Australian Energy Market Commission

Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia: Draft Second Report

Comments by Uniting*Care* Wesley Adelaide
November 2008

Preparation of this report has been partly funded by the National Electricity Consumers Advocacy Panel. The support of the Advocacy Panel is gratefully acknowledged by the Uniting*Care* Wesley Adelaide.

Graphs and charts without attribution in this report were provided by NEM Review which uses NEMMCo data

The content and conclusions reached in this submission are entirely the work of the consultants.

Bob Lim
Economics and Public Policy

Headberry Partners P/L
Energy, Management & Procurement Services

Contents **Page**

Executive Summary

Uniting Care Wesley Adelaide (UCW) considers that this AEMC review has failed consumers, particularly low and modest income households, by failing to understand the realities of the SA energy markets in practice.

UCW considers that the AEMC has not unambiguously established that there is effective retail competition in the electricity, or gas market in South Australia.

An attachment to this submission critiques the AEMC's First Final Report and concludes that the AEMC's conclusion of effective retail competition is in error and is based on assumptions, analytic omissions and erroneous analysis.

Against that background, the UCW comments on the recommendations of the draft Second Report. In particular, the UCW considers:

1. A repeat of the summer 2008 price events in the wholesale market in summer 2009 should trigger a review, possibly by the AEMC, to enable the South Australian government to reintroduce retail price regulation in electricity.

2. Upon release of the AER investigations into the bidding activities of AGL/TIPS in summer 2008, the AEMC to initiate a review to advise the SA government on the impact on retail competition in electricity.

3. ESCOSA to monitor and report every three months on observed standing contract and default contract prices for a minimum of three years. ESCOSA, in consultation with the AER, to advise on any wholesale market issues which it considers may be distorting the standing contract prices posed by retailers.

UCW has provided commentary on each of the 13 recommendations made by AEMC in its draft second report and supplementary questions raised at the AEMC presentation on 6th November 2008.

1. Introduction

In South Australia, small electricity and gas consumers are exposed to retail competition in the supply of electricity and gas. Currently this retail competition has a market cap but allows retailers to offer lower prices but not to exceed the cap. This approach allows retailers the ability to offer small consumers pricing a discount from the retail price cap. As a result, small consumers can confidently assess retail price offers and there has been significant “churn” between retailers.

Under the AEMA, the AEMC is required to analyse the competitiveness of the various regional energy markets in order to assess the degree of retail competitiveness as they apply to small consumers. From this review, the AEMC is required to recommend to the regional government an approach which will lead to greater competitiveness and less protection for small consumers of energy. The reason behind this decision is that an open and competitive energy market will deliver efficient prices, which will provide benefits to small consumers.

Victoria was the first region reviewed and the AEMC assessed that the Victorian market was characterised as having strong retail competition. The removal of price caps was expected to increase this competition and so further reduce prices seen by consumers. Subsequently, the Victorian government introduced legislation to move small consumers into “unprotected” retail marketing from energy providers. This move was in direct opposition to all groups representing small consumers.

The AEMC has now reviewed the SA energy markets and again as in Victoria, the groups representing small consumers opposed a change from a retail price cap on the basis that there is no (or not likely to be) effective retail competition, especially in the light of recent market events (in electricity).

What was not carried out in either the Victorian review or the SA review, was any analysis of the competitiveness of the retail market where there is no price cap (ie for consumers using >160 kWh pa of electricity). The importance of seeking such input is that retailers operate across the whole spectrum of consumption and not just in the small consumer market. A review of the impact of large consumers of energy would provide first hand information to AEMC of what is really occurring in the retail sector. In its response to the AEMC draft first report the UCW offered to provide access to consumers operating in the unconstrained energy market so that AEMC could access first hand data as to the real retail competition in the energy markets. This was not taken up by the AEMC.

Along with the AEMC consultant NERA, the UCW also provided a view that a competitive retail market is predicated on a competitive wholesale market in the primary and secondary markets. In both, a high level of liquidity is necessary for retailers to be able to offer tailored supply arrangements to meet the needs of consumers. The AEMC decided that such wholesale market issues are not necessary in order to demonstrate there is a competitive retail market.

It became apparent to the UCW that the AEMC processes could be interpreted by some as more intent on demonstrating that competition was strong. It is worth noting that the AEMC's first draft report reached a very unambiguous conclusion of effective retail competition before it carried out a wide range of analysis, including the many key areas suggested by stakeholders.

Accepting there is a competitive retail market, the AEMC has now, in its draft second report, provided a "how to" transition from a protected retail market with a price cap, to a market where retailers will offer to any consumer a proposal for the supply of energy, without any constraints as to how high the price might be.

Most commodity markets, be they for petrol or tomatoes[1], do not require the consumer to lock in a contract for extended periods typically 12-36 months for the supply of an essential service. Consumers that make a wrong decision due to their lack of knowledge cannot mitigate their error by reducing their demand. Because of the complexity of the energy markets, combined with their unique feature of being "essential", it is not sufficient just to assume that an unprotected market based on an assumption there is sufficient competition is adequate to protect the interests of the most vulnerable in the community, especially, as acknowledged by the AEMC, there have been recent fundamental changes at the wholesale and retail markets.

In this regard, we consider that the AEMC review has failed consumers.

[1] In the mobile telephony market, consumers usually get hardware as well as the commodity, providing some longer term benefit to the consumer. In the energy market there is no ability to put the telephone down and not use it as electricity (and gas) is an essential service. Thus there is little ability to mitigate a bad decision by not using power.

2. UCW assessment of the process so far

Uniting Care Wesley Adelaide (UCW) now provides its comments on the AEMC's Second Final Report on the Review of the Effectiveness of competition in Electricity and Gas Retail Markets in South Australia. The UCW comments are primarily directed at the electricity retail market.

The UCW is disappointed with the conclusion of the AEMC with respect to the effectiveness of retail competition in electricity in South Australia. Where the AEMC concludes that recent strong increases (especially during the summer of 2008) in wholesale electricity costs that have undermined retailers' profit margins as leading to their temporarily ceasing marketing activities to prospective new customers until margins improve, the UCW sees the price increases as squeezing the competitive ability of those retailers unable to obtain hedging contracts for wholesale electricity (and therefore exposed to spot price volatility) because of the strategic behaviour of AGL/TIPS (the dominant generator and retailer) and therefore exiting the relevant retail market segment, and possibly unlikely to return.

The AEMC has observed that second tier retailers have exited the market and has attributed this to there being insufficient "head room" above costs. What the AEMC totally failed to do was to assess whether these retailers could have secured any hedging contracts at all. If the AEMC had taken up our proposal for the AEMC to discuss directly with larger consumers exposed to an unconstrained retail market, the AEMC would have found that regardless of the cap on pricing for small consumers, consumers in SA in the contestable market are not receiving offers from second tier retailers because of the scarcity of hedging contracts, and not because of the cap on small consumer contracts. If the AEMC was correct in its assumption that the retail price cap was the problem in the SA market, then it would mean that the retailers would be offering to consumers not protected by a retail price cap. The fact that this is not occurring puts the lie to the AEMC deduction.

Where economic rents can be shifted upstream (at the wholesale market sector) retailers that are unable to obtain hedge contracts will never be able to compete with vertically-integrated competitors, or dual fuel, larger competitors that have access to gas supplies.

The UCW is able to distinguish between competition issues and non-competition issues (such as the affordability of energy for low income households) and where these issues can be addressed at the policy level. Where prices rise as a result of rent seeking and/or predatory pricing because of the presence of an uncompetitive market structure, price regulation is necessary because, if left unchecked, such behaviours cause economic damage – even in the short term – and are not in the interests of consumers, including the more vulnerable in our society.

Rent seeking is especially an unproductive activity which constitutes a form of hidden taxation, lowering both the living standards of Australians and the productivity and international competitiveness of South Australian industries. It is due to this ability of dominant gentailers to squeeze out the smaller retailers that shows the AEMC has failed in a fundamental way to properly assess the reality that the SA electricity market in not competitive at all.

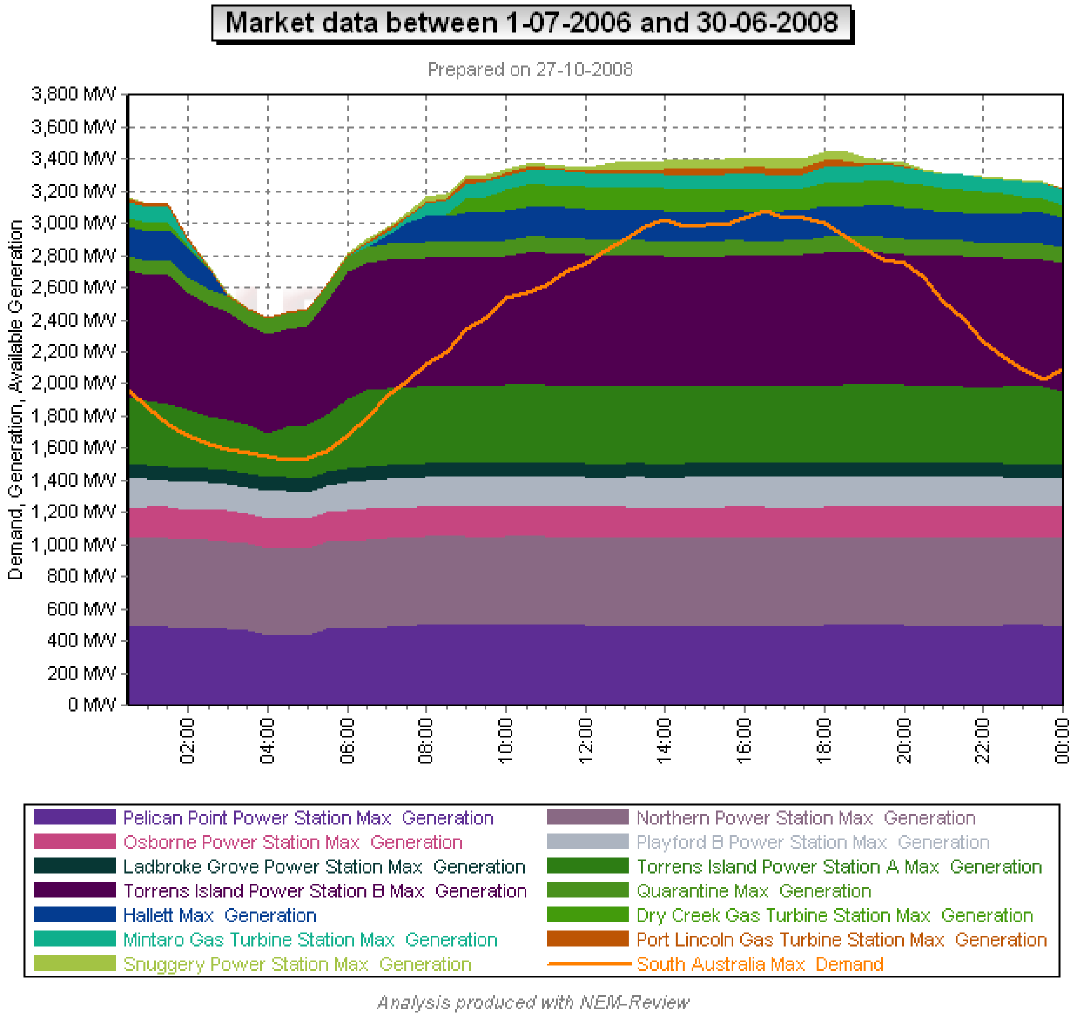
It is interesting to note the irony of the AEMC releasing a report advocating removal of regulation on the very day when world financial markets – which are highly competitive – collapse due to poor (or no) regulation. In much of the AEMC's discourse on basic precepts of economics (see Section 2.2. – The benefits of competitive markets) its discussion ignores the reality that a vertically-integrated business – i.e. a gentailer, with dominance in generation (i.e. base and intermediate load generation) and retail – is able to capture rents (i.e. price at inefficient levels) at the upstream sector, whilst making competitive offers at the retail level and chasing out existing retailers (such as second tier retailers) and impeding new entrants. Generalisations about the effects of regulation, conditioned by assumptions and analytic omissions are not a substitute for carefully constructed rigorous analysis! That the AEMC failed to interrogate consumers not protected by price caps or to discuss the AER concerns of AGL/TIPS bidding activities does not reflect well on the AEMC processes.

The UCW agrees that the principal objective of competition policy is to maximise economic efficiency. But where there is inadequate competition at the wholesale level, and where there is a vertically-integrated business, with dominance at the wholesale and retail levels, removing regulation at the retail level – whose objective is to minimise price exploitation - will not deliver, let alone maximise, economically efficient outcomes for small consumers. This is a clear failure of public policy and of this review.

The UCW considers that the market structure of the South Australian Energy Sector – with the dominance of the gentailer, AGL/TIPS and the potential for it to exercise market power even for short periods – must be considered by the AEMC in its draft advice. Yet, it does not appear to have been adequately considered by the AEMC as evidenced by section 2.3.1.2 (Factors specific to the South Australian Energy Sector) which only listed the following:

- Peaky and weather dependant load
- More expensive fuel used for generation in South Australia
- Tightening supply-demand balance

It is the statement there is a tight supply/demand balance in SA that has particularly concerned UCW. This observation is made regularly in both the first and second reports from the AEMC, but this observation is simply not supported by the facts. Below is a chart which shows the maximum dispatch of all scheduled generation in SA for the last two full financial years. Superimposed is the maximum demand of the region in the same time. This shows that SA has regional dispatchable capacity of more than 10% of the highest demand ever recorded in the region.



In addition to the regional dispatchable load there is the nominal ability to import some 600+ MW from Victoria via Heywood and Murraylink. In fact even with constraints the combined capability of these two interconnectors can augment SA supply by between 10-20% of the dispatchable supply in the region. This analysis indicates that the SA region is provided with a surplus of 20-30% in power supply, excluding the impact of some 400+MW of wind power.

With this amount of supply available, UCW finds the AEMC observation there is a tight supply/demand balance unsubstantiated. The UCW view is supported by the Electricity Supply Industry Planning Council

(ESIPC) in its 2008 Annual Planning Report. In its report the ESIPC comments:-

> "The outlook in terms of the balance between peak summer demand and available supply shows that South Australia is projected to have sufficient capacity both to meet peak demand **and to have an additional safety margin in excess of the industry standard for the next four summers**." (emphasis added).

If the SA Planning Council feels constrained to make such an observation, then why would the AEMC to make observations to the contrary without any substantiation?

The AEMC states that it has been guided by best practice principles for prices oversight developed by the Productivity Commission. It is interesting to assess the AEMC's approach, for example, under the heading of "A preference for market-based rather than regulatory solutions". The AEMC illustrates poor regulation as creating distortions to markets and involving costs for regulators, consumers, etc., but chose to ignore the fact that poor (inadequate) regulation can create economic damage and damage consumer interests. Likewise, the AEMC refers to effectively competitive markets encouraging businesses to produce, etc but fails to refer to the fact that ineffective competitive markets are socially unproductive! Far too frequently, the AEMC sets out conditional events (such as "poor regulation" and "effectively competitive markets") and then develops generalisations as to their impacts, with a particular bias to make its point that regulation is necessarily bad and that the state of competition in the eyes of the AEMC appears always to be "effective", and so regulation is usually bad for consumers, etc.

In its recent "probe" into retail markets in the UK, Ofgem makes the observation (finding 1.34):

> "In the course of the Probe, small suppliers and potential new entrants have highlighted the lack of liquidity in the wholesale electricity markets and raised concerns about the functioning of the wholesale market itself. Action is needed to address these concerns. We also need to be certain that the vertically integrated industry structure does not exacerbate these liquidity issues or distort long term investment decisions in wholesale businesses. Ofgem will continue to examine these issues in a GB context and through our significant involvement at the EU level."

Thus even in the more mature market that exists in the UK, the issue of the wholesale market is perceived to have a major impact on the retail market. That these same issues are embedded in the SA electricity marker should be of major concern to the AEMC. That the AEMC has almost blithely glossed over these concerns is of great concern to UCW.

Gas Market

In the first draft report, the AEMC reported:

> "Of the total number of gas customers located throughout South Australia (around 375,000), approximately 4.5 per cent are located in regional areas. The Commission has not identified any regional distinctions for the 775,000 small electricity customers in South Australia."

This shows that only about half of the electricity small customers in South Australia were gas customers, indicating to us a significant supply issue for gas, namely that up to half of South Australia's small energy customers do not have access to reticulated gas. Further, the small percentage of regional households with gas supply suggests that reticulated gas is not widely available in regional South Australia.

This lack of market coverage, coupled with the high market concentration for gas retailers, the lack of new market entrants since soon after the introduction of FRC for gas market and the observed lack of market offers to households in some Adelaide suburb's as well as regional South Australia, suggests to us that the retail gas market is not competitive.

The remainder of this submission provides the UCW's response to the Commission's draft recommendations. This does not mean that the UCW agrees with the AEMC's underlying conclusion that there is effective electricity retail market competition.

3. UCW's Response to the Draft Recommendations

The AEMC has concluded that there is adequate retail competition sufficient to allow removal of the retail price cap for small consumers. As noted above the UCW is of the view that the AEMC decision is flawed, and that the retail price cap should not be removed. The UCW considers that the AEMC should review its basic decision.

The following commentary is provided by UCW on the flawed premise that if there is adequate competition at the retail level then there still is required some controls to adequately protect small consumers.

All of the following comments by UCW should be read on the basis that the UCW does not consider there is adequate retail competition and therefore the retail price caps should not be removed.

In its response to the AEMC draft first report, the UCW provided extensive information pointing out that overseas jurisdictions (in particular the UK which has a similar market structure to that in the NEM) investigations have shown the retail market delivers poor outcomes to many consumers.

In particular, the UK market has seen that in over 30% of cases, consumers have been convinced to switch retailers to the detriment of the consumer. In any market the principle of caveat emptor (buyer beware) should and does apply, but this presupposes that the buyer has the competence to understand the way the market operates and the risks it faces in any change. There is no doubt that the electricity market (and the gas market) is complex. The assumption that small consumers have the knowledge and understanding to be able to operate effectively with the market created, is doubtful. The UK market has been operating now for nearly 2 decades (with the small consumer retail market operating for a decade and without price caps for six years), yet the recent Ofgem "Probe" into retail markets makes for interesting reading

Finding 1.11 is that:

> "…active consumers are significantly in a minority. Action is now needed to encourage a greater proportion of consumers to engage in this way. Some still find it difficult or time consuming to assess competing offers; some are not confident that they can make a sound choice; some are sceptical about the scale of potential benefits and whether they will be sustained; some still worry about administrative or billing errors, service problems or moving inadvertently to a worse deal; some are unable to get the best deals because they do not have internet access, a current bank account or both."

Findings 1.12 and 1.13 go on to advise:

> “Around half of the less active group of consumers do in fact engage with the market if approached directly by a sales person and supply companies put in significant direct sales effort in order to persuade these customers to switch. Such sales effort is to be welcomed - it is a sign of a vibrant market. Yet we have evidence that most consumers who change supplier in response to such an approach do not investigate alternative deals in the market, and may not therefore be making well informed switching decisions.
>
> Almost all consumers tell us that they switch supplier in order to save money.
> Our analysis suggests, however, that price differences explain only a proportion of switching decisions and other factors may be important - including the impact of sales activity, brand and customer service. Consumers may also be switching on the basis of poor or partial information. As a result, the high levels of customer switching may not yet be exerting as much constraint on suppliers' prices as it could. As many as one third of switchers may not achieve a price reduction. This proportion is higher for Pre-Payment Meter (PPM) customers (45 per cent) and consumers who switch as a result of a direct sales approach (48 per cent for gas, 42 per cent electricity).”

These results raise the serious questions as to whether the market is delivering the benefits promised to consumers, and whether the market is too complex for many consumers to manage. In this regard, the Ofgem Probe findings provide some guidance in finding 1.27

> “Many initiatives and programmes are already in place to protect the interests of vulnerable customers (see Chapter 9). Ofgem has made this a key priority for 2008, culminating in our recent Fuel Poverty Summit and the Action Plan agreed subsequently. The Probe has identified a number of concerns that may particularly impact vulnerable groups. For example:
>
> - **Older people** are among the least active consumer groups, are most likely to be with their original supplier and most likely to pay by standard credit. As a result, they will suffer more from higher in-area pricing by former incumbent electricity suppliers and the premium charged to standard credit customers, and benefit least from dual fuel discounts. Moreover, only a third of elderly consumers have access to the internet, and so are least able to compare offers or access the cheapest online deals.
>
> - **Low income groups** are far more likely than other groups to switch as a result of direct sales activity and therefore far

less likely to compare a range of competing offers before switching. Moreover, low income groups have lower rates of access to the internet and a significant number do not have personal current bank accounts. As a result, there is lower access to the cheapest online deals and direct debit tariffs. Low income groups are also disproportionately high users of pre-payment meters, and pay higher prices as a result. A higher proportion of low income groups may also be prevented from switching by their current supplier with whom they are in debt.

- Many **rural customers** are not on the gas grid and thus are impacted by the higher margins earned on electricity consumers, but cannot benefit from lower margins on gas or the discounts available to dual fuel customers. This is compounded by higher heating costs (from their use of oil, electricity or liquefied petroleum gas), which drives a higher proportion of these consumers towards fuel poverty."

The Ofgem Probe has identified that those consumers most at risk of a competitive market as proposed by the AEMC, are the elderly, the less well off and those in rural areas.

It is with the above concerns in mind that UCW offers the following comments on the AEMC recommendations

<u>Recommendation 1</u>

The regulation of standing contract prices should cease by no later than the expiration of the current price determinations made under section 36AA of the Electricity Act and section 34A of the Gas Act.

UCW: *UCW is not confident that retail competition (in either electricity or gas) is effective, especially based on the AEMC views of retail competitiveness. There must be an on-going monitoring and assessment process to demonstrate that there is no substantial change in current retail competition conditions prior to the actual cessation of standing contract price regulation. The UCW is especially concerned that summer 2009 could see a repeat of the price events of summer 2008 in the wholesale market, which could see more existing retailers withdraw from market segments, deter potential new retail entrants, engender a more concentrated retail sector, and result in more inefficient retail prices. Should this happen, it should be a trigger to initiate a review (possibly by the AEMC) to enable the SA Government to reintroduce retail regulation in electricity.*

The AER is still to report on its investigations into the bidding practices of TIPS during summer 2008 and this report should throw light on the structure of the wholesale market, on the potential for the exercise of market power and the economic damage that that exercise of market *power can cause. Yet in the absence of this report, the AEMC has already concluded that the wholesale market developments and the related retailer impacts do not affect its conclusion of effective retail competition moving forward. Upon release of the AER investigations, the AEMC should initiate a review to advise the SA government on the impact on retail competition in electricity.*

The following comments, only apply if recommendation 1, which we oppose, is accepted.

<u>Recommendation 2</u>

A price monitoring framework to monitor standing contract and default contract prices should be introduced for a period of at least three years following the removal of retail price regulation.

UCW: *Agree. Given the specific factors applying in the SA market (as recognised by the AEMC), the price monitoring framework should provide quarterly (rather than half yearly) price monitoring reports. The SA market is especially exposed to summer price events (i.e. January to March) and the price impacts are likely to be visible in the three months following.*

<u>Recommendation 3</u>

A conditional statutory power that can be exercised by the South Australian Government to re-introduce retail price regulation should be included in each of the Electricity Act and the Gas Act. In accordance with the terms of the AEMA, the exercise of the power would be conditional upon a review of competition by the Australian Energy Market Commission concluding that competition is no longer effective and recommending the re-introduction of retail price regulation as the appropriate policy response.

UCW*: UCW does not consider the retail price cap should be removed. However, in the event that it is removed, UCW considers a conditional statutory power should be provided to enable the SA Government to re-introduce retail price regulation. The SA Government should have the power to re-introduce a retail price cap should competitiveness deteriorate in an energy market.*

We recognise that the recommendation make such action by the SA Government conditional upon receiving a report from the AEMC which responds to terms of reference for a review of competition by the AEMC, which terms are set by the SA government. UCW regards the AEMC has one option for conducting a review, but does not consider that there should be a monopoly of opinion or of reviewer options. The SA government should not be bound by the findings of such a review, the conducted by the AEMC, or another reviewer, if recommendations are not rigorously unambiguous. This is

There is also a question about the 'trigger factors' for the type of review that is proposed, to be conducted. We understand that the most likely 'trigger factor' would be an observation from the proposed monitoring of market contract prices by ESCoSA.

We consider ESCoSA to be an appropriate body, along with the SA Minister for Energy, to identify factors that may suggest that there is a deterioration in competitiveness in a South Australian energy market.

We also remain concerned about the lack of ongoing capacity for consumer/community to participate in a observations and debates about energy market effectiveness and utility issues more generally in South Australia. For example, a deterioration in market effectiveness is likely to be experienced in its early stages of decline, by low income and disadvantaged households who would raise their concerns with financial counsellors in non-government community organisations. It is not clear where such observations could be taken, structurally, it such observations are likely to be early warnings of a deterioration in energy markets.

Recommendation 4

The obligation to agree to supply electricity, and the obligation to agree to sell and supply gas, to small customers pursuant to the standing contract price and subject to the standing contract terms and conditions remain in place. In respect of new connections, the obligations should bind the relevant standing contract retailer and, in the case of existing connections, the financially responsible market participant for that connection.

UCW: *Agree*

Recommendation 5

The framework for entering into default contracts should remain in place. Each retailer should determine its own default contract price. The provisions allowing ESCOSA to fix the default contract price and for the price to be fixed by reference to the Electricity Pricing Order or Schedule 2 of the Gas Act should be removed.

UCW: *Agree*

Recommendation 6

Each retailer should determine its own standing contract and default contract prices for energy and publish its prices on its website. Notification that the standing contract price or the default contract price is to change should be published in a newspaper with an appropriate circulation in accordance with any requirements specified by ESCOSA.

UCW: *Agree*

<u>Recommendation 7</u>

The application of the Energy Price Disclosure Code be extended to standing contracts and default contracts.

UCW: *Agree*

<u>Recommendation 8</u>

ESCOSA should be tasked to monitor and report every six months on observed standing contract and default contract prices for a minimum of three years. ESCOSA should also maintain and update a central data base on its website of the current standing contract and default contract prices of all South Australian retailers.

UCA: *The reporting should be made every 3 months (rather than 6 months). Each report by ESCoSA should include its analysis of what it considers would be a reasonable benchmark (standing) contract price for comparison purposes. ESCoSA, in consultation with the AER, should be required to advise on any wholesale market issues which it considers may be distorting the standing contract prices posted by retailers.*

<u>Recommendation 9</u>

ESCOSA should also maintain and update a central data base on its website of the current standing contract and default contract prices of all South Australian retailers.

UCW: *Agree*

<u>Recommendation 10</u>

The AEMC should undertake a review of the price monitoring framework within three years of its implementation.

UCW: *Agree, but with terms of reference set by, or in consultation with, SA Government. It is normal for Commissions of Review to have terms of reference set by, or in consultation with, elected governments and this practice should be maintained.*

<u>Recommendation 11</u>

The South Australian Government undertake a consumer awareness and education campaign as part of the transition to phasing out retail price regulation.

UCW: *Agree. The AEMC also has a professional duty to disseminate its 'assessment' and decision. This is an important element for transparency and accountability of the review.*

In light of the Ofgem "Probe" there is a serious concern that despite the efforts of regulators and governments to provide support and education for consumers they have been forced to be exposed to the competitive markets, it must be recognised that there will be consumers not capable of understanding the competitive electricity and gas markets provided. It is unacceptable to require these consumers to be assumed to understand the markets. Accordingly, the powers of the energy ombudsman must be strengthened to prevent these consumers from being exposed to retail sales practices which result in their being further disadvantaged.

<u>Recommendation 12</u>

ESCOSA should consider whether the reference in the RoLR guideline to linking the variable element of the price should continue to be referenced to the variable element of the standing contract price.

UCW: *Agree*

<u>Recommendation 13</u>

A RoLR scheme for gas should be introduced at the earliest opportunity.

UCW: *Agree, we agree that a gas RoLR is essential, but are concerned about the capacity of a gas RoLR to require additional supply (pipeline) capacity in the event of a retailer suddenly withdrawing from the gas market. We suggest that there are ways of overcoming the issue of capacity on transmission pipelines and suggest that, in the event of the RoLR incident, the gas RoLR has first call on any relinquished pipeline capacity from the retailer that has withdrawn from the market, and any additional under-utilised capacity, that may be required. Amendments to the SA Gas Act, are likely to be required to give effect to the gas RoLR having a priority call on access to supply.*

4. Supplementary Questions from AEMC Presentation 6/11/08

At its presentation to stakeholders, of the second draft report, in Adelaide on the sixth of November 2008, Commissioner Tamblyn concluded a presentation by presenting five “Specific Questions for Discussion.” The following is a brief response to each of these:

1. Price oversight of default contracts.

- What are the potential costs and benefits of monitoring default contract prices?
- Do default contract prices need to be monitored, noting that these prices may be set by reference to retailers standing contract prices?
- Are there other comments on the price monitoring regime design or operation?

UCW: *“Perfect information” for customers is a necessary precondition for competitive markets. Therefore, we suggest, default contract prices do need to be monitored and this information made readily available to customers. In general, the benefits of an informed marketplace significantly outweigh the potential costs accruing to under-informed consumers.*

2. Extension of Energy Price Disclosure Code to standing contract and default contract prices

- What are the potential costs and benefits of extending the code to standing contract and default contract prices?
- Should the market contract prices remain subject to the code during the initial three years of the framework?
- Are there any other comments on the Commission's price disclosure proposals?

UCW: *Some elements of response to these questions have been dealt with elsewhere in this submission, specifically we have proposed that the monitoring by ESCoSA should be reported on a quarterly basis and that a benchmark contract price, similar to current standing contract prices, should be established and published as a basis for comparison by consumers.*

We also submit that all market contract prices should remain subject to the Energy Price Disclosure Code, on an ongoing basis, including for the initial three years of the framework.

3. Proposals for ESCOSA to monitor and report on the price differences between comparable gas market contracts in regional SA and Metropolitan Adelaide.

- What are the potential costs and benefits of this additional price monitoring role for regional gas market contracts?
- Given that Origin's regional gas market offers currently provide the same discounts as market offers available in Adelaide, is this additional pricing oversight necessary?

UCW: *we continue to be very concerned about the effectiveness of competition in South Australian gas markets and have highlighted the lack of access to reticulated gas supply in regional South Australia, it is therefore essential that ESCoSA monitor and report on any reticulated gas supply price differences between regional South Australia and metropolitan Adelaide.*

4. Proposals for ESCOSA to establish and maintain a register of Origin's negotiations for access to the SESA pipeline

- what are the potential costs and benefits of this register?
- What type of information should be reported on by Origin under this register?
- Should the information in the register be publicly available?
- Should ESCOSA be required to report on the outcomes of requests for access in its half yearly price monitoring reports?

UCW: *the marginal costs for ESCoSA to report on any negotiations with Origin for access to the SESA pipeline are small, while the benefits are part of enabling appropriate information disclosure to enable the market to operate competitively.*

ESCoSA should report on:

- *requests for access to the SESA pipeline*
- *outcomes of requests for access*
- *any dispute resolution processes invoked*
- *any observations about market efficacy related to SESA pipeline access negotiations.*

This information should be presented publicly as part of ESCoSA's regular reporting of energy market contract prices

5. Impact of the Country Equalisation Scheme on the development of retail electricity competition

- What are the costs and benefits of the scheme?
- Given that competition is effective for electricity retailing, is the scheme necessary?

UCW*:* *This is an issue of fundamental importance. In theory the cost of generation is really the same for every consumer subject to (mainly) transmission losses which are usually les than 10%. There is a premium for marketing of retail offerings and for meter reading. The retail costs are relatively modest and therefore the premiums (in actual $ terms) for serving country areas, is relatively small. Technology in remote meter reading should further reduce the premiums for retailing.*

It does however cost more, per unit, for network costs to serve regional areas. Currently large electricity and gas users pay for the network costs appropriate to their locations. Allocative economics says that each user should pay their costs for the provision of the service, so equalisation is then a distortion. Equally importantly, rural consumers have many other higher costs as a result of their location. A large business will make its decision on location for many reasons and might accept higher costs in one area and balance these against other costs. It is not as easy for small consumers to make such a pragmatic decision, especially as many made their decisions before the new pricing approach.

We observe that the actual costs of providing energy services to rural customers are not significantly greater than for metropolitan customers. The whole South Australian market currently pays higher prices than interstate counterparts anyway, suggesting that the regional issues have already been factored into South Australian energy prices.

On balance, we suggest that the equity benefits of maintaining the Country Equalisation Scheme outweigh the relatively minor actual price differentials between supplying country and metropolitan Adelaide customers - we support the retention of the Country Equalisation Scheme.

Rule Making and Regulation

At the meeting with the ESCoSA CAC on 13th November comments were made about the AEMC being a “Rule Maker”, not a “Regulator”. This was partially in response to concerns being raised about potential impacts of AEMC decisions on low income and disadvantaged people. The argument being that the responsibility for recognising adverse impacts of energy markets on disadvantaged consumers was the responsibility of State governments, specifically through their concessions programs, with no responsibility being with rule makers or regulator's

We suggest that this is an inadequate approach, as the rule maker, the AEMC in this instance, must still make Rules that make sense for the economy/society to which they apply. Energy industries are complex and inter-related industries, so regulators and rule makers would be failing in their duty if they applied simple rules to the complexity of these industries.

For example the AEMC has made Rules which are stated to be supportive of investment by the regulated infrastructure businesses. If the AEMC makes Rules which are too supportive of networks, then the up stream and down stream businesses will suffer. In particular the large energy-using down stream businesses which provides the effective underwriting for investment could close down due to costs being too high, resulting in stranded assets which the end users remaining connected will have to pay for. If the rule maker does not address the outcomes of their rule setting, then they have failed in their primary duty.

Effective rules must be equitable if they are to achieve the intended outcome and the market objective. A good rule recognises the impacts it creates, and ensures that there is balance and that no one group in society bears a disproportionate burden of adverse consequences of rule making and regulation.

We therefore reinforce our view that the AEMC must act to ensure that it's findings and rules do not adversely and unfairly impact on any group of citizens.

Jurisdictional concessions programs can only be effective where the rules are fair and reasonable and regulators are effective in applying the rules.

This is why the AEMC needs to consider energy price burdens and likely future burdens on all societal groups, particularly low income and disadvantaged households, in it's rule making

5. Other: Additional Competition Reviews by the AEMC

The AEMC provides a listing of events whereby the SA government might or should seek the AEMC to carry out competition reviews.

UCW: *Strong request that there is an option for the South Australian Government to request at short notice, the AEMC to undertake an accelerated competition review if there is a substantial deterioration in the effectiveness of competition in either the retail supply of gas or electricity. These events include those listed by the AEMC:*

- structural changes in the retail sale of gas or electricity, such as the exit of retailers or the suspension of active marketing activities by a number of retailers;
- a rapid increase in the number of retailers pursuing vertical integration with generators;
- an increase in the number of customer complaints to the Energy Industry Ombudsman; or
- a sharp reduction in customer churn.

To this listing the UCW consider should be added:

- A deterioration in competition in the wholesale electricity (or gas) market.

6. UCW's Views of the Commission's Analysis

The UCW places on record its dissatisfaction with the AEMC's review of the SA retail market as espoused in it final first report because of its lack of balance and inadequate process. The UCW's views in regard to elements of dissatisfaction with the AEMC analysis are recorded in the following attachment to this submission, Appendix 1.

We have made these responses for two reasons. Firstly we recognise the importance of a genuine understanding by all stakeholders about effectiveness of competition and particularly have good rulemaking and good regulation should be implemented. We respond because the debates are too important to leave un-resolved.

Secondly, we observe that there is room for improvement in processes to engage with consumers in important elements of rule making and regulation associated with the developing Australian energy structures and processes.

Possibilities for Process Improvements

We observe that the process for this review could have benefited considerably from a discussion involving stakeholders, early in the process, where criteria for assessing the effectiveness of competition and key issues for South Australian energy markets could have been identified and mutually agreed.

The process that ensued, meant that by the time there was any face-to-face contact between AEMC and stakeholders, all parties were seen to be locked into entrenched positions of either agreeing or disagreeing with AEMC findings. We believe that this significantly hampered the process.

We also observe that, unlike jurisdictional regulators, the AEMC (and AER) have not yet built ongoing consumer involvement into the structures and processes, limiting understanding and ultimately trust, between stakeholders.

We suggest that in response to observations about consumer involvement, the AEMC actively consider the following for future reviews and inquiries:

1. establish a standing consumer reference group, including consumer perspectives from a range of jurisdictions, to assist with consumer engagement in AEMC processes
2. commence significant reviews and inquiries with a stakeholder forum that was able to consider the range of issues requiring investigation and best options for exploring those issues.

For further information or clarification on any of the points made in this submission, contact:

Mark Henley
Manager Advocacy and Communication
Uniting*Care* Wesley Adelaide

Ph 0404 067 011
Email mark.henley@ucwesleyadelaide.org.au

Appendix 1

<u>Comments on AEMC Final First Report</u>

The UCW has reviewed the final first report from the AEMC which concludes that the SA retail energy markets are competitive, and there is sufficient competition in the market to remove the retail price caps.

The UCW is of the view that the retail markets are an oligopoly with a dominant retailer in each of the gas and electricity markets. In its submissions the UCW made two fundamental points:- that the retail markets require competitive wholesale markets in order to be competitive, and that the wholesale markets are not competitive. The UCW went on to assess that based on the data provided by the AEMC (and on which the AEMC based its conclusions) demonstrated that at best, the energy retail markets are oligopolistic and do not show signs of being truly competitive.

The AEMC sought to address the UCW concerns in its first final report, especially in appendix E. The UCW has reviewed this additional information and remains dissatisfied with the unbalanced analysis (especially on electricity) and considers it helpful for these important and ongoing debates, to rebut arguments used in the AEMC analysis.

1. **Wholesale Electricity Market Competition**

   AEMC states:

   "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." (AEMC, pp.xii and xiii).

UCW: *Essentially the AEMC has stated that the SA retail sector is competitive on the basis that:*

- *Churn is high*
- *A retail market can be competitive without having a competitive wholesale market*
- *Wholesale prices have risen due to a tight supply/demand balance*
- *Retailers have withdrawn due to being unable to source wholesale offers within the price cap*
- *Prices must rise more than the price cap allows or competition will reduce.*

The AEMC persists in describing the recent wholesale outcomes as being due to a combination of transitioning circumstances and unexpected market events, and that they should not impact adversely on the effectiveness of competition at the retail level. It continues to ignore the facts, such as:

- *The AEMC persists in stating there is a tight demand/supply balance in SA. This observation is totally unsupported by the facts and by the SA electricity planning council (ESIPC). For the AEMC to persist in its untrue and unsupported allegation is curious in the extreme.*

  The 2008 Annual Planning Report from ESIPC states (page x):

  > "The outlook in terms of the balance between peak summer demand and available supply shows that South

> Australia is projected to have sufficient capacity both to meet peak demand and to have an additional safety margin in excess of the industry standard for the next four summers."

This view is supported by facts on generation capacity in SA. The maximum demand in SA has been ~3100 MW. In the last 12 months, TIPS has demonstrated its capacity to generate 1290 MW. This implies that less than half of TIPS output was required to meet the difference between the supply without TIPS (ie 2500 MW without TIPS as identified by the AER) and the peak demand so far reached in SA. Further, the installed generation in SA plus the output of TIPS, increases the SA region capacity to nearly 3800 MW, or 20% excess capacity. Thus there is no substantiation for the AEMC to persist in asserting tight demand/supply balances in SA as a cause of the excessive prices seen in recent times.

- *Retailers can only make offers to consumers if they are able to hedge these offers from generators. The alternative is that the retailer must take spot risk. If a retailer is unable to get a generator hedge, then it must withdraw from the market or offer a price based on the spot price. An unhedged offer must perforce include a significant risk premium – such a premium would make the retailer uncompetitive. If AGL sources significant hedging from generators other than TIPS, this reduces the amount of independent generator hedging available to other retailers who must then go to AGL/TIPS for hedges.*

- *AGL/TIPS is a vertically-integrated business with dominance in both generation and retail (especially to small customers);*

- *AGL/TIPS is able to maximise revenues at the generation sector, by driving up wholesale prices, as occurred in the summer of 2008, and in particular at regional demand levels above 2400-2500 MW. This view is supported by the AER as in its report[2] it stated*

> "It is likely that the existence of the CPT and the threat of administered pricing mitigated the number of times that the spot price exceeded $5000/MWh. **Figure 2** shows the installed generation capacity by participant and the total import capability in South Australia that together make up the supply options to meet demand. As the figure shows, when demand exceeds 2500 MW, Torrens Island power station must be dispatched. That is, when demand exceeds 2500 MW Torrens Island power station becomes the marginal generator" (AER, page 5).

[2] AER report: Spot prices greater than $5000/MWh South Australia: 5 - 17 March 2008

- *The price spikes in the wholesale market in summer 2008 occurred when the incumbent gentailer did not present generation capacity, suggesting market structural problems (AER, Appendix B);*

- *The incumbent gentailer was able to bid into the wholesale market to avoid breaching the CPT;*

- *The AER is investigating certain activities to ascertain whether bids were made in good faith;*

- *Industrial customers have lodged submissions (including providing confidential information) to the AER providing their analyses of the summer 2008 price events and subsequent events, including concerns about (and the circumstances that will enable) the potential for a repeat of those price events in summer 2009, but the AEMC chose not to access this source of information;*

- *The summer 2008 price events have had major impacts on new retail price contracts as unhedged retailers experience substantially higher wholesale price increases, which are passed through or suffer a diminution in profit margins or withdrawal from certain retail segments;*

- *The summer 2008 price events and the potential for a repeat in the summer of 2009 will deter new retail entrants;*

- *The AEMC's apparent continuing reluctance to investigate industrial users' contract experiences, despite the UCW's urging;*

- *The AEMC has made the observation that the wholesale market is competitive and therefore the retail market is competitive. The facts clearly show that the wholesale market is not competitive, especially when demand exceeds 2500 MW. If retailers cannot get competitive wholesale offerings except from a competitor then this raises serious concerns as to the competitive nature of the retail market. The AEMC persists in assuming that the only constraint on achieving a competitive retail market in SA lies with releasing the retail market price cap.*

- *The AEMC's recognition that the electricity industry is entering a period of transition that could cause very significant disruptions, including prices and costs, for consumers, yet without any analysis other than a faith that "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" (what if* *they are not?) the AEMC recommends lifting the price cap that protects residential customers from the vagaries of uncompetitive or distorted markets!*

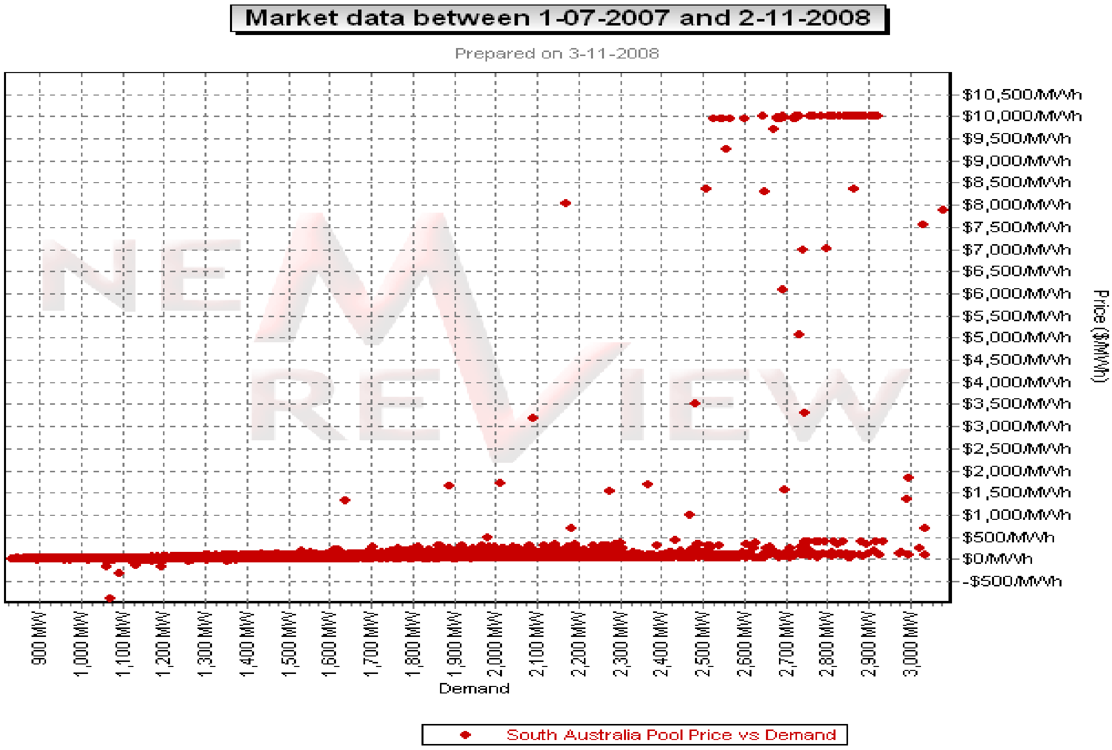
- *The AEMC persists in ignoring its own consultant's (NERA) report on the linkages between the wholesale and retail markets.*
- *The AEMC assumptions are flawed and beset by an absence of rigorous analysis.*

2. Vertical Integration, Market Power, etc

AEMC states:

"Responses to the Retailer Survey indicated that vertical integration into generation is an important consideration for retailers and would be expected to provide them with improved access to risk management strategies. Although vertical integration may not be required for a small retailer to enter, some retailers believed that the ability of smaller retailers to expand would be limited without it." (AEMC p 142).

UCW: *This is also the view of UCW. This situation is exacerbated by the presence of a dominant gentailer business from which most retailers must get a wholesale offer or be exposed to major market risks. As noted above, AGL/TIPS is the marginal generator when demand exceeds 2500 MW. Demands above 2500 MW are not rare in SA, and when they occur, prices can be very high, thereby increasing risks to retailers. This is shown in the following chart of SA price and demand since AGL was granted ownership of TIPS.*



This graph shows that if a retailer sought to take spot risk without seeking (or having) some protection from the high spot pricing that AGL/TIPS can generate effectively at will, then the risk premium the retailer must impose would be uncompetitive. If there are no hedges or price caps available from the wholesale market except from a retail competitor, it is no wonder that small non-gentailer retailers have exited the market.

The UCW then asks the very basic question – If a retail market effectively forces a retailer to seek offers from its retail competitor, how can that market be considered to be competitive?

AEMC states:

"Vertical integration can, however, affect the liquidity of the contracts market, thereby increasing reliance on integration for viable entry or expansion. Some retailers and consumer groups expressed concern that AGL's ownership of the TIPS was exacerbating already poor liquidity in the South Australian contract market." (AEMC pp 142 and 143)

UCW: *Lack of availability of hedge contracts can discourage existing and new retail entrants. Pricing of hedge contracts can also discourage such retailers. It can provide AGL Retail with a competitive advantage, enabling it to compete on price and on non-price areas.*

AEMC states:

"Uniting*Care* Wesley in its submissions to the Issues Paper and the First Draft Report expressed the view that AGL has market power in the wholesale electricity market, and that this was undermining the effectiveness of competition in the retail market. The views put forward by Uniting*Care* Wesley may be summarised as:

• AGL has wholesale market power through its ownership of TIPS;
• The wholesale prices are not efficient, due to TIPS' market power, and therefore retail prices are not efficient as a consequence and therefore retail competition cannot be effective; and
• AGL is able to leverage its wholesale market power into the retail market to the detriment of retail competition and its retail competitors.

These views have also been supported by other stakeholders. In order to further analyse the issues raised, the Commission obtained and reviewed analysis and information provided by market experts and stakeholders, including confidential information provided by AGL." (AEMC page 143)

UCW: *These are real concerns with the retail market situation <u>going forward</u>. The AEMC's analysis of retail competition is largely <u>historical –. AGL/TIPS has this market power going forward.</u>*

The AEMC observes that historically TIPS did not exercise the market power that TIPS had prior to its acquisition by AGL. This has some validity, but overlooks some basic differences between the TRUenergy ownership and AGL ownership and this relates to market shares of the retail market. TRUenergy has never held the retail market dominance that AGL holds. As such TRUenergy looked to sell the capacity of TIPS to meet its retail market needs. After doing so it still had capacity available to sell into the wholesale market. AGL has such a share of the retail market that it must seek hedges from other generators, especially the base load plants of Pelican Point and Northern Station. Both of these plants must sell their excess capacity as their retail activities are less than their output. This gives AGL the ability to secure long term retail hedges with its competitors at attractive price offerings. By not using the output of TIPS for their entire output at TIPS, leaves AGL with the opportunity to use the TIPS market power when demand exceeds 2500 MW to set spot prices, and thereby achieve significant wealth transfers. This ability will be further enhanced by the AEMC decision to increase the values of VoLL and CPT from 2010.

AEMC states:

"Under Uniting*Care* Wesley's proposition, AGL has market power because:

- it can withhold the capacity of TIPS and/or raising the price at which TIPS capacity is bid into the pool (as evidenced by the periods of high wholesale prices in the South Australian region in the first quarter of 2008) and that AGL is able to do this to such an extent and sufficient frequency that it has a material effect on the long run wholesale price for the region;

- which then affects the price and availability of hedging instruments available in South Australia (as evident by the reported increase in price and reduction in the availability of hedging instruments in the last 12 month period).

The Commission notes that the pricing outcomes over the recent summer period, as well as in March 2008, that Uniting*Care* Wesley refer to were impacted by the combined effect of the unprecedented weather and demand conditions and the derating of the Heywood interconnector. Origin's submission on the First Draft Report noted that the derating of the interconnector was not expected by retailers as it had not been appropriately communicated to the market. It was also noted during meetings with stakeholders that some retailers may have faced higher than expected risk exposure as the unexpected interconnector derating and the timing and duration of the extreme weather events may not have been incorporated into their risk management portfolios. As AGL was also responding to these unexpected and uncontrollable events, it raises doubts about whether AGL could use TIPS to predictably and sustainably raise wholesale prices over the long run. This is not to say that TIPS did not enjoy temporary *ex post* price setting power during these particular periods of time, as the AER has found. The potential *ex post* power would have been the same regardless of the ownership of TIPS. However, the derating of the interconnector and the extreme and unusual weather events, may have combined to give the new owner of TIPS greater opportunities to exploit those conditions. As noted by the AER:

> "It would appear likely that the recent combination of record demand and reduced interconnection would have led to high prices in South Australia regardless of whether the asset swap proceeded."" (AEMC page 143, 144)

UCW: *The AEMC Report selectively quotes from the AER Report and ignores facts it does not appear to favour. The UCW had pointed to:*

- *The ability of TIPS to control spot price movements in both directions i.e. up and down;*
- *That TRUenergy (the previous owner of TIPS) wanted to sell hedges on TIPS because its retailing was less than the output of TIPS, whereas AGL, due to its dominant retail position, can use TIPS in ways that were not possible for TRUenergy;*
- *The recognition by AER that TIPS is the only marginal generator when demand exceeds 2500 MW which is not an infrequent occurrence in SA, and has occurred in every year since the NEM commenced.*
- *The ability of TIPS to control breaching the CPT;*

- *AGL/TIPS not presenting capacity;*
- *The continuing investigations by the AER into possible breaches by AGL/TIPS of the NER.*

AEMC states:

“To the extent that AGL’s acquisition affected the availability of hedge contracts, consistent with the public competition assessment by the Australian Competition and Consumer Commission (ACCC), a number of stakeholders have indicated that this is likely to be a transitory situation that can be expected whenever new generation assets are acquired. AGL indicated in its supplementary submission to the First Draft Report that it was already substantially hedged in the South Australian market when it acquired TIPS resulting in a “long” position which exposed it to the spot market. AGL also indicated that as a prudent retailer and generator, it would have preferred to have the TIPS capacity hedged rather than being exposed to spot prices. Further, AGL expects that its contract positions will realign going forward. This is supported by the confidential information provided to the Commission by AGL. To the extent that AGL was “over hedged” at the time of acquiring TIPS, it is unlikely to be a sustainable commercial position.

New generation projects have also been committed in the South Australian region including a 120MW expansion at the Quarantine Power Station due to come online in 2008/2009 and more than 300MW of wind generation projects. This suggests that the market conditions have not deterred new investment. Consistent with the anticipated operation of a competitive market, new entry, and the threat of further entry, should constrain the future behaviour of the existing generators including AGL. The new investment also suggests that the market outcomes of the recent summer have not resulted in any sustained increase in barriers to generation entry. Clarification of the parameters of climate change policy by the end of 2008 should provide a further stimulus to generation investment in South Australia and elsewhere.

These observations provide support for the view that the supply of generation capacity in the electricity wholesale market is continuing to respond to competitive price signals in the spot and contract markets but may do so with a lag. Consistent with the behaviour of other commodity markets, there can be periods of relatively high prices, reflecting a tightening of the supply/demand balance, followed by investment responses and the potential for periods of excess capacity and lower
prices. This view is supported by the AER:

> “…in an energy only market like the NEM, wholesale price outcomes provide signals for future investment in generation capacity. To date, it appears that these signals have proven very effective in attracting new generation investment in South

> Australia, where capacity has grown by over 50 percent since NEM commencement. High spot prices around 1999 – 2000 fuelled new investment in peaking and intermediate generation in South Australia."" (AEMC page 144, 145)

UCW: *Who are the stakeholders mentioned? Despite UCW urging the AEMC to consult with the ECCSA members who have had direct experiences with contract negotiations before and after the price events, the AEMC did not make that contact. Again, there is a suspicion that the AEMC is selective in its research and presentation.*

The AEMC Report fails to analyse the position of TIPS as a base/intermediate generator capable of exercising market power for sustained periods, as demonstrated in summer 2008.

The AEMC points to new generation projects that have already been commissioned before the 2008 price events and the changed market conditions. The AEMC's assertions that new investments have not been deterred by the market conditions in 2008 are irrelevant, as the projects proposed, such as Origin's Quarantine station are defensive against high spot prices or the result of SA's unique potential for wind farming and therefore are unlikely to have been deferred as a result of the high prices of Q1 2008.

The quote from the AER is qualified and also somewhat misleading. The AER qualification implies that market signals have resulted in a large increase in generation overlooks the SA government active incentive to cause Pelican Point PS to be built as a part of the deregulation process. The other generation built has been wind farms and peaking plants by retailers to provide self hedging against high spot prices. The qualification by the AER by its reference to – "to date" – implies a degree of reticence to unambiguously support the view of the AEMC.

AEMC states:

"Leverage wholesale market power into retailing

If AGL had enduring market power in the wholesale sector, its market power could potentially be leveraged into the retail sector in two ways by:

i) Imposing a price squeeze on its retail rivals by increasing wholesale prices for energy and hedging contracts and not making any adjustments to its own retail prices; or alternatively reducing retail prices to below competitive levels without adjusting wholesale prices. Thereby forcing a material number of retailers to exit the market; or

ii) “Bypassing” the wholesale market through vertical integration, producing an intrinsic and sustained cost advantage and creating long term barriers to retail entry

In the first scenario, a critical element is that AGL would need to sacrifice short run profits with the expectation of being able to recoup that loss in the long run. This sacrifice would arise either in the form of wholesale prices being forced above profit maximising levels, i.e. AGL would be forgoing profitable output from TIPS in order to drive the wholesale market price beyond that which it would choose to do otherwise, and/or in the form of setting retail prices that did not fully reflect the wholesale cost of electricity.

Such a strategy can only be rational if the sacrifice of profits in the short run is accompanied by the expectation of recoupment in the long run. AGL’s ability to recoup the losses must rest on its ability to create and sustain retail market power to recoup these losses by increasing its customer share and an ability to sustainably increase the retail price above what it would be absent the conduct.

However, the presence of four vertically integrated dual fuel retailers and multiple small and inter-state retailers, who have generally expressed a willingness and ability to enter/expand in the retail market where profit opportunities arise, suggests that any attempt by AGL to recoup its sacrificed profits through higher retail prices would not be successful. As described in the Retailer Survey, retailers generally viewed electricity retailing in South Australian as having low barriers to entry, provided they could access hedge and risk management contracts at acceptable prices:

> “Those retailers that had ceased actively marketing (and those that have not yet entered the market) were for the most part keeping a watching brief on the market and indicated they would return to active marketing (or actively consider entering the market) should they perceive improved margins either from a reduction in wholesale prices or through lifting of the standing offer rates.”

Furthermore, the argument is not supported by actual market outcomes as AGL’s discounts off the standing contract price are not as high as the discounts available under its competitors’ market offers. In addition, AGL’s customer share has been decreasing since the start of FRC thereby reducing the number of customers from which it can recoup its losses.

To put this analysis another way, the assumption of market power in wholesaling is not sufficient in itself to establish a threat to the competitiveness of the electricity retailing. The assumption also rests on the ability to create and sustain barriers to entry or expansion by other, potentially competing retailers. Otherwise TIPS would need to continue engaging in profit sacrificing conduct indefinitely and would be better off simply exercising its wholesale market power by pricing to maximise wholesale profits.

In the second leveraging scenario, it is suggested that AGL, as a vertically integrated entity, will engage in less hedging and provide a cost advantage to its retail business. However, as outlined above, it is not realistic to assume that a vertically integrated generator will engage in less hedging by an amount that simply reflects the extent of its retail load. The ownership of one major, intermediate generator inevitably means that AGL's retail operation would need to enter into hedge contracts with other generators (say, for base load or peak output) that it cannot efficiently provide itself. Likewise, TIPS would also need to enter into hedge contracts with other retailers in order to realise the greatest value from the intermediate output that it produces. The net effect of this activity may mean that, in seeking to raise its rivals hedging costs, AGL will also be raising its own hedging costs. The risk of increasing its own costs by at least as much as its rivals would seem to be significant for AGL, given its apparent position of having a much larger share of the retail market than it does of generation output. In addition, in terms of retail competition, all retailers would then be exposed to the same cost increases. If these costs can be effectively passed through, there would not necessarily be any impact on the effectiveness of retail competition. As discussed above, to the extent that there may be wholesale market inefficiencies in this scenario, these inefficiencies would need to be addressed at the wholesale level.

Any express or implied allocation of TIPS' capacity to AGL's own load portfolio forgoes the opportunity to sell hedge contracts to other retailers. Once this opportunity cost is recognised, the natural advantage of vertically integrated electricity gentailers is likely to be much less than it appears. This view is supported by Simply Energy, who noted that the recent changes in market conditions have affected all retailers and vertically integrated firms did not necessarily have any significant advantages:

> "Integrated retail and generation businesses typically transact at arm's length. In any event, transfer pricing would not explain why retailers have recently suspended or lessened their marketing activities. That is, even if a gentailer engaged in transfer pricing, so long as the overall operations of a gentailer were sufficiently profitable, it would have no incentive to suspend or lessen its marketing activities."

As AGL noted in its supplementary submission to the First Draft Report, as a prudent commercial operator AGL would have preferred to have the TIPS capacity contracted rather than risk exposure to the pool. Further, AGL believes that had TIPS been contracted over the first quarter of 2008, it would have earned higher revenue from contracts than it actually did from the pool.

In conclusion, even under the assumption that TIPS does possess a significant and sustained degree of power in the wholesale electricity market, the analysis outlined above shows that AGL is unlikely to be able to leverage that power into electricity retailing. To do so would require an ability to recoup the profit sacrificed in the long run which is a high risk strategy and is not supported by the evidence available to the Commission. AGL faces competitive constraints from both significant (and vertically integrated) rivals already in the market and from potential entrants. The proposition that vertically integrated gentailers somehow bypass the wholesale market and so have an intrinsic and sustained cost advantage over specialist retailers represents an overly simplistic view of the implications of vertical integration, and ignores the opportunity cost to generators of supplying hedging services to its affiliated retailer. This analysis, and the evidence before the Commission, does not support the hypothesis that any wholesale market power could be leveraged into retailing." (AEMC page 146, 147, 148).

UCW: *There are a number of inconsistencies within this section of the AEMC rationalisation of its decision.*

- *The AEMC notes "*retailers generally viewed electricity retailing in South Australia as having low barriers to entry, provided they could access hedge and risk management contracts at acceptable prices*". This view is accepted by UCW but it notes the emphasis on the provision of access to hedge and risk management contracts. UCW is concerned by the fact that large users of power have seen a diminishing supply of hedge and risk management contracts, and prices reach unacceptable levels. If there is a diminishing supply and if the prices are not acceptable then the AEMC assumption loses validity.*
- *The attribution of AGL motives for managing their generation portfolio and retail business would be more believable if AGL did not have such a large retail portfolio, where the retail business exceeds the output of the generation assets it holds. In no other market in the NEM does the dominant retailer also hold the dominant generation capacity. With this mix, AGL has a much greater ability to maximise its profitability by providing careful attention to its coverage and use its output of TIPS to achieve a balance between short and long term profitability. The fact that its retail hedging approach has the potential to drive other retailers to hedge with TIPS places AGL in a unique position not seen elsewhere in the NEM. Thus the conclusion that AEMC reaches (*"even under the assumption that TIPS does possess a significant and sustained degree of power in the wholesale electricity market, the analysis outlined above shows that AGL is unlikely to be able to leverage that power into electricity retailing. To do so would require an ability to recoup the profit sacrificed in the long run which is a high risk strategy and is not supported by the evidence available to

the Commission") *depicts a view that is not consistent with the unique features of the actuality. If the AEMC conclusions are correct, it then raises the question as to why did AGL purchase TIPS, if not to improve its overall commercial position. Accepting that the purchase was to seek an improved commercial outcome, then the AEMC summation as to AGL's position as dominant retailer and dominant generator in SA, is open to question. No extensive rationalisation avoids the view that if it walks like a duck and talks like a duck it probably is a duck.*

- *The arguments developed by AEMC in defence of its position are predicated on the assumption that all generation output is hedged back to retailers. In fact there is a considerable volume of power that is traded in the spot market. Not all consumers are hedged and few retailers are fully hedged, as forward demand is not known. In its development of the retail price cap ESCoSA included a significant element of the total as being related to hedging mismatch (the difference between the demand that is hedged and the actual demand). This requires the retailer to either source or bid in the difference in the spot market. This mismatch is asymmetrical with greater risk attached to sourcing additional power from the spot market. The outcome is a generator with the ability to set prices can distort the market.*
- *The AEMC views the acquisition of TIPS by AGL as effectively unrelated when its states: "*Any express or implied allocation of TIPS' capacity to AGL's own load portfolio forgoes the opportunity to sell hedge contracts to other retailers. Once this opportunity cost is recognised, the natural advantage of vertically integrated electricity gentailers is likely to be much less than it appears." *A realistic view of this observation shows that a dominant gentailer can use its market position to maximise its profitability by careful balancing of selling generation hedges and retail offers so as to put other retailers at a disadvantage. It must be expected that AGL would use this "transfer pricing power" in the most effective manner. To assume that after making a significant purchase (such as it did in its acquisition of TIPS) AGL will act at all times with the generation and retail functions being at "arms length" is, itself, a simplistic (and unreal) assumption. In fact many businesses have deliberately sought vertical integration so that they can exercise the market power that results.*

AEMC states:

"E.1.1.5 Impact of current conditions

"Notwithstanding the causes, higher wholesale energy prices and the increased cost of financial contracts, which have not been passed through in revised standing contract prices, appear to be affecting decisions about entry and expansion. Currently, six retailers are not actively marketing to new customers, including three who ceased marketing in mid-2007. These retailers have attributed the high increase in prices and the inability for these costs to be recovered at current retail prices as the reasons for the suspensions. As one retailer noted:

> "… when that [a period of volatility] happens in the spot market that means that all the hedging products that are available become far more expensive …in South Australia [hedging products] have gone up so it's got to the point now where there are no margins, we can't offer competitive retail prices to customers in South Australia and earn a profit based on using those hedging products so basically we're not competing in South Australia any more, we used to but we actually don't have any sales teams operating..."

At least two prospective new entrants have also deferred plans to enter the market until conditions improve. However, these retailers and those who have suspended marketing activities are monitoring the market and expect to enter or recommence active marketing once the available margins improve. This view is supported by South Australia Electricity:

> "… there are several retailers including South Australia Electricity, ready and able to re-enter the market at relatively short notice."

The Commission recognises that access to competitive wholesale energy contracts and risk management tools are necessary requirements for the entry and ongoing viable operation of energy retail businesses. It also notes that the cost of contractual tools to mitigate price and volume risk are placing increasing pressure on the ability of some retailers to continue to acquire new customers profitably given the level of the standing offer prices with which they must compete. These circumstances are also adversely affecting the decisions of prospective retailers to enter the market. Retailers are likely to face further pressure as the tightening supply/demand balance and the implementation of climate change policies increase energy retailing input costs. The Commission believes, however, that effective competition in the energy retail market will be able to efficiently accommodate these developing market conditions provided retail prices are able to respond flexibly to future changes in energy input costs. Such price changes will be needed to maintain competitive retail margins and so the viability of efficient retailers. To the extent that the current standing contract pricing arrangements are constraining such price adjustments there can be unintended consequences for the ongoing viability of energy retailers and potential implications for future competition in the energy retail market." (AEMC page 149, 150).

UCW: *The AEMC seems to be accepting the UCW's analysis that the wholesale market is being driven higher, but then reverts to form by* *arriving at the conclusion that only revocation of the retail price cap regime is the only solution to allow re-entry of retailers who have withdrawn. What the AEMC does not do is to analyse why some retailers (eg AGL, Origin, Simply and TRUenergy – all gentailers) appear to be able to stay in the retail market, yet the non-gentailer retailers (eg Aurora, Country Energy, etc) have had to withdraw. The UCW has offered reasons why this might be the case (that the non-gentailer retailers cannot get adequate hedging because of the dominance of AGL) but the AEMC has concluded that it is all because the retail price cap is too low.*

The AEMC has not even countenanced that the current retail problem might be solved by lifting the cap for a period, preferring its approach of removing the price cap.