



Tel: 02 9921 2999  
Fax: 02 9921 2552

AGL Energy Limited  
ABN 95 052 167 405

72 Christie Street  
St Leonards NSW 2065

Locked Bag 1837  
St Leonards NSW 2065  
www.agl.com.au

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Australian Energy Market Commission  
PO Box H166  
AUSTRALIA SQUARE NSW 1215

[submissions@aemc.gov.au](mailto:submissions@aemc.gov.au)

**Review of effectiveness of competition in the gas and electricity retail markets:  
Issues Paper, 1 June 2007**

AGL Energy Limited<sup>1</sup> (AGL) welcomes the opportunity to comment on the Issues Paper for the review of effectiveness of competition in the gas and electricity retail markets (the Review) by the Australian Energy Market Commission (the Commission). The Commission is required to undertake this review under the Australian Energy Market Agreement (AEMA).

AGL is the largest energy retailer in Australia with a significant interest in upstream markets. We are also developing a number of new energy generation assets. The assets in development include Hallett wind farm (95 MW), Bogong hydro power generator (140 MW), Hallett gas-fired power station expansion (250 MW), Townsville gas-fired power station (370 MW), Victorian wind farm sites (400 MW) and Leaf's Gully gas-fired power station (300 MW). Our upstream investment is required to ensure a natural, long-term hedge for our retail business.

AGL's development assets are consistent with a carbon-constrained future and premised on our ability to earn an appropriate rate of return in a competitive market. Removal of regulatory constraints on retail pricing and certainty with respect to greenhouse mitigation measures are critical for this investment.

We support the agreement by the Australian governments under the AEMA to phase out the exercise of retail price regulation for electricity and natural gas where effective retail competition can be demonstrated.

Regulated retail prices in Victoria are currently determined under the price paths agreed between the incumbent retailers and the Victorian government. The government has the reserve power to determine retail prices under electricity and gas legislation. The government has not exercised the reserve power since 2002, however the price path agreements are based on estimates of cost benchmarks established by the government which is not dissimilar to the approach generally adopted by regulators, but is more light handed. This is a pertinent matter with regards to the requirement on the Commission to establish

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<sup>1</sup> AGL is Australia's largest retailer of gas and electricity with 4.1 million customer accounts in New South Wales, Victoria, South Australia and Queensland (including ActewAGL and AlintaAGL customers (Joint Ventures)). AGL has significant investments in upstream energy markets. We own and operate 645 MW of hydroelectric power generation assets, the 1280 MW Torrens Island Power Station and the Somerton gas-fired power stations. AGL also has a 32.5% equity investment in the Loy Yang A power station.

that prices in the Victorian market are efficient and has implications for how reserve powers are established (if this is to be a recommendation) and exercised.

### **Assessing effectiveness of competition**

AGL believes that a market has effective competition if:

- Customers are aware that they have a choice;
- Customers know how to exercise choice and it is easy to do; and
- Choices (ie. Offers) are being made available to them.

The Commission has outlined a number of indicators that it proposes to utilise to assess effectiveness of competition which incorporate the above.

As the Commission is aware, the Essential Services Commission of Victoria (ESCV) has undertaken reviews of effectiveness of competition in Victoria in 2002 and in 2004. These ESCV reviews provide a valuable reference point, in particular the 2004 review, for the Commission's review.

The ESCV's conclusions are reproduced in Attachment 1. In summary, the ESCV concluded that competition in the Victorian market was sufficient in 2004 to discipline any exercise of market power and to enable considerations on the gradual roll back and potentially the elimination of retail price regulation. The ESCV noted that more could be done to enhance the level of competition and recommended a number of actions most of which, as outlined below, have been implemented. The ESCV also found that customers, who chose not to participate in the market, did so, mainly because the savings against the regulated prices were not available or significant. This issue has also been largely addressed under the price paths agreed with the Victorian government.

The ESCV findings in 2004 highlighted the contradiction noted by the Energy Reform Implementation Group<sup>2</sup> (ERIG) in its report to the COAG with respect to retail price regulation and effective competition:

*"ERIG notes there is a potential contradiction inherent in the agreed MCE process. Retail price caps may be either (i) higher than actual market prices, or (ii) binding (that is, actually constraining market prices).*

*In case (i), price caps are effectively redundant – regulation imposing some 'red tape' costs but otherwise not affecting market outcomes.*

*In case (ii), where price caps are binding, ERIG concludes that governments responsible for such restrictions face a dilemma. In such cases, there are government policy-induced competition problems:*

- *retail price caps and retail price restrictions are effectively barriers to entry, impeding the bringing-forward of efficient supply;*
- *such price controls themselves are impediments to competitive and efficient electricity markets; and*
- *if the emergence of competition is a prerequisite for removal of retail price caps that themselves impede competition, this is a Catch-22 situation.*

*ERIG encourages COAG and the MCE to revisit this process and to deal with this inherently contradictory situation as soon as possible."*

The Victorian government has, in our view, addressed this contradiction through its light handed approach to retail price paths under its reserve powers. Going forward, it is critical that the challenges in the electricity market arising from natural causes such as drought and

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<sup>2</sup> Energy Reform: The way forward for Australia; A report to the Council of Australian Governments by the Energy Reform Implementation Group p.96

the tightening of the supply/demand balance (which have a flow on effect in the gas market) do not erode the market effectiveness that has been achieved.

### Developments since the 2004 ESCV review

Our detailed comments to the issues raised by the Commission are provided in Attachment 2 and referenced to the indicators of effectiveness of competition proposed by the Commission. In addition, we have provided the ESCV's assessment from its 2004 review to establish a comparative benchmark for developments since, in order to validate and extend the ESCV's findings and conclusions.

The ESCV's key findings/recommendations of 2004 to further enhance retail competition in the Victorian gas and electricity markets and actions taken are provided below.

ESCV Finding/Recommendation	Implementation measures to date
Customer acceptance of market contracts is being constrained by limitations on the availability and quality of transparent and easily understood information.	<ul style="list-style-type: none"> <li>The ESCV consulted on and established price disclosure guidelines in 2006.</li> <li>The ESCV introduced a web based price comparator in 2006.</li> </ul>
Identify specific improvements required to establish a more accountable and efficient B2B system for electricity, and establish arrangements for monitoring the industry's future performance.	<ul style="list-style-type: none"> <li>The national B2B procedures have been agreed and implemented (automated) through the industry-based Information Exchange Committee with secretariat support from NEMMCO.</li> </ul>
Greater price flexibility	<ul style="list-style-type: none"> <li>Price flexibility under retail price agreement with the government has enabled more customers to 'actively' participate in the market.</li> </ul>

Increasing maturity of the Victorian market and the implementation of recommendations by the ESCV have led to robust competition in Victoria with annualised churn rates (between retailers) consistently exceeding 20%. In addition to this, we estimate that a similar number of customers have transferred from standing offer contracts to market contracts with their host retailers.

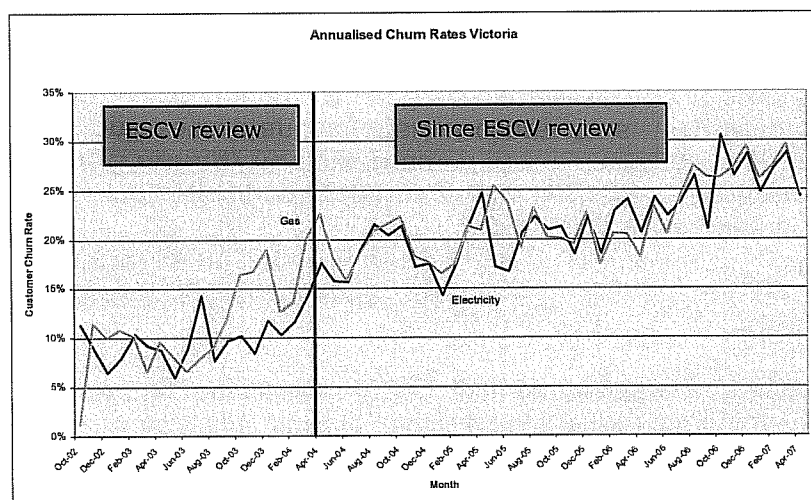


Figure 1

Category	Market*	Rank
HOT	Victoria (Australia)	1
	Great Britain	1
ACTIVE	South Australia (Australia)	3
	Texas (USA)	4
	Norway	5
	New Zealand	6
	Netherlands	7
	Sweden	8
	New South Wales (Australia)	9
	Finland	10
SLOW	Flanders (Belgium)	11
	New York	12
	Denmark	13
DORMANT	Austria; Germany; Spain; Ireland; Portugal; Alberta, Ontario (Canada); Connecticut, Illinois, Maine, Maryland, Massachusetts, Michigan, California, New Jersey, New Hampshire, Ohio, Pennsylvania, Rhode Island (USA)	Not ranked

\* Designated by country, province, or state  
Source: First Choice Water, licensed ESCV

Figure 2

The 2004 ESCV review looked at data and market performance prior to April 2004 when competition in the market was ramping up towards 20%. Figure 1 shows that since then the churn rate has been around 20% and increased to 25% in late 2006 and 2007.

Figure 2 shows that the churn rate performance when compared to other countries ranks Victoria as the hottest market in the world (equal first with UK).

It is noted that SA is ranked third in the world and that a recent report on the review of the effectiveness of competition in the South Australian gas and electricity market commissioned by the Essential Services Commission of SA and undertaken by NERA Economic Consulting<sup>3</sup> (p.87), has concluded that competition in the SA:

- electricity market is effective; and
- metropolitan gas market is well established and likely to be effective with some concern that access to pipeline laterals may be the cause of the less intense competition in some regional areas.

### **Role of consumer safety net**

The consumer safety net arrangements, with particular reference to retail price regulation, was established at the time that the market was opened up for full retail competition (FRC) to ensure an orderly transition to a competitive market and to prevent potentially inefficient price increases whilst competition was not effective. The safety net provisions have included both price and non-price customer protection measures.

To the extent that access to supply is required, it is important to note that this obligation is regulated under a licence condition (clause 8.1) whereby local retailers are required to offer sell to any small customer at gazetted tariffs and terms and conditions approved by the ESCV. It is proposed that this provision also be transferred to the national regulatory framework for distribution and retail (national framework). We note however, that the provision will need to decouple the pricing and obligation to offer to sell from the standing form contracts if retail price regulation were to be removed.

Retail price regulation can have detrimental effect and unintended consequences with respect to the development of competition and demand and supply side investment. The ESCV report on the effectiveness of competition noted that customers whose regulated prices were not cost reflective or did deliver sufficient savings did not receive offers or chose not to participate in the market. This had the effect of delaying the achievement of effective competition in the Victorian market.

A more important unintended consequence of retail price regulation is that it does not provide regulatory certainty for demand management and investment. Customers who do not receive appropriate price signals are less likely to manage demand thereby increasing the need for investment in energy infrastructure. Further, lack of certainty on investment returns discourages long term investment in generation and supply.

### **Protection of vulnerable customers**

Clause 14.11 (b) of the Australian Energy Market Agreement (AEMA) states that all parties agree to phase out the exercise of retail price regulation for electricity and gas where effective retail competition can be demonstrated and that social welfare and equity objectives will be met through clearly specified and transparently funded State or Territory community service obligations that do not materially impede competition. This agreement is consistent

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<sup>3</sup> <http://www.escosa.sa.gov.au/webdata/resources/files/070614-R-Phase2ReviewERMC.pdf>

with the recommendations of the Productivity Commission<sup>4</sup> following its review of Competition Policy Reforms in 2005.

The price path arrangements in Victoria have rightly maintained the protection of vulnerable customers and retail price regulation as two separate issues. Under the existing price path arrangements all customers are subject to prices that are designed to be fully cost reflective but customers who are not able to pay their bills are then assisted under a shared responsibility between retailers, the Victorian government and the customers and community.

The Victorian government amended the Electricity Industry Act 2000 and the Gas Industry Act 2001 in 2006 to make the retailers' voluntary customer hardship programs a mandatory requirement. As a result all retailers are now required to implement hardship programs that meet the legislated requirements. The ESCV issued a guideline (Guideline 21) for the preparation and approval of retailer hardship policies that commenced in April 2007. The government has also allowed for recovery of some costs associated with the implementation of the hardship programs that are now reflected in the regulated prices, and as a result in market offer prices.

The significant benefit of this approach is that customers who are likely to be financially vulnerable are not excluded from the competitive market.

### **Conclusions and way forward for Victoria**

Based on the ESCV's 2004 review and developments in the Victorian market since, AGL strongly believes that competition in the Victorian energy market has been effective for several years.

We believe that retail price regulation can and should be phased out in accordance with the AEMA. AGL supports that the requirement of the 'obligation to supply' (obligation to offer to sell) remain at prices determined by market forces and be placed on the Financially Responsible Market Participant (FRMP).

We note that the Victorian government can maintain a reserve power on retail price regulation as provided for under clause 14.14(c) of the AEMA. AGL supports this reserve power but considers that any such reserve power should only be exercised in accordance with a regulatory methodology promulgated by the Commission that ensures that any intervention by government may only occur where there is demonstrable evidence of market failure. The Commission should undertake the assessment of market failure.

AGL looks forward to contributing further to the Commission's review. For any enquiries in relation to this submission please contact Kam Khelawan, Manager Policy & Strategy on (02) 9921 2611 or [khelawan@agl.com.au](mailto:khelawan@agl.com.au).

Yours sincerely,



Sean Kelly  
General Manager Energy Regulation

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<sup>4</sup> "In retail infrastructure markets, once effective competition has been established, regulatory constraints on prices should be removed. Ensuring that disadvantaged groups continue to have adequate access to services at affordable prices should be pursued through adequate, well targeted and transparent community service obligations (or other appropriate mechanisms), that are monitored regularly for effectiveness." - Productivity Commission Inquiry Report: Review of Competition Policy Reforms, February 2005.



## Attachment 1 – ESCV conclusions from its 2004 review.

The Commission's specific findings<sup>5</sup> regarding the extent to which retail competition has been or is likely to be effective are:

- The Commission has concluded from its analysis that competition in the Victorian energy retail markets has been fully effective in constraining prices, delivering non-price benefits and providing customer choice among retailers and their price/service offerings in substantial sub-markets, covering of the order of 40 per cent of customers in the household and small business sectors of the market.
- These competitive sub-markets typically include customers who consume higher volumes of energy, are dual fuel energy users and/or are located in metropolitan Melbourne or larger regional centres. New entrant retailers are participating successfully in these submarkets, where competition for customers has been vigorous in constraining profit margins and powering stimulating product and service differentiation.
- The Commission's analysis has also identified relatively large groups of customers that are not currently participating in the energy retail market and are not being directly targeted by retailers' marketing campaigns. These customers provide low or negative margins relative to the standing offer prices and tend to be lower volume and more remotely located energy users, and may also have relatively high off-peak energy consumption.
- Although general market offers are being made to all small energy customers, the offers made to these low margin customers are not yet attractive relative to the standing offer price. As a result these customers tend to remain on the standing offer price and contract terms. In that sense they are protected from retail price rises by these safety net arrangements during the period of transition to more effective retail competition.
- Some remaining obstacles to effective retail competition have also been identified and the Commission has recommended a number of measures to reduce or remove them in order to further strengthen the effectiveness of retail competition in the period ahead.
- The Commission has concluded that competition is likely to become effective for a much larger proportion of small energy customers in the next few years, as the current competitive momentum in the Victorian retail energy markets continues to build and the full effects of existing and proposed measures to enhance competition are felt.
- Based on this assessment, the Commission considers that the competitive market has developed to a stage where it will discipline any potential to exercise market power and that consideration can now be given to a gradual roll back, and potentially the elimination of retail price regulation, over the coming period without the risk of significant disadvantage to energy customers.

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<sup>5</sup> FINAL REPORT TO MINISTER SPECIAL INVESTIGATION: REVIEW OF EFFECTIVENESS OF RETAIL COMPETITION AND CONSUMER SAFETY NET IN GAS AND ELECTRICITY, Overview report, 22 June 2004, section 2.1, p13

**Attachment 2: Effectiveness of competition in Victoria against measures proposed by the AEMC.**

<b>Measures</b>	<b>2004 ESC effectiveness of competition review</b>	<b>Comments</b>
<b>Assessment</b>	In its 2004 Review, the ESCV found that competition for the retail supply of gas and Electricity in Victoria was generally effective in those groups within the market where sufficient profit margin existed or had emerged. These profitable sub-markets accounted for almost 40% of customers (based on customer numbers), and typically encompassed customers who consumed more than 50 GJ of gas or 6MWh of electricity per annum, operated dual fuel accounts, and were located in metropolitan and large regional centres.	
<b>Market structure [Issues Paper 1, 2, 3, 4, and 5].</b>		
1. Number, type and size of contestable customers, and changes in the number size of those customers over time.	2.3 M electricity (12% business) and 1.6M gas customers. ESCV Report <sup>6</sup>	Current 2.4M electricity, 1.6 M gas customers.
2. The number, type and size of competitors, and changes in the number and size of competitors over time.	19 licensed electricity retailers, 8 licensed gas retailers. 97% of electricity and 99% of gas customers with local retailers. 17% of electricity and 14% of gas customers on market contracts.	There are 19 licensed electricity and 12 licensed gas retailers showing that barriers to entry is low and participation is high – ESC website. ESCV Comparative Performance Report (CPR) 2007 indicates that 87% of electricity and 94% of gas customers are with local retailers. Note these figures include customers on market contracts.
3. Market concentration indices.	"Based on the information available, the Commission's preliminary view is that the structure of the electricity and gas retail markets is broadly consistent with the requirements of effective competition" - p.48, ESCV Report.	Refer to comments on items 1 and 2.
4. Market shares of competitors, and	Refer to 2.	AGL's analysis based on UBS June 2006

<sup>6</sup> FINAL REPORT TO MINISTER - SPECIAL INVESTIGATION: REVIEW OF EFFECTIVENESS OF RETAIL COMPETITION AND CONSUMER SAFETY NET IN GAS AND ELECTRICITY, BACKGROUND REPORT, ESCV 22 June 2004



<p>changes to those shares over time</p>		<p>data shows that market shares were as follows; AGL (31%), Origin (35%), TRU (25%), VE (2.7%), Red (1.7%) with remainder with others. ESCV's recent report indicates the incumbents have lost a further 4% market share.</p>
<p>5. Barriers to entry, including the extent, and effect, of economies of scale and scope, and access to wholesale markets and risk management vehicles.</p>	<p>"New entrant niche retailers are challenging the significance of some presumed barriers to entry – p.48. The remaining material barriers to entry and growth by retailers in the Victorian energy markets appear to be: ongoing inefficiencies in electricity B2B processes (currently being addressed by NEMMCO); continuing limited access to competitively priced gas supplies for dual fuel offers (although this is a lessening barrier to entry as gas wholesale market accessibility continues to improve); the operation of price equalisation arrangements in NSW and Queensland which reduce the liquidity of Australia's regional hedging markets and limit growth opportunities in the energy markets outside Victoria."</p>	<p>B2B process have now been streamlined and automated through NEMMCO IEC. The interstate distortionary arrangements are being wound back. Gas issues are being further resolved through Gas Market Leaders Group recommendations on Bulletin Board and Short Term Trading Market. ERIG assessments on market liquidity for both gas and electricity found market to be liquid.</p> <p>The number of retailers participating and gaining market share provides evidence of low barriers to entry.</p> <p>The Commission's consultants will assess barrier to entry issues in upstream markets. The Commission's retailer surveys should validate low barriers to entry and participation.</p>
<p><b>Market conduct [Issues Paper 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 16, 17, 18 and 21]</b></p>		
<p>6. Number of customers accepting market offers and/or switching retailers, and whether switches are by first tier or second tier customers</p>	<p>ESCV examined switching rates; 13% for electricity and 12% for gas, and net switching (1<sup>st</sup> v 2<sup>nd</sup> tier), and market v standing offers. ESCV referred to churns in NZ and UK (no price regulation) of 20% over similar FRC period.</p> <p>The ESCV noted that customers who did not achieve significant saving compared to the</p>	<p>In 2006-07 annualised churn rates for electricity and gas is around 25%. Since FRC, 1.4M electricity (60%) and 850K gas customer (53%) churns (ESCV CPR p. 11). To April 2007, there have been 2.0 electricity and 1.3M gas customer churns. Note this churn includes customers who may have changed retailers more than</p>

	<p>standing offer price or whose prices were not cost reflective tended not to switch or accept market offers. It would appear the realisable savings, including any non-price benefits and the opportunity to have both gas and electricity by one retailer, are the key motivations for switching.</p>	<p>once. The retail price paths have to a large extent addressed the issue of savings and cost reflectivity (as supported by the recent rates of churn). AGL is not aware of any direct costs charged to customers when they switch retailers.</p>
<p>7. Market research on customer awareness of competition and choice</p>	<p>9 in 10 electricity and over 8 in 10 gas customers aware of retailer choice – p.49.</p>	<p>Increased marketing activity increases customer awareness of competition and should lead to increase rates of churn or transfers to market contracts. The Commission's customer and retailer surveys/interviews should validate this view.</p>
<p>8. Market research on ease of obtaining, understanding and comparing information</p>	<p>Ease of obtaining and comparing information was cited as an issue for Victorian customers.</p>	<p>Since 2004, the ESC has established a price comparator and established a price disclosure guideline (implemented in 2006). Under the guideline retailers are required to present the information in a manner to enables customers to make comparisons. We expect that the Commission's survey will show that this is not an issue now.</p>
<p>9. Extent and type of marketing activity, extent of offers being sought and made</p>	<p>Residential customers – 83% found greater variety and 60% more innovative offers Business customers – 80% found greater variety and 49% more innovative offers. Retailers used a number of channels to market: "Whilst the ESCV found that door-to-door sales allows retailers to target particular customer segments, another important means of mass marketing to increase</p>	<p>We expect the Commission's retail and customer surveys will validate similar channels with increased activity given the recent customer churn rates.</p>

	<p>awareness of a retailer's presence in the market is through television, radio, print (including internet) and other forms of advertising."</p>	
<p>10. Nature and frequency of customer complaints</p>	<p>ESC examined market conduct complaints from EWOV. AGL believes that this is compliance and enforcement issue rather than a competition issue and not an indicator of effectiveness of competition.</p>	<p>The 2005/06 Ombudsman report provides details on customer complaints. Most common issues identified for energy and water are as follows:</p> <ul style="list-style-type: none"> <li>• 43% Billing — covers all aspects of the billing process, from meter reading, application of tariffs and bill formats through to errors, delays, high bills, and fees and charges;</li> <li>• 18% Credit — to do with bill payment, payment options and plans, collection of arrears, and billing-related disconnection or restriction of supply;</li> <li>• 11% Transfer — the process of transferring from one energy retailer to another, including transfer errors and contract terms &amp; conditions;</li> <li>• 8% Provision — anything to do with a service provider's assets, such as pipes, meters, wires, and pole cabling (may also include customers' assets, such as private electric lines);</li> <li>• 6% Supply — covers planned or unplanned outages, and the quality or reliability of energy or water supply;</li> <li>• 5% Marketing — concerns an energy retailer's sales or advertising activities</li> </ul>
<p>11. Nature of regulatory enforcement investigations</p>	<p>Refer to comments in 10.</p>	

**Market performance [Issues 19, 20 and 21]**

<p>12. Evidence of changes in the retail price of gas and electricity;</p>	<p>ESC undertook margin analysis for standing offers with reference to standing offers and cost benchmarks. Market offers were assessed with reference to standing offer prices, with saving between 5-10% off the standing offer prices noted. ESCV examined the various forms the incentives as well – ie. price and non-price.</p>	<p>Pricing to customers in the Victorian market is generally with reference to the standing offer contracts. AGL will provide some details on savings from our market offers to customers since market start, as part of the retailer survey.</p>
<p>13. Evidence of prices converging to an efficient long term cost of supply</p>	<p>Refer comments on item 12.</p>	<p>Retail prices (standing offers) to date, have been agreed with the government, in accordance with industry benchmarks (for wholesale and retail operating costs in particular) that are publicly available (CRA Reports). The regulated price should therefore be efficient. The market offers are generally with reference to standing offers.</p>
<p>14. Evidence that differentiated and innovative products and services are being offered to the market which meet customer preferences and needs</p>	<p>Residential customers – 83% found greater variety and 60% more innovative offers Business customers – 80% found greater variety and 49% more innovative offers. Also refer to comments on items 12 and 13.</p>	<p>The Commission's retailer and customer surveys should provide evidence on product and service differentiation.</p>