COTA Seniors Voice and SACOSS

Responses to AEMC Review of Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia - First Draft Report

This brief submission makes comment on a selection of specific issues that were raised during discussions with AEMC representatives at the forum in Adelaide on Thursday 17th of July and subsequent COTA meeting on Friday 18th of July 2008, in response to the Draft Report.

The authors of this submission are aware that UnitingCare Wesley Adelaide has addressed a couple of key issues raised on the 17th of July in their recent submission. We endorse the content of that submission and so do not re-address those issues here. However, we wish to restate the importance of the AEMC addressing the questions of competitiveness of the wholesale energy markets in South Australia and the capacity for 'gentailers' to 'game the market'. Both of these issues raise very serious questions about the extent and effectiveness of retail energy competition.

The AEMC Conclusion

In its draft report the AEMC concludes:

> "The Commission's preliminary finding is that competition is effective for small electricity and small gas customers in South Australia, although competition is relatively more intense in electricity than in gas. However, in making its preliminary finding the Commission has identified some structural limitations that are affecting the ability of small gas customers in regional areas to access the full benefits of competition." [1]

We wish to respond to this conclusion with brief reference to four (4) issues:

1. The SA Gas Market
2. The Structure of SA Retail Energy Markets
3. Interpreting 'Churn data'
4. New Pressures on Energy Prices

[1] AEMC (2008) Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – First Draft Report (4 July 2008) - page ix

1. The South Australian Gas Market

We observe that there are significant limitations in supply, reach and retailer options available to customers in the regional SA gas market. We submit that while evidence for this has been presented to the AEMC and recognised in its report, too little attention has been given to this in the findings presented in the First Draft Report released on 4 July 2008.

Our evidence for this conclusion is incorporated within the AEMC's First Draft Report and the submissions made by various parties to the first consultative process. We submit that the evidence presented below can only lead to a conclusion that competition is NOT CURRENTLY PRESENT in regional gas markets in SA.

<u>Comments from the Draft Report</u>
In its First Draft Report the AEMC identify a range of structural limitations affecting the supply of gas to small retail customers in regional South Australia. One of these limitations concerns the 'contract carriage model' operated in SA, and in our view this leads to an uneven playing field in regional gas retailing.

> "The duration and contracted gas quantities of many foundation contracts and other similar contractual arrangements mean that new retailers or retailers with a small load may be unable to contract for access to wholesale gas as readily as a larger retailer…. Accordingly, retailers who are affiliated with a gas-fired generator or who have existing contracts to supply large gas customers may be at a competitive advantage relative to their competitors."[2]

Furthermore, there are barriers to retailer entry and expansion resulting from difficulties with access to gas infrastructure.

> "Access to gas customers in Whyalla and Port Pirie and in the Riverland and Murray Bridge areas requires access to the Port Pirie and Angaston laterals connected to MAPS. Obtaining access to these laterals is considered to be problematic by some retailers because all firm capacity is fully contracted to the host retailer, Origin. … retailers wishing to supply Mt Gambier gas customers must negotiate for firm capacity with Origin, which they regards as problematic given that they are, in effect, negotiating with their competitor." [3]

AEMC admitted the following :

> "The effects of these structural limitations are that small gas customers in regional areas are unable to obtain competitive supply from retailers other than Origin. [4]

Furthermore, they indicate that :

[2] AEMC (2008) Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – First Draft Report (4 July 2008) - page 140-1
[3] AEMC (2008) Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – First Draft Report (4 July 2008) - page 143-44
[4] AEMC (2008) Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – First Draft Report (4 July 2008) - page 144

"… regional electricity customers have shown themselves to be willing to switch to an alternative retailer as electricity customers in Adelaide, thus regional gas customers could be expected to exhibit the same propensity to switch *if they were in a position to actually make such a choice*." [5]

Given that AEMC have admitted that regional gas customers are only able to gain supply from one retailer, Origin, how can competition be said to be effective in this market? If energy customers in regional areas only have one provider to 'choose from' then can competition for this segment of the South Australian population be said to be effective? We would argue that the answer to this is a resounding 'no'.

Further Issues Raised in Submissions to AEMC

Simply Energy have outlined in their submission to the AEMC that :

"…there are significant market constraints in the South Australian gas market that require attention." [6]

They raised four major issues in relation to the South Australian gas retail market, being :

1. Large fixed costs
2. Credit support requirements
3. Significant risk
4. Access to retail delivery points. [7]

TruEnergy also raised concerns in their submission.

"Consistent with the views of NERA, TruEnergy does have concerns with some structural features of the South Australian gas market which impede retail competition :

- Access from SEA Gas is not possible to customer on Le Fevre peninsula, and problematic to commercial/industrial customers in Adelaide's northern suburbs in the absence of additional gate stations.

- Pipeline access to customers on lateral pipelines to the north of Adelaide (and SESA pipelines) requires separate negotiations with the incumbent retailer. Retail products that are based upon interruptable haulage are not commercially viable for large customer sites and potentially non-compliant with regulatory instruments for mass market customers.

[5] AEMC (2008) Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – First Draft Report (4 July 2008) - page 144—5 - our emphasis
[6] Simply Energy (2008)) Submission to AEMC Review of Effectiveness of Competition in Electricity and Gas Retail Markets in SA- covering letter
[7] Simply Energy (2008)) Submission to AEMC Review of Effectiveness of Competition in Electricity and Gas Retail Markets in SA- pages 1 and 2.

- Commercial risks for new entrant retailers arising from potential exposure to swing gas, which are not recognised in ESCOSA retail price determinations."[8]

The SA Farmer's Federation have expressed concern in their submission about the ability of households and business in regional areas to access more than one retailer.

> "Our (energy) providers in the past have found gas provision in the city to be possible but in regional areas to be impossible to provide at any competitive price to the huge costs levied against them for access. From their perspective the initial costs were far too high to spread over the user base to make it worthwhile to enter the market in any form. Even charging the full regulated rate wasn't considered profitable due to the wholesale costs associates with the provision of service. "[9]

We also ask if an essential service is only available to and used by about a half of households, how can there be effective competition when there isn't even availability?

<u>Our Conclusion</u>

Limitations in supply, reach and retailer options mean the retail gas market in regional SA cannot be considered to be competitive.

2. The Structure of SA Retail Energy Markets

The draft report, in figure 2.1 provides a diagram outlining the "development of competition over time" through the 'Progression of Competition' from monopoly through oligopoly to monopolistic competition and finally to perfect competition. The report then introduces the notion of 'effective competition' which we assume would sit somewhere between 'monopolistic competition' and 'perfect competition'.

However, the report does not consider or define characteristics of any market structures other than 'monopoly and 'effective competition.' We believe that this is a short-coming of the draft report.

We suggest that an oligopoly market is generally characterised by the following characteristics :

- There are many buyers but not many suppliers (but more than one);
- Firms are large as a proportion of the size of the market;

[8] TRUenergy (2008) Submission to AEMC Review of Effectiveness of Competition in Electricity and Gas Retail Markets in SA – page 2.
[9] South Australian Farmer's Federation (SAFF) (2008) Submission to AEMC Review of Effectiveness of Competition in Electricity and Gas Retail Markets in SA – page 8.

- Capacity for incumbent firms to influence price, eg by various forms of tacit, or even explicit understanding;

- Products can be differentiated or homogeneous; and

- A range of barriers to entry exist for would-be new entrants.

There is considerable debate in the economics literature about what constitutes a measure of Oligopoly, we identify two:

1. "As a quantitative description of oligopoly, the four-firm concentration ratio is often utilised. This measure expresses the market share of the four largest firms in an industry as a percentage. Using this measure, an oligopoly is defined as a market in which the four-firm concentration ratio is above 40%"[10]

2. The Herfindahl-Hirschman Index (HHI), which is calculated by summing the squares of the market shares (in percentage terms) of all the market participants. In its most general formulation, this equilibrium can be characterised as:

   (P - C)/P = (H*Beta)/e

   where P is price, C is marginal cost, H is the Herfindahl-Hirschman Index, e is the constant elasticity of demand for market output and Beta is a parameter which represents the manner in which firms in the market interact.[11]

Using the four firm concentration ratio, there can be no doubt that both retail electricity and gas markets in South Australia are characterized as oligopolistic markets

In the case of gas retailing and using the AEMC data from the draft report Origin AGL, Tru and Simply/IP have 100% of the retail gas market, and in electricity they have 92% of the retail market. A Herfindahl-Hirschman assessment shows that the gas market has an HHI index of 4000 and the electricity market an index greater than 3800, an index above 1800 indicates a market with high concentration; an oligopoly market.

Using these two measures of market concentration leads to very clear conclusions that South Australian electricity and gas markets are oligopolies and so cannot possibly be considered to be characterized as 'effectively competitive' markets.

[10] Wikipedia
[11] Are the ACCC's Merger Guidelines Too Strict? A Critical Review of the Industry Commission's Information Paper on Merger Regulation, Henry Ergas, The Centre for Research in Network Economics and Communications School of Business and Economics
The University of Auckland

Henry Ergas makes the following general observations about oligopolistic markets:

> "The HHI can be interpreted as the ratio of the (likely) non-cooperative mark-up to the cooperative (collusive) mark-up. Each percentage increase in the HHI then translates into higher mark-ups, regardless of whether firms actually collude. In short, simple oligopoly theory suggests that increased levels of concentration raise concern on two grounds: (1) because for a given pattern of interaction (the Beta coefficient above) higher concentration will yield higher margins of prices over costs; and (2) because as concentration rises, the pattern of interaction may change towards or to collusion."

We conclude that the South Australian electricity and gas markets meet the criteria ascribed to oligopoly markets, which means that market concentration enables the firms to potentially influence price, using non-market mechanisms. Oligopoly markets also means that there is the potential for tacit collusion amongst firms, meaning there is the potential and we would suggest likelihood, of customers being charged more than they would in a fully competitive market.

We recommend that the AEMC consider the applicability of oligopoly market models to explain South Australian electricity and gas markets. We will also encourage the AEMC to review contemporary game theory analysis and critique retail market behaviour in South Australia, against these various strategies that firms in oligopoly markets can employee to bid up prices and extract better than competitive profit margins.

We also observe that the useful concept of "Theory of Second Best" is not utilised, or even acknowledged by the AEMC as providing useful insight for markets in transition, such as energy markets in South Australia.

We suggest that a rudimentary application of the Theory of Second Best might suggest that where any of the necessary preconditions for perfectly competitive markets do not hold then the second best public policy response is likely to be significantly different from the policies that would be applied by assuming that markets behave like effectively competitive markets. We suggest this is likely to mean that in the absence of all necessary conditions for perfect competition holding in South Australian energy markets, in the retention of consumer protections, including price controls is the next best policy setting.

3. Interpreting 'Churn data'

The draft report relies heavily on 'market switching' or 'churn' evidence or as evidence of competitive markets.

> "While South Australia's small energy customers are unlikely to actively seek out competitive market offers, they demonstrate the willingness to participate in the competitive retail market if approached directly by retailer.

> Large numbers of small electricity and metropolitan gas customers have responded to competitive offers an exercise choice between the available offers when approached by retailers and given sufficient incentive. Approximately 66% of small electricity customers and 59% of small gas customers have switched to a market contract" (page 22)

We observe that 34% of electricity retail customers have stayed on the AGL standing offer while 41% of residential gas customers have stayed with the Origin standing offer. The draft report does not consider these customers despite standing offer customers forming the largest single group of customers in both electricity and gas markets.

We also note that there has been a direct cash incentive, $50.00, from the SA Government, for electricity customers to move to a market contract and significant effort invested by retailers in marketing and promotion of market contracts.

Despite all of these incentives and inducements, just over a third of electricity customers and a higher percentage of gas customers have stayed with the standing contracts. The AEMC has not asked why this is the case, with the largest customer groups in both markets choosing to stay with the standing offer?

We suggest that this is because very significant numbers of South Australian consumers are choosing to retain the consumer protections and relative price certainty that is associated with standing offers when compared with competitive market contracts. We suggest that it would be poor public policy to simply think that standing offer customers have failed to take up market contracts because of indolence or some other personal failing. Many customers want the choice of retaining consumer protections afforded by standing contracts, including price regulation.

We also draw your attention to the submission from UnitingCare Wesley Adelaide and specifically the discussion of emerging thinking in the UK about churn being a poor indicator of good customer outcomes.

4. New Pressures on Energy Prices

We observe that there is a range of factors that are all likely to add to the price of electricity over the next two to three years and so add a great uncertainty to energy affordability, these include:

- growing global demand for energy with petrol and liquefied gas demand in particular likely to add significant cost pressures for these energy sources;

- higher costs of supply, in particular "peak oil" and rising costs of electricity generation due to seasonal events including drought;

- pass through costs of interval metering, although this may not impact on South Australians as soon as eastern states consumers; and

- the costs of the Residential Energy Efficiency Scheme (REES) in South Australia will be spread across the bills of all South Australian residential customers.

Then on top of these household energy cost pressures, the Carbon Pollution Reduction Scheme will be introduced from 2010, which will put a price on carbon emissions. These prices will flow through to residential energy customers. We are very supportive of pricing carbon as an environmental measure, but note that it is one of a number of pressures, which will force energy prices, including electricity and gas prices significantly higher during the next 2-3 years.

We are firmly of the view that to find the South Australian energy markets competitive and subsequently recommend the removal of energy price caps would be adding another major uncertainty to energy pricing over a very volatile time. There is little doubt that such an approach would badly hurt disadvantaged and low income households. These households will simply be unable to bear significant additional essential service cost increases and much greater uncertainty.

Postscript - Engaging With Community and Consumer Groups

We conclude this brief submission by noting that community and consumer groups were very unhappy with the AEMC's draft report, believing that despite actively encouraging with the consultation process they had not been “heard” through the process leading to the production of the draft report. We recognize the importance of the AEMC in setting energy policy and practice in the future and urge the AEMC to review its processes of consumer and community engagement. We are happy to provide further comment on this matter if the AEMC would find it helpful.