AGL Energy Limited
ABN: 74 115 061 375
Level 22, 120 Spencer Street
North Sydney NSW 2060
T: 02 99212516
www.agl.com.au

Energy in action.®

28 February 2014

Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

AEMC project number RPR0002

Dear Sir/Madam

AEMC 2014 retail competition review

AGL Energy (**AGL**) welcomes the opportunity to make a submission to the Commission's Approach Paper on the first of its annual reviews of competition across the NEM States.

As one of the largest energy retailers in Australia, AGL is well placed to comment on issues in the electricity and gas industries. AGL operates nationally across the energy supply chain and has investments in coal-fired, gas-fired, renewable and embedded electricity generation. AGL is Australia's largest private owner, operator and developer of renewable generation in Australia, and is also a significant retailer of energy with more than 3.8 million electricity and gas customers in Victoria, New South Wales, Queensland and South Australia.

We are broadly supportive of the general approach that the Commission intends to take to its NEM-wide competition review. In particular we support the Commission's intended focus on the state of competition in the South-East Queensland electricity market, with a view to recommending that price regulation be replaced with price monitoring if it finds that competition is effective.

AGL has addressed many of the issues below that the Commission has asked specifically about in Attachment A to its Approach Paper. Unless we have specified that our comments are applicable to a particular State alone, our views are intended to apply to all the States in which AGL retails energy.

Market definition

AGL agrees with the Commission's definition of separate product markets for gas and electricity retailing, however we consider that the geographic scope of the markets should be broader than State-wide. However, we do not believe that narrowing the definition of the market in the way that the Commission proposes would have any impact on the overall outcome of the Commission's analysis, which we consider should be a finding that retail competition is effective in the NEM States in which AGL retails energy. Accordingly we do not have significant concerns with the Commission's proposed market definitions.

Customer activity in the market

Availability to customers of energy-related information

There is a wide range of energy-related information available to customers in a form that is easy to understand, relevant and up-to-date. The precise nature and format of this information is dependent on the particular product or service offered by the retailer. However, being able to provide customers with useful, high quality information is a form of product innovation and product differentiation that is being increasingly embraced by energy retailers.

AGL, for example, offers My AGL IQ, which is a world class energy reporting and analysis tool that enables customers to access very high quality energy related information. This facilitates, amongst a range of other information, the provision of customers' energy consumption and usage patterns in as real time as their meters will allow. For example, customers with smart meters are able to access hourly information up to the day before, review projected usage and bill estimates, and benchmark usage against similar households within their geographic region. Customers with manually read meters can access information up to the time of their last bill, and benchmark usage against similar households within their geographic region.

In addition to the information that individual retailers make available to customers about their products on their websites or at a customer's request, independent brokers, and comparison services and websites exist, to which retailers provide and verify the information about the products they offer. Such facilities enable customers to readily compare the energy products offered by various retailers and make their choices accordingly. This is complemented by the Energy Made Easy website, administered by the Australian Government and the AER, which also enables the ready comparison of energy retailers' products in the various NEM States in which NECF arrangements have been adopted. This information is also be provided and verified by energy retailers themselves, thus enabling customers to be confident of its accuracy.

Customer motivation to switch to market offers from regulated rates, and to change retailers

Customers are generally influenced by a range of factors when choosing to switch from a regulated contract to a market offer contract, or to a product offered by a different energy retailer. These include factors such as price (eg. through the level of discount offered), convenience (eg. through different payment options), the availability of loyalty programs, and an ability to reduce their overall energy consumption through the use of information or tools provided by retailers. Generally, customers' overriding consideration will be the overall impact of these factors upon the likely cost of their energy usage.

Additional factors specific to a decision by a small customer to switch energy retailers include dissatisfaction with their current providers (eg. due to billing issues or the level of service offering), or if a customer is moving house.

Rationale for customers remaining on standing (or regulated) offers

We believe there are a range of reasons that a customer may choose to remain on a regulated tariff. It can be an active choice by customers who, after assessing their personal circumstances, conclude that it is the most suitable option for them. Less price sensitive customers may choose to remain on a regulated offer if they consider the search and switching costs associated with moving to a market offer to exceed the financial benefits of switching.

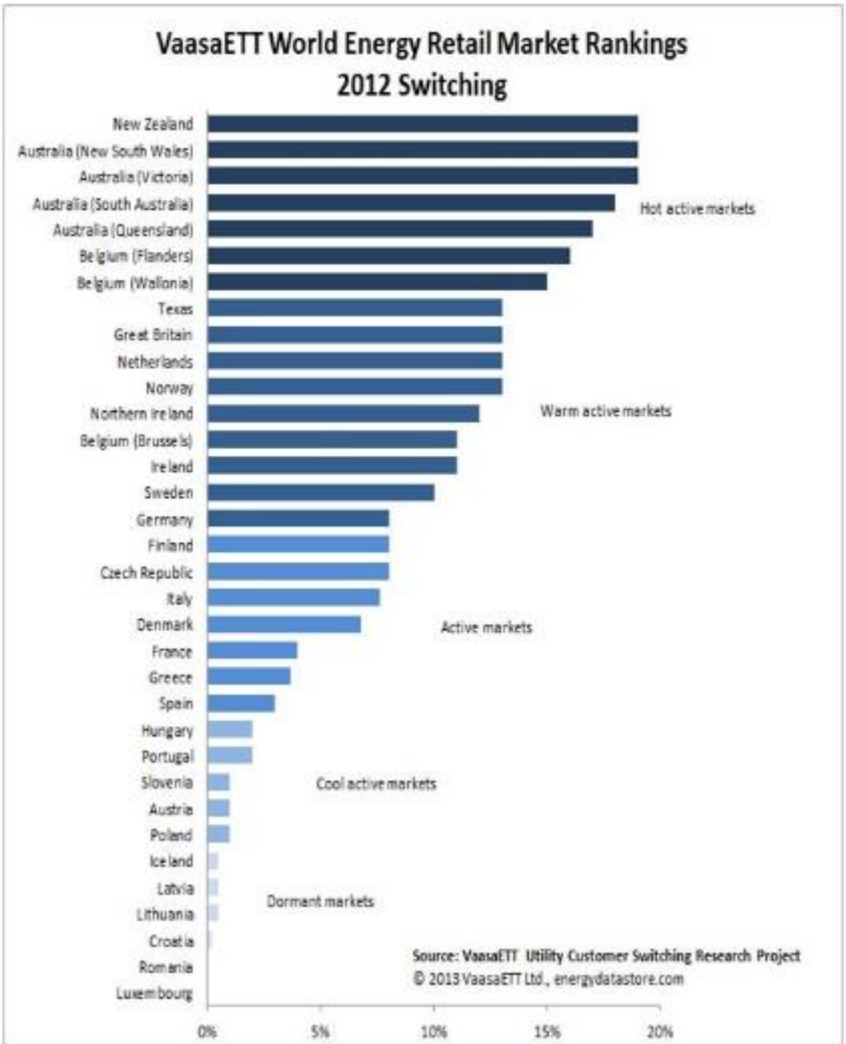
The Commission may recall demographic analysis that AGL undertook in 2013 in response to the Commission's inquiries about small gas customers in New South Wales who were on regulated rates, in the context of the Commission's review of the effectiveness of competition in New South Wales. AGL's analysis at the time suggested that AGL's gas customers on regulated tariffs were largely on that rate not because of a lack of understanding of the market or their inability to move to a different rate, but rather out of a lack of motivation or financial imperative to do so.

There are likely to be some customers who remain on regulated rates because of a lack of awareness of the benefits that moving to a market offer can provide. However, we do not believe that this comprises a large proportion of AGL's customers who remain on regulated rates.

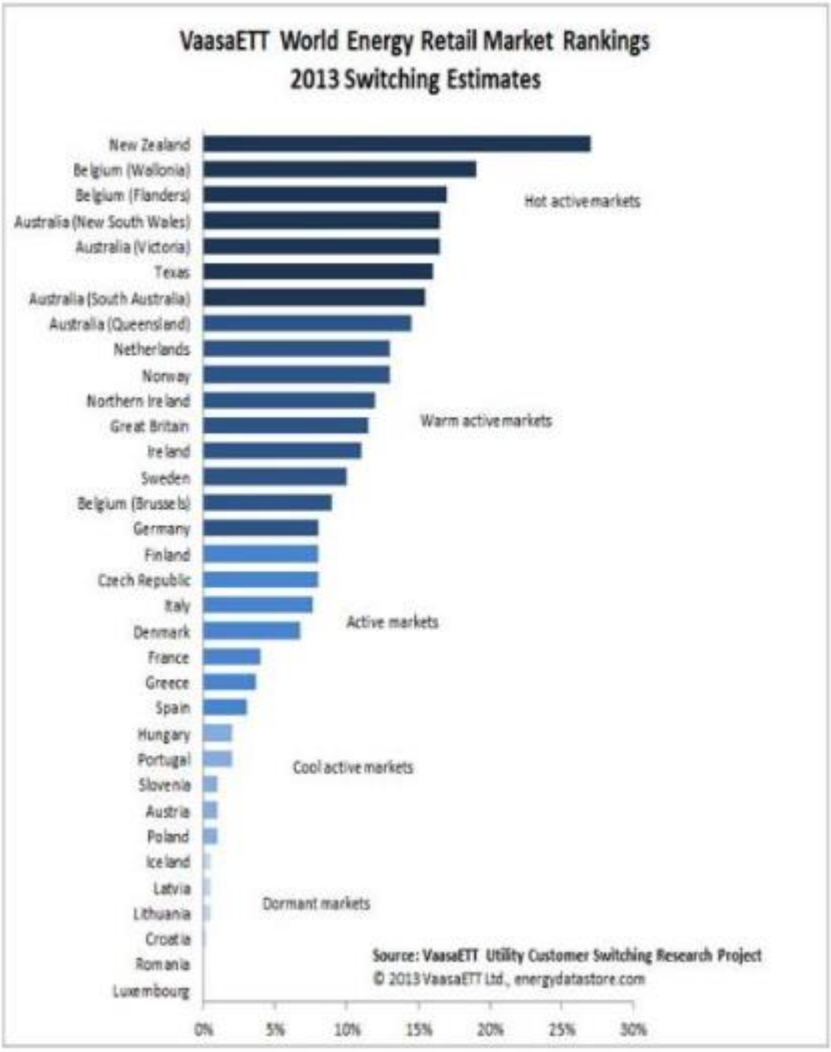
Barriers to switching energy plans

There are no significant barriers that prevent customers from switching energy plans within their current retailer, or across different retailers. AGL waives early termination fees where customers move between AGL's energy plans so as to minimise the difficulty of moving between plans. Early termination fees are applicable on some contracts where customers churn to a different retailer part-way through an energy contract with AGL. This may constitute a barrier to switching. However, high comparative switching rates in Victoria, New South Wales, South Australia and Queensland by international standards suggest that it is not a significant barrier. Research published in the Electricity Journal indicates that in many instances the savings available through switching are greater than early termination fees[1].

We have included below some charts from VaasaETT that show global comparisons of switching rates. Please note that the FY13 chart is an estimate, and we consider that it may understate the likely churn rates in some areas, such as Victoria. However even on the basis of these charts, switching rates in New South Wales, Victoria, South Australia and Queensland are clearly high by international standards.



[1] Nelson, T. and Reid, C. (2014), "Reconciling energy prices and social policy", The Electricity Journal, Vol. 27, No. 1, p.104-114.



Barriers to entry, exit or expansion

Electricity retailing

Barriers to entry and expansion in electricity retailing are low. There are no material barriers to retailers acquiring electricity for resupply. The most significant costs that retailers face upon commencement of retailing electricity are the prudential and registration requirements necessary to become a participant in the NEM, and the costs of either developing a billing system or appropriately outsourcing this function. These costs must be faced by all retailers, however, and do not place incumbents at a particular advantage over new entrants.

This is supported by French J of the Federal Court, who found in *AGL v ACCC*[2] that "the hurdles to entering the business of electricity retailing are reasonably low and the requirements for a licence are not onerous."

This is evidenced by the numerous electricity retailers operating, or licensed to operate, in each NEM State in which AGL retails, and successfully acquiring customers, which suggests that sunk costs and legal or regulatory differences between jurisdictions are not material barriers to entry.

---

[2] *Australian Gas Light Company v Australian Competition and Consumer Commission* [2003] FCA 1525

Gas retailing

As with electricity retailing, licensing requirements are not onerous. There are numerous companies holding current retailer authorisations in each east-coast State in which AGL retails, with several retailers actively marketing gas to small customers in each State at any time.

A gas retailer must have (or be able to procure) access to wholesale gas supply and gas haulage arrangements in order to retail to customers. Existing and prospective retailers in the east coast market should have sufficient access to wholesale gas supplies and to gas haulage arrangements in order to provide a competitive gas retail service offering.

As an example, Existing and prospective new entrants can source gas from Moomba or Longford along the Moomba to Sydney Pipeline or the Eastern Gas Pipeline. An additional production source, Patricia-Baleen, also feeds into the Eastern Gas Pipeline. The QSN Pipeline also provides a means by which gas from southwest Queensland can be transported to Sydney. Further, the development of the short term trading market in Sydney provides another option for sourcing gas.

Independent rivalry

Extent of retailer competition by way of price or product/service differentiation

High levels of competition exist between gas and electricity retailers across all NEM States in which AGL retails, and retailers actively compete with each other to develop and market new products to existing and new customers and to grow their customer bases.

This highly competitive environment has incentivised the development of a number of product and service innovations, and improvements in the quality and scope of the products offered to customers. It is relevant to note that AGL has historically launched many of its most innovative products out of Victoria, which is seen as having a less risky commercial and regulatory environment given that it has had a deregulated retail pricing regime for the longest period of time.

AGL’s current suite of products incorporates such features and innovations as:

- Access to My AGL IQ, a highly sophisticated energy reporting and analysis tool that enables customers with smart meters to see their energy consumption and usage patterns in real time and to review projected usage and bill estimates, and all customers regardless of their meter type to benchmark usage against similar households within their geographic region.
- Discounts off energy usage charges.
- Access to loyalty programs such as flybuys and AGL Rewards (which offers savings on a large range of everyday spend categories as well as AGL products and services).
- Home energy efficiency programs and energy appliance installations (such as home energy audits, free light bulb replacement service, and the provision of free standby power boards) which enable consumers to reduce their overall energy usage.
- Solar PV products.
- The ability for customers to monitor their energy consumption and usage patterns and to manage their accounts online through services such as AGL Online.
- Option for customers to receive and pay energy bills monthly, and ability to smooth payments across a year.

Impact of price regulation on tariff and product/service innovation

Retail price regulation of electricity and gas can impede the potential for tariff innovation, product differentiation and service competition where the prices being regulated are in a market in which effective competition exists, which is the case in South East Queensland and New South Wales.

Where price regulation is retained despite the existence of effective competition, then the only effective way to avoid inhibiting the competitive aspects of the market from operating is to ensure that the retail cost component of regulated default tariffs is set at a level which allows retailers to recover their costs, allowing them to develop products which provide appropriate returns in line with the market. However, even where such an approach is taken, the possibility of a different methodology being adopted at future regulatory price resets which will not allow efficient cost recovery acts as a significant disincentive for retailers to develop innovative tariffs or pricing structures.

In particular, the existence of retail price regulation stifles the incentive for retailers to roll out smart meters, which in turn limits the extent to which time of use tariffs can be offered. The innovative time of use pricing that smart meters will facilitate are unlikely to be developed by retailers until actual cost-reflective pricing is permitted and retail price caps are removed. Accordingly, the removal of retail price regulation (and its replacement with price monitoring), combined with an increase in the number of smart meters in the market (achieved through a contestable, market led roll-out), will greatly improve retailers' incentives to demonstrate product and service innovation through dynamic pricing structures and enhanced product offerings. We would expect this increased product differentiation and innovation by retailers to be accompanied by a greater proportion of customers moving to market contracts, as they are encouraged to take advantage of the greater service offerings available in the market.

There is no rational economic nor public policy explanation for the existence of price regulation in a competitive market. In fact, price regulation in competitive markets can inhibit the exercise of customer choice and competitive market forces.

This is clearly demonstrated by comparative residential electricity churn rates by State since 2004, which indicate that switching rates are highest in States in which there is no evidence of regulatory intrusion. The detrimental impact of inefficient price regulation can be seen clearly by considering the history of price regulation in New South Wales. The over-regulation and sub-economic decision-making that occurred in NSW between 2004 and 2006 resulted in significantly diminished competition and switching rates (switching rates in NSW were as low as 5% at that point in time). Tariff innovation, product differentiation and service competition were significantly stifled over this period of sub-economic regulation of electricity prices, with retailers having only very limited opportunities to compete by providing market contracts at lower prices.

The fact that default electricity tariff caps applicable between 2004 and 2006 in New South Wales were set too low was acknowledged by the Australian Energy Regulator in its 2009 State of the Energy Market Report [3]. In its following price determination, IPART increased allowances for energy purchase costs, retail operating costs, retail margin and network charges, leading to an increased level of competition [4]. This was evidenced by increased customer switching rates in respect of electricity in New South Wales over the second half of 2009, accompanied by a declining proportion of customers on the regulated rates in each of the standard supply areas. Regulated tariff increases effective from 1 July 2010 further improved competition in New South Wales, with relatively higher and more reasonable prices presenting retailers with a more attractive basis upon which to compete through market offers.

In an effectively competitive market, the best way in which to encourage tariff innovation, product differentiation and service competition is to deregulate prices and allow the market to set prices at an efficient level. For example, many of the product and service innovations that AGL has developed and described above have been piloted, launched or marketed first in Victoria. While AGL develops its products with the capability of being able to offer them nationally, its most innovative products are generally launched and offered first in Victoria, which AGL has traditionally viewed as being inherently less risky than some other States in which it operates due to the absence of regulatory pricing intrusion.

In addition, Victoria, has consistently had the highest customer churn rates across the NEM States in which AGL retails since the deregulation of its electricity and gas prices, indicating customers' willingness to shop around for appropriate energy products.

---

[3] AER: Australian Energy Regulator, 2009, "State of the Energy Market", AER Publication, Melbourne. Page 207.

[4] IPART, "Promoting retail competition and investment in the NSW electricity industry, regulated electricity retail tariffs and charges for small customers 2007 to 2010, Electricity – Final Report and Final Determination", June 2007. Page 3

Marketing practices typically employed by retailers

Electricity and gas retailers utilise a broad range of marketing practices when promoting products. Such channels include telephone contact; online promotions; direct mail marketing; door-to-door sales (although AGL no longer uses this channel for the residential market due to customer insight showing that it was generally not a positive experience for them); advertising on billboards, in print media and on television; as well as via third parties such as brokers, intermediaries and aggregators.

Further, there has been an expansion of more innovative marketing techniques in response to customer demand, such as a significant increase in sales through AGL's online sales channels. This indicates retailers' responsiveness to customer demand and a tendency towards innovation and differentiation in marketing techniques in order to grow retailers' customer bases.

Customer satisfaction

Consumer research studies are conducted for AGL by independent research provider AMR, which is an accredited and recognised supplier of market research. These studies utilise the Australian Market and Social Research Society guidelines, and involve extensive surveys and interviews being undertaken (of around 2,000 households each quarter) into customers' views on a range of aspects of energy service provision. They deliver very useful insights into the energy market.

Some key findings on areas in which the Commission has asked specific questions are:

- The main driver of satisfaction across all retail brands is a positive service experience. Customers indicated that lower prices was the top factor for improving overall satisfaction, while better customer service was the second most important factor.

- Customers' satisfaction with the services provided by their energy retailers is generally high. AGL's customers reported the highest levels of satisfaction, with over 75% of those surveyed scoring AGL between 6 and 10 out of a score of 10. This is consistent with findings since 2012. Quarterly surveys conducted over this time period have revealed satisfaction levels between 73% and 76%. Customer satisfaction levels with other energy retailers has also been consistently high over the past 12 months, with 64-73% of customers surveyed rating their energy retailers between 6 and 10 for overall satisfaction with the services provided.

- Generally, customers consider that they obtain a reasonable level of value for money from their energy retailers, with quarterly surveys across the market over the preceding 12 months indicating ratings in excess of 6 out of 10 (with a score of 10 representing excellent value for money).

- The vast majority of customers across all States in which AGL retails are aware of their ability to switch retailers of gas and electricity. Customer awareness is highest for both gas and electricity in Victoria and South Australia. There are also high levels of awareness of different brands across the various State markets, which suggests that customers are aware of the competitiveness of the market. This awareness is highest in Victoria, where there is a greater awareness of smaller brands as well. This general customer knowledge, combined with high churn rates across the States, would tend to indicate a reasonable degree of customer satisfaction with the level of choice available in the market.

- AGL is currently developing processes to increase the speed with which customer transfers can be effected. A small survey was conducted of customers who had been through the newly implemented processes, and 90% were satisfied with their overall experience with the process.

Further information on customer experience can be found in the Customer chapter of the 2013 AGL Sustainability Report (see http://www.agl.com.au/~/media/AGL/About%20AGL/Documents/Media%20Center/What%20We%20Stand%20For/2013/AGL051_Sustainability%20Report_2013_LR.pdf).

Retailer outcomes

Impact of price regulation on retailer risk profiles and risk management strategies

The operation of the regulated price as a 'price-cap' in the market means that if the regulated price does not adequately account for wholesale market fluctuations, then the ability of retailers to offer products and services will be compromised. The uncertainties associated with regulatory intervention, and in particular, the risk that future price resets will not be based on an LRMC as floor methodology, significantly disincentivises tariff innovation by retailers, by increasing the risk that retailers will not be able to adequately cover their costs in the future.

In the absence of retail price regulation, wholesale market fluctuations should not impact the ability of a prudent and efficient retailer to offer products and services to small customers. A key role for a retailer is to manage price and volume risk for their small customers in such a way as to enable them to offer a competitively priced retail product. If a retailer is unable to perform this function it will be unlikely to continue to operate in a competitive market over the longer term.

The extent to which energy retailers choose to expose themselves to fluctuations in wholesale electricity and gas prices is entirely dependent on the particular risk profile that the retailer wishes to adopt. Numerous financial hedging products are available to electricity retailers wishing to minimise their exposure to wholesale electricity price fluctuations. Similarly, gas retailers wishing to avoid purchasing gas from the wholesale pool are able to enter into appropriate contractual arrangements.

Concluding comments

AGL would be happy to provide further information to the Commission should this be helpful. Please contact Anita George at ageorge@agl.com.au or on (03) 8633 7212 if you have any questions in relation to AGL's position on these issues.

Yours sincerely,

Tim Nelson
Head of Economic Policy and Sustainability