



**Review of the Effectiveness of
Competition in Electricity and
Gas Retail Markets in South
Australia: Issues Paper**

**Submission to the
Australian Energy Market Commission**

11 April 2008

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Executive Summary

Origin Energy (Origin) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia: Issues Paper* (Issues Paper).

Origin is a leading energy retailer in the South Australian market and was the incumbent gas retailer before contestability was introduced.

Since the commencement of full retail contestability (FRC) in South Australia, more than 60% of electricity and 55% of gas customers have moved off standard contracts onto market contracts¹. This has been reflected in annualised churn rates varying between 15% - 25% for both electricity and gas customers.

Furthermore, the number of licensed retailers in the South Australian market has grown from sole incumbent companies to 20 electricity and 12 gas retailers.

Origin would note that this continues to grow with four new electricity and gas retail licenses having been issued by ESCOSA for the South Australian market in the last 12 months. The emergence of new entrant retailers for both electricity and gas over the past five years has contributed significantly to the high level of customer switching seen in the market.

As a result, the combined market share of the incumbent retailers in South Australia, AGL and Origin, have declined significantly with the new entrants now commanding over 25% market share for both electricity and gas.

This in itself is compelling evidence of the effectiveness of the South Australian energy markets but more specifically examination of data reveals;

- that no significant barriers to entry or exit remain in the South Australian gas and electricity markets;
- the appetite and awareness of consumers to choose an energy retailer and enter the market continues unabated;
- that a variety of products are being offered by both incumbent and new entrant retailers; and
- that no segment of consumers are disadvantaged by, or are systematically denied access to the competitive market.

Origin would also highlight the conclusion of the AEMC's comprehensive competition review of Victoria energy markets which found that competition is effective. The South Australian energy market was considered the third most competitive energy market in the world², only trailing Victoria and the UK.

Origin is well placed to comment on the effectiveness of competition in the South Australian market and it is Origin's view that competition is effective.

¹ ESCOSA 2007, *2006/07 Annual Performance Report: Performance of South Australian Energy Retail Market*, November 2007.

² First Data Utilities and VaasaETT Utility Customer Switching Research Project 2007, *World Energy Retail Market Ranking*, Third edition, July 2007.

1. Introduction

Origin Energy (Origin) welcomes the start of the review of the effectiveness of competition in electricity and gas retail markets in South Australia being undertaken by the Australian Energy Market Commission (AEMC) and is pleased to make submission in response to the Issues Paper released on 14 March 2008.

Origin is a leading Australian energy company that supplies natural gas, electricity and liquid petroleum gas (LPG) to over 3 million business and residential customers in Australia, New Zealand and the Pacific region. In 2007, Origin completed the sale of its Network businesses, including all interests in Envestra and in the SEA Gas Pipeline, to the APA Group. Following the sale, Origin's interests in the gas market in South Australia is now solely focused on gas retailing and some interests in gas production.

In addition to its South Australian gas retail business, Origin is a participant in the electricity retail market and has invested in a number of generators in South Australia. Origin is joint owner of the Osborne generation station (180MW) and has full ownership of Ladbroke (80MW) and Quarantine (95MW) generation stations. Origin is expanding the open cycle gas-fired Quarantine station with the construction of a new 120 MW peaking power generator. The expansion will be supplied with natural gas through the SEA Gas Pipeline and will provide additional peaking capacity that is expected to come on line in time for summer 2008/09.

Consequently, Origin is well placed to comment on the effectiveness of competition in the South Australian electricity and gas markets. It is Origin's view that competition is effective in both instances.

Origin notes that the Issues Paper only addresses the questions of whether competition is effective and has not considered the questions of how to implement removal of price regulation or conversely, how to promote further competition. Origin has therefore not commented on these matters while noting that they have been well canvassed in the Second Final Report of the Victorian review³.

This submission makes little comment on the process being used to assess competition as Origin believes that the AEMC has taken into account many of the comments raised by Origin⁴ and other retailers in the previous Victorian review and these should not need to be revisited.

In summary, these were that:

- the review not rely on an attempt to assess end prices and profit margins as these are difficult to assess reliably and are not necessarily representative of efficient competition because they are only an estimate at a point in time while competition is a dynamic process; and
- the impact of prices on vulnerable customers, while important from a social policy perspective, should be considered separately from any assessment of competition and price regulation. The issue of vulnerable customers is a matter to be considered separately in that (in the absence of demonstrated market failure) it is a consideration of the social wage contract not energy pricing.

However, Origin would reiterate that it is effectively circular to use measures of competition and product variety to answer the question of price deregulation when the regulated price framework actually drives the level of competition and product variety.

³ AEMC 2008, *Review of Effectiveness of Competition of Electricity and Gas Retail Markets in Victoria: Second Final Report*, February 2008

⁴ Origin 2007, *Submission of Origin Energy to the Review of the Effectiveness of Competition in Gas and Electricity Retail Markets: Issues paper*, June 2007

Consequently, Origin proposes that the measures for reviewing effective competition must relate directly to the removal of barriers to entry and to assess objectively, the direct impact that the current pricing framework has on this.

This submission focuses on specific responses to the questions raised in the Issues Paper and these are outlined in section 3.

Origin will be supplying further detailed information and data to the AEMC through their survey and interview process but is willing to discuss this submission with the AEMC in greater detail as required.

2. Framework for the Review

The Issues Paper addresses the question of whether competition is effective in the South Australian gas and electricity retail markets.

Origin substantially agrees with the AEMC's definition of effective competition as described in the Issues Paper but would reiterate some key points on effective competition namely that it:

- deals with the process of competition and dynamic efficiency;
- focuses on price and non-price behaviour as firms discover what their customers want and are prepared to pay for, and then determine the most effective means of delivering those products and services; and
- is not and should not be confused with perfect competition which is a competitive state that is rarely met in the real world and changes over time. Effective competition does not require that prices must track costs at all times as by definition, this would inhibit any prospect for innovation. The opportunity for costs and prices to be de-linked must exist if incentives are to be provided for product development and innovation.

Ideally, effective competition in the energy market would be characterised by:

- output levels and the range of qualities available should be responsive to consumer demands for energy products;
- success should accrue to those retailers who best serve consumer wants;
- opportunities for introducing technically superior new products and processes should be exploited; and
- profits, considered over time, should be at levels just sufficient to reward investment, efficiency and innovation.

3. Issues for Consultation

Origin considers that the South Australia market displays all indicators of an effectively competitive market.

As outlined below in response to the questions, Origin believes:

- that there are no barriers to energy retailers for entry or exit to the market and that the current structure has supported competition;
- that there has been considerable retailer rivalry and consequently, customer participation in the energy market as clearly demonstrated by the statistics on customer movement; and
- that customer entry to the energy market has been spread across all customer groups with no obvious inequities.

3.1 Market Structure

1. Have the structural conditions for energy retailing in South Australia supported or hindered the development of effective competition? Are these structures likely to support or impede further improvements in competition in the future?
2. Are there barriers to entry that impact on the development of effective competition? Have these barriers dissuaded prospective energy retailers from entering or can they be overcome? Are these barriers likely to persist or abate?
3. Are there barriers to expansion or exit that impact on the development of effective competition? Have these barriers dissuaded prospective energy retailers from entering or can they be overcome? Are these barriers likely to persist or abate?

Origin believes that the structural conditions of the South Australian market have supported effective competition and envisages further market participation and customer transfers as the competitive structure of the energy market develops.

The construction of new energy infrastructure including electricity generation, interconnection and gas pipeline expansion being undertaken by various market participants, as noted in the NERA consultant reports to the AEMC⁵⁶, can only enhance effective competition.

Furthermore, Origin does not perceive any real barriers to entry or exit that would impact on effective competition in South Australia. There are several unique factors influencing the South Australian gas market but these do not restrict effective competition and they are addressed under question 4.

It is important to note that, unlike the situation in the AEMC's recent review of the Victorian energy market, the South Australian gas transmission market is based on a contract carriage model rather than market carriage framework. That is, retailers are required to procure contracts for gas transport to the market. This is the situation in all other states apart from Victoria.

Origin does not believe this is an impediment to market entry but does require a retailer to seek and negotiate contracts for supply in advance of retailing within the gas market and

⁵ NERA 2008, *The Gas Supply Chain in Eastern Australia*, A report to the Australian energy Market Commission, March

⁶ NERA 2008, *The Wholesale Electricity Market in Australia*, A report to the Australian energy Market Commission, March

they will incur all the costs that are associated with this. In taking this into account, the AEMC should also note recent changes where major transmission pipelines are increasingly removed from AER coverage. The proposed changes to the regulation of natural gas pipeline services, which are currently in the South Australian Parliament⁷, may also be relevant to the AEMC review.

That other retailers have entered the South Australian gas market since the start of full retail contestability (FRC) and now hold over 40% of the market is a clear indication that this is not a barrier to entry but does impose retailer risks that must be considered and priced accordingly.

Origin would consider that the primary barrier within the market is price regulation itself. The perception of regulation can be a limiting factor on competition from limiting competitive outcomes or by introducing risks to the policy and regulatory environment. This is particularly the case in the recent environment of increasing wholesale prices for both gas and electricity.

Regulated prices are inflexible and are not able to respond quickly to changes in the energy purchase prices which impacts on retail margins, retail risks and future expectations. This situation is exacerbated when regulated prices are set for periods longer than a year, such as in South Australia, where a three year price path for a standard retailer's costs to supply gas is set by the regulator based on their forecast of cost inputs. In the current complex gas supply and transmission market, incorporating a mix of legacy and new contracts all of which are confidential, it is a very onerous task, and one that will inevitably be wrong.

In Origin's experience, the regulatory framework for gas pricing provided no means for cost recovery (either during the period, or retrospectively) of the additional costs of gas supply experienced in winter 2007. This limitation may then flow through to potential market participants' perceptions of the regulatory risks of participation in the SA gas market.

In such an environment, it is effectively circular to use measures of competition and product variety to answer the question of price deregulation, as the regulated price and pricing framework drives the level of competition and product variety. In Origin's view, if the objective is as set out in the AEMA to move towards price deregulation, then the measures and the actions must relate more directly to removal of barriers to entry and to assess objectively, the direct impact that the current pricing framework has on this.

In addition, the presence of price regulation affects retailers' choices regarding market entry and innovation as the regulated price necessarily becomes the price and offer to 'beat'. This is discussed further under questions 6 and 7.

4. Are there unique or specific features of the South Australian electricity or gas retailing environments that may support or impede the development of competition?

Origin has not identified any specific factors that impact on the South Australian electricity market, other than perhaps, the particular retail price regulatory regime itself as noted above.

However, Origin notes that the NERA report has identified several factors that may be impacting on retailers' competitiveness for supply and delivery of gas to the South Australian market.

⁷ Natural Gas (South Australia) Bill 2008. As stated in the second reading speech to the South Australian Parliament by the SA Minister for Energy, "*By the promotion of an economic efficiency objective in access to pipeline services, competition will be promoted in upstream and downstream markets*" (page 4)

Specifically these are that:

- historically, there was a capacity constraint at the Adelaide city gates;
- there is a lack of access to customers in north Adelaide because of constraints in the Envestra distribution network; and
- there are possible capacity constraints on the SEAGas pipeline;

Origin would comment on these concerns.

First, as acknowledged by the NERA report, since the termination of the Origin contract with Epic Energy at the end of 2005, Origin no longer has any control of access to the Adelaide city gates. Consequently, since 1 January 2006, there is no capacity constraint and any retailer is free to contract directly with Epic Energy for access to the city gates.

Even prior to this, Origin had a Memorandum of Understanding (May 2004) with the South Australian Government that Origin would provide access to any retailers seeking access and during this period, Origin was approached by a retailer and accordingly provided them access to the Moomba to Adelaide Pipeline (MAPS).

Secondly, with regard to distribution network tariffs, both SEAGas and MAPS supply the Southern and Central zones and there is no distinction between the pipelines for network tariffs. Envestra's network tariffs do not vary across the South Australian gas supply regions for small to medium sized customers (ie "volume" or V tariff customers).

Admittedly, for large customers on demand (D) tariff, the network rates are slightly lower for the Northern Zone which is supplied by the MAPS Elizabeth city gate. However, the network rates are non-discriminatory and available to any retailer. Origin does not consider this a limitation on effective competition because:

- all retailers are free to negotiate with the MAPS for transmission capacity and as noted by NERA, the MAPS has spare capacity for delivery; and
- the difficulty in supplying north Adelaide customers via the SEAGas pipeline is a temporary issue which is to be assuaged with the addition of a further Elizabeth gate station by Envestra.

Finally, Origin does note that the SEAGas pipeline is currently contracted to full capacity by the three foundation shippers that entered into long-term contracts to enable the pipeline to be built. The capacity is mainly used for Power generation but can be expanded on request to SEAGas. However, as stated above, Origin urge the AEMC to assess competition as a dynamic process rather than consider static impediments at a point in time.

The capacity constraint on the SEAGas pipeline will end in the future because of:

- competitive pressures from the MAPS pipeline;
- current contracts ceasing; or
- market pressures requiring capacity expansion.

The South Australian gas market is, however, being serviced by more than one gas pipeline and retail entrants have the opportunity to obtain access and acquire customers, if not without some effort.

The amount of retail activity and the number of customer transfers in the gas market put this issue into perspective that this is not a barrier to competition, even at this select point in time.

3.2 Retailer Rivalry

5. To what extent do retailers compete with each other to acquire new customers and retain existing customers? What does the current level of rivalry between retailers indicate about energy retailing in South Australia?

The extent to which new entrant retailers have competed with incumbent retailers is transparent when analysing trends in the South Australian market energy market.

Since the commencement of FRC in South Australia, more than 60% and 55% of electricity and gas customers respectively have moved off standard contracts on to market contracts⁸. This has been reflected in annualised churn rates varying between 15% - 25% for both electricity and gas customers.

Furthermore, the number of licensed retailers in the South Australian market has grown from sole incumbent companies to 20 electricity and 12 gas retailers. Origin would also note that this continues to grow with four new electricity and gas retail licenses having been issued by ESCOSA for the South Australian market in the last 12 months.

As a result, the combined market share of the incumbent retailers in South Australia, AGL and Origin, have declined significantly with new entrants now commanding over 25% market share for both electricity and gas.

The emergence of new entrant retailers for both electricity and gas over the past five years has therefore contributed significantly to the rivalry between retailers and the high level of customer switching seen in the market and is a clear indicator of effective competition.

6. Has retail price regulation encouraged or impeded tariff innovation, product differentiation and service competition?
7. On what basis, and to what extent, might retailers be expected to compete in the future?

It is Origin's view that price regulation has impeded tariff and product innovation because the standing offer price is usually used as the benchmark 'price to beat' for all retailers in the market and small customers retain the right to revert to the standard price at any time.

As the standing offer is always available, retailers have relied on comparing new product offers with the regulated price for ease of customer comparison. While this has been seen as a positive effect from a consumer information perspective, the actual result is that retailers' products rarely diverge far from this standing contract price. Even product offers that may be more advantageous for the customer are avoided as they can be complicated to promote relative to retailers that offer simple percentage discounts to the standard price.

Another result of this narrowing of price offerings around the standing offer is that individual consumers that may not benefit from the current structure of the standing offer may not receive price offers that reflect their situation. Removal of price regulation would incentivise products to remedy this situation.

If price regulation was removed then Origin would expect to see further variations in the pricing approaches and products that enter the energy market in South Australia. Even similar energy products for the same customer group would vary between retailers

⁸ ESCOSA 2007, *2006/07 Annual Performance Report: Performance of South Australian Energy Retail Market*, November

depending on their approaches to pricing, apportionment of their underlying costs and their overall strategies for obtaining customer share.

As well as price differentiation, you would expect innovation in non-price benefits and customer service to take up even greater importance. Even using standard prices as a benchmark, many products have been offered including magazine subscriptions, loyalty benefits or green products. This would be greatly expanded once price can be tailored to the product offerings without customer resistance.

8. What does the nature and extent of marketing activity indicate about the level of competition? What do the types of marketing activities undertaken by retailers indicate about the level of competition?

Origin notes that the preferred marketing activities used by energy retailers are door to door sales, telemarketing and internet.

This is predominantly because of the nature of energy retailing with energy products being:

- low involvement product;
- a small part of household disposable income; and
- a basic, uninspiring commodity.

However, there is obviously a vigorous competitive market in these forms of direct communication and sales as demonstrated by the electricity and gas market annual churn to date and the market share being won by new entrant retailers. There does not appear to be any incumbency advantage in these forms of activity.

As noted, most of customers' take up of market contracts is in response to forms of retailer marketing rather than a customer approach to a retailer which also demonstrates that marketing has been effective and has been key to the high level of customer participation.

High exposure and high cost marketing activities such as television or media advertising is utilised for brand awareness and has limited benefit in market competitiveness. Thus the effectiveness of competition in South Australia should not be judged on these activities.

9. Is there evidence of retailers engaging in mis-selling and other anti-competitive marketing practices?

Origin notes that this issue was widely discussed in the Victorian review of competition and summarily discarded as not being relevant to the assessment of effective competition in energy markets.

For completeness, Origin would reiterate that:

- there is no evidence of significant anti-competitive or misleading marketing activity that would reflect market failure or would warrant the retail energy market to not be found fully competitive;
- there have been instances of misrepresentations but the energy industry is active in self-regulating to ensure compliance and that any misleading activities are summarily curtailed;
- any material or systematic anti-competitive or misleading activity is a matter for regulators of market conduct to address; and
- the existence or such behaviour is not relevant to the question of market competitiveness.

10. Are retailers able to recover their efficient costs at current standing and market offer contract tariffs? Are future expected profit margins likely to be sufficient so as to encourage new entry and increase competition or insufficient such that new entry is deterred?
11. What effect, if any, does retailer exposure to fluctuations in wholesale electricity and gas price have on retailers' ability to offer competitive product and service offerings?

Origin believes that energy prices are currently set to reasonably recover efficient costs in South Australia with recent price decisions by ESCOSA on electricity (final) and gas (draft) endeavouring to manufacture standard prices that will attain cost reflective levels on average.

Unfortunately, the price decisions to set the regulated tariffs will apply for the next three years and in all likelihood, regulated prices will not reflect a retailer's efficient costs of supply within a short period of time. As all retailers have experienced, current price controls that are efficient and profitable at one time may not be so at another time and this has never been more evident than in the last 12 months with significant changes to wholesale energy costs while regulated prices remaining fixed.

Consequently, future retail profitability and market competition will be dependent on whether price regulation continues and if it does, will then depend on any cost changes that actually occur within the energy market.

An energy retailer's role is to manage risk and market products to end use customers.

With regard to fluctuations in the wholesale market, a retailer's ability to compete effectively in the energy market is dependent on the efficiency of their risk management strategies and their ability to acquire customers based on these efficiencies. The removal of price regulation will accentuate a retailer's ability and likelihood to compete based on these elements.

In Origin's view, a competitive market, operating without rigid price controls is far better placed to "find" the efficient price/product feature combination(s), than a regulator tasked with setting a specific value for the efficient retailer for each year of a three year price path.

3.3 Customer Participation

12. What motivates customers to switch from a standing offer to a market contract or to switch retailer? For those customers who are not willing to participate in the competitive market, what underpins their decision to remain on a standing offer?
13. Do retailers actively compete to offer the products, services, prices and other conditions of supply which are most attractive to customers? Do retailers respond to changes in consumer taste by offering new, different or better products in a timely manner?

A customer's decision to enter a market contract or take-up an energy product is dependent on many elements such as:

- price;
- being unhappy with the service of their existing supplier;
- being encouraged to look at their options;

- advertising; and
- non-price benefits such as magazine subscriptions or loyalty benefits.

In essence, customers respond to products that appeal to them, whether this is price driven or not. However, inertia and lack of interest is the major reason for customers remaining on a standing product.

Retailers actively compete on energy products and Origin has found that the vast majority of customers who have switched energy retailer have done so because of the product being offered. As a result of this, retailers quickly respond to changes in consumer choices or new products that have sparked consumer interest.

For example, Origin has always led the energy market with green based products but recent changes in society's value of green and carbon neutral products has seen a marked escalation in the number of retailers offering such green products. Many customers have been and are continuing to be willing to pay more for choosing a premium green product.

Different product offerings and the speed at which they appear is a sign of effective competition as retailers respond to different customer needs in a way that regulated prices cannot.

14. Are customers able to access information that is easy to understand, relevant and up to date, and enables competing offers to be compared? Do customers rely on this information when deciding whether to switch? If not, why not?

The high take-up of market contracts in South Australia is a clear indicator that customers are able to access and compare product offers in the energy market. That the retail energy market has been so effective despite it being a low engagement commodity and only a small element of overall household expenditure demonstrates customer's awareness. Otherwise, customer inactivity would be clearly shown in significantly less market activity.

It is necessary to understand that it is not customers' acute awareness of energy companies per se that is important in understanding consumer's behaviour in the market place. Origin would point to other low involvement products where consumers will find companies names to supply a certain good or service when they actually need it. Customers seeking energy products will similarly be able to access specific information from various energy retailers with little difficulty once they have decided to act.

The wide-spread access by the community to the internet is an important factor here in enabling customer's to easily compare prices and offers. Product comparators such as that provided by ESCOSA provide yet another means of comparison and are generally accepted by the industry as an important part of the customer communication mix.

Retailers have also individually addressed the need to provide clear and accurate information to consumers through their marketing collateral which highlights:

- the price components of a market contract;
- the existence of exit fees or otherwise; and
- the key terms and conditions that the consumer should be aware of under the contract.

Further to this, retailers are constantly seeking to improve our service to customers to meet their needs. For example, Origin carries out research to inform how best to present information to customers and consistently uses this information to implement changes to its approach as required.

3.4 Equitable Access to Competition

15. Are there classes of customers who are unable to access the benefits of competition? If so, what factors contribute to the difficulties experienced by these customers?

First, Origin must reiterate that policy makers need to separate the issue of the causes of financial hardship or vulnerability from the issue of retail competition. This was discussed and accepted during the competition review in Victoria.

Retailers have always been faced with the problem of delineating between customers who cannot pay and customers who will not pay, and therefore how to deal appropriately with customers experiencing genuine problems with affordability of energy use. In summary, this has nothing to do with competition. Origin believes that no customer groups are being excluded from the market based on socio-economic characteristics. Evidence supporting this view can be found in competition reviews carried out by the ESC in Victoria and ESCOSA in South Australia, which showed that customers of all types are taking up market contracts.

Origin's experience with retail customers who might be considered 'vulnerable' is that their vulnerability does not appear to affect their participation in the market. Origin markets to all customer groups and has found that take up of market contracts does not vary significantly across customer classes.

16. What steps, if any, do retailers take to assist customers experiencing difficulties in participating in the competitive market? Are these initiatives effective in assisting these customers?

Origin does not try and determine if customers have genuine difficulty in paying but instead takes a customer, in the initial phase, on face value and provides support accordingly. This avoids any debate about deciding who *will not* pay and who *cannot* pay as retailers have no way of knowing what a customer's genuine circumstances are.

Origin has found this approach to be very effective from customers and the business perspective. When a customer advises Origin that they are having difficulty, procedures are in place to assist them including individual case management through the Origin *Power On* programme - a programme that has been in place prior to any regulated requirement for hardship policies and applies equally to customers on standard or on market contracts. In other words, customers who take up a market contract with Origin do not need to fear that they will at a later time, be denied access to Origin's hardship initiatives.

Origin feels that existing government and retailer initiatives are effective as all domestic customers:

- have a right to a basic offer and are provided a quote for a market contract from their retailer of choice if they request one;
- have basic contractual rights and obligations, including payment terms, bill content, disconnection provisions and access to the Ombudsman, guaranteed through the Retail Code and other legislation;
- have access to payment plans from retailers when they require support paying a bill;
- have access to additional government support through the concessions and grants regime within South Australia; and
- have access to retailers' hardship programmes to assist with more serious hardship issues, including energy efficiency advice and appliance assistance.

This means that customers, whether vulnerable or not, have access to the market, and also have access to financial and other support services if they require them.