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

Dear Dr Tamblyn

I refer to the Australian Energy Market Commission's First Draft Report (the Report) on its Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia that was released on 4 July 2008.

On many measures the South Australian energy market could be considered as competitive as any in the world. Full Retail Competition (FRC) has been in operation for four years (gas) to five and a half years (electricity). It is important that consumers feel confident that the regulatory framework in place will deliver the best outcome for them.

The Standing Contract regulatory framework has enabled consumers to feel confident that the prices charged have been subject to stringent review by the independent economic regulator the Essential Services Commission of South Australia (ESCOSA). Vulnerable consumers particularly can have comfort that together with regulated terms and conditions they have an appropriate level of protection. Customers who have entered market contracts also have the confidence of returning to Standing Contract tariffs at any time.

The Standing Contract regulatory framework has been shown to be responsive to even large cost adjustments and the existence of standing contract prices per se does not prevent retailers earning sustainable margins.

The overall regulatory structure has enabled the highly competitive environment experienced in South Australia allowing the majority of customers to venture into the market with confidence. This has been reflected in a high level of preparedness of consumers to participate in the market in response to the direct marketing initiatives of retailers. Assessing the merits of any movement to a new more open market arrangement needs to consider those customers (approximately 40 percent) who remain on the standing contract.

The Report finds that competition is effective for both small electricity and small natural gas customers throughout South Australia noting that competition is relatively

more intense in electricity than in gas. The Australian Energy Market Commission (the Commission) however identifies some structural limitations affecting the level of competitiveness for regional gas customers.

This overall conclusion has been reached notwithstanding that the Commission has indicated that it intends to undertake significant additional assessment including further detailed consideration of some of the submissions it received to its Issues Paper released in March 2008.

It is important that the Commission's review makes an assessment of the level of effective competition in all relevant markets and sub-markets including sub-classes of customers (e.g. vulnerable and low income, level of consumption) as provided for in the terms of reference. In this regard I make the following observations.

Gas Market

The Commission states that gas customers in South Australian regional areas are not enjoying the full benefits of retail competition. As the Report notes the only offer gas customers in many regional areas can expect to receive is an offer of a market contract from the incumbent retailer. The Report notes that in regional areas even the large dual fuel retailers have been unable to compete effectively.

The Report also notes that only 16 percent of small businesses have transferred to gas market contracts.

Further the Report indicates that activity in the gas retail market is totally reliant on activity in the electricity market as contracting of gas customers is treated as an "add-on" to electricity retailing.

It is difficult to perceive how the gas market could be deemed to be effectively competitive in its own right.

Electricity Market

The Report identifies that the South Australian electricity retail market is dominated by the same four vertically integrated companies (owning generation and retail assets) that dominate the gas retail market. The Commission suggests that current market conditions in combination with the standing contract tariff have made it more difficult for smaller tier two retailers to be able to compete at the moment.

The Commission's Retailer Survey noted the opinion of many retailers that there was a national trend towards a small number of large vertically integrated energy companies albeit with room for smaller standalone retailers as well as small niche retailers.

Examination of market shares shows the South Australian energy retail market continuing to be dominated by the incumbent retailers AGL SA and Origin Energy. Market share figures supplied in the Report show the combined Origin and AGL market shares to be 72 percent for small electricity customers and 76 percent for small gas customers when standing and market contract customers are combined. Accordingly all other retailers supply less than 30 percent of the market.

There has been considerable merger speculation over the past year or so with proposals including a previous proposed merger between AGL SA and Origin Energy, Origin Energy being pursued by a UK firm and more recently media speculation that AGL might be interested in purchasing TRUenergy's operations. Any of these proposals if adopted could result in considerable increase in market concentration.

I support the Commission's view that it is important to consider the effectiveness of competition in a "forward rather than backward looking approach".

The Commission's assessment of the competitiveness of the South Australian retail energy market needs to be made with full regard of the potential for further concentration of the market.

Wholesale Energy Costs

By their nature vertically integrated companies operate in both the wholesale and retail markets. Extended periods of volatile wholesale prices will affect the ability of standalone retailers to gain access to hedging contracts at a sufficiently competitive price to enable them to compete in the retail market. The Commission's background Wholesale Electricity paper suggests that South Australia lags the other States in terms of the size and growth of the electricity derivatives market and that the volume of contracts traded has not grown since 2004. The Retailer Survey indicated that most retailers consider that the drought and interconnector constraints have resulted in a markedly reduced supply of forward contracts with resulting pricing at levels making it unprofitable to take on new customers.

Also the Retailer Survey indicated that the change in ownership of the Torrens Island Power Station had reduced forward contract liquidity; with a number of retailers stating that one vertically integrated retailer was in a position to periodically exercise market power.

It is noted that as retailers provided a varying response to the Commission's request for information the Commission is unable to undertake a robust analysis of actual profit margins under market offers.

I note that the Commission is yet to be persuaded that the current wholesale market structure is effecting competition at the retail level. The aforementioned factors suggest a need to be confident that there are no structural issues in either the wholesale or retail markets that might restrict sufficient competition in practice.

Consumer Behaviour

The Report mentions that a core characteristic of a competitive market is the active involvement of consumers. Findings from the Report however suggest that a large proportion of customers are unlikely to actively search for energy contracts. Therefore if they didn't receive an offer directly from a retailer they would be unlikely to transfer or if they did receive an offer they would be unlikely to 'shop around'. In addition only 19 percent of gas customers surveyed had been contacted directly by a retailer since the commencement of FRC. These findings suggest a lack of interest on the demand side in the gas industry. With regard to the provision of information the Consumer Survey showed that only around half of the respondents indicated that

the information provided was adequate for them to make an informed decision on a product.

Whilst recent declines in the small customer transfer rates may be attributable to wholesale electricity price volatility resulting in reduced marketing activity, the Commission's Customer Survey analysis indicates a trend of reducing interest in changing energy retailer. For residential electricity customers, the proportion of customers 'quite unlikely' or 'very unlikely' to change supply arrangements with their current retailer or switch to another retailer in the next 12 months has increased – 51 percent (2004), 73 percent (2006) and 77 percent (2008). Equivalent figures for residential gas customers are 49 percent (2004), 70 percent (2006) and 82 percent (2008). Those residential customers aged over 65 (2008 – electricity 86 percent, gas 91 percent), low income (2008 – electricity 81 percent, gas n.p.), and concession holder (2008 – electricity 83 percent, gas 89 percent) appear even less engaged.

There appears to be the potential for increased concentration on the supply side and reduced interest on the demand side that raises a question as to the potential intensity of competition going forward.

Climate Change

The impending emissions trading scheme will have a significant effect on consumers and the industry as a whole particularly with the effect of the carbon price ending with consumers.

The public confidence achieved by independent oversight of retail pricing would be especially important at the time of implementing this scheme. The current retail price determinations have provisions for addressing the effect on costs from the introduction of the emissions trading scheme.

Conclusion

There are a range of factors relevant to the South Australian energy markets which I ask the Commission to further consider in finalising your views on the effectiveness of competition in South Australia.

I await the release of the Commission's First Final Report incorporating the results of the Commission's additional analysis and consideration of submissions.

If you or your officers wish to discuss any element of this submission further, please contact Mr Kym Jervois, Director Retail and Demand Management from the Department for Transport, Energy and Infrastructure on telephone (08) 8204 1669.

Yours sincerely



**HON PATRICK CONLON MP
MINISTER FOR ENERGY**

5 September 2008