

A Request for Advice

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21 DEC 2007

Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box H166
AUSTRALIA SQUARE NSW 1215

Dear Dr Tamblyn

PHASE OUT OF RETAIL PRICE REGULATION – COMMENCEMENT OF SOUTH AUSTRALIAN ASSESSMENT OF COMPETITION

At its meeting of 13 December 2007, the Ministerial Council on Energy (MCE) agreed that I write to you to request the AEMC to provide advice to the MCE on the state of competition in, and retail price regulation for, the electricity and natural gas market(s) in South Australia. The detailed request for advice taking account of the AEMC's Statement of Approach is attached.

The MCE would like to thank you for the first draft report "Review of the Effectiveness of Competition in the Gas and Electricity Retail Markets in Victoria". We note from your draft report that competition in both electricity and gas retailing in Victoria is effective. We look forward to the release of the final report in February 2008.

We look forward to receiving your advice on South Australia by no later than 31 December 2008.

Yours sincerely



Martin Ferguson

**MINISTERIAL COUNCIL ON ENERGY REQUEST TO AEMC FOR ADVICE ON THE STATE
OF COMPETITION IN ELECTRICITY AND NATURAL GAS RETAIL MARKET(S) FOR
SMALL CUSTOMERS IN SOUTH AUSTRALIA**

S.6(B) AUSTRALIAN ENERGY MARKET COMMISSION ESTABLISHMENT ACT 2004 (SA)

ADVICE**BACKGROUND**

1. The Ministerial Council on Energy (MCE) has agreed, in clauses 14.11 to 14.15 of the Australian Energy Market Agreement (AEMA):
 - To a process for assessing the effectiveness of competition in the electricity and gas retail markets of the jurisdictions for the purpose of phasing out retail price regulation where effective retail competition is demonstrated (clause 14.11);
 - That the Australian Energy Market Commission (AEMC) will assess the effectiveness of competition against criteria developed by the MCE;
 - That the AEMC will provide advice to jurisdictions on the retention, removal or reintroduction of retail energy price controls;
 - The effective competition review process is to commence with those jurisdictions most likely to have effective competition.
2. On 19 April 2007, AEMC provided advice to the MCE regarding the proposed public consultation process and the factors to be considered in its reviews of the effectiveness of competition in gas and electricity retail markets and for providing advice to jurisdictions for the purpose of retention, removal or reintroduction of retail energy price controls. This advice is referred to as the Statement of Approach and is set out in **Attachment A**.
3. Pursuant to s.6(b) of the *Australian Energy Market Commission Establishment Act 2004* (SA) the MCE may request the AEMC to provide advice.
4. Participating jurisdictions under the National Electricity Law (NEL) and Gas Pipelines Access Law (GPAL) have agreed to the request set out below with respect to the provision of advice by the AEMC on the state of competition in, and retention, removal or re-introduction of retail price regulation for electricity and natural gas market(s) in the State of South Australia (South Australia).¹

¹ The Essential Services Commission of South Australia regulates retail prices for electricity and gas retailers for small customers (ss 5 and 25 of the *Essential Services Commission Act 2002* (SA)). For electricity a small customer consumes less than 160MW.h (r.4B of the Electricity (General) Regulations 1997 read with s 4(1) of the *Electricity Act 1996* (SA)) and for gas a small customer consumes less than 1TJ (r.5(4) of the Gas Regulations 1997 read with s 4 of the *Gas Act 1997* (SA)).

The most recent electricity standing offer price determination was made by the Commission on December 2004. It sets a price path to apply to AGL SA's standing contracts for the period 2005-2007. On 24 August 2007, the Commission released its Draft Inquiry Report and Draft Price Determination in respect of AGL SA's standing contract prices for the period 2008-2010 (see <http://www.escosa.sa.gov/site/page.cfm?u=4&c=2406>). The Commission will release a Final Report by the end of November 2007.

The most recent gas standing offer price determination was made by the Commission in June 2005. It sets a price path to apply to Origin Energy's standing contract prices for the period 1 July 2005 ending 30 June 2008. The next SA gas retail price determination process for Origin Energy's standing contract prices will commence shortly.

In January 2007, the Commission commenced a Review of the Effectiveness of Energy Retail Market Competition in South Australia. The Commission appointed NERA Economic Consulting to advise it in relation to the Review (see

REQUEST

5. The MCE has by resolution dated 13 December 2007, agreed to request the AEMC to provide advice to the MCE on:
- the AEMC's assessment of the effectiveness of competition for small customers in the electricity (ie customers consuming less than 160MWh per annum) and natural gas markets (customers consuming less than 1TJ per annum) in South Australia, having regard to the full range of customers in this class; and
 - the retention, removal or re-introduction of retail price regulation for standing contracts for small customers in the electricity and natural gas market(s) in South Australia.

The advice must be prepared in accordance with the following requirements.

6. The AEMC must carry out its assessment and provide its advice generally in accordance with the Statement of Approach and in particular must assess whether competition is effective in relevant South Australian electricity and retail gas markets²:
- applying the criteria that have been developed by the MCE (at **Attachment B**); and
 - using the methodology and approach set out in Part 2 and Part 3 of the Statement of Approach.
7. In formulating its advice on whether competition is effective in the relevant markets, the AEMC should have regard to the fact that under clause 14.14 of the AEMA, participating jurisdictions have agreed that the phase out of the exercise of retail price regulation:
- need not include the removal of 'obligation to supply' arrangements;
 - may involve a further period of price monitoring and/or price agreements with retailers under appropriate oversight arrangements; and
 - need not prevent the exercise of a reserve price regulation power where effective competition for categories of users ceases, provided that the power is only exercised in accordance with a regulatory methodology promulgated by the AEMC, and is subject to review by the AEMC of the effectiveness of competition in accordance with the AEMA.

<http://www.escosa.sa.gov/site/page.cfm?u=4&c=2187>). The Commission has not made any conclusions.

² The MCE notes that, consistent with the AEMC's Statement of Approach (at 3.2) there may be more than one relevant retail electricity and natural gas market for small customers in South Australia. The AEMC will consider the relevant retail market(s) in which competition will be assessed. For the avoidance of doubt, a market may be defined by reference to groups of users or regions within South Australia.

Commencement of the review

8. Consistent with the AEMC's consultation process set out in its Statement of Approach (at 4.3), the AEMC must, before commencing its assessment of competition in South Australian electricity and natural gas markets:
- issue a public notice announcing the commencement of an assessment together with a proposed timetable for its completion including providing advice; and
 - call for public submissions within a time nominated by it on the effectiveness of competition in the relevant South Australian electricity and natural gas market(s).

Consultation with the South Australian Government and relevant stakeholders

9. The AEMC must, at each step in the advice process, consult with the South Australian government. The AEMC must also consult and meet with relevant stakeholder groups in South Australia who have an interest in the oversight, regulation or other control of retail prices.

Four Stages of Reporting and Advice

10. In providing the advice the AEMC must follow a four stage reporting and advice process (consistent with Section 4.3 of the Statement of Approach) as follows:

Stage 1

- 10.1. Publish a draft report (First Draft Report) on its assessment of the effectiveness of competition in the relevant South Australian electricity and natural gas market(s), inviting public comment on the draft findings.

Stage 2

- 10.2. Consider all submissions and the result of any other consultation undertaken and publish a final report (First Final Report) advising of its assessment on the effectiveness of competition in the relevant South Australian electricity and natural gas market(s).

Stage 3

- 10.3. Publish draft advice (Second Draft Report):
- where the AEMC finds competition is effective, on ways to phase out retail price regulation in the relevant market, including a draft timeframe within which the phase out should occur; or
 - where the AEMC finds competition is not effective, draft advice on ways to promote competition in the relevant market; and
 - include advice on South Australia's compliance with clauses 14.10-14.14 of the AEMA.

Stage 4

- 10.4. Consider all submissions and the result of any other consultation undertaken and publish advice (Second Final Report):
- where the AEMC finds competition is effective, on the phase out of retail price regulation in the relevant market, including an appropriate timeframe, taking account of comments received on the draft report; and
 - where the AEMC finds competition is not effective, on ways to promote competition in the relevant market.

MAKING REPORTS AVAILABLE

11. The AEMC must provide each of the reports referred to in clause 10 (the Reports) to the MCE and South Australia, and at the same time:
- make each of the Reports available on its website;
 - provide a copy of each of the Reports to all MCE Ministers; and
 - place a notice of publication of each of the Reports in a nationally circulating newspaper.

Date by which advice is due

12. The AEMC must provide its Second Final Report to the MCE by 31 December 2008.

Management of confidential information

13. The MCE notes that the AEMC will manage confidential information provided to it in accordance with the Statement of Approach (at 4.4).

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B Extract of AEMA

Retail Price Regulation

14.10 The Parties reaffirm their commitment to full retail contestability in accordance with the National Competition Policy Agreements.

14.11 All Parties agree to phase out the exercise of retail price regulation for electricity and natural gas where effective retail competition can be demonstrated and that:

- (a) the AEMC will assess the effectiveness of competition for the purpose of retention, removal or reintroduction of retail energy price controls, whereby:
 - (i) the criteria for assessing the effectiveness of competition will be developed by the MCE in consultation with the AEMC and other interested parties based on the principles set out in Annexure 3;
 - (ii) the assessment process will commence from 1 January 2007 starting with those jurisdictions most likely to have effective competition; and
 - (iii) reviews will be conducted biennially, unless the AEMC recommends otherwise, until all retail energy price controls are phased out or at the request of a Party thereafter;
- (b) 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; and
- (c) the AEMC will publicly report on its assessments of effective competition in which it will provide advice to each jurisdiction on their compliance with clauses 14.10-14.14 and on:
 - (i) ways to phase out the exercise of retail price regulation if competition is determined to be effective and an appropriate timeframe; or
 - (ii) ways to promote the growth of effective competition for those users or areas of a jurisdiction which do not enjoy effective competition.

14.12 The Parties agree that where competition is not yet effective for a market, group of users or a region:

- (a) retail energy price controls (including those furthering social welfare and regional equity objectives) can be imposed by the relevant State or Territory but should, to the extent possible, not hinder further development of competition and ensure that the benefits outweigh the costs, and costs are minimised; and

- (b) retail energy price control will be retained under the existing arrangements or be transferred to the AER and the AEMC at the discretion of each jurisdiction (such a transfer would not include the funding of community service obligations).

14.13 Where competition has been found to be effective under clause 14.11, the Parties agree to implement the phase out of the exercise of retail price regulation in accordance with clauses 14.14 and 14.15.

14.14 The Parties agree that the phase out of the exercise of retail price regulation under clause 14.13:

- (a) need not include the removal of 'obligation to supply' arrangements;
- (b) may involve a period of price monitoring and/or price agreements with retailers under appropriate oversight arrangements;
- (c) does not prevent the exercise of a reserve price regulation power by the State or Territory where effective competition for categories of users ceases, provided that the power is only exercised in accordance with a regulatory methodology promulgated by the AEMC, and is subject to review by the AEMC of the effectiveness of competition in accordance with clause 14.11.

14.15 The Parties further agree that, for the purposes of the phase out of the exercise of retail price regulation under clause 14.13, the process for responding to advice from the AEMC under clause 14.11(c)(i) will be as unanimously agreed by the MCE by 1 July 2006.

14.16 The functions and powers conferred on the AEMC by clauses 14.11, 14.14 and 14.15 are taken to be conferred on the Economic Regulation Authority for the State of Western Australia until such time as Western Australia elects to join the NEM or the Economic Regulation Authority is disestablished. The Economic Regulation Authority will conduct these functions and powers in consultation with the AEMC and in accordance with the national consistent developed by the AEMC.

...

ANNEXURE 3

INDICATORS OF COMPETITION IN RETAIL ENERGY MARKETS

1. **Customer experiences** – for competition to be effective, customers must be aware of different retailers and perceive that they can make price comparisons – data compiled from customer surveys.
2. **Customer switching** – transfer rates can indicate customer interest and activity in the competitive market – available from market data.

3. **Price and non-price offers** – evidence that suppliers are actively competing by offering innovative products that meet customer needs – compiled from retailer surveys and ‘mystery shopper’ surveys.
4. **Entry and exit of suppliers** – numbers of competing suppliers and changes in the numbers of suppliers can indicate the degree of competition – available from market data.
5. **Market shares** – market shares and changes in market shares are an indicator of market structure and dynamics – available from market data.
6. **Barriers to entry** – the threat of new entry creates pressures to reduce prices and improve service – to be ascertained by analysis.

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C Energy retailing in South Australia

History of electricity and gas retailing in South Australia

From its formation in 1946, the Electricity Trust of South Australia (ETSA) was responsible for the generation, transmission, distribution and retailing of electricity in South Australia. In July 1995, ETSA was corporatised, creating ETSA Corporation. During the late 1990s, ETSA Corporation's major generating assets and related liabilities were transferred to SA Generation Corporation, which was itself subsequently disaggregated to form four entities. Three of these - Optima Energy Pty Ltd, Flinders Power Pty Ltd and Synergen Pty Ltd - owned electricity generation assets and the fourth, Terra Gas Trader Pty Ltd, arranged the supply of gas to the generators. In 1998, ETSA Corporation was disaggregated into a transmission company (ElectraNet SA) and a "stapled" distribution and retail business (ETSA Utilities and ETSA Power, now part of AGL Energy).¹

The privatisation of the South Australian gas industry occurred in a substantially different way. In 1978, the South Australian Gas Company and the Government-owned South Australian Oil and Gas Corporation merged to form Sagasco, which was acquired by Boral in the early 1990s.² Boral combined Sagasco's distribution business with similar businesses in other jurisdictions in a company called Envestra and floated it on the Australian Stock Exchange (ASX). The remainder of the Sagasco energy business traded under the Origin Energy name. Origin Energy was demerged from Boral Limited in February 2000 and separately listed on the ASX.³

In the mid 1990s, the gas transmission assets owned by the Pipeline Authority of South Australia were privatised to form the Moomba to Adelaide Pipeline System (MAPS) and the South East Pipeline system, both of which are now owned by EPIC Energy.

Retail competition in the electricity and gas sectors was introduced progressively. At the introduction of competition in South Australia in December 1998, only the largest commercial and industrial customers were able to choose between the host retailer and new entrant energy suppliers. Full retail competition (FRC), where all customers - including the smallest users of energy - are able to choose their retailer, was available for electricity customers from 1 January, 2003. Regulatory barriers to FRC were removed for gas customers on 1 July 2001, however systems to facilitate FRC were not in place until 28 July 2004. The timeframe for the phased introduction of FRC is described in Table 1 below.

¹ Further information the corporatisation and privatisation of the South Australian electricity industry is available in the South Australian Budget Papers, 1999-2000, Chapter 8.

² http://www.boral.com.au/history/Ch6_5.html

³ <http://www.originenergy.com.au/233/History?rt=y>

Table 1: Timeline for the introduction of FRC in South Australia

Electricity		Gas	
Consumption	Contestability Dates	Consumption	Contestability Dates
≥ 4GWh	20 December 1998	≥ 100 TJ	1 April 1998
≥ 750 MWh	1 July 1999	≥ 10 but ≤ 100 TJ	1 July 1999
≥ 160 MWh	1 January 2000	Industrial and commercial customers ≤ 10TJ	1 July 2000
All customers	1 January 2003	All customers	1 July 2001 – but systems not in place to handle mass transfers until 28 July 2004

The standing offer and “safety net” regulations

The host retailers for electricity and gas in South Australia are AGL Energy and Origin Energy respectively. As a host retailer, AGL is required to offer to supply and sell electricity to all customers who consume less than 160MWh of electricity per annum at a regulated price and on defined terms and conditions. Origin is subject to a corresponding obligation in relation to those gas customers who consume less than 1TJ per annum. These offers are called “standing offer contracts”.

The price for energy under a standing offer contract – the standing offer tariff – and the defined terms and conditions are determined by the Essential Services Commission of South Australia (ESCOSA)⁴ following a public consultation process. The standing offer tariff is set for three years and allows for agreed price adjustments from year to year.

The standard terms and conditions of the standing contract determined by ESCOSA are set out in the Energy Retail Code. The standing offer contract contains terms and conditions relating to customer rights, market conduct, service standards and billing. Aside from some exceptions defined in the Retail Code, retailers must not deviate from this contract format when providing a standing offer contract or a market offer contract to a small customer.

South Australia’s retail competition experience

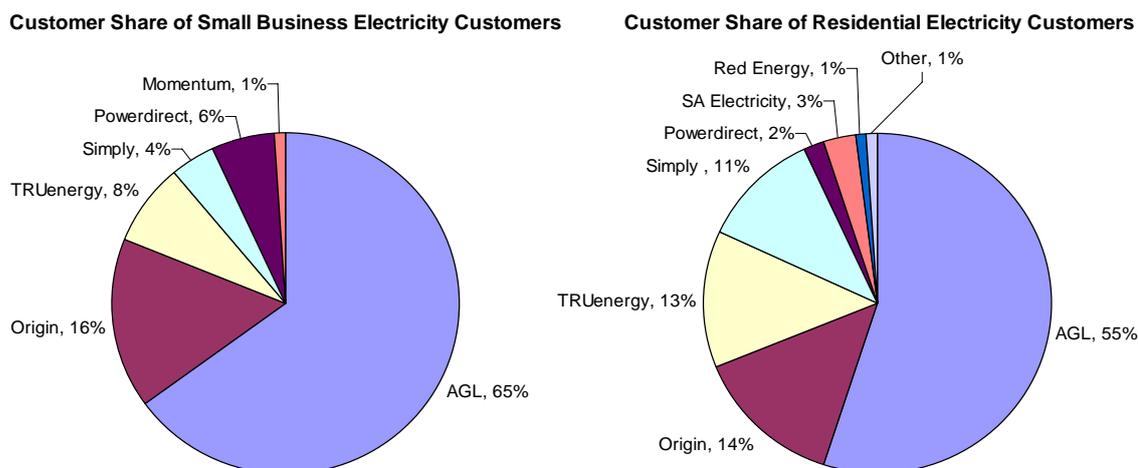
As at 31 December 2007, there were approximately 679,522 residential electricity customers and 85,671 small business electricity customers in South Australia and 364,910 residential gas customers and 7,535 small business gas customers.⁵ As at 1 January 2008, eighteen retailers were licensed to retail electricity to small customers, with eleven currently offering to supply to small customers. Ten retailers were licensed to sell gas to small customers, however, only four were currently offering supply.

Since the commencement of FRC, AGL’s and Origin’s customer shares have steadily declined, although markedly less so in the small business gas sector. Each retailer’s share of electricity and gas small customers is depicted in the charts below.

⁴ Section 35(A), *Electricity Act 1996* (SA); section 33(1), *Gas Act 1997* (SA).

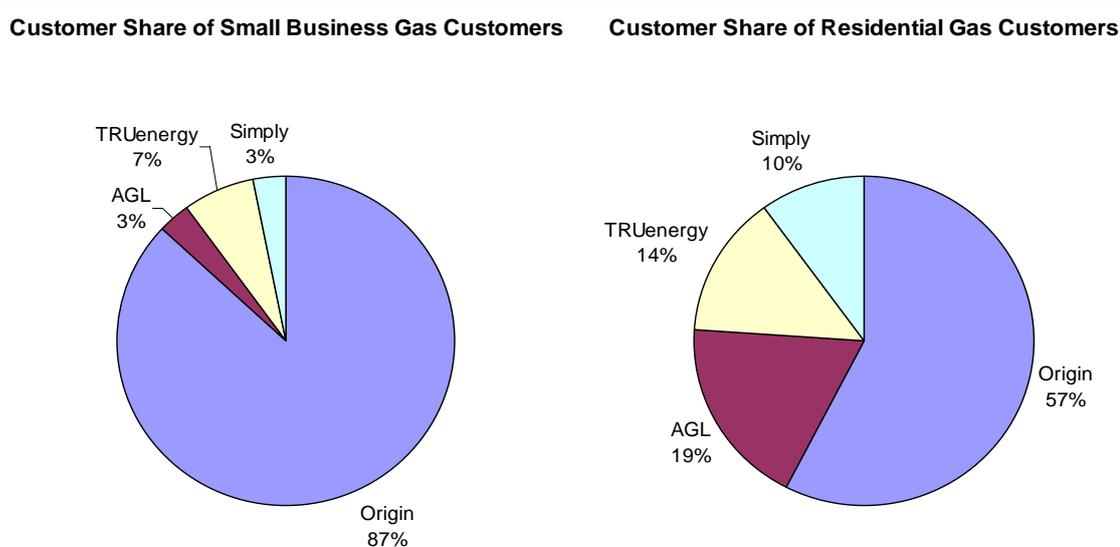
⁵ Essential Service Commission of South Australia, data collected through *Guideline 2: Reporting*, unpublished.

Figure C.1 Customer share of electricity customers



Data source: Essential Service Commission of South Australia, data collected through *Guideline 2: Reporting*, unpublished. Figures as at 31 December 2007.

Figure C.2 Customer share of gas customers



Data source: Essential Service Commission of South Australia, data collected through *Guideline 2: Reporting*, unpublished. Figures as at 31 December 2007.

Note: Retailers not listed in these charts have customer shares of less than 1 per cent.

As at 31 December 2007, approximately 68 per cent of residential electricity customers and 45 per cent of small business electricity customers have switched to market contracts. Approximately 60 per cent of residential gas customers and 16 per

cent of small business gas customers are now being supplied gas under a market contract.⁶

In January 2007, ESCOSA commenced its review of the effectiveness of energy retail market competition in South Australia. The purpose of the review was to inform ESCOSA's approach to setting the electricity and gas standing contract prices, and to build on market monitoring and reporting which ESCOSA had undertaken over the preceding years.

This review was conducted with the assistance of NERA Economic Consulting (NERA) and was based on a three phase process. After establishing appropriate criteria for the review in Phase 1, NERA undertook an assessment of the effectiveness of competition in Phase 2. In its Phase 3 report, NERA suggested areas where ESCOSA could improve its current retail market development activities to enhance the effectiveness of retail competition in South Australia.

In its Phase 2 report, NERA found that retail competition in the South Australian electricity and gas markets appeared to be generally effective, citing levels of market entry, retailer rivalry and customer switching as well as the availability of discounts to the standing offer.⁷ NERA also identified certain matters that it considered may be adversely affecting the effectiveness of competition. These included issues relating to vertical integration, access to gas distribution networks, lack of retailer compliance with the Energy Price Disclosure Code (EPDC) and the effectiveness of competition in rural and regional South Australia due to congestion in lateral pipelines.

In its Phase 3 report, NERA's recommendations included increasing the level of detail recorded and reported in market monitoring, improving ESCOSA's awareness of access issues in the gas market, increased monitoring of retailer's compliance with the EPDC and enhancing the estimator service.

⁶ *Id.*

⁷ NERA Report, p.86.