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Review of effectiveness of competition in the gas and electricity retail markets in South Australia: Issues Paper, April 2008

AGL Energy Limited (AGL) welcomes the opportunity to comment on the Issues Paper for the review of effectiveness of competition in the gas and electricity retail markets in South Australia (the Review) by the Australian Energy Market Commission (the Commission). The Commission is required to undertake this review under the Australian Energy Market Agreement (AEMA).

AGL is one of Australia's largest integrated energy companies, focused on power generation, gas production and energy retailing and has significant electricity and gas customer bases across Australia. We are currently developing a number of new generation assets, which are consistent with a carbon-constrained future and premised on the ability to earn an appropriate rate of return in a competitive energy market. Removal of regulatory constraints on retail pricing and certainty with respect to greenhouse mitigation measures are critical for these investments.

We strongly support the removal of retail price regulation in those markets that are open to competition. The promotion of efficient investment in power generation and upstream gas capacity, the efficient use of energy, product and service innovation and the consumers long term interests with respect to price, quality and reliability will best be achieved through cost reflective market based retail prices. AGL therefore supports the agreement by the Australian governments under the AEMA to phase out the exercise of retail price regulation for electricity and natural gas where effective retail competition can be demonstrated. It is pleasing that the reviews are being conducted in a consistent manner in line with the criteria determined by the Ministerial Council of Energy (MCE).

Assessing effectiveness of competition

AGL strongly believes that the following outcome indicators are the primary measures of the effectiveness of competition in a given market:

- Customers are aware that they have a choice;
- Customers know how to exercise choice and it is easy to do; and
- Choices (ie. Offers) are being made available to them.

The Commission has outlined a number of indicators that it proposes to utilise to assess effectiveness of competition which incorporate the above.

The Essential Service Commission of South Australia (ESCOSA) has undertaken a number of reviews of the effectiveness of competition in South Australia for both gas and electricity markets. These reviews, the last of which was conducted in June 2007 will provide the Commission with a valuable reference point and insight into the South Australian energy market and assist in determining the whether the markets are such that retail price regulation can be removed.

For the most recent review ESCOSA engaged NERA Economic Consulting (NERA). In its report, released in June 2007, NERA concluded that competition in both the electricity and gas retail market for small customers is generally effective for most customers.[1] With reference to the specific markets, NERA noted that the[2]:

- Electricity market is effective; and
- Metropolitan gas market is well established and likely to be effective with some concern that access to pipeline laterals may be the cause of the less intense competition in some regional areas.

NERA also noted that "while there have been fewer entrants in the gas retail market, due largely to capacity constraints along the two pipelines that serve the South Australian market, this has not limited the rate of customer switching to gas market contracts"[3]. In fact, while full retail contestability (***FRC***) for gas customers was introduced eighteen months after FRC for electricity customers, the switching rates from standing contracts to market contracts for gas customers has equalled that of electricity customers.

Going forward, it is critical that the challenges in the gas market arising from capacity constraints not erode the market effectiveness that has been achieved.

Protection of vulnerable customers

Clause 14.11 (b) of the Australian Energy Market Agreement (AEMA) states that all parties agree to phase out the exercise of retail price regulation for electricity and gas where effective retail competition can be demonstrated and 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. This agreement is consistent with the recommendations of the Productivity Commission[4] following its review of Competition Policy Reforms in 2005.

The price path arrangements in South Australia have rightly maintained the protection of vulnerable customers and retail price regulation as two separate issues. Under the existing price path arrangements all customers are subject to prices that are designed to be fully cost reflective but customers who are not able to pay their bills are then assisted under targeted assistance programs.

Conclusions and way forward for South Australia

Based on the developments in the South Australian market since full retail contestability was introduced and ESCOSA's 2007 review of the effectiveness of competition in electricity and

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[1] NERA Economic Consulting, *Review of the Effectiveness of Energy Retail Market Competition in South Australia – Phase 2 report for ESCOSA*, June 2007, pg. I.

[2] Ibid, pg 87

[3] Ibid, pg ii

[4] "In retail infrastructure markets, once effective competition has been established, regulatory constraints on prices should be removed. Ensuring that disadvantaged groups continue to have adequate access to services at affordable prices should be pursued through adequate, well targeted and transparent community service obligations (or other appropriate mechanisms), that are monitored regularly for effectiveness." - Productivity Commission Inquiry Report: Review of Competition Policy Reforms, February 2005.

gas markets in South Australia, AGL strongly believes that competition in the South Australian energy market has been effective for several years.

AGL also highlights the fact that South Australia has been ranked third in the world for switching (behind Victoria and the UK) and is considered to be a 'hot' market[5]. In February 2008, the Commission recommended that retail price regulation for both the gas and electricity market in Victoria be removed, as competition in the gas and electricity markets is effective. In the UK, retail price regulation was removed in 2002 and since this date the markets have continued to remain competitive with retailers offering a wide range of market offers. Following the removal of retail price regulation in the UK, the Office of Gas and Electricity Markets (Ofgem – energy regulator) monitors prices paid by customers for energy in the retail supply markets and produces regular reports on competition in the retail sector, covering customer switching and other indicators.

We believe that retail price regulation can and should be phased out in accordance with the AEMA. AGL supports that the requirement of the 'obligation to supply' (obligation to offer to sell) remain at prices determined by market forces and be placed on the Financially Responsible Market Participant (FRMP).

We note that the South Australian government can maintain a reserve power on retail price regulation as provided for under clause 14.14(c) of the AEMA. As outline in our response to the Victorian effectiveness of competition review, AGL supports this 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.

Our detailed comments to the issues raised by the Commission are provided in Attachment 1.

AGL looks forward to contributing further to the Commission's review.

Yours sincerely,

Elizabeth Molyneux
General Manager, Energy Regulation

[5] First Data Utilities and VaasaETT Utility Customer Switching Research Project, *World Energy Retail Ranking*, 3rd edition, July 2007, p. 2

Attachment 1 – Effectiveness of Competition in South Australia - AGL comments on specific issues raised by the Commission

<table>
<tr><th>Issues raised for comment by the Commission:</th><th>Comments</th></tr>
<tr><td colspan="2">Market structure and conditions for entry, expansion and exit</td></tr>
<tr><td>Have the structural conditions for energy retailing in South Australia supported or hindered the development of effective competition? Are these structures likely to support or impede further improvements in competition in the future?

Are there barriers to entry that impact on the development of effective competition? Have these barriers to entry dissuaded prospective energy retailers from entering or can they be overcome? Are these barriers likely to persist or abate?

Are there barriers to expansion or exit that impact on the development of effective competition? Have these barriers dissuaded prospective energy retailers from entering or can they be overcome? Are these barriers likely to persist or abate?

Are there unique or specific features of the South Australian electricity or gas retailing environments that may support or impede the development of competition?</td><td>AGL does not consider there to be any material barriers to entry, expansion and exit within the South Australian gas and electricity markets.

The number of retailers participating in the South Australian market and gaining market share provides evidence of low barriers to entry. The number of energy retailers in South Australia is continually expanding, with Dodo Power & Gas Pty Ltd in being granted gas and electricity licenses in January 2008.

The Commission has suggested in the Issues paper that the presence of structural conditions such as a single host retailer for electricity (AGL) and a single host retailer for gas (Origin) may make it difficult for new entrant retailers to compete effectively[6]. AGL does not believe this to be an issue. On the contrary, the market share of AGL and Origin as host retailers has diminished significantly since the introduction of FRC. The high level of churn away from the host retailers highlights the fact that competition is strong and those customers, for any number of reasons, are switching away from the host retailers to take up market offers with new entrant retailers.

The Commission highlights economies of scale as a potential competitive advantage for some companies. AGL submits that the majority of new entrant retailers in a given market are already active in other jurisdictions. Therefore, these retailers may already be enjoying some benefits from economies of scale. However, we also note that it is not always possible for an incumbent retailer to benefit all of the potential cost advantages one would expect from having a greater market share. To the contrary, AGL as incumbent electricity retailer is obliged to offer contracts to all customers while other new entrant retailers are free to ‘cherry pick’ particular market segments. Thus leaving the incumbent with the remaining higher cost customers.

While AGL does acknowledge that there may be some issues surrounding capacity constraints in the gas market, we do not believe these to be materially affecting the level of competition in South Australia. AGL refers to the finding of the NERA report which states:</td></tr>
</table>

[6] AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia*, March 2008, pg. 11

Issues raised for comment by the Commission:	**Comments**
	"While there have been fewer entrants in the gas retail market, due largely to capacity constraints along the two pipelines that serve the South Australian market, this has not limited the rate of customer switching to gas market contracts. Despite the fact that competition for small gas customers was opened 18 months after that for electricity, around the same percentage of residential gas customers have switched to market contracts with new retailers".[7]
Retailer Rivalry	
To what extent to do retailers compete with each other to acquire new customers and retain existing customers? What does the current level of rivalry between retailers indicate about entry retailer in South Australia? *Has retail price regulation encouraged or impeded tariff innovation, product differentiation and service competition?* *On what basis, and to what extent, might retailers be expected to compete in the future?* *What does the nature and extent of marketing activity indicate about the level of competition? What do the types of marketing activities undertaken by retailers indicate about the level of competition?* *Is there evidence of retailers engaging in mis-selling and other anti-competitive marketing practices?* *Are retailers able to recover their efficient costs at current standing and market offer contract tariffs? Are future expected profit margins likely*	As outlined above, AGL believes that retail rivalry in the South Australian market is strong and is a primary indicator that competition is effective and that there are no material barriers to entry. AGL expects that the quantum and variety of market offers would be primarily dependent upon the number of active retailers in a market. Given the level of customer churn since FRC, it can be assumed that retailers are active in their marketing activities and that a substantial amount of customers are taking advantage of the offers that are being presented to them, whether these offers are being made over the phone or during door knocking campaigns. Following the removal of retail price regulation in the UK, there has been an increase in the number of market offers and innovation in those offers. For example, some retailers are offering fixed price contracts whereby the prices are set for a number of years. AGL cannot see any reason why the variety and innovation of retail market offers would not continue to expand following the removal of retail price regulation. Competitive forces will ensure that retailers offer competitive deals to not only win, but also to retain market share, especially as the market becomes more familiar with choice and competition. With respect to retailer marketing practices, AGL is of the view that any mis-selling or other anti-competitive marketing practices should be dealt with under the relevant provisions of the Trade Practices Act (1974 (Cth) and the Fair Trading Act 1987 (SA) as well as a number of energy specific instruments. Retail price regulation should not be used as protection for customers where retailers are acting inappropriately, such as through marketing mis-conduct. As for retailer exposure, prudent retailers will have hedged their load over previous years and months, therefore, will not be exposed to the majority of normal fluctuations in wholesale

[7] NERA Economic Consulting, *Review of the Effectiveness of Energy Retail Market Competition in South Australia, Phase 2 Report for ESCOSA, June 2007*, pg.i-ii.

Issues raised for comment by the Commission:	Comments
to be sufficient so as to encourage new entry and increase competition or insufficient such that new entry is deterred? *What effect, if any, does retailer exposure to fluctuations in wholesale electricity and gas prices have on retailers' ability to offer competitive product and service offerings?*	electricity and gas prices. However, AGL does submit that retail prices should reflect the true cost of sourcing and supplying energy to consumers, therefore, where those input costs genuinely increase (eg, retail operating costs, wholesale electricity and gas costs and transmission / network charges), so too should the retail prices. AGL believes competition is the best mechanism for producing efficient prices, providing the price signals for new investment and providing incentives for the most efficient use of energy.
Customer participation and experience	
What motivates customers to switch from a standing offer to a market contract or to switch retailer? For those customers who are not willing to participate in the competitive market, what underpins their decision to remain on a standing offer? *Do retailers actively compete to offer the products, services, prices and other conditions of supply which are most attractive to customers? Do retailers respond to changes in consumer taste by offering new, different or better products in a timely manner?* *Are customers able to access information that is easy to understand, relevant and up to date, and enables competing offers to be compared? Do customers rely on this information when deciding whether to switch? If not, why not?*	It is AGL's view that the majority of consumers will switch from one retailer to another when they are offered a service and/or price that provides greater benefits to that consumer. It is important however, not to assume that where a customer does not switch from one retailer to another that it is due to lack of information or offerings. On the contrary, some customers are averse to change and/or are very happy with the price/service offering that they are currently enjoying with their existing retailer. As outlined earlier, South Australia has been ranked as the third hottest switching market in the world[8]. This is further evidence that customers are motivated to switch retailers, and that this is likely to be the result of market offers that are attractive. In order to remain viable and competitive in any market, it is important for a retailer to offer services and products that maximise its market share whilst maintaining sufficient profit margin. We believe that the products offered to consumers will change as the market develops. The Essential Services Commission of South Australia (ESCOSA) offers a price comparator tool on their website, which allows a consumer to compare electricity, gas or duel fuel offers to assist in determining which offer is best for them. AGL believes this tool is useful for consumers to compare offers and assist in their decision on whether or not to switch retailers. However, we also believe that many customers rely on the merits of a particular offer at the time of marketing, such as being offered a 5% discount on their existing prices under a standing offer contract.

[8] First Data Utilities and VaasaETT Utility Customer Switching Research Project, *World Energy Retail Ranking*, 3rd edition, July 2007, p. 2

Issues raised for comment by the Commission:	**Comments**
Equitable access to the benefits of competition	
Are there classes of customers who are unable to access the benefits of competition? If so, what factors contribute to the difficulties experienced by these customers? *What steps, if any do retailers take to assist customers experiencing difficulties in participating in the competitive market? Are these initiatives effective in assisting these customers?*	As outlined in the Issues paper and in NERA's June 2007 report there are some customers in regional South Australia gas market where competition may not be readily available due to capacity constraints. AGL is of the view that the removal of retail price regulation for gas customers should not be delayed as a result, rather, AGL submits that the prices being offered to these customers following removal of retail price regulation will be subject to monitoring. The threat of reintroduction of retail price regulation will alleviate any concerns of the potential for irregular pricing activities being adopted for any affected customers. Removal of price controls will not impact on a customers rights and obligations (customer protection provisions) under the Consumer Protection Code and voluntary measures such as retailers hardship policies adopted by the incumbent and new entrant retailers. The hardship policies are generally designed to assist those customers who identify themselves to retailers as having difficulties, whereby alternative arrangements are made between the retailer and customers, such as bill smoothing. AGL strongly believes that issues of financial hardship are not effectively addressed by regulating energy prices. Price regulation and assistance to customers in financial hardship should be managed as two separate issues. Effective and efficient assistance to customers in financial hardship requires adequate, well-targeted and transparent community service obligations.