



9 November 2007

Submission to the Australia Energy Market Commission relating to the Review of the Effectiveness of Competition in the Gas and Electricity Retail Market

On 4 October 2007, the AEMC published the first draft report of its review of the effectiveness of competition in gas and electricity retailing in Victoria. The Commission has commenced consultation on the First Draft Report and has invited submissions by Friday 9 November 2007. Please find Victoria Electricity's submission.

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1. Victoria Electricity generally supports the Commission's preliminary assessment that competition in both electricity and gas retailing in Victoria has been effective. However that assessment was largely complete before the events in the gas market during the winter of the 2007 had been fully understood. A review of this winter has raised material concerns about the ability of the new market structures to support competitive gas retailing. As energy retailing in Victoria strongly favours dual fuel offers, any reduction in competition in the retail gas market will also materially impact on electricity retailing.
2. Part of the purpose of the AEMC review is to consider the removal of price caps for customers on default contracts with host retailers. That action can only proceed if the Government has confidence about ongoing retail competition in energy markets. The Government will not be in a position to have confidence about competition until it eliminates the new and unacceptably high wholesale gas market risks imposed on non-incumbent retailers by new market rules and procedures. When that step is complete, Victoria Electricity would support the Government in removal of price caps.
3. Prior to 2007 Victoria has been by far the easiest market in Australia in which to retail gas because the rules and procedures, as administered by VENCORP, enabled retailers to operate without the need to invest in physical assets or the contract structures that parallel physical investment. Other jurisdictions in Australia have rule structures that favour incumbents by materially penalising retailers who do not own upstream assets or legacy commodity and transportation contracts. In Victoria, the physical assets and contracts tend to be owned by vertically integrated retail incumbents and are tightly controlled and only available infrequently, if at all.
4. In February 2007, the Victorian gas market changed in a number of ways as a result of the Pricing and Balancing Review. The primary objectives were a desire to achieve more accurate forecasting of demand by market participants, to better deal with gas fired electricity generation (which has the ability to heavily impact the gas market) and to introduce ex ante pricing, market participant forecasting and five trading intervals during the day. Victoria Electricity supports the intent of most of these changes.

The review also included the introduction of injection dependency for AMDQ validation, materially affecting ancillary payments. This change is largely unrelated to the other changes. Ancillary payments arise in situations where gas needs to be scheduled outside of the normal bid stack due to localised gas shortages (as opposed to market wide shortages). These payments can amount



to tens of millions of dollars each day and, to fund ancillary payments, VENCORP levies “congestion uplift” charges on retailers. Up until February this year, retailers automatically received a hedge against congestion uplift, up to the level of their Authorised Maximum Daily Quantity. Under the new market, retailers are only hedged if they inject gas to the same level as their AMDQ (and nominate that cover) or buy injections under an agency arrangement. Only certain sources of injection (Longford/VicHub) provide that hedge for Tariff V (residential) customers. LNG and gas injections into the South-West pipeline can also provide AMDQ hedges up to a point.

As a result, the ability to manage “congestion uplift” risk is now only available to retailers that own Longford contracts, AMDQ credits on the South West pipeline and / or LNG injection rights.

Injection dependency appears to have proceeded on the basis that most retailers (particularly incumbents) have relevant injection contracts, and those that do not have these contracts could theoretically, under the market rules, purchase AMDQ through agency arrangements.

5. These changes fundamentally changed market dynamics in Victoria:
 - a. Parties without Longford contracts or LNG storage now face risks materially higher than can be supported by current retail margins. Non incumbent retailers, and new entrants yet to enter the market, now need to purchase physical gas contracts from the owners of the Longford contracts, namely the incumbent retailers (or agency injection hedges where another party injects gas on their behalf to validate AMDQ). This represents a material transfer of market power and wealth to owners of Longford contracts and LNG storage, and means new entrants need to negotiate contracts with the very parties whose customers they are likely to be targeting.
 - b. The costs and risk associated with supplying residential customers have increased. This will result in either very substantial pressure on residential pricing from parties continuing to sell in the market or reduced competition, both of which will also lead to higher prices.
 - c. The market now has a physical dimension which will lead to retailers restricting their growth ambitions to capacity available from Longford.
6. VEL accepts that these rule / procedure changes were made in good faith but believes that the process has uncovered some material weaknesses impacting on future retail competition.
 - a. It is not evident that any party considered the competitive impact of the rule / procedure change that introduced injection dependency. The changes to market rules and associated changes in procedures were not reviewed or authorised by the ACCC or any competition body as has been the case in the past. No regulatory body appears to have represented the interests of potential new entrants who by definition cannot represent themselves. Looking forward it is not obvious that any party is particularly charged with this responsibility. As the AEMC points out in the draft Report, the interests of consumers are highly dependent on the ability of those new entrants to enter and grow in a market.



- b. The rapid introduction of these rule / procedure changes takes no account of the ability of industry participants to respond to price signals. A signal designed to incentivise, for example, additional transmission or LNG capacity must recognise that time is required for such an investment to be made. Otherwise, considerable wealth transfer will occur in the interim, principally from consumers to vertically integrated retailers and infrastructure providers.
 - c. The rule / procedure revision relating to the injection dependency of AMDQ was intended to be the first step in series of changes designed to introduce tradable transmission capacity rights. The industry now universally accepts that a market for these rights is unlikely to progress for a number of years. We would also observe that the most recent significant investment in transmission capacity came not from “pricing signals” in transmission, but a planned investment approved by ACCC.
 - d. There is an assumption that the rule changes approved in February are an improvement on the prior rules and must be defended by the groups involved in their formation. It is not obvious to Victoria Electricity what benefits accrue from injection dependency or, if they do exist, that they offset the negative impacts raised in this paper.
7. In parallel with these market changes VENCORP is releasing 1500 tonnes of LNG and its associated Gasnet storage capacity. It is expected that a tender process will have transferred ownership of the storage capacity prior to Christmas 2007. The rule introducing the injection dependency of AMDQ has materially increased the value of LNG storage as the tender is really the only tool still available to manage congestion uplift risk. Pricing for LNG reached \$700/GJ in the winter of 2007 compared to previous pricing of less than \$50/GJ illustrating the degree of value transfer. Contracts covering LNG storage capacity are currently owned by two incumbent retailers and VENCORP. The tender process will further concentrate market power if either of the two incumbents secures additional capacity. It is Victoria Electricity’s understanding that there are no restrictions on participation in the tender and no parties feel any obligation to consider the impact of the tender on market competition.
8. No prudent new entrant retailer will be able to grow in the Victorian gas market for many years to come if injection dependency of AMDQ is allowed to remain in place. For those not yet active, that means not entering. For those already in the market and able to hedge their current customer base, expansion is simply not worth the risk. As Victoria is a dual fuel market, this also means a major reduction of retail competition in electricity.
9. The picture for residential customers is not appealing. They face reduced competition at the retail level and higher underlying wholesale gas prices. The money for the windfall gains to some has to come from somewhere, and that will inevitably be from residential customers, the customers with the least ability to respond to the very strong price “signals”. To date, this problem has remained relatively low profile. However, losses sustained through the winter of 2007 are unlikely to remain below the radar in coming months. AGL has recently announced a profit downgrade and attributed that in part to wholesale gas issues. Simply Energy has recently decided to pass cost increases on to residential customers.
10. At its meeting on the 27 October 2006, the MCE Ministers finalised criteria that will form the basis for the impending AEMC assessments of the effectiveness of



competition in retail energy markets. In undertaking the assessments the MCE has agreed that the AEMC should apply the following criteria;

- independent rivalry within the market;
- ability of suppliers to enter the market;
- the exercise of market choice by customers;
- differentiated products and services;
- prices and profit margins; and
- customer switching behaviour

A brief analysis of the impact of the introduction of injection dependency for validation of AMDQ is detailed below.

- a. *Independent rivalry within the Market.* Rivalry depends on relatively equal access to wholesale supply and risk management tools. The current model will lead to retailers moulding their retail ambitions to available wholesale supply.
- b. *Ability of Suppliers to Enter the Market.* New entrants are unlikely to access gas injection contracts at Longford in a timely and price effective manner to enable incremental growth as these contracts are only available infrequently and require material fixed volume commitments.
- c. *The exercise of market choice by customers.* New entrant retailers have driven switching in Victoria. If new entrants cannot access competitively priced wholesale gas and the associate risk management tools for uplift, they will not be active in the gas markets. If they are not active in the gas markets, competition for electricity customers will also be affected due to customer preferences for dual fuel offers.
- d. *Prices and profit margins.* Pricing to residential customers cannot be favourably affected by the injection dependency of AMDQ. A shift in value to the owners of Longford contracts and LNG storage has already occurred.
- e. *Customer switching behaviour.* Customer churn has largely been driven by new entrants and incumbents response to those new entrants. The rule changes of Feb 2007 have markedly reduced the ability of new entrants to operate.

11. Victoria Electricity therefore recommends;

- a. *Suspending injection dependency of AMDQ* for at least three years to allow time for a thorough review to be conducted and for processes designed to protect competition to be reaffirmed. This step is simple, easily implemented and, because it is a reversion to the arrangements in place prior to February 2007, is well understood by all participants.
- b. A major *revision of VoLL and administered pricing* in the gas market, including the introduction of a cumulative price threshold. VENCORP has already commenced this process.
- c. The leasing of the LNG storage capacity being released by VENCORP should be conducted in such a way as to *avoid allocating further LNG storage to those that already have storage*, and promote the diversification of LNG storage, including to smaller retailers.



- d. That *price caps be removed once AMDQ injection dependency has been addressed*. If price caps are not going to be removed, the price caps need to be revised substantially upward to reflect the underlying costs of wholesale electricity and gas. It would be very risky to have prices in the industry capped below wholesale price levels (or at levels that leave no margin).
12. Victoria Electricity believes that a number of objections will be raised to the proposals above and we have attempted to discuss these objections below. A focus on VE's particular case is distracting and we have therefore tried to consider this issue from the point of view of a new retailer planning to enter that market in 2008. Criticisms fall into three broad categories;
- a. *That non-incumbent retailers should have objected to injection dependent AMDQ during the consultation process in 2006*. We can only agree, but would observe that there were a number of changes being canvassed under the Pricing and Balancing Review. Unless a matter is highlighted and competition issues specifically reviewed, smaller retailers by their nature do not have the resources to thoroughly examine every possible rule or procedural change contemplated in what can be a very long process. We understand we were not alone in overlooking the significance of the change in question. In any case, whether or not existing small retailers should have raised their concerns earlier, it does not change the strength of the points raised above, nor address the issue of potential new entrants who have not yet commenced competing in retail markets.
 - b. *That retailers should have contracted commercially to address the risk / that smaller retailers are not competent at risk management / that commercial solutions are currently available but retailers are not prepared to pay the price*. In response to this line of argument we would make three points. Firstly market structures should support new entrants who may appear in the future. Clearly no discussion about what VE should have done in 2006 is relevant to such a new entrant. Secondly, a structure where one class of participant is obliged to contract with their retail competitor to enable them to win customers from that retail competitor is not conducive to vibrant market. In reality, the "market" for securing risk cover for congestion uplift is highly illiquid, if not non-existent. Finally, like others VE is a highly prudent and professional manager of wholesale risks and has traded successfully through a very volatile period in Australian energy markets.
 - c. *That the winter of 2007 was unique, that the market responded as it should have and that increased capacity (e.g. the Corio Loop) will address minimise a chances of a repeat of 2007 pricing*. Our response is in two parts. Firstly a reduction in the probability of a material risk does not change the need for prudent organisations to hedge that risk and hedging in a non liquid market is not reliable. Secondly the supply side improvements only address demand side growth for a period. A flawed rule change should not be supported just because the immediate consequences *may* be limited.
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