

15 April 2008

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

SA Retail Review – Response to Issues Paper

Thank you for the opportunity to respond to the Commission's Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – Issues Paper.

A detailed submission is attached. In brief, Simply Energy believes that competition in the South Australian electricity market is generally effective, although there are some areas of concern which impact on the level of that competition. On the other hand, there are significant market constraints in the South Australian gas market which require attention.

If you have any questions about this submission, please contact Nick Koutroumanis, Commercial Manager, on (03) 8807 1135.

Yours sincerely



Domenic Capomolla
CEO

Simply Energy's Response to the AEMC's Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – Issues Paper

3.1 Market structure and conditions for entry, expansion and exit

South Australian electricity market

The South Australian electricity market has two barriers that impact on competition:

1. credit support requirements
2. liquidity in the electricity market

The key barrier to entry and expansion in the South Australian electricity market is the cost of credit support. For instance, if a retailer cannot demonstrate that it has a Standard & Poor's credit rating of at least BBB- or its equivalent, or that the performance of its obligations are guaranteed by an entity that does, ETSA's Co-ordination Agreement permits ETSA to request an unconditional undertaking in an amount up to 3 months' estimated distributor charges to be incurred by the retailer during the 3 months following the request. This level of credit support does not reflect the default risk faced by ETSA. A retailer that does not have a BBB- rating will therefore face a higher cost of credit support (in the form of a bank guarantee or a parental guarantee) than a retailer that does. This is perhaps more likely to be the case for a smaller, new entrant retailer.

Credit support is also required by NEMMCO for trades on the spot market. Credit management facilities such as reallocation are not as widely available in South Australia as in the rest of the NEM, disadvantaging those not vertically integrated in SA.

An additional barrier to entry and expansion is the lack of liquidity in the South Australian electricity market. Electricity derivatives in South Australia typically have low levels of liquidity when compared to other regions of the NEM, such as Victoria. As a result, obtaining a hedge against wholesale electricity price risk is harder to achieve for new entrants as compared to retailers who have an established customer base in South Australia or their own generation. This may become a bigger concern if, as is proposed, significant primary industry infrastructure that draws heavily on electricity supply in South Australia is developed in the near future.

On the other hand, there appears to be over-capacity in South Australian generation. In time, this should lead to generators being prepared to offer hedges to new entrants. In this regard, we note that the Flinders assets do not have a strong alignment to South Australian retailers and that International Power remains long in South Australian generation (compared to its retail position), and that both of these assets could therefore be expected to deliver competitive hedges.

South Australian gas market

The South Australian gas retail market has four major issues that impact on the level of competition:

1. Large fixed costs

South Australia operates a contract carriage market model that requires a new entrant retailer or a retailer expanding their South Australian market share to contract with:

- a) gas producers for commodity and plant capacity,
- b) gas pipeline companies for access to capacity on each of the main transmission pipelines, and
- c) Envestra for access to the gas distribution pipeline.

In each case, contracts are typically long term and include minimum payment obligations (such as take-or-pay). The retailer has to incur these significant fixed costs and accept the take or pay risk. A small retailer does not have the retail volumes and market share to recover these costs.

2. Credit support requirements

The cost of credit support in order to meet Envestra's prudential requirements is substantial. Under the Envestra access arrangements, Envestra may request security in the form of a bank guarantee in an amount up to 3 months average charges if the retailer does not meet a Standard & Poor's credit rating of BBB or higher. These prudential requirements impose an additional cost on those retailers that do not have a BBB rating. This is more likely to be the case for smaller, new entrant retailers.

3. Significant risk

Retailers also face the complex swing gas arrangements in the South Australian gas market. Swing gas is a process for accommodating the difference between supply and demand. Swing Gas is a feature of the Retail Market Rules, but has proven to be very illiquid and exposes parties unable to hedge to Swing Provider of Last Resort (a VoLL pricing principle) of \$1600/GJ.

4. Access to retail delivery points

The original constraints to access to capacity along the MAPS pipeline have been reduced in recent years following the expiry of a number of contracts for carriage.

However, obtaining access to delivery points is problematic from a commercial perspective as it requires the new entrant retailer to incur a substantially higher fixed cost than its competitors.

Arrangements may be able to be put in place with other Transporters on the MAP (parties whom have already put in place a contract with EPIC), but they are limited in scope. Accordingly, not all the gas retailers have access to all geographical regions in SA.

3.2 Retailer rivalry

South Australian electricity market

The South Australian electricity market has strong retailer rivalry, in that:

1. there are a number of retailers competing with diversified product offerings and marketing through various sales channels
2. sustained increases in wholesale prices have impacted profitability; however, there are financial products to mitigate this risk, although
3. uncertainty with movements in regulated rates and the impacts of regulatory requirements may hinder competition

The electricity market has a number of retailers competing actively to acquire, maintain, and expand their market presence in South Australia. Retailers offer a range of differentiated and innovative products. Customers can choose to receive green products, discounted products, products bundled with additional services or affiliations, and products that help control electricity usage (such as pre-payment). Simply Energy offers accredited GreenPower electricity, planting a tree as part of a bio-diversity project, discounts for paying on time or by direct debit, and rebates for customer loyalty.

Retailers also use a range of sales channels, including door to door, telesales and online channels as well as alliances. For example, Simply Energy has alliances with the Port Power Football Club and the Royal Automobile Association of South Australia.

Although there is diversity among existing products, retailers have typically referenced their product offerings to the standing offer tariffs (for example, as a discount to the regulated rate). The existence

of a standing offer tariff encourages a degree of uniformity among market offers (and therefore inhibits innovation) which would not necessarily be the case in the absence of price regulation.

In addition, the existence of certain minimum customer service obligation imposes uniformity among product offerings. Taking customer response times as an example (retailers must make best endeavours to answer telephone calls within 30 seconds), the costs of meeting this obligation are built into the price offered to a customer. It should be noted that customer response times are not the only way – nor are they necessarily the best way – to measure customer service standards. However, this obligation means there is reduced scope for a retailer to differentiate itself on the basis of service standards or price.

The wholesale price of energy is a significant cost for retailers. Exposure to fluctuations in wholesale electricity prices can therefore have a significant impact on the profitability of market offerings. However, hedges and other financial products allow retailers to manage and mitigate exposure to wholesale price fluctuations.

The current regulated price path has been set at a level that allows investment in the South Australian electricity retail market with the expectation of profitability over the longer term. However, the recent proliferation of environmental initiatives may squeeze retail margins unless increases in the regulated rates are allowed. Proposed changes in MRET and GreenPower, and the introduction of the Residential Energy Efficiency Scheme, will increase the costs for energy retailers. Cost increases are expected to occur not only in complying with the new obligations, but also in increased administration, reporting, and auditing. Further, uncertainty on the amount of these costs and how (or if) they will be incorporated in any regulated price path may deter investment and competition.

South Australian gas market

Retailer rivalry in the South Australian market is not as strong as in the electricity market. The number of retailers actively participating in the gas market is smaller. For the most part, gas market competition is driven by activity in the electricity market – that is, gas is generally sold as an add-on to an electricity product. This is the case for Simply Energy, which does not offer gas as a stand-alone product.

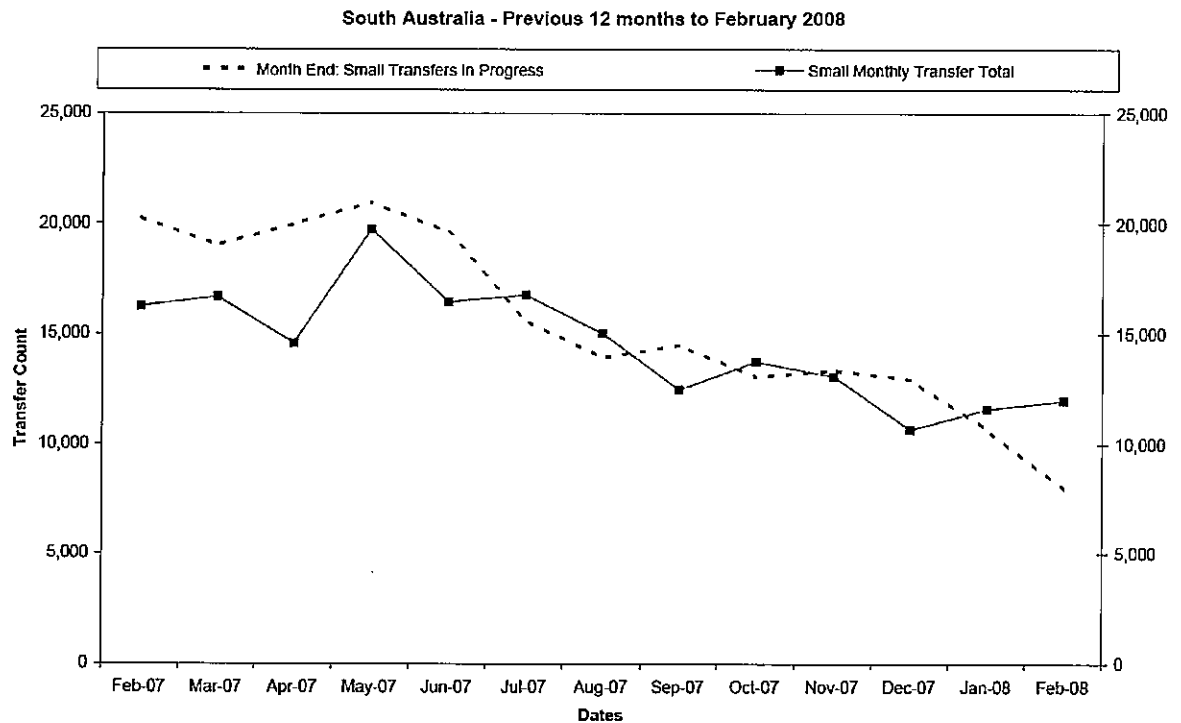
In addition, not all retailers in the gas market participate in all geographical regions. Simply Energy only has a presence in Adelaide, but not in the northern regions of the State.

3.3 Customer participation and experience

South Australian electricity market

Strong customer participation in the South Australian electricity market was evidenced in the 2006/07 Annual Performance Report published by ESCOSA, which shows that, as at 30 June 2007, 61% of small electricity customers were on market contracts. The percentage of monthly transfers in the South Australian electricity market (24% annualised for the 2006-07 year) is equivalent to that in Victoria (26% annualised for the 2006-07 year) and considerably higher than in NSW.

Having said this, it is worth noting the important role that second-tier retailers play in maintaining this level of market activity. As an example, when Simply Energy suspended its marketing activity during the period June 2007 to February 2008 (a result of increased wholesale prices), there was a noticeable reduction in market activity in the State. The NEMMCO chart on MSATS transfers below details the reduction in market transfers that occurred when Simply Energy suspended marketing. From June 2007 to February 2008 there was a 20% reduction in transfers and the total number of transfers in progress reduced by over 50%. The reduction in transfers after June 2007 is approximately equivalent to the marketing activity that Simply Energy was generating prior to suspending sales. It can therefore be assumed that a large portion of competition in the South Australian market was being driven by Simply Energy.



South Australian gas market

As with the electricity market, there has been strong customer participation in the South Australian gas market, although the rates of transfer are lower than they are for electricity, and lower than the transfer rates for the Victorian gas market. ESCOSA's 2006/07 Annual Performance Report shows that, as at 30 June 2007, 56% of small gas customers were on market contracts. The rate of transfers between South Australian gas retailers was 1.5% per month, or 19% annualised for the 2006/07 year. REMCo's Market Activity Report dated March 2008 shows that the monthly figure has reduced to less than 1% in March 2008.

As mentioned above in respect of gas wholesale market structure issues, retailers that currently participate in the gas retail market do not compete in all regions of South Australia. The result is that customers in different areas of the State have differing opportunities to transfer between retailers.