

A few
words.

20 November 2008

**Australian Energy Market Commission
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Submissions@aemc.gov.au



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

AGL Energy Limited (**AGL**) welcomes the opportunity to comment to the Australian Energy Market Commission (**Commission**) on its Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia (**the review**) – Second Draft Report (**Draft Report**).

AGL welcomed the Commission's First Final Report which found that competition is effective in the South Australian electricity and gas markets. AGL also supports the Commission's recommendation in its Draft Report that retail price regulation be removed in South Australia.

AGL's detailed comments on the Commission's Draft Report are attached.

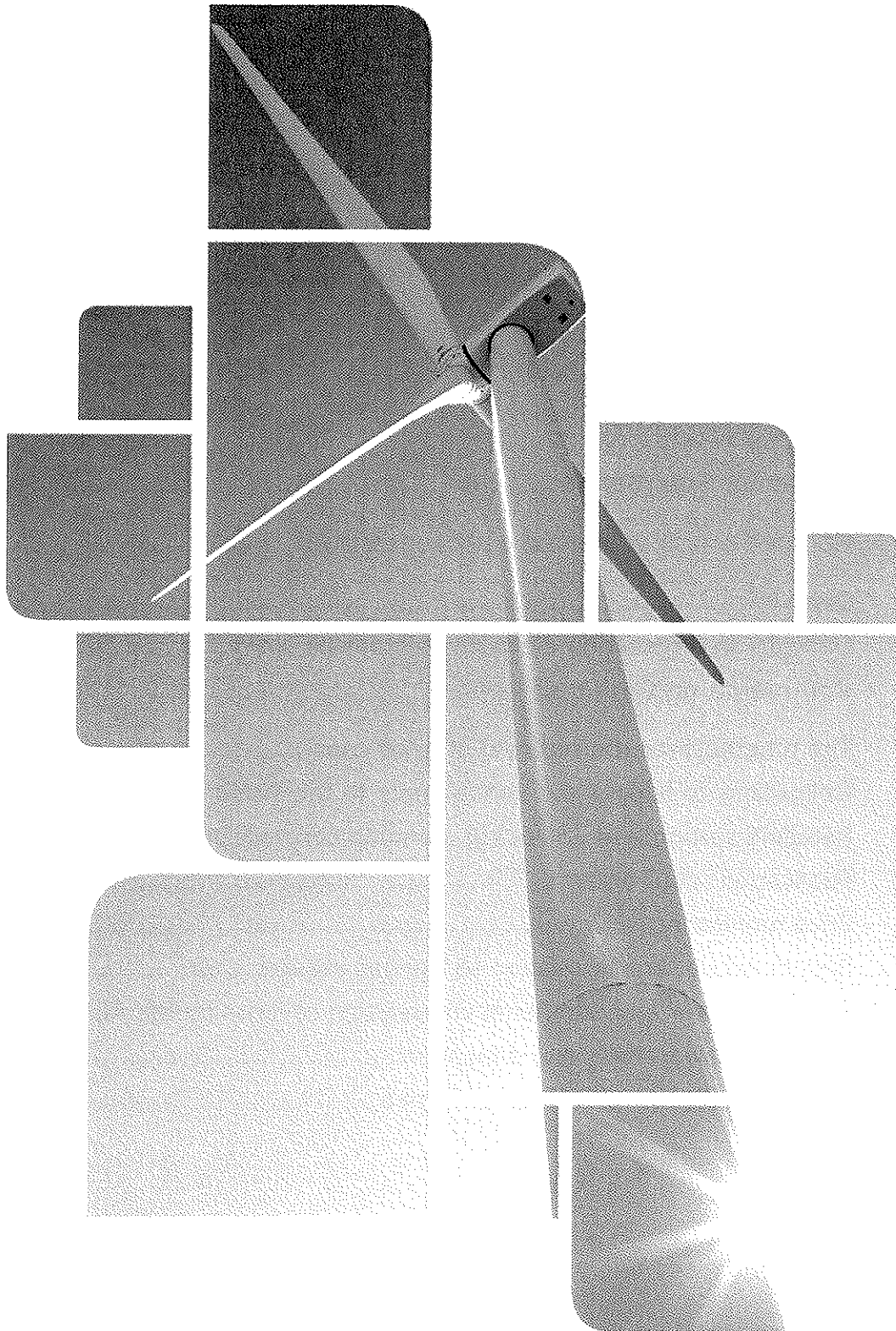
For any enquiries in relation to this submission please contact Michelle Shepherd, Manager Regulatory Pricing Strategy, on (03) 8633 6263.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Elizabeth Molyneux'.

Elizabeth Molyneux
General Manager, Energy Regulation

- > Being selected as a member of the Dow Jones Sustainability Index 2006/07
- > Gaining accreditation under the National GreenPower Accreditation Program for AGL Green Energy®, AGL Green Living® and AGL Green Spirit
- > Being selected as a constituent of the FTSE4Good Index Series



AGL response to Australian Energy Market Commission

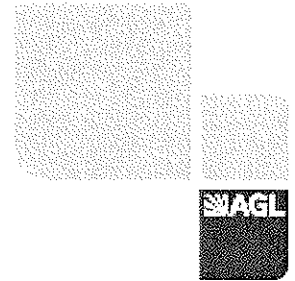
Review of Effectiveness of Competition in the Electricity and Gas
Retail Markets in South Australia – Second Draft Report

Date: November 2008



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Executive Summary

AGL agrees with the Commission's statement that regulated prices *"will almost always be an imperfect substitute for prices determined by competitive processes and are likely to impose costs and distortions not present in a competitive market"*.

It therefore follows that the best outcome for South Australian consumers of electricity and gas is for the market to set prices. In a competitive market like South Australia this will guarantee consumers will receive the benefit of the most efficient prices.

Accordingly, we fully support the Commission in its findings that given competition is effective in the South Australian electricity and gas retail markets, the regulation of retail prices should be removed.

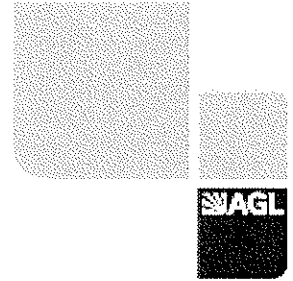
The removal of retail price regulation does not mean diminishing the existing customer protection arrangements such as obligation to supply. AGL supports the intent of the Commission's recommendations in this regard to ensure the above customer protection arrangements remain in place.

However, AGL has some concerns about a number of recommendations which impose unnecessary obligations on retailers operating in such a highly a competitive market, for example:

- A restriction on the frequency with which retailers can vary tariffs;
- An extension of the Energy Price Disclosure Code to apply to standing and default contract prices; and
- A requirement that retailers comply with any "reasonable" information requests from ESCOSA in relation to its price monitoring framework.

To the extent possible obligations should be consistent with the national model. As Victoria has recently removed regulated price caps effective from 1 January 2009, this model should be the basis for any changes to the South Australian customer protection framework.

AGL's specific comments on the Draft Report and review follow.



Competition is preferred over regulation

Overview

AGL agrees with the Commission's statement that:

"Regulated prices will almost always be an imperfect substitute for prices determined by competitive processes and are likely to impose costs and distortions not present in a competitive market. Because regulators have imperfect information, regulated prices will generally either be set too low, deterring investment and innovation, or too high, to the detriment of consumers. Regulated pricing arrangements also lack the flexibility of market prices."

While the Essential Services Commission of South Australia (**ESCO**) has in the past ensured that regulated tariffs overall reflect appropriate retail costs, there is always the risk of a regulator getting it wrong.

Regulators will always have imperfect information given:

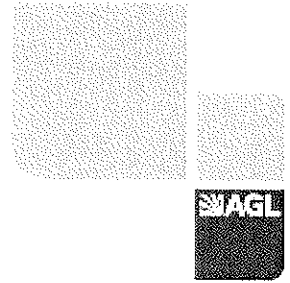
- regulators, and their consultants, are not in the business of managing energy costs and risks;
- it is extremely difficult to forecast costs for a price path period, particularly wholesale costs which can be subject to considerable volatility and represent over 75% of the total retail cost and;
- the difficulty in forecasting the incumbent retailer's customer numbers, which is vital to estimating wholesale costs and the allocation of fixed costs.

Accordingly, by their nature, regulated prices cannot replicate market driven prices and will always be an imperfect substitute, particularly when set for an extended price path period.

Difficulty in forecasting electricity wholesale costs

Forecasting electricity wholesale costs is the single most difficult issue that faces regulators when determining regulated electricity tariffs.

Energy costs incurred by retailers in a competitive market are a combination of the hedge contract prices paid to generators (swap, cap and other derivative costs) and the pool price for energy purchases not covered by hedge contracts, including pool prices below the cap strike prices. To determine wholesale costs, an accurate forecast of these costs is required, as well as an accurate forecast of the total jurisdictional NEM load and the individual load of the retailer, for each half hour of the day. This is a difficult task for any entity, particularly for a regulator or their consultants, who have not had experience in managing a wholesale energy portfolio.



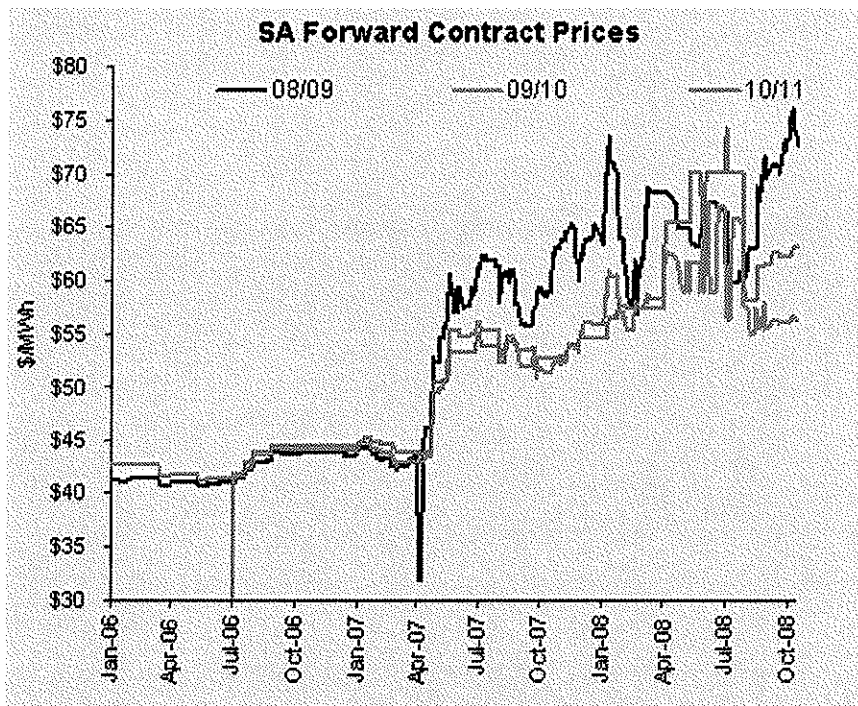
This difficulty is compounded in South Australia as it has the peakiest load in the NEM. For example, one third of South Australian generation capacity was used for less than 10% of the financial year 2007/2008. This worsens during extreme summers like 2001 and 2008. Forecasting costs in such a volatile market is extremely difficult.

In addition, forecasting wholesale costs for an extended period is very difficult, as is required in some jurisdiction like South Australia which have a minimum 3 year price path. Regulators are therefore required to forecast wholesale costs some 3½ years out from the end of the price path period.

The difficulty in forecasting wholesale electricity prices was most evident in the recent 3 year price path set by ESCOSA which was consulted on in 2007. During the consultation period wholesale electricity prices rose across the NEM to unprecedented levels, more than doubling in some jurisdictions.

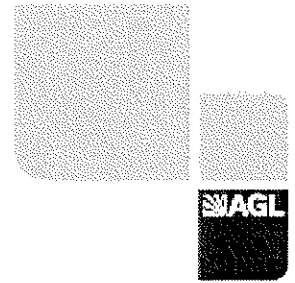
Graph 1 below shows that South Australian forward contract prices increased significantly in the first quarter of 2007, particularly for 2008/2009 financial contracts. This shift was largely caused by drought conditions and supply constraints.

Graph 1 – South Australian Forward Contract Prices¹



At this time, it was an extremely difficult task for ESCOSA to determine with certainty the wholesale contract prices going forward, including whether they would remain at the

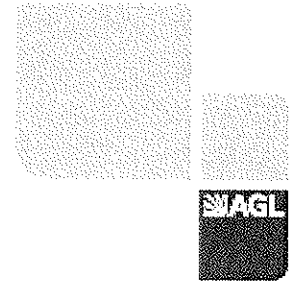
¹ Source: Based on published market data



unprecedented high levels. Graph 1 illustrates that wholesale costs have continued to remain high.

In an environment with no price caps, retailers would be free to ensure their tariffs were reflective of the changing market conditions. This would remove the risk of regulators setting tariffs too low and negatively impacting competition and investment.

It is important to note that with the advent of the Carbon Pollution Reduction Scheme forecasting wholesale costs becomes very difficult. The CPRS will have a significant impact on costs going forward in both the electricity and gas markets.



Comments on the Draft Report

The timetable for the removal of price caps

AGL agrees with the Commission that price caps should be removed in South Australia upon the cessation of the current electricity and gas price paths, that is 31st December 2010 and 30th June 2011 respectively.

This timeframe allows adequate opportunity for government and industry to develop a customer protection framework to ensure that customers are confident they will be protected following the removal of price caps.

Obligations to supply and sell to apply to the FRMP

AGL supports the Commission's recommendation that the FRMP should have an obligation to supply for the relevant premises and for new connections. This is the same model being applied in Victoria.

However, AGL does not believe that the Commission's recommendation could be achieved by new retailers being bound by section 36AA of the Electricity Act and section 34A of the Gas Act. This is because these sections apply to all customers, not just those where the licensed retailer is the FRMP. Accordingly, the relevant section should be amended to reference that the obligation only exists for the FRMP.

AGL agrees that the FRMP for new connections should be the standing contract retailer. It should be noted that for new connections, the customer should not be obliged to contract with the standing contract retailer. It should only serve as a default contract in the absence of the customer making a decision to contract with a retailer.

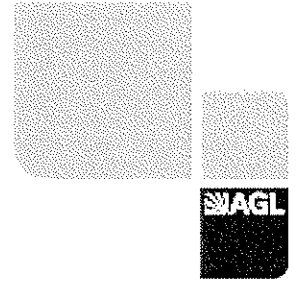
Retailers setting and amending standing contract prices

It is vital that retailers be given as much flexibility as possible to vary tariffs in response to changing market conditions. This is particularly relevant to the electricity market where wholesale costs can change significantly in a matter of months.

As shown previously in Graph 1, from January 2007 South Australian electricity prices increased significantly in a few short months. This level of price rise was unprecedented and largely unexpected by the market. In addition, prices have remained relatively high since this period.

To restrict tariff variations to 6 monthly intervals, as is likely to be the case in Victoria, will significantly impede a retailer's ability to respond to such significant and unpredictable changing wholesale costs and risks.

In a competitive market like South Australia, competition itself will prevent retailers changing prices more frequently than the market will bear.



Publication requirements

Publication of summary notices

AGL agrees with the Commission's statement that removing the requirement to publish contract prices in the South Australian Government Gazette "will have minimal impact, as few customers will be aware of the publication". For the same reason, AGL considers that a requirement to publish summary price variation notices in newspapers is an unnecessary administrative burden on retailers, which has limited benefits for consumers. As retailers are not restricted to varying prices on a given day a consumer would need to monitor the public notices every day of the year to receive the benefit of such a regulatory obligation.

Extension of the Energy Price Disclosure Document

AGL does not agree that the Energy Price Disclosure Code should be extended to apply to standing and default contract prices.

Currently, there is no such obligation on standing or default contracts and there is no indication that this raises concerns for customers. ESCOSA sets the terms and conditions for standing and default contracts, and these terms and conditions and prices are published by retailers and ESCOSA.

In particular, the Energy Price Disclosure Code should not apply to default contracts. Default contracts apply to customers that have not identified themselves to an energy retailer but are consuming energy. Given the risk of supplying these "unknown customers" default prices should be higher than standing and market contracts. Given the unique nature of these contracts, and the fact they are not generally available, there is no reason to publish default contract fact sheets for price comparison purposes.

However, for standing and market contracts ESCOSA should consider developing a price comparator, similar to that on the Essential Services Commission's website. This enables customers the ability to compare all available offers.

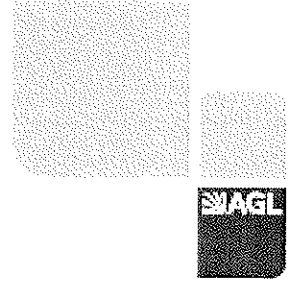
Price monitoring

Energy is an essential service and AGL understands that the phase out of retail price regulation without any independent monitoring of prices will not be acceptable to some stakeholders. Further, independent 'price monitoring' together with reserve price regulation powers will ensure that customers have confidence that price outcomes will remain efficient.

AGL therefore supports the Commission's recommendation that ESCOSA monitor pricing performance of the retail market for a three year transitional period.

After the three year period AGL believes that formal price monitoring should cease, and that retailers only be obliged to publish their tariffs for transparency purposes.

AGL believes it is important that any price-monitoring regime remain non-interventionist and not become a de facto retail price review. AGL therefore supports the Commission's recommendation that ESCOSA's price monitoring role not be extended to movements in wholesale costs.



However, AGL is concerned with the Commission's recommendation that retailers be required to provide additional information to ESCOSA to perform its price monitoring role. Retailers should only be required to provide its various retail prices and relevant terms and conditions. In particular, retailers should not be required to provide their unique cost information. If ESCOSA wants to understand retail costs, it should undertake an independent industry benchmark study to determine whether prices reflect appropriate costs and margin.

Recommendations in relation to the gas market

AGL recognises there are some townships in South Australia where competition has not developed as it is not currently possible to secure transmission access on a firm basis, or, where access is available the cost may be currently prohibitive. AGL considers this to be a short-term issue which will be resolved by the market in due course.

Until such time as competition develops in these areas, AGL agrees that following the removal of price caps, the following should occur:

- ESCOSA to report on the price differences between Origin's regional and metropolitan market contracts; and
- ESCOSA to maintain a register of access requests on the SESA Pipeline and the outcome of each request.

In relation to the access register, it is vital that the register remain confidential. Disclosure of the parties requesting access could undermine their commercial position by essentially publicising their marketing strategies.

In addition, AGL notes that the applicant, as well as Origin, should have the ability to notify ESCOSA of access requests and their outcome. This would ensure that any inconsistencies between Origin and the applicant's submissions can be addressed quickly.

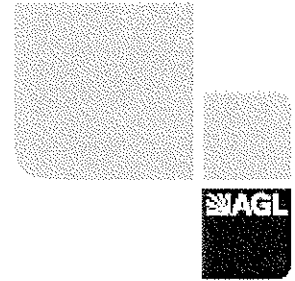
AGL believes that the above activities should continue until such time as competition develops in the affected regional areas.

Reserve power and additional competition reviews by the AEMC

AGL notes that the phase out of retail price regulation does not prevent the exercise of a reserve power by government where effective competition ceases. AGL continues to support such reserve power but considers that any such power should only be exercised in accordance with a regulatory methodology promulgated by the Commission that ensures that any intervention by government only occur where there is demonstrable evidence of market failure.

AGL does not agree that the following are necessarily indications of market failure or that competition is lessening:

- *"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”.*

If ESCOSA becomes concerned about any of the above factors, it should first consult with industry to determine whether there are reasonable explanations for the change. Only if ESCOSA believes competition has been significantly lessened due to market failure should it request a competition review by the Commission.

In performing any future competition review, particularly an accelerated review, it should be a priority for the Commission to allow appropriate consultation with industry.

Consumer awareness and education

AGL notes the Commission’s recommendation that there be “...an appropriately targeted and timely consumer awareness and education campaign”.

AGL believes that any customer awareness program should not be alarmist in telling customers that ESCOSA are no longer responsible for agreeing tariffs with retailers, as many customers will be unaware that this was the case in the first place.

The awareness program should be a positive message informing customers that:

- they have a right to choose their electricity and gas retailer and customers should shop around to get the best deal;
- ESCOSA will monitor electricity and gas prices; and
- The customer protection framework and any concessions will remain in place.

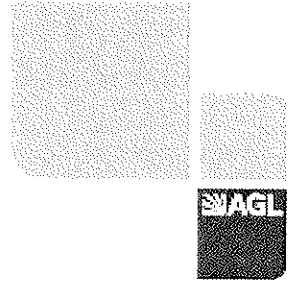
AGL believes that this program should be run through the media and need not involve costly communication to each household.

Specific customer protection schemes

Customer concessions

AGL supports the South Australian Government funded customer concession scheme. AGL considers this scheme an integral part of the protection of low income households, particularly in an environment of rising electricity costs and prices.

AGL also has a comprehensive hardship program, “Staying Connected”, aimed at assisting those customers experiencing genuine financial hardship.



Country Equalisation Scheme

AGL agrees with the Commission's following statement in relation to the Country Equalisation Scheme (**CES**):

"...the evidence before the Commission suggests that cost drivers for location pricing in South Australia are currently weak or absent. Retailers in South Australia face the same charges for using the transmission and distribution systems regardless of the location of the customers they are supplying. Similarly, a single loss factor applies to each system throughout the state."

The absence of significant cost differences between small rural and urban customers makes the scheme redundant. This conclusion is supported by the fact that no retailer has been paid compensation under the CES.

Accordingly, AGL agrees that the CES has limited impact on the market and therefore we prefer that the CES be formally abolished to remove any confusion created by this superfluous obligation.

