better, off from switching. The analytical approach adopted for the South Australian Review recognises that the costs of searching for and acquiring additional information may be perceived to outweigh the benefits of having that information in order to exercise better informed choices. Energy consumers may therefore rationally limit their search activity while accepting that they may not achieve the best possible outcomes available in the market. In this situation, retailer marketing activity can be lower cost than direct customer search as the means of informing customers of the price and non-price offers available in the market.

The Consumer Survey indicated that South Australian customers have been willing to change retailers when approached with a price discount offer. The high percentage of consumers that have switched retailers, evidence that price discounts have been the principal motivation for customer switching and the high levels of satisfaction with the outcomes of their market contract choices, provides evidence in the case of South Australia that a large proportion of energy consumers have been participating in the competitive retail market and have benefited from their choices.

In summary, the evidence before the Commission indicates that customers are both willing and able to participate in the market in an informed manner and, in so doing, exert some degree of competitive discipline on the price, product and service offerings of South Australian gas and electricity retailers.

3.3 Retailer rivalry

The Commission's findings are supported by evidence of strong retailer rivalry in the provision of retail energy services as they offer small customers alternative combinations of price, product and service. The Commission's analysis of the evidence before it concerning retailer rivalry in South Australia is detailed in Appendix C.

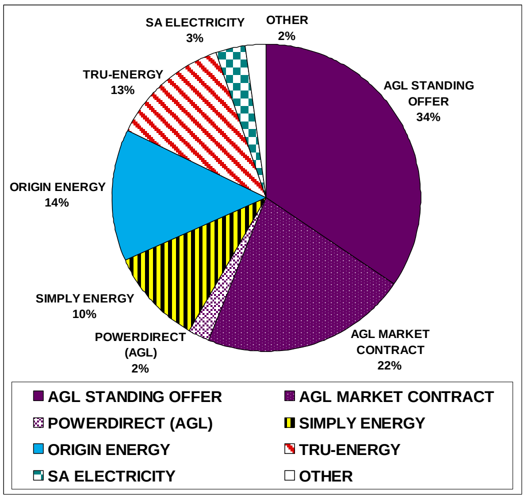
In the short time since the introduction of FRC, the supply of retail energy services to small customers in South Australia by two single fuel host retailers has been replaced by competition between four large dual fuel retailers and several smaller, mostly electricity-only, retailers. As a result of competition, new retailers now supply 42 per cent of small customers (see Figure 3.3 below).[54]

53 Do Consumers Switch to the Best Supplier? CM Wilson & CW Price, CCP, April 2007.

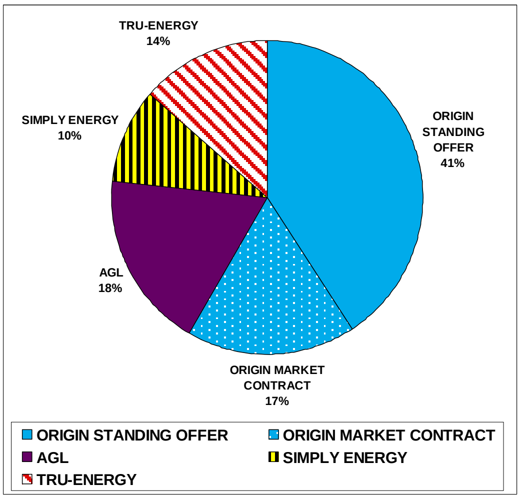
54 The new retailers' share of customers does not include Powerdirect, which is a wholly owned subsidiary of AGL.

Figure 3.3 Retailer customer shares: electricity and gas

Electricity



Gas



Note. Electricity retailers listed as “Other” are those with one per cent or less of the total share of customers. For a complete list of retailers currently selling electricity to small customers in South Australia, refer to Table 3.1.

Data source: ESCOSA data reported under Guideline No 2

3.3.1 Basis of rivalry between retailers

Retailers principally compete on the basis of price discounts from the standing contract price and a range of non-price incentives in an effort to retain existing and secure new customers.

The focal point for price-based competition has been the standing contract prices which have operated as the benchmark product and the prices against which most retailers have sought to compete. To date, the up-front discounts retailers have offered electricity customers relative to the electricity standing contract price have ranged from 10-12 per cent but have diminished recently, reflecting the recent increase in the costs of acquiring wholesale electricity. Recently, up-front discounts of 3-7 per cent were available under electricity market contracts, with discounts available to gas market customers ranging from 0.5-4 per cent when compared to the gas standing contract.

To provide customers with an additional incentive to take up a market offer, retailers also offer other price and non-price incentives such as rebates, one month free supply or bill credits for customers staying longer than one year, or free gifts such as magazine subscriptions, sporting club memberships and appliances. While most retailers offer accredited Greenpower or renewable energy products, some retailers are also offering other innovative products and product features which appeal to customers e.g. prepayment metering.[55] Taking into account all the direct price benefits, small electricity customers can save between 4.5 and 8.5 per cent compared to the standing contract prices. Gas customers are offered discounts of between 0.5 and 7.5 per cent in comparison to the gas standing contract prices.

3.3.2 Retailer strategies to overcome customer attitudes to energy

The strategies retailers have adopted to grow their customer shares are influenced by the nature of demand for energy. Customer perceptions of energy as a low involvement product mean that retailers face a strong incentive to overcome customers' lack of engagement with basic energy products. The Customer Survey shows that many customers do not have a strong interest in their energy service arrangements and, in the absence of an active approach to marketing by retailers, are unlikely to be motivated to search for superior energy contract prices and conditions, at least absent more substantial price incentives.[56] Consequently, it is advantageous for retailers to actively seek out customers and communicate directly to them the price and non-price features of their energy offers.

Energy retailers in South Australia view direct sales and marketing channels, principally door-to-door sales and telesales, as very important in overcoming the perception held by customers that search and switching costs are high. New retailers considered corporate sponsorship and, to a lesser extent, mass marketing channels (such as television) as useful tools for advertising their brand. A number of retailers, particularly those offering dual fuel products, use bill inserts and telesales to leverage their existing customer base.[57]

A number of retailers reported that good customer service is a key strategy for retaining customers. The opportunity to "win-back" a customer considering switching to another retailer, for example by matching the competitor's price, was also identified as an important retention strategy.[58]

3.3.3 Prevalence of mis-selling in energy retailing

Retailers face strong incentives to avoid mis-selling. Misleading or deceptive marketing conduct, high pressure sales tactics and other unconscionable conduct can adversely affect a retailer's reputation and impose immediate costs associated with processing complaints. However, the incentives facing individual sales agents may sometimes differ from those of the retailers employing them, and can distort the competitive process in particular instances.

Information provided by the Energy Ombudsman indicates that while there have been a number of instances of mis-selling, there is no evidence to suggest that

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55 Country Energy had previously offered a fixed price market contract where the price was constant over the life of the contract but this product is not currently available.

56 McGregor Tan, *Consumer Survey Report*, p. 15.

57 LECG, *Retailer Survey Report*. p. 58.

58 *Ibid*, p. 37.

adverse selling practices are widespread or systemic in South Australia.[59] Importantly, retailers' decisive responses to complaints regarding inappropriate marketing conduct reflect the broader incentives facing a retailer to avoid the direct and indirect costs that mis-selling can impose on a retailer. Although adverse selling practices have not been widespread, the Commission continues to see an important role for an effective consumer protection framework in deterring misleading or deceptive conduct and supporting the functioning of an effectively competitive market.

3.3.4 Competition is reflected in the redistribution of customer shares

On the information currently before the Commission, rivalry amongst electricity retailers has been relatively strong to date and has resulted in substantial reductions in the proportion of customers supplied by the host retailer, AGL Energy (AGL).

As noted above, ten retailers currently offer to sell electricity to small customers in South Australia. Strong competition has resulted in a substantial decline in the proportion of small customers supplied by AGL. By 31 December 2007, AGL (including Powerdirect) had contracts in place with:

- 57 per cent of all residential customers, including 37 per cent of all market contracts taken up by residential customers; and

- 70 per cent of all small business customers, including 33 per cent of market contracts taken up by small business customers.

While rivalry amongst electricity retailers has been relatively strong to date, six of the ten retailers currently selling electricity to small customers have temporarily ceased marketing to acquire new customers and the remaining four retailers' marketing activities have been reduced. The Retailer Survey reported that increased price levels and volatility in the wholesale market has increased the cost of acquiring wholesale electricity and risk management instruments, including forward contracts.

Because the standing contract prices act as a reference point for the prices offered under market contracts, the increased input costs have affected the margins that retailers are able to achieve, given the cost to acquire customers. Of the six retailers who had suspended their active customer acquisition strategies, most indicated that they were unlikely to commence actively marketing again until either wholesale market conditions improved or the margin available to retailers under the standing contract prices are improved.[60]

New retailers have entered gas retailing, with three new retailers offering to sell and supply gas to small customers. Although smaller in number, new retailers have competed effectively with the host gas retailer in the Adelaide region, generally through dual fuel marketing strategies. Competition has reduced the proportion of

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59 Energy Industry Ombudsman of South Australia, submission to the Issues Paper, 10 April 2008, p. 3.

60 LECG, *Retailer Survey Report*, p. 9.

gas customers supplied by the host retailer, Origin. As at 31 December 2007, Origin supplied:

- 57 per cent of all residential customers and 30 per cent of market contracts taken up by residential customers; and
- 87 per cent of all small business customers and 17 per cent of market contracts taken up by small business customers.

The Commission notes that the ability for new retailers to compete for gas customers located in regional areas is constrained by a number of structural features and low profit margins. The structural issues include the limited availability of firm transmission haulage services on the MAPS laterals, which service regional areas. The firm transmission haulage capacity on the gas pipelines in question are contracted to the host retailer, Origin, on legacy contracts, which are expected to expire in the short to medium term. Other retailers require firm transmission haulage in order to service small gas customers and, for this reason, these retailers are limited in their ability to expand into regional areas when the required haulage services cannot be obtained or obtained at competitive prices.

Submissions to the First Draft Report questioned the finding that competition is effective for gas customers when regional gas customers only have the choice between a standing contract or market contract from Origin.[61] The Commission has ascertained that Origin's market contract offers to regional gas customers are at prices that are commensurate with Origin's offers to customers in metropolitan Adelaide. As Origin's Adelaide offers are subject to competition from other retailers, regional gas customers are able to gain some benefits of retail competition. However, the Commission recognises that regional gas customers may not be benefiting fully from the competitive energy market due to the structural issues that have been identified. The Commission will consider options for improving this situation and, if appropriate, will provide additional discussion in the Second Draft Report.

The impact of structural limitations in the ability of regional gas customers to participate in the retail sector is discussed further in sections 3.4.2 and 3.5 below.

3.3.5 Role of dual fuel in driving competition in gas retailing

The moderate South Australian climate, combined with low gas penetration, means annual gas consumption amongst small customers is low relative to other jurisdictions. Low consumption, together with the level of the standing contract prices, means the dollar value of the margins per customer that are available from selling and supplying gas are small relative to electricity. For this reason, some gas retailers either do not offer gas only market contracts or do not actively market them.

[61] See for example, submissions to the First Draft Report from COTA & SACOSS (p. 3); South Australian Minister for Energy (p. 2); Uniting*Care* Wesley (p. 30).

Adopting a dual fuel strategy can help to overcome some of the constraints imposed by slim margins. Offering dual fuel products enables retailers to earn an additional margin for each customer who signs up to purchase gas as well as electricity for an incremental increase in the acquisition cost. Because electricity market contracts have been the subject of strong retailer rivalry, competition for electricity customers has provided the incentive for dual fuel retailers to compete for gas customers as well.

However, the Retailer Survey revealed that some retailers have reduced, or temporarily ceased, marketing gas to small customers in recent months. Further, some prospective gas retailers indicated that they have indefinitely deferred their plans to enter.[62] This reflects increasing wholesale fuel costs relative to the standing contract prices, which have substantially eroded the margins available from retailing gas to small customers. Since all of the gas retailers operating in South Australia are vertically integrated dual fuel "gentailers", it is likely that more attractive margins are available from the use of gas for electricity generation under current market conditions and, in some cases, from direct supply to large gas users.

3.4 Conditions for entry, expansion and exit

Another factor that can facilitate effective competition is ease of entry into, expansion within, and exit from, energy retailing. In markets where the conditions for entry, expansion and exit are relatively easy and entry or expansion can occur within a reasonable time period and on a sufficient scale, the threat of entry or expansion can impose a credible competitive constraint on retailers operating within the market.

The Commission's analysis of the evidence before it in relation to conditions for entry into, expansion within and exit from South Australia energy retailing is contained in Appendix E.

3.4.1 Electricity

Until recently, the structural and regulatory conditions prevailing within the electricity supply chain in South Australia were conducive to both entry by new retailers and the expansion of existing retailers. Nine new entrants commenced operations in the period following the commencement of FRC, three of which have become large scale retailers. Small scale entrants have utilised outsourcing business models to access scale economies and minimise sunk costs, allowing them to enter the market and compete effectively with larger retailers. However, expansion by smaller retailers to a large scale is generally associated with more substantial sunk cost investments in vertical integration into electricity generation and developing the retailer's own in-house systems. While vertical integration may be a strategy for a larger organisation considering entry or a large retailer considering expansion, smaller retailers are able to utilise outsourcing as an effective strategy to maintain a viable operation.

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62 *Id.*

However, the ease of entry and expansion by electricity retailers has become more difficult in the recent past with higher spot prices, increased spot price volatility and increased vertical integration. These changes have culminated in a material increase in the cost of acquiring wholesale electricity and risk management instruments, with the effect that prudential obligations and working capital requirements have also increased. Some stakeholders expressed concern that changes in the extent to which some electricity retailers are vertically integrated have contributed to reduced liquidity in the South Australian contract market.[63]

At present, the ability of electricity retailers to pass on higher input costs to small customers is constrained by standing contract prices which act, in effect, as a price ceiling and place an upper limit on the margin available to retailers. Most retailers indicated that, notwithstanding the reduction in contract market liquidity, hedge contracts are available but the cost of the contracts cannot currently be recovered at competitive retail prices.[64] As discussed above, a number of electricity retailers operating in South Australia have responded to the reduction in margins and the increased cost of hedging by ceasing to market to new electricity customers. Prospective new entrants have also indicated that they are unlikely to enter the market until margins improved.

An illiquid contract market can create significant risk for retail entry. In addition to upward pressure on contract prices, a reduction in contract market liquidity also has the potential to create a further impediment to large scale entry and expansion. If a large scale entrant is unable to obtain access to the quantum of contracts required to operate in South Australia it may face pressure to vertically integrate to ensure it has access to sufficient hedge contracts in order to manage its exposure to the spot market. Entry or expansion predicated on vertical integration will entail substantial sunk costs and may therefore act as a barrier to large scale entry or expansion.

In submissions to the Issues Paper and First Draft Report, some stakeholders expressed the view that AGL, following its acquisition of TIPS, has significant market power in the wholesale electricity market and has been able to exercise that market power in ways that adversely impact on the competitiveness of the electricity retail market. These stakeholders pointed to the high spot price outcomes of the recent summer and the reported decreases in contract liquidity as evidence of this market power.[65]

The Commission has investigated these issues further and set out is analysis and conclusions in Appendix E. In summary, the Commission notes that the recent spot pricing outcomes and contract liquidity issues were influenced by the combined effect of transitory contract market arrangements, unprecedented weather and demand conditions and the unexpected derating of the Heywood interconnector. The Commission notes that its views are consistent with those expressed by the AER.[66] Further, if there were existence of sustained wholesale market power it does

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63 See, for example, submission to the Issues Paper Uniting*Care* Wesley (p. 27).

64 LECG, *Retailer Survey Report*, p. 62.

65 See, for example, submission to the Issues Paper Uniting*Care* Wesley (pp. 26-29).

66 AER, submission to the First Draft Report, September 2008, p. 1.

not automatically imply that retail competition is not effective. The ability to influence energy prices at the wholesale level would only impact on competition at the retail level if AGL could expect to profitably squeeze out retail competition by using TIPS to provide its retail arm with a sustainable commercial advantage. This in turn would require AGL to have an expectation of raising future retail margins to recoup the costs incurred in providing such an advantage by raising barriers to retail entry or expansion. Based on the evidence before it, the Commission does not believe that this has been the case or that a vertically integrated retailer, such as AGL, has the incentive or capacity to pursue such strategies in South Australia.

Looking to the future, the Commission recognises that the electricity industry is entering a period of transition associated with the need for new investment to address the tightening supply/demand balance. There will also be a period of adjustment to the cost structure changes that are anticipated to result from future policy responses to climate change. However, effective retail competition can be expected to accommodate these changes in the real cost of inputs as long as the standing contract and/or market contract prices are able to adjust to provide competitive retail margins.

3.4.2 Gas

Conditions for entry into, or expansion within, gas retailing have been sufficiently positive to date to encourage entry by three new retailers. Each new entrant has interests in gas fired power generation assets and/or a customer base that can support the highly fixed cost nature of gas supply and transportation.[67] This suggests that the scale economies and sunk costs associated with entry mean gas retailing is more conducive to large scale than small scale entry.

The Retailer Survey identified a number of additional difficulties associated with entry to gas retailing in South Australia. Of principal concern were complexities in the operation of the Retail Market Rules, particularly the swing gas service, which exposed retailers to substantial risk when seeking to manage volume risks.[68] New retailers reported that entry requires significant expertise to contend with these

67 The South Australian gas retail market is based on a "contract carriage" model, which requires a gas retailer to enter into bilateral contracts with a producer of gas for gas supply and contracts with a gas transmission pipeline operator for the transportation of gas. To establish these contracts would require an upfront cost. In comparison to retailing electricity, where there are no contracts to be entered into for the transmission of electricity and a retailer may purchase electricity from the wholesale pool managed by NEMMCO, establishment costs for a gas retailer would potentially be higher than for an electricity retailer. These issues are further discussed in Appendices A and E.

68 As discussed further in Appendix E, swing gas under the Retail Market Rules is a concept which relates to imbalances that can occur between pipelines when there are more than one pipeline supplying a distribution network (i.e. the Adelaide distribution network, which is supplied by MAPS and the SEAGas Pipeline). When imbalances occur, swing gas services must be purchased by retailers to address the imbalance. If retailers do not have sufficient swing gas service arrangements in place it is possible for retailers to be exposed to the "Swing Service Provider of Last Resort" price of $1600/GJ, which could potentially be a significant cost to retailers.

complexities and risks, as well as sufficient resourcing and experience to negotiate and execute contracts to purchase and ship wholesale gas.[69]

The Commission also identified structural features that affect the ability of retailers to expand their gas retailing operations into regional areas, limiting the offers available to regional gas customers.[70] Firm transmission haulage services on the MAPS laterals that service regional areas and competitively priced haulage services on the SESA Pipeline are not readily available. This is impeding regional gas market penetration by new retailers wishing to supply small gas customers in the areas around Whyalla, Port Pirie, Riverland, Murray Bridge and Mt Gambier. However, it has been noted by some market participants that some of these structural issues relate to legacy contracts that are due to expire in the near term, after which access to capacity is expected to improve.[71] The fixed cost nature of selling and supplying gas and, in addition, the small number of customers residing in these areas has limited the economic viability of retailing gas in these regions.

Unattractive profit margins have limited the opportunities for new retailers to compete for South Australian gas customers. As a result, some gas retailers have temporarily ceased actively acquiring customers while other prospective retailers have deferred their plans to enter indefinitely. Looking forwards, however, as long as standing contract and/or market contract prices offer sufficient margins, effective gas competition is likely to continue in metropolitan areas. As existing pipeline contracts expire, the potential for competition to strengthen in regional areas should increase.

3.4.3 Host retailer advantage

Other than the limitations on the opportunity for new retailers to compete for regional gas customers noted above, host retailers AGL and Origin do not appear to enjoy any significant competitive advantage over new entrant retailers. Brand loyalty has not been a significant deterrent to customer acquisition and new retailers have not needed to engage in large scale mass media advertising to penetrate the market (although the focus groups conducted as part of the Consumer Survey suggest that customers may prefer "South Australian" energy retailers).[72] The use of outsourcing business models to minimise sunk costs reduces the cost of new entry and the scale required to compete effectively with larger retailers. There is no evidence that exit costs are deterring entry.

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69 LECG, *Retailer Survey Report*, p. 72.

70 Approximately 4.5 per cent of all gas customers in South Australia are located in the regional areas of Whyalla, Port Pirie, Riverland, Murray Bridge and Mt Gambier: Office of the Technical Regulator, *Annual Report of the Technical Regulator: Gas 2006-07*, p. 7.

71 AGL, submission on the First Draft Report, p. 6; Origin Energy, submission on the First Draft Report, p. 4.

72 McGregor Tan, *Consumer Survey Report*, p. 163.

3.4.4 Regulatory obligations

The regulatory obligations that apply to energy retailers are, in large part, shared by all retailers. However, the scope and compliance costs associated with these obligations may influence potential entrants' willingness (or their perception of their ability) to commence efficient retail operations, and decisions by existing retailers to expand. Obligations of particular concern to retailers included the costs of complying with policy initiatives to improve residential energy efficiency in South Australia, increased compliance costs associated with regulatory differences between jurisdictions, and the regulation of service standards which have removed customer service as a point of differentiation.[73] While the Commission notes that the breadth of, and divergence in, regulatory obligations can affect retailers' compliance costs, they do not appear to have been a significant barrier to entry or expansion to date. To the extent that compliance with new policies (e.g. the CPRS) results in substantial changes to real input costs, effective competition can be expected to accommodate these changes provided that prices are able to adjust to deliver competitive retail margins.

On balance, the conditions for entry and expansion in electricity and gas since the advent of FRC have been positive. Significant entry has occurred, such that existing retailers are generally constrained in their price setting and output decisions. Provided the margins available under standing contract and/or market contract prices are sufficient, effective competition is likely to continue. In any event, although ease of entry and expansion can and does impose an additional form of competitive constraint on retailers, effective competition would remain feasible in South Australia in the absence of the threat of entry, as long as sufficient rivalry continued between existing retailers for individual customers and for shares of the total number of customers.

3.5 Measured profit margins

In an effectively competitive market, prices will converge over time toward the efficient economic cost of delivery (including a return that is commensurate with the prevailing conditions in the financial markets and the risks involved in providing the service). It follows that an assessment of whether the revenue earned by retailers on market offers is consistent with, or in excess of, the economic cost of delivery can provide some insight into the effectiveness of competition.

One way of ascertaining whether retailers' revenues are consistent with the economic cost of delivery is to estimate the margins earned under market offers, and to compare this with an estimate of the margins that would be expected to prevail in a competitive market (the 'competitive' margin). The Commission recognises that an analysis of this form is an inherently imprecise exercise and that care must be exercised when interpreting the results and drawing inferences about the effectiveness of competition. That said, the Commission does consider that an analysis of margins can provide some insight into whether:

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[73] LECG, *Retailer Survey Report*, p. 68.

- the margins earned by retailers to date on market contracts are consistent with the outcomes that would be expected in an effectively competitive market; and

- the margins available under the standing contract prices have facilitated or deterred entry and competition.

To determine whether the margins earned by retailers to date are consistent with the outcomes of an effectively competitive market, the Commission has had to estimate both the 'competitive' margin and the margins earned by retailers under market offers.

The competitive margin estimate utilised by the Commission in this context has been developed having recourse to information from a variety of sources, including decisions made by a number of jurisdictional regulators in relation to retail margins. Rather than using a single point estimate of the competitive margin, the Commission has developed a range. The lower bound of this range is based on the 5 per cent margin adopted by ESCOSA in its standing contract price determinations which ESCOSA has assumed includes an appropriate allowance for customer acquisition costs. There is some debate surrounding whether or not a margin of 5 per cent adequately reflects the costs of acquiring customers and thus the Commission has developed an upper bound for the competitive margin by incorporating an explicit allowance of between \$80 and \$150 for customer acquisition costs. Incorporating these costs into the analysis gives rise to a 'competitive' margin range which extends from:

- 5.0 per cent to 6.6 per cent for electricity if the cost of acquiring customers is equivalent to the commission paid to door-to-door sales teams, or 8 per cent if the full customer acquisition cost of \$150 per customer is used; and

- 5.8 per cent to 6.9 per cent for gas if gas is marketed as the marginal product in a dual fuel offering, or 8.7 per cent if gas is marketed on stand alone basis (or 11.2 per cent if the full customer acquisition costs is used, albeit with a risk of double counting).

The Commission's estimates of the margins earned by retailers under market offers have been developed using publicly available information. That is, while the Commission sought actual revenue and cost information from retailers the information was not supplied by all retailers. The specific information that the Commission has had recourse to when estimating the margins earned by retailers under market offers includes:

- information from ESCOSA's on-line Estimator which was used to estimate the revenue generated by retailers under market offers for residential customers of average size, below average size and across locations; and

- cost information obtained from ESCOSA's determinations on electricity and gas standing contract prices.

Drawing on this revenue and cost information the Commission has estimated the 'base case' margins earned by retailers under market offers involving the supply of average sized electricity (5 MWh per annum) and gas customers (22 GJ per annum).

To account for the fact that the ESCOSA cost estimates are historic in nature and do not necessarily reflect the costs that are currently prevailing or are likely to prevail in the future, the Commission has also considered the sensitivity of the base case results to changes in wholesale energy prices. The specific sensitivities considered by the Commission in this context include:

- wholesale electricity prices that are 10 per cent higher or lower than those assumed in ESCOSA's electricity standing contract price determination[74]; and
- wholesale gas and transmission costs that are 15 per cent higher than those assumed in ESCOSA's gas standing contract price determination.[75]

The results of the Commission's base case margin analysis and the sensitivity analysis for electricity and gas are summarised in Table 3 below. This table also includes an estimate of the average margin prevailing under the standing contract over the period of analysis.

Table 3 Average margins under the standing contract and market offers (September 2004-February 2008)

	'Competitive' margin range	Base case	Sensitivity analysis	
Electricity			**+10% wholesale electricity prices**	**-10% wholesale electricity prices**
Standing contract		7%	4.1%	9.8%
Market offer single fuel	5-8%	3.3%*	-0.7%	7.2%
Market offer dual fuel		5.3%**	1.5%	9.2%
Gas			**+15% wholesale gas and transmission costs**	
Standing contract		12%	8.6%	
Market offer single fuel	5.8-11.2%	8.4%^	5.0%	
Market offer dual fuel		7.0%^^	3.5%	

*if non-monetary inducements are included this margin falls to 2.9 per cent.
** if non-monetary inducements are included this margin falls to 4.3 per cent.
^if non-monetary inducements are included this margin falls to 8.4 per cent.
^^ if non-monetary inducements are included this margin falls to 6.3 per cent.

The results in this table indicate that under the base case:

- the margins available under both electricity and gas standing contract prices appear to have fallen within the plausible range expected in a competitive market and have been sufficient to enable competition and profitable entry by new retailers seeking to supply the average customer; and

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74 ESCOSA, *2007 Electricty Price Standing Contract Price: Final Inquiry Report and Final Price Determination*, November 2007.

75 ESCOSA, *2008 Gas Price Path Review*.

- in the presence of standing contract prices, competition appears to have constrained retailer market offers, with the average margins earned by:
  - gas retailers falling within the plausible range (8.4 per cent versus 5.8-11.2 per cent); and
  - electricity retailers falling below the plausible range (i.e. 3.3 per cent versus 5-8 per cent).

It is important to recognise that, in this context, the base case margin analysis does not explicitly incorporate the effects:

- of the recent increase in the cost of acquiring wholesale electricity and risk management instruments or the increase in the level of residual risks borne by retailers which have prompted a number of electricity and gas retailers to temporarily cease active marketing and a number of prospective new entrants to postpone their plans to commence retailing in South Australia;
- that policies addressing climate change may have on the costs incurred by retailers going forward; or
- of tightening supply/demand conditions in both the wholesale electricity and wholesale gas markets.

This list of factors suggest that, going forward, there will be upward pressure on wholesale energy prices. As outlined in Chapter 2, an effectively competitive retail energy market can be expected to accommodate significant changes in energy input costs so long as standing contract and market contract prices are able to adjust to continue to provide competitive retail margins. However, if future standing contract prices, which currently provide the reference point for competitive market offers, are unable to adjust to reflect rising energy costs, then it would appear from the sensitivity analysis presented in Table 3 that:

- the margin available under gas standing contract prices would continue to fall within the competitive margin range while the margins available to gas retailers under market offer prices would fall below the lower bound of the range; and
- the margins available under electricity standing contract prices (4.1 per cent) would fall below the lower bound of the competitive margin range while the margins available under market offer prices would fall below zero (-0.7 per cent) which implies that it may no longer be commercially viable for retailers to continue to operate in the market.

Overall, this analysis suggests that while the margins in the past appear to have been conducive to both entry and competition, going forward margins will come under increasing pressure. If standing contract prices are not able to accommodate the higher input prices that are likely to flow from the tightening supply/demand balance and the introduction of climate change policies, then retailer viability and effective competition could be placed at risk.

3.6 Second Draft Report

The publication of the First Draft Report concludes the first stage of the South Australian Review; that is, the Commission's assessment of the effectiveness of competition in electricity and gas retailing in South Australia. Given the Commission's finding that competition is effective, the AEMA requires that the Commission consider ways to phase out the current retail price regulation arrangements. The Commission's draft advice, which is the subject of the Second Draft Report, will be published by the Commission in October 2008.