

A few
words.

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Australian Energy Market Commission
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Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia, first Draft Report – July 2008 (ref: EOR0017/2)

AGL Energy Limited (**AGL**) welcomes the opportunity to comment to the Australian Energy Market Commission (**Commission**) on its Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia (**the review**) - First Draft Report (**Draft Report**).

AGL as a retailer of gas and electricity in South Australia is committed to providing its customers with gas and electricity at reasonable prices and has always endeavoured to ensure prices reflect the costs and risks incurred in supplying energy to consumers.

Accordingly, AGL looks forward to assisting the Commission in its review. We would be happy to meet with the Commission to discuss in more detail the energy market in South Australia and how competition has affected that market.

Our detailed comments on the Commissions Draft Report are attached.

For any enquiries in relation to this submission please contact Michelle Shepherd on (03) 8633 6194.

Yours sincerely,

Elizabeth Molyneux
General Manager, Energy Regulation

- > Being selected as a member of the Dow Jones Sustainability Index 2006/07
- > Gaining accreditation under the National GreenPower Accreditation Program for AGL Green Energy®, AGL Green Living® and AGL Green Spirit
- > Being selected as a constituent of the FTSE4Good Index Series



AGL response to Australian Energy Market Commission

Review of Effectiveness of Competition in the Electricity and Gas
Retail Markets in South Australia – First Draft Report

Date: August 2008



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Preamble

On 13 December 2007, the Ministerial Council on Energy (**MCE**) requested the Australian Energy Market Commission (**Commission**) to provide advice on:

- › The Commission's assessment of the effectiveness of competition for small customers in the electricity (i.e. customers consuming less than 160MWh per annum) and natural gas markets (customers consuming less than 1TJ per annum) in South Australia, having regard to the full range of customers in this class; and
- › The retention, removal or re-introduction of retail price regulation for standing contracts for small customers in the electricity and natural gas market(s) in South Australia.

The Commission is required¹ to follow the framework provided for in clauses 14.10 to 14.16 of the Australian Energy Market Agreement (**AEMA**) when conducting each review. This requires, amongst other things, the Commission to base its assessment of the effectiveness of competition on the criteria developed by the MCE:

- › Independent rivalry within the market;
- › The ability of suppliers to enter the market;
- › The exercise of market choice by customers;
- › Differentiated products and services;
- › Prices and profit margins; and
- › Customer switching behaviour.

AGL notes that the request for advice made by the MCE to the Commission specifically require that the South Australian review focus on "small customers".

AGL Energy Limited (**AGL**) is pleased to provide comment on the Commission's First draft Report (**Draft Report**) of its Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia (**the review**).

¹ As outlined in the Issues paper released by the Commission: AEMC, "*Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia*", Issues Paper, March 2008,



Executive Summary

AGL, as a retailer of gas and electricity in South Australia, is committed to providing its customers with electricity and gas at efficient prices. We have always endeavoured to ensure prices reflect the costs and risks incurred in supplying energy to consumers. Accordingly, AGL welcomes the opportunity to comment on the Draft Report.

AGL agrees with the Commission that competition is effective in South Australia for all customers, when measured against the indicators established by the MCE and further developed and agreed to by all stakeholders. We also note that the methodologies used for the assessment, such as customer and retailer surveys, are consistent with approaches that have been used in past effectiveness of competition reviews in South Australia, which have also found that competition in the energy market is effective.

AGL notes there have been some concerns raised by stakeholders regarding competition in the wholesale market. On this matter, we note that:

- there is sufficient liquidity in both the gas and electricity wholesale markets in South Australia to allow retailers to enter the market and sell energy to consumers on a competitive basis – as is evidenced by the number of retailers currently licensed and/or active in South Australia;
- there appears to be no correlation between churn in the electricity market and wholesale electricity contract prices; and
- while there are some short term wholesale gas market issues affecting competition in a few regional gas markets, these issues will be resolved by the market in due course and competition will develop.

In AGL's view, competition is to be preferred over regulation, requiring an emphasis on letting the markets work rather than regulating for potential inadequacies, as such, we fully support the Commission in its findings that the South Australian retail energy market is effective and that regulation of retail prices should be removed.

The removal of retail price regulation does not mean diminishing the existing customer protection arrangements such as obligation to supply arrangements for customers in financial hardship, and community service obligations.

AGL's specific comments on the Draft Report and review follow.



Specific Comments on the Draft Report and Review

Competition in South Australia

AGL supports the Commission's finding that the gas and electricity markets in South Australia are demonstrating effective competition.

Since the South Australian energy markets were opened to full retail contestability, AGL has seen aggressive competition by second tier retailers seeking to win market share away from the incumbent retailers. This level of competition has resulted in less than half of electricity and gas customers remaining on standing contracts.

AGL accepts that while competition in the electricity market is unhindered, there are some short term structural issues that may have impeded levels of gas market competition in some regional areas in South Australia. These issues primarily relate to legacy wholesale gas contracts. AGL believes that as these contracts come up for renewal, new entrants will be able to secure access and compete in the affected regional areas. However, that being said, we concur with the findings of the Commission that in general competition is effective in the gas market.

The Commission has highlighted an important factor in ensuring competition in the retail sector, that being sufficient margin for any participating retailer. With increased supply costs (particularly wholesale costs), it is only a matter of time for margin to be eroded away if the total tariff cannot reflect these increased input costs. It is important that in the transitional period leading up to the removal of price regulation, retail tariffs set or maintained through a pricing determination allow for appropriate cost recovery as well as sufficient margin on those costs. It is common for new entrant retailers to price their products from a regulated or default rate (e.g. 5% discount off the regulated rate). If the regulated or default rate is not set at realistic levels, this can compromise a new entrant retailer's ability to price products on a competitive basis while maintaining a sufficient margin to warrant remaining in a market.



Retail Competition and the Wholesale Energy Market

AGL notes that some respondents to the Review have commented on the need to assess the state of wholesale trading in South Australia before it can be concluded that retailing is fully competitive. While AGL does not disagree with this position, it is important that the Commission only consider wholesale issues in so far as they have a direct impact on retail competition. The key issues are the availability and pricing of wholesale energy.

The wholesale electricity market

AGL agrees with the Commission that the wholesale electricity market is competitive and it facilitates competition in the retail market. This is evidenced by the high rates of customer churn in the market away from the incumbent retailer and between new entrant retailers.

Retailers are able to obtain wholesale electricity by contracting with a wholesale market participant (such as a National Electricity Market (*NEM*) generator or a speculator), buying energy through the spot market, or buying or building their own generation plant. How a retailer chooses to acquire wholesale electricity will depend on their size, their customer base and their appetite for risk.

Wholesale electricity prices have recently risen, largely brought about by the ongoing drought conditions nationally as well as a tightening of the supply-demand balance - an inevitable consequence of economic growth.

South Australian specific issues

As shown by the South Australian Government review² into the market in 2001 (the SA Review), the wholesale cost of energy rises sharply when supply shortages are forecast. They often fall just as quickly when new supply is brought into the market. The SA Review noted prices rising sharply around the time of the construction of the Northern Power Station (1980s) and again during the extreme summer of 2000/01 while Pelican Point Power Station was under construction.

The SA Review also noted that the demand curve for South Australia was significantly peaky and that wholesale prices during the first quarter of each year were significantly higher than the remainder of the year. This is exacerbated during extreme summers like 2001 and 2008.

Impact of SA prices on retail competition and customer churn

AGL notes that, despite high wholesale costs, churn has continued. As shown in the graph below, there has been no evident correlation between the wholesale electricity forward contract price and churn in South Australia. In fact, churn appears to be related to time. That is, churn was highest shortly after the opening of the market, and has declined as the market has matured and progressively “stickier” customers remain on their existing contracts.

² The State Government Electricity Task Force Final Report, 2001. Usually referred to as the SA NEM Task force. Chapter 7 outlines pricing issues in SA.

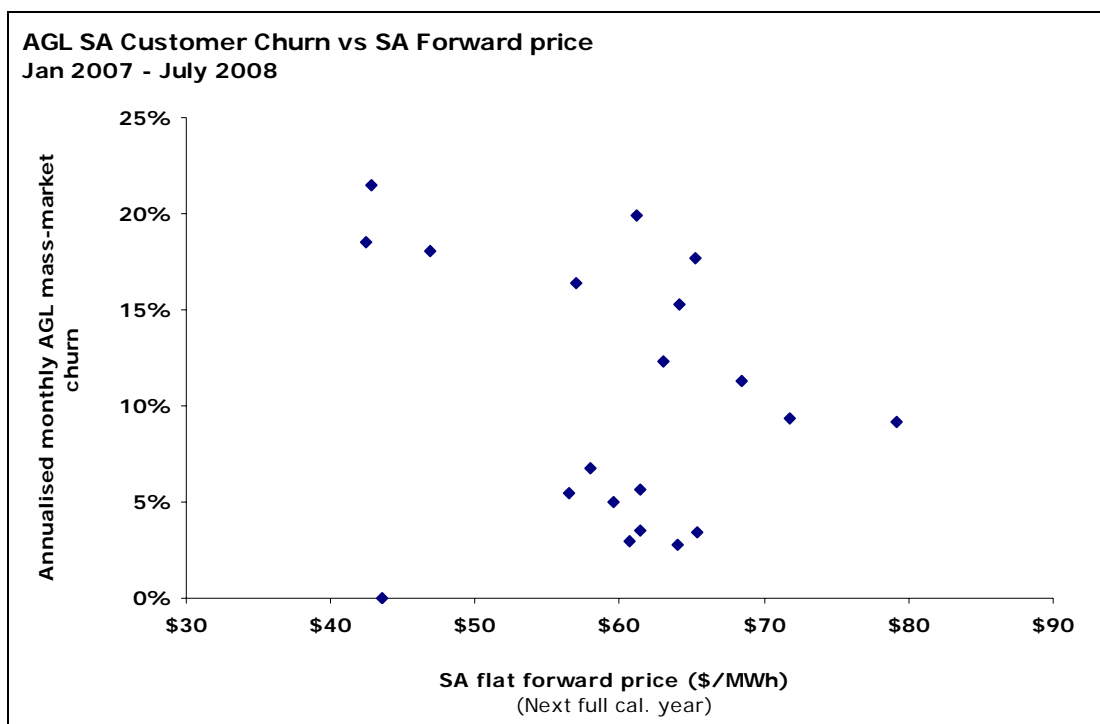


Figure 1 This chart is a scatter plot of the annualised monthly AGL small-customer churn, vs the prevailing SA forward price for the next full calendar year – displaying no evident correlation.

Wholesale market liquidity

The strong level of liquidity in South Australia can be illustrated through analysing the volume of futures contracts traded in the South Australian market for the past 2 summers³.

As shown in Table 1 below, the number of contracts traded for the peak summer periods has increased dramatically since AGL's acquisition of the Torrens Island Power Station ("TIPS"), reflective of AGL's interest in retaining liquidity of contracts in South Australia.

³ Information from the SFE website.



Table 1: Volume of Contracts Traded

CONTRACTS	Quarter 1 2007	Quarter 1 2008
Base Contracts	783 MW	1270 MW
Peak Contracts	90 MW	115 MW
Cap Contracts	20 MW	157 MW
TOTAL	893 MW	1542 MW

For 2009, the current indication is that the volume of contracts traded for Quarter 1 will be consistent to that seen in Quarter 1 2008.

In addition, in the lead up to and throughout the first quarter of 2008, AGL and other generators were offering generation contracts on the OTC market.

This demonstrates that financial market liquidity for SA has not diminished since the AGL acquisition of TIPS.

The wholesale gas market

AGL agrees that competition is generally effective in the gas market, with the majority of customers (over 95%) having the ability to choose their retailer.

However, AGL acknowledges that there are some short term structural issues which may affect competition in some regional areas of the gas market.

As highlighted in the Commission's Draft Report, there are some townships in South Australia where it is not currently possible to secure transmission access on a firm basis, or, where access is available the cost may be currently prohibitive.

As outlined earlier, AGL is of the view that as the contracts for transmission capacity in the affected areas sunset, access will become available and competition will develop. Therefore this can be considered to be a short-term issue which will be resolved by the market in due course.

The Australian Energy Market Agreement

Under the Australian Energy Market Agreement (**AEMA**), the Commonwealth and State and Territory governments have agreed to phase out the exercise of retail price regulation for electricity and natural gas where effective competition can be demonstrated.

Clause 14.11 (a) of the AEMA states that the Commission will assess the effectiveness of competition for the purpose of retention, removal or reintroduction of retail energy price controls.

Clause 14.11 (c) of the AEMA requires the Commission to publicly report on its assessments of effective competition in which it will provide advice on:



- (i) ways to phase out the exercise of retail price regulation if competition is determined to be effective, and an appropriate timeframe; or
- (ii) ways to promote the growth of effective competition for those users or areas of a jurisdiction which do not enjoy effective competition.

The rationale and pre-conditions for the phase out of retail price regulation have been discussed in the lead up to the agreement under the AEMA. The comprehensive assessment by the Commission and the ranking of South Australia as the second most competitive energy market in the world by FirstData/VaasaEMG⁴ leaves no doubt that competition in South Australia is effective.

The next stage of the review

Now that the Commission has found the gas and electricity markets to be demonstrating effective levels of competition, the focus for the next stage of the Commission's considerations should be on transitional issues and the timetable for the phase out of retail price regulation, such as:

- obligation to supply; and
- arrangements for price monitoring and reserve powers, if relevant.

It is important that the outcome following the implementation of the agreement under the AEMA, in particular with respect to customer protection, is clearly understood and articulated so as to ensure continued consumer confidence. Consumer confidence is critical to maintaining competition in South Australia.

In the past there may have been a view held by some that the removal of price controls will only lead to weaken customer protection and impact on arrangements for assisting vulnerable customers. AGL does not support this theory. Customers will still be afforded the same levels of customer protection currently in place, with the exception of 'regulated' retail prices. Rather, it will be market forces that will determine retail prices, and, as witnessed internationally (such as the UK), market forces generally keep retail prices at relatively low levels – subject to changes in policy and government initiatives such as carbon trading schemes. However, should there be evidence that competition has ceased to be effective in South Australia in future years, the AEMA provides for powers to monitor and intervene with respect to retail pricing.

The removal of retail price regulation does not mean diminishing the existing customer protection arrangements such as obligation to supply arrangements for customers in financial hardship, and community service obligations.

In order to ensure continued customer protection and to ensure there is sufficient information in the market to allow customers access to energy at reasonable prices, the current legislation and regulations in South Australia need to be reviewed to clarify or define arrangements with respect to:

- Obligation to supply;
- Default prices;

⁴ World Energy Market Rankings, Utility Customer Switching Research Project, August 2007, FirstData Utilities/VaasaEMG.



- Price monitoring; and
- Reserve powers.

These are discussed below.

Obligation to supply

Incumbent or host retailers currently have the obligation to supply small retail customers in South Australia. Under a deregulated pricing regime the standard terms and conditions would not need to change except that any reference to standing offer tariffs would be changed to an alternative (unregulated) publicly available price ('default price') – as discussed below.

With respect to who has the obligation to supply, AGL supports the obligation being placed on the Financially Responsible Market Participant (FRMP), as is the case for electricity in Queensland.

As outlined in previous submissions to the Commission on the removal of retail price regulation, AGL supports the FRMP having the obligation to supply for the following reasons:

- The energy market in South Australia has reached a level of maturity where the 'incumbent or host' concept is becoming increasingly irrelevant. New entrant retailers of both gas and electricity supply a large percentage of customers;
- Obligation to supply can complement the deemed price provisions where customers move in and commence using energy without entering into an arrangement or where customers' contracts expire and have not been renewed;
- This arrangement ensures that retailers who market and have the service infrastructure in a particular geographic region carry the obligation;
- A FRMP can be more readily identified compared to alternative options;
- Avoids the customer having to transfer from the current FRMP to another retailer; and
- Avoids the administrative complexity of determining responsibility for wholesale market costs and subsequent adjustment processing.

However, in the lead up to the national regulatory framework for retail regulation, AGL would support the retention of obligation to supply being placed on the host retailers.

Default prices

In the absence of regulated retail prices, it is clear that retailers will need to publish 'default prices' that will apply in a number of circumstances such as:

- in the event that a customer's contract expires and they have not made alternative arrangements;
- where a customer moves into a premise and commences to use energy without making arrangements with a retailer; or
- under the obligation to supply provisions.



The publication of the default prices ensures that customers are aware of the costs that they will incur when consuming energy. In addition, publication will also ensure that prices can be monitored under an appropriately designed price-monitoring regime, if deemed necessary.

Price monitoring

Clause 14.14 (c) of the AEMA states that transitional arrangements may involve oversight of retail prices under a deregulated pricing regime.

Energy is an essential service and AGL understands that the phase-out of retail price regulation without any independent monitoring of prices will not be acceptable to some stakeholders, especially consumers. Further, independent 'price monitoring' together with reserve price regulation powers will ensure that customers have confidence that price outcomes will remain efficient.

There are Price Disclosure Guidelines currently in place in South Australia, which require retailers to have certain information available to small customers on their websites. AGL would support the extension of the Price Disclosure Guidelines to include the publication of 'default prices'. This would ensure that retail prices are transparent and effectively communicated to customers.

However, AGL maintains its view that any price-monitoring regime should remain non-interventionist and not become a de facto retail price review. In addition, since the Commission is responsible for the effectiveness of competition reviews for the retention, removal, or reintroduction of retail energy price controls under the AEMA, it would make sense for the Commission to also undertake 'price monitoring'.

Following a review of general market conditions, such as number of retailers, availability of market offers and customer choice, the Commission could determine if competition has ceased to exist. Action, such as the reintroduction of regulated price controls should only be taken where it can demonstrate that there is market failure.

Reserve powers

We note that under clause 14.14(c) of the AEMA, the phase out of retail price regulation does not prevent the exercise of a reserve power by the State or Territory where effective competition ceases. AGL continues to support such reserve power but considers that any such reserve power should only be exercised in accordance with a regulatory methodology promulgated by the Commission that ensures that any intervention by government may only occur where there is demonstrable evidence of market failure.

The Commission should undertake the assessment of market failure (competition has ceased to be effective) which may be triggered as a result of the Commission's ongoing price monitoring, or through a direction for an effectiveness of competition review from the MCE.

Protection of vulnerable customers

It is anticipated that arrangements with respect to assistance to vulnerable customers are expected to remain unchanged. Current arrangements for vulnerable customers, such as retailer hardship policies address the process for identification and delivery of assistance to



those customers who are not able to pay their bills through retailers, government and welfare organisations.

AGL reiterates that clause 14.11 (b) of the AEMA states that social welfare and equity objectives will be met through clearly specified and transparently funded State or Territory community service obligations that do not materially impede competition.

There are a number of social programs in place in South Australia that are being delivered by retailers, consumer groups and governments. In addition, AGL notes that there is a new energy efficiency scheme which is expected to commence at the beginning of 2009 which will seek to further assist customers in managing their energy usage. These will continue to be delivered when retail price regulation is phased out.