A South Australia's Electricity and Gas Industries

Both the electricity and gas industries in South Australia have undergone a range of significant reforms over the last fifteen years, commencing with the vertical disaggregation of the electricity and gas supply chains in the mid-1990s and culminating with the introduction of FRC for customers of all sizes during 2003-04. In the wake of FRC, gas and electricity retailing in South Australia has moved from a single host retailer model to a multiple retailer model. The remainder of this appendix provides both an historic perspective on the reforms that were undertaken in advance of the introduction of FRC and an overview of the current structure of energy retailing.

A.1. Progression to FRC

A.1.1. Electricity industry progression to FRC

Between 1946 and 1995, the Electricity Trust of South Australia (ETSA) was responsible for all aspects of the electricity supply chain in South Australia including the generation, transmission, distribution and retail sale of electricity. On 1 July 1995, the Electricity Trust of South Australia was corporatised and became ETSA Corporation under the *Public Corporations Act 1993*.

In January 1997 the South Australian Government undertook the first steps towards vertical disaggregation, transferring ETSA's generation assets to SA Generation Corporation.

The second step toward vertical disaggregation occurred in October 1998 when the South Australian Government announced that, in order to meet its commitments under the Competition Principles Agreement and in preparation for entry into the NEM, ETSA Corporation and SA Generation Corporation would need to be further disaggregated. SA Generation Corporation was disaggregated and its assets allocated to the following entities:

- Flinders Power Pty Ltd, which took over the operation of the Northern and Thomas Playford power stations in Port Augusta (also including the Leigh Creek coal supplies);
- Optima Energy Pty Ltd, which took over the operation of the Torrens Island Power Station; and
- Synergen Pty Ltd, which took over the operation of the gas peaking units located at Dry Creek, Mintaro, Snuggery and Port Lincoln; and
- Terra Gas Trader Pty Ltd, which had the main focus of arranging the supply of gas to the South Australian generators.

In 2000, these assets were leased under a 100 year lease to the private sector. The Flinders Power assets (including the contracts for the Osborne Power Station) are now operated by Babcock and Brown Power, while AGL operates and maintains the

Torrens Island Power Station and International Power operates and maintains the Synergen assets under similar arrangements. In the period following the Government's structural reform of electricity generation, a number of significant new facilities were constructed by the private sector, including the Quarantine Power Station (owned and operated by Origin), the Hallett Power Station (owned and operated by TRUenergy), the Pelican Point Power Station (owned and operated by International Power), and the Ladbroke Grove Power Station (owned and operated by Origin). Significant investment in wind powered generation has also occurred.

Terra Gas Trader Pty Ltd was sold in October 2000 to Tarong Gas Trader Pty Ltd.

The disaggregation of ETSA resulted in the establishment of a separate transmission business, ElectraNet SA Pty Ltd, and a "stapled" distribution and retailing business (ETSA Utilities Pty Ltd and ETSA Power Pty Ltd). The electricity transmission and distribution services were leased under a 200 year lease to the private sector. The South Australian Government leased ETSA Utilities and sold ETSA Power to CKI/HKI[76] in December 1999. CKI/HKI's interest in the host electricity retailer, ETSA Power, was on-sold to AGL in January 2000.

ElectraNet SA was leased in September 2000 to a consortium of companies including Macquarie Bank Limited, Powerlink and ABB.

Another important development that occurred in the South Australian electricity industry in the lead up to FRC was the construction of the Murraylink interconnector which commenced operation in 2002. Following the construction of this interconnector, South Australia was serviced by both the Murraylink interconnector and the Heywood inteconnector.

A.1.2. Gas industry progression to FRC

The progression of gas retailing toward FRC also involved the divestment of the South Australian Government's upstream production, transmission, distribution and retail interests. This divestment commenced in 1993 with the sale of the South Australian Government's upstream, distribution and retail business, SAGASCO, to Boral. Boral later combined SAGASCO's distribution business with similar businesses in other jurisdictions and formed Envestra which was floated on the Australian Stock Exchange (ASX) in 1997. Envestra currently owns and operates the distribution systems in Adelaide, Mt Gambier, Whyalla, Port Pirie, the Barossa Valley, Riverland, Murray Bridge and Peterborough.

The remainder of the SAGASCO energy business, including the upstream production interests and the host retail interests, was transferred to Origin. Origin

[76] CKI/HKI consists of CKI Utilities Development Limited (ABN 65 090 718 880), HEI Utilities Development Limited (ABN 82 090 718 951), CKI Utilities Holdings Limited (ABN 54 091 142 380), HEI Utilities Holdings Limited (ABN 50 091 142 362) and CKI/HEI Utilities Distribution Limited (ABN 19 091 143 038).

was demerged from Boral Limited and separately listed on the ASX in February 2000.

In the mid 1990s, Tennco Gas Australia acquired the assets of the Pipeline Authority of South Australia which included both the MAPS and the South East Pipeline. EPIC Energy Pty Ltd acquired the pipeline assets when it was created in December 1996 as the successor to Tennco Gas Australia. EPIC Energy later sold its interests to a consortium of buyers including Allgas Energy, AMP Investments and Hastings Funds Management. In June 2004 Hastings Funds Management purchased the outstanding interests of the other members of the consortium, but retained the name of EPIC Energy.

In 2002 International Power, TRUenergy and Origin[77] agreed to develop the South East Australian Gas Pipeline (SEAGas Pipeline) to link the Otway Basin with the Torrens Island Power Plant, Pelican Point and Adelaide. Construction of the SEAGas Pipeline was completed in 2004. The construction of this pipeline paved the way for gas to be supplied to Adelaide from either the Cooper Basin or the Otway Basin and provided an additional source of gas to regional customers located in the Mt Gambier region when Origin completed the construction of the SESA Pipeline.

To facilitate the advent of FRC, the Retail Energy Market Company (REMCo) was formed to act as the independent retail market administrator in South Australian and Western Australia. As the market administrator, REMCo was accorded responsibility for, amongst other things, managing customer transfers, balancing gas nominations and withdrawals across retailers and pipelines, operating the swing service and administering the Retail Market Rules.

A.2. FRC

Competition has been introduced progressively into electricity and gas retailing in South Australia since 1998. Commencing with the large commercial and industrial customer segment, retail competition was gradually expanded to encompass all customers segments of electricity and gas retailing. From 1 January 2003 all electricity customers were able to select their retailer and from 28 July 2004 all gas customers were able to select their retailer. The timeframe for the phased introduction of retail competition is summarised in Table A.1 below.

[77] In 2007, Origin sold its interest in the SEAGas Pipeline to the Australian Pipeline Trust.

Table A.1 Timeline for the introduction of FRC in South Australia

Electricity		Gas	
Consumption	Contestability Dates	Consumption	Contestability Dates
≥ 4GWh	20 December 1998	≥ 100 TJ	1 April 1998
≥ 750 MWh	1 July 1999	≥ 10 but ≤ 100 TJ	1 July 1999
≥ 160 MWh	1 January 2000	Industrial and commercial customers ≤ 10TJ	1 July 2000
All customers	1 January 2003	All customers	1 July 2001 – but systems not in place to handle mass transfers until 28 July 2004

Data source: ESCOSA

A.3. Current structure of energy retailing in South Australia

A.3.1. Electricity

A.3.1.1. Background

As at 31 December 2007, there were 681,672 residential customers and 86,250 small business customers being supplied with electricity.[78]

A.3.1.2. Retail participants

A small customer, i.e. a customer consuming less than 160MWh per annum, can be supplied by one of a number of licensed electricity retailers. As at 4 March 2008, ESCOSA had issued 26 electricity retail licences. Of the 26 retail licences, four have been issued to subsidiaries of the same corporate brand[79], nine have chosen not to retail energy to this customer class[80] and three are licensed to retail electricity but have not yet launched their retail operations.[81] Taking into account these factors, there are ten retail electricity businesses currently selling electricity to small customers. However, the Retailer Survey indicates that only four of these retailers are currently actively marketing to small customers. Table A.2 below identifies those retailers that are currently supplying small electricity customers. A more detailed overview of each retailer is set out in section A.3.3.

78 Data provided to ESCOSA in response to Energy Industry Guideline No 2.

79 For example, AGL Sales (Queensland Electricity) Pty Ltd, Powerdirect and AGL South Australia Pty Ltd, International Power (Retail) Pty Ltd and Simply Energy, TRUenergy Pty Ltd and TRUenergy.

80 For example, BHP Billiton Olympic Dam Corporation, Cowell Electric Supply Pty Ltd, Dalfoam Pty Ltd, District Council of Coober Pedy, Flinders Power Holdings, Jeril Enterprises Pty Ltd, Municipal Council of Roxby Downs, OneSteel Manufacturing Pty Ltd and ERM Power & Retail.

81 EnergyAustralia, Australian Power & Gas, and Dodo Power & Gas.

Table A.2 South Australian licensed electricity retailers selling to small customers

Licensed electricity retailer	Currently selling to small electricity customers
AGL Energy (host retailer)	✓
Aurora Energy	✓
Australian Power & Gas	✗
Country Energy	✓
Dodo Power & Gas	✗
EnergyAustralia	✗
Jackgreen (International)	✓
Momentum Energy	✓
Origin	✓
Red Energy	✓
Simply Energy[82]	✓
South Australia Electricity	✓
TRUenergy	✓

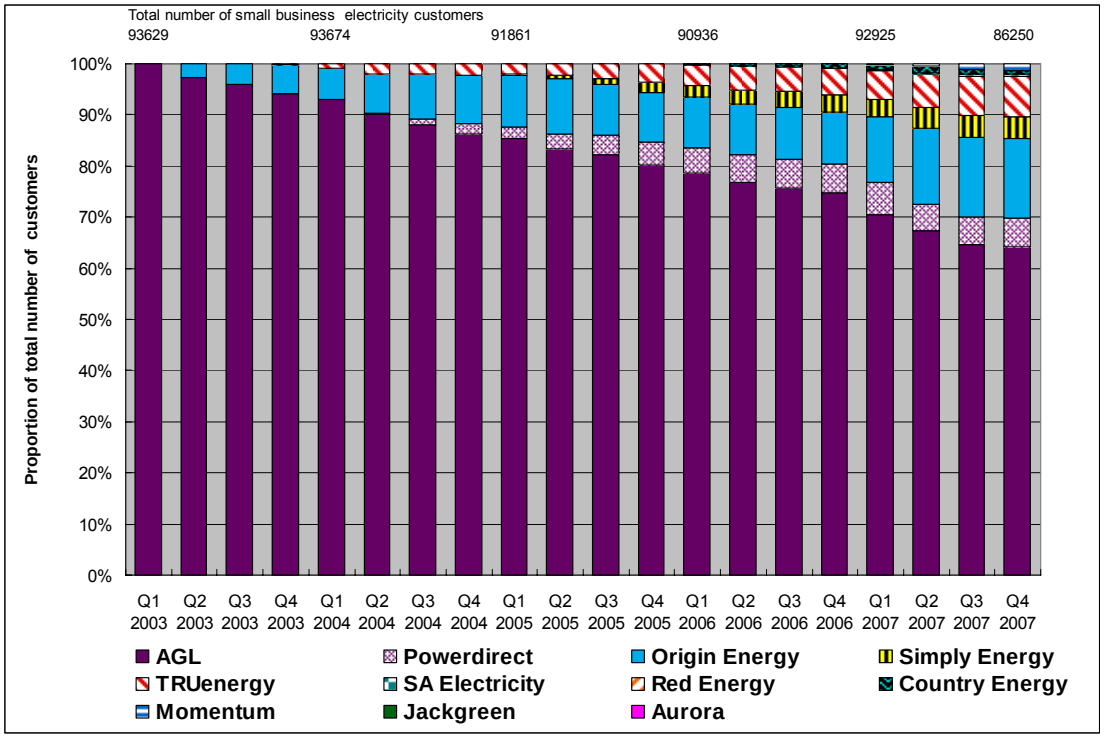
Data source: ESCOSA and Retailer Survey Report.

A.3.1.3. Customer shares

Figures A.1 and A.2 below illustrate the relative changes since FRC commenced in January 2003 in the customer shares of the retailers who currently sell electricity to small customers in South Australia. In this context, customer share is measured by the number of customer connections in South Australia and has been separately measured for both the residential and small business segments.

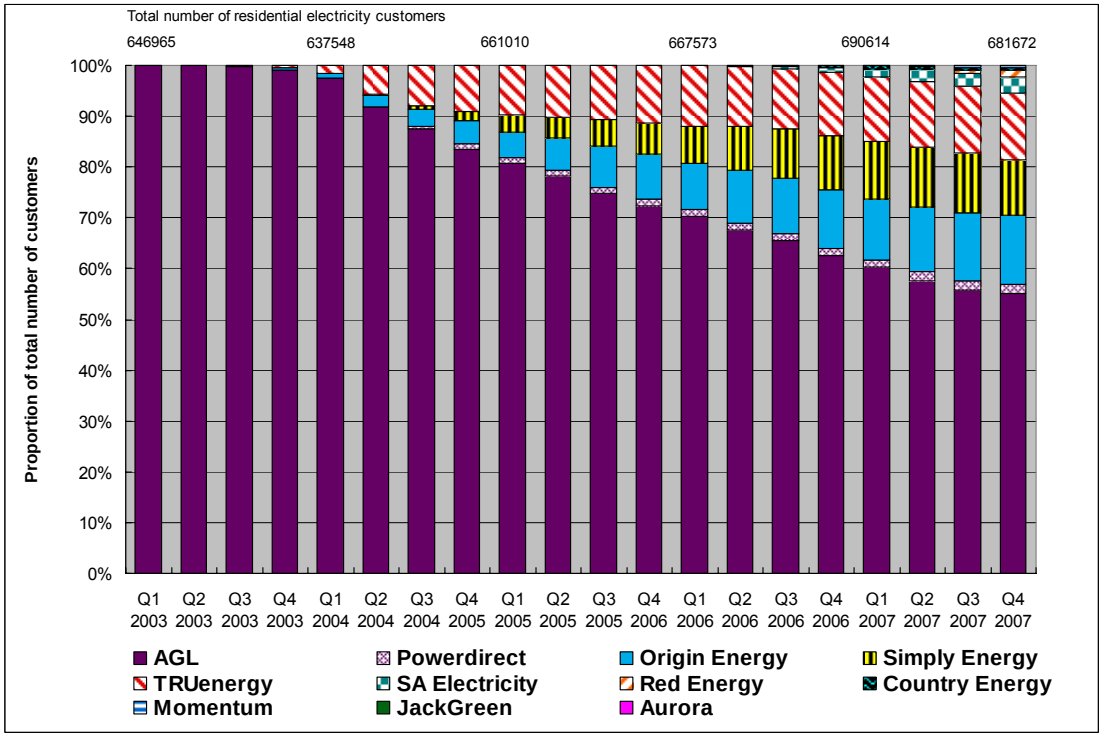
82 The licence is held by a partnership comprising IPower Pty Ltd and IPower 2 Pty Ltd and trading under the name Simply Energy.

Figure A.1 Customers shares: small business electricity customers



Data source: ESCOSA data reported under Guideline No 2.

Figure A.2 Customer shares: residential electricity customers



Data source: ESCOSA data reported under Guideline No 2.

Reviewing these charts and, in particular, the customer share estimates at the end of the fourth quarter in 2007, a number of observations can be made:

- first, while the new retailers have been successful in attracting customers, AGL continues to supply the greatest proportion of the small business (70 per cent) and residential (57 per cent) segments;

- secondly, the customer share gains by the new retailers has been greater in the residential segment than in the small business segment;

- thirdly, AGL's closest rivals in the residential and small business segments include Origin, TRUenergy and Simply Energy all of which are vertically integrated dual fuel retailers (accounting for 13.8 per cent, 13.1 per cent and 10.7 per cent respectively in the residential segment and 15.7 per cent, 7.8 per cent and 4.2 per cent respectively in the small business segment). The remaining retailers are stand alone retailers and account for 5.5 per cent of the residential segment and 2.6 per cent of the small business segment;

- fourthly, the three firm concentration ratio in the residential segments has declined steadily since the inception of FRC from 100 per cent to 84 per cent while the four firm concentration ratio has fallen to 94 per cent; [83] and

- finally, the three and four firm concentration ratios in the small business segments have declined at a slower rate than in the residential segment such that the three firm ratio had only fallen to 94 per cent while the four firm ratio had fallen to 97 per cent.

Although AGL's retail share is substantially higher than those of its closest rivals, it has fallen significantly in a relatively short space of time. A large proportion of its customer base remains on standing contracts. If the influence of this factor is removed and the retail share is calculated on the basis of market contracts only then the position changes substantially. This analysis is contained in Figure A.3 and Figure A.4, both of which demonstrate that new entrants account for a greater proportion of market contracts than AGL in both the small business and residential segments.

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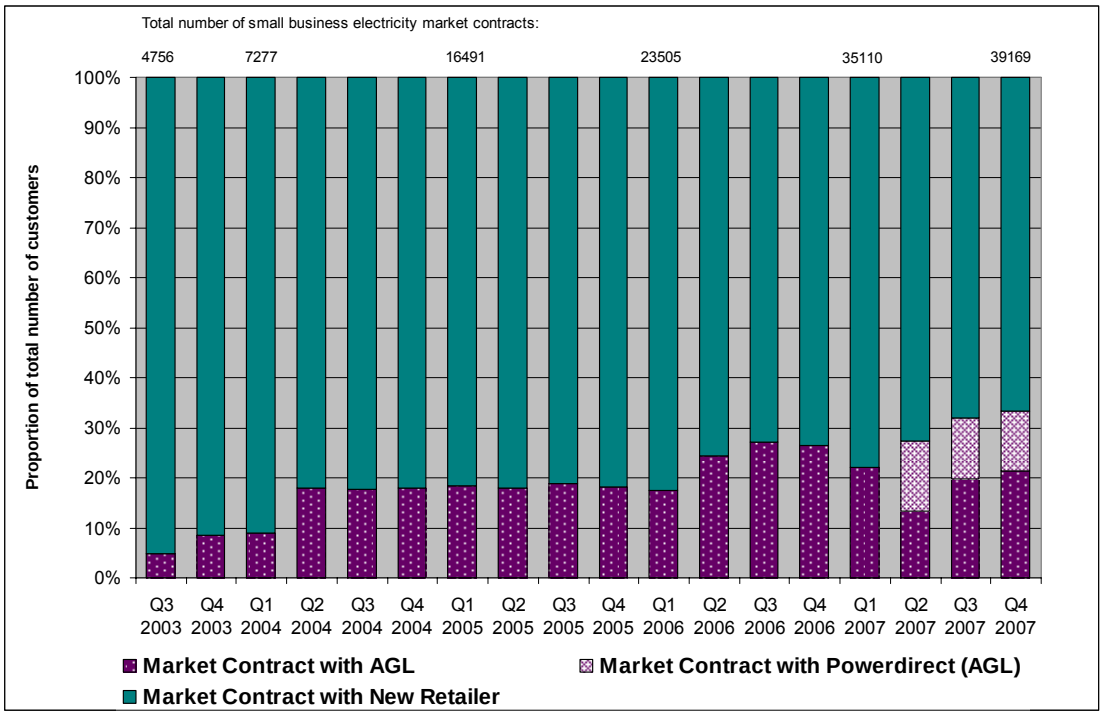
83 The application of the Herfindahl-Hirschman Index indicates similar changes in concentration. While the four firm concentration ratio and the Herfindahl-Hirschman Index may be useful first indicators of the structure of the sector, they must be considered in light of other factors. As the Trade Practices Tribunal noted in *Re Queensland Co-operative Milling Association; Re Defiance Holdings Ltd* (1976) 25 FLR 169 at 189:

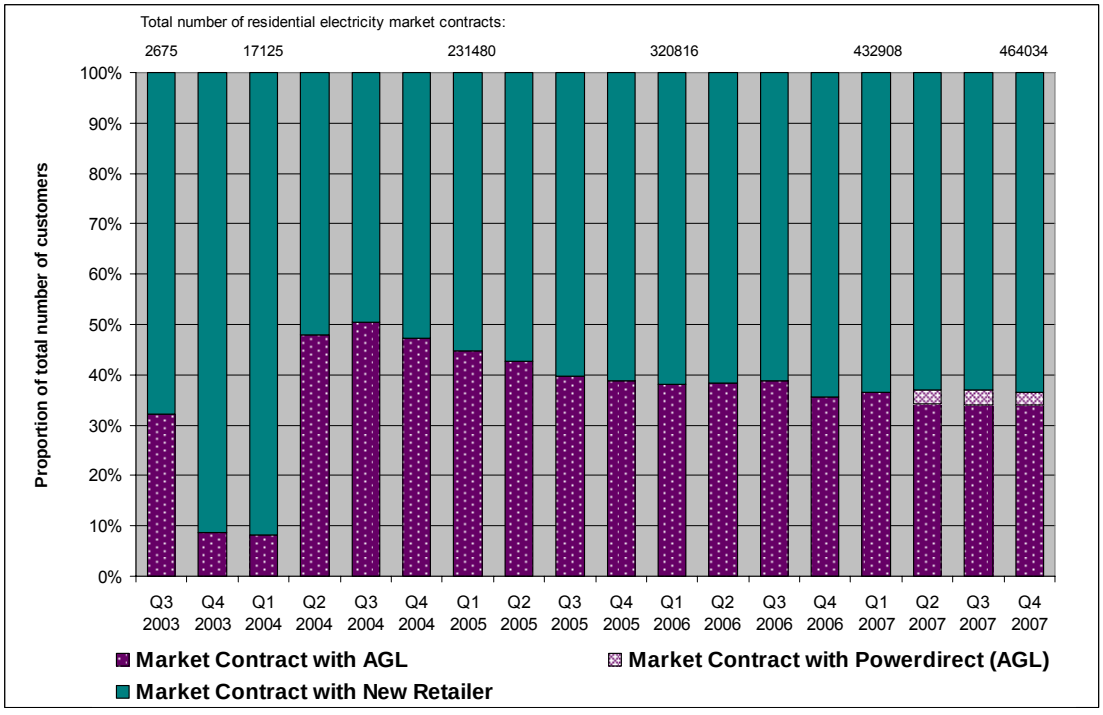
> "significantly lower market concentration is preferable to a high level. But other things are rarely likely equal… Moreover the very significance of the change in the concentration ratio will depend upon other competitive characteristics of the industry."

Figure A.3 Customer shares: small business electricity customers on market contracts



Data source: ESCOSA data reported under Guideline No 2

Figure A.4 Customers shares: residential electricity customers on market contracts



Data source: ESCOSA data reported under Guideline No 2

A.3.1.4. Current industry structure

All wholesale electricity is purchased through the spot market operated by NEMMCO.[84] Any person who is registered with NEMMCO as a market customer is entitled to buy electricity on the spot market. The price at which electricity is bought and sold varies on a half hourly basis and can range from –$999 to a maximum of $10,000 per MWh. The potential for such extreme variations exposes retailers to two main categories of risk:

- price risk, which results from the volatility of the spot price; and
- financial risk due to volume uncertainty, which arises when the customer load exceeds the retailer's contracted load and the retailer is forced to buy on the spot market at prevailing spot prices.

The central function of an Australian electricity retailer is to act as an intermediary between the electricity generator and the end use customer which, because of fluctuations in the wholesale price of electricity compared to committed retail prices, can expose the retailer to price risk. Accordingly, retailers enter into forward contracts and a range of derivative instruments to hedge their exposure. In this sense, retailers provide risk management services to end use customers that enable retailers to offer longer term retail contracts at specified prices and limit customers' exposure to price fluctuations in the wholesale market. The costs incurred by retailers include the cost and risk of providing these risk management services and must be recovered in retail prices. The most common strategy to manage risk is to enter into financial contracts with generators to lock in the future price of electricity that will be supplied by a generator or purchased by a retailer.[85] These contracts are known as derivatives and include swaps, options, caps and futures.

In addition to being supplied by generators located in South Australia, the electricity needs of South Australia are also met by imports from Victoria. Over 2005/06 imported electricity accounted for 20 per cent of South Australia's electricity consumption.[86] Electricity imports are supplied via the two interconnectors, Heywood and Murraylink. South Australia's reliance on imports means that any change in the ability to import electricity into South Australia may give rise to deviations in the price of electricity prevailing in South Australia and those prevailing in other regions of the NEM. Given the potential for deviations in prices, retailers operating in South Australia tend to hedge a large proportion of their South Australian load exposure using South Australian based risk management products.

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84 The National Electricity Market Management Company (NEMMCO) fulfils the dual roles of market operator and system operator for the NEM. This means that NEMMCO is responsible for managing both the wholesale spot market in electricity and the transmission elements of the physical power system that underpins the operation of the NEM.

85 NEMMCO, *Australia's National Electricity Market: Trading Arrangements in the NEM*, 2004, p. 25.

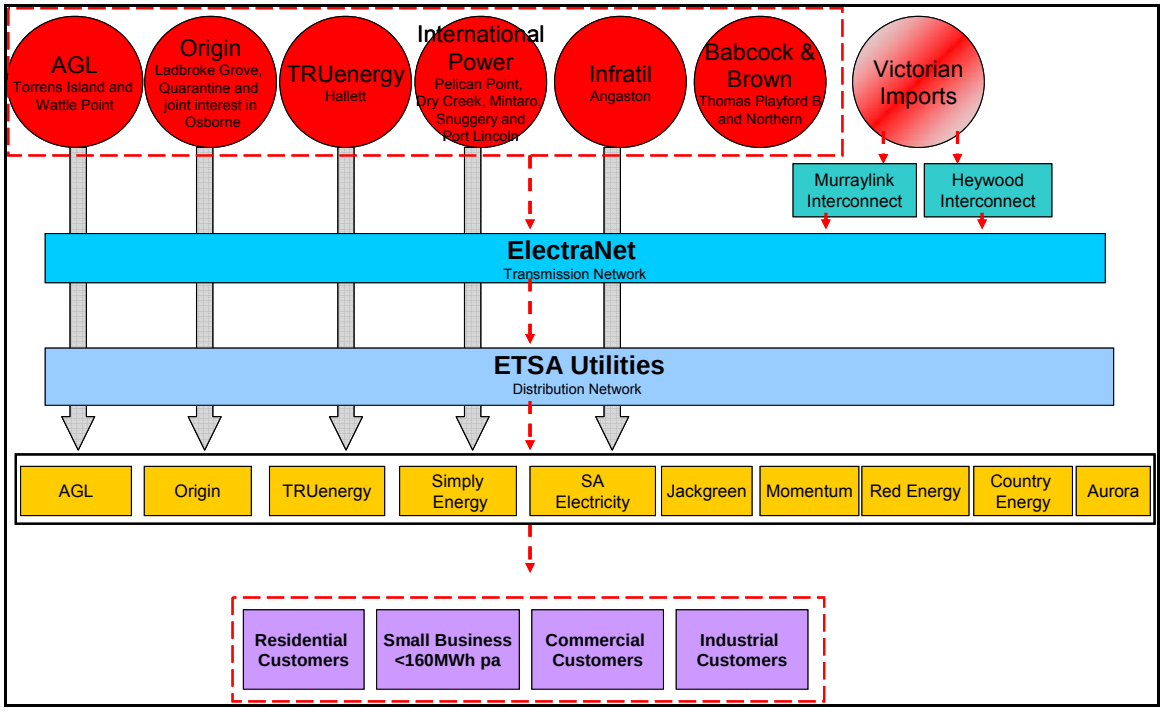
86 Core Collaborative, *Australian Electricity Market Study 2020 Outlook*, 2007, p. 7-7.

The diagram below provides an overview of the current structure of the electricity industry in South Australia and illustrates the vertical relationships that exist between generators and retailers.

The extent of vertical integration in the South Australian electricity industry and across the NEM more generally, was an issue raised by retailers in the Retailer Survey. Within this context the surveyed retailers observed that while there was a trend toward large vertically integrated companies, there would still be room for standalone retailers within the industry. It was acknowledged that larger standalone retailers may find it difficult to obtain the volume of forward contracts required.

Further information about electricity generation and gas production assets affiliated with South Australian retail businesses is contained in the report prepared by NERA, on behalf of the Commission, *Wholesale Electricity Market in Australia*.

Figure A.5 Structure of the South Australian electricity industry



A.3.2. Gas retailing

A.3.2.1. Background

Over 2007, 364,910 residential customers consumed approximately 7.5 PJ of gas while 7,535 small business customers consumed approximately 1.3 PJ of gas. While the Commission has been unable to obtain a breakdown of customer numbers and

consumption across locations, information contained in the Annual Report of the Office of the Technical Regulator indicates that approximately:[87]

- 95 per cent of the customers are located in Adelaide;
- 1.9 per cent are located in Mount Gambier
- 1.5 per cent are located in Port Pirie;
- 1 per cent are located in Whyalla;
- 0.06 per cent are located in Murray Bridge;
- 0.07 per cent are located in the Riverland area; and
- 0.01 per cent are located in Peterborough.

Within Adelaide small gas customers can be supplied by any retailer, although constraints on the Envestra distribution network have meant that some retailers obtaining gas from the Otway Basin in Victoria and transporting that gas into Adelaide via the SEAGas Pipeline city gates have had difficulty servicing large customers in the northern suburbs of Adelaide. Currently, only the host retailer, Origin, supplies and sells gas to small customers located in the Mount Gambier, Port Pirie, Whyalla, Murray Bridge and Riverland regions.

A.3.2.2. Retail participants

As at 19 May 2008, ESCOSA had issued 11 gas retail licences.[88] One of these licences was issued to Santos Direct, which retails to large and industrial customers that consume more than 300 TJ per annum, leaving 10 businesses that are licensed to supply and sell gas to customers consuming less than 1 TJ per annum (i.e. small customers). Only four of the ten businesses that have obtained a gas retail licence are currently retailing gas to customers and, according to information obtained by the Commission during its Retailer Survey, only three are actively marketing gas to new customers at this time.[89] Table A.3 below identifies the businesses that supply and sell gas to customers consuming less than 1 TJ per annum. A more detailed overview of each retailer is set out in section A.3.3.

87 Office of the Technical Regulator South Australia, *Annual Report of the Technical Regulator 2006-07: Gas*, p. 7.

88 ESCOSA, *Licensed Retail Entities*, 19 May 2008.

89 LECG, *Retailer Survey Report*, p. 5.

Table A.3 South Australian licensed gas retailers supplying and selling to small customers

Retail business	Currently Supplying and Selling to Customers
AGL Energy	✓
Australian Power & Gas	✗
Country Energy	✗
Dodo Power & Gas	✗
Energy Australia	✗
Jackgreen (International)	✗
Momentum Energy	✗
Origin (host retailer)	✓
Simply Energy[90]	✓
South Australia Electricity	✗
TRUenergy	✓

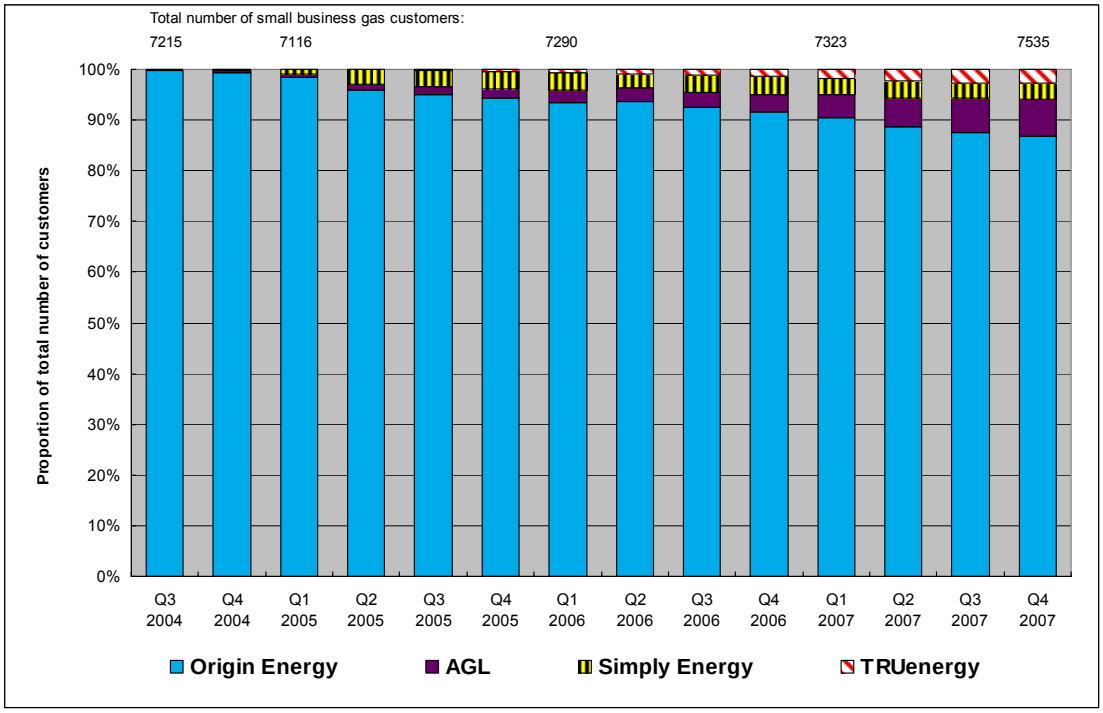
Data source: ESCOSA and Retailer Survey Report.

A.3.2.3. Customer shares

Figure A.6 and Figure A.7 below illustrate the relative changes since FRC commenced in July 2004 in the customer shares of the retailers who currently supply and selling gas to small customers in South Australia. In this context, customer share is measured by the number of customer connections in South Australia and has been separately measured for both the residential and small business segments. The customer shares reported in Figure A.6 and Figure A.7 are based on customers throughout South Australia and therefore include the small gas customers located in Mount Gambier, Port Pirie, Whyalla, Murray Bridge, and Riverland where Origin is the sole retailer.

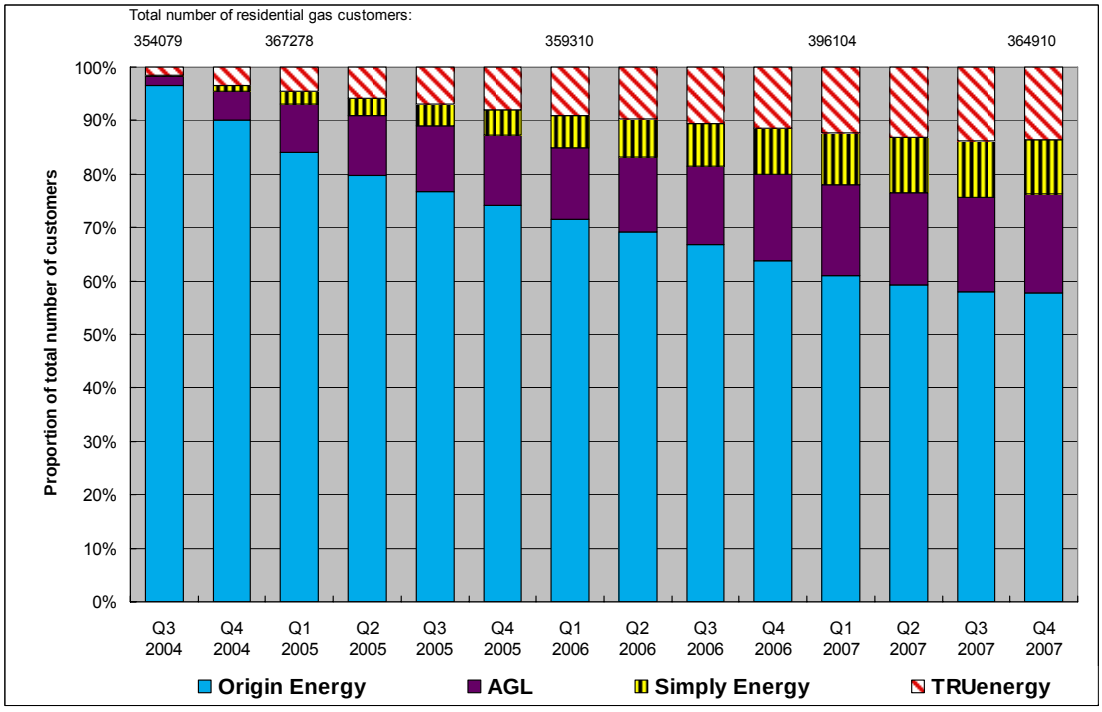
90 The licence is held by a partnership comprising IPower Pty Ltd and IPower 2 Pty Ltd and trading under the name Simply Energy.

Figure A.6 Customer shares: small business gas customers



Data source: ESCOSA data reported under Guideline No 2

Figure A.7 Customer shares: residential gas customers



Data source: ESCOSA data reported under Guideline No 2

Reviewing these figures, particularly the customer share estimates at the end of the fourth quarter in 2007, a number of observations can be made:

- first, while the three new retailers have encroached on the customer share held by the host retailer, Origin continues to supply the greatest proportion of the small business segment (86.85 per cent) and residential (57.75 per cent) segment;

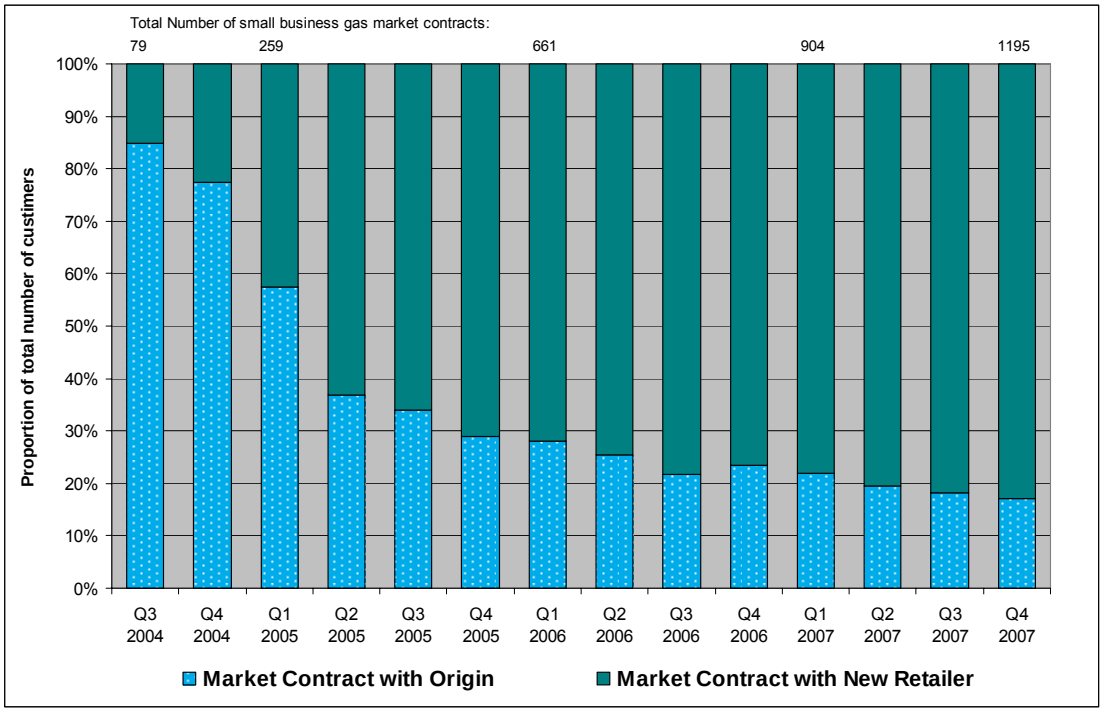
- secondly, the gains made by the three new retailers have been greater in the residential segment than in the small business segment;

- thirdly, AGL is the second largest retailer of gas in the residential segment followed by TRUenergy and Simply Energy (accounting for 18.65 per cent, 13.65 per cent and 9.96 per cent respectively). The three firm concentration ratio at the end of the fourth quarter of 2007 was 90 per cent; and

- finally, TRUenergy is the second largest retailer of gas in the small business segment followed by AGL and Simply Energy (accounting for 7.22 per cent, 3.12 per cent and 2.81 per cent respectively). The three firm concentration ratio at the end of the fourth quarter of 2007 for this segment was 97 per cent.

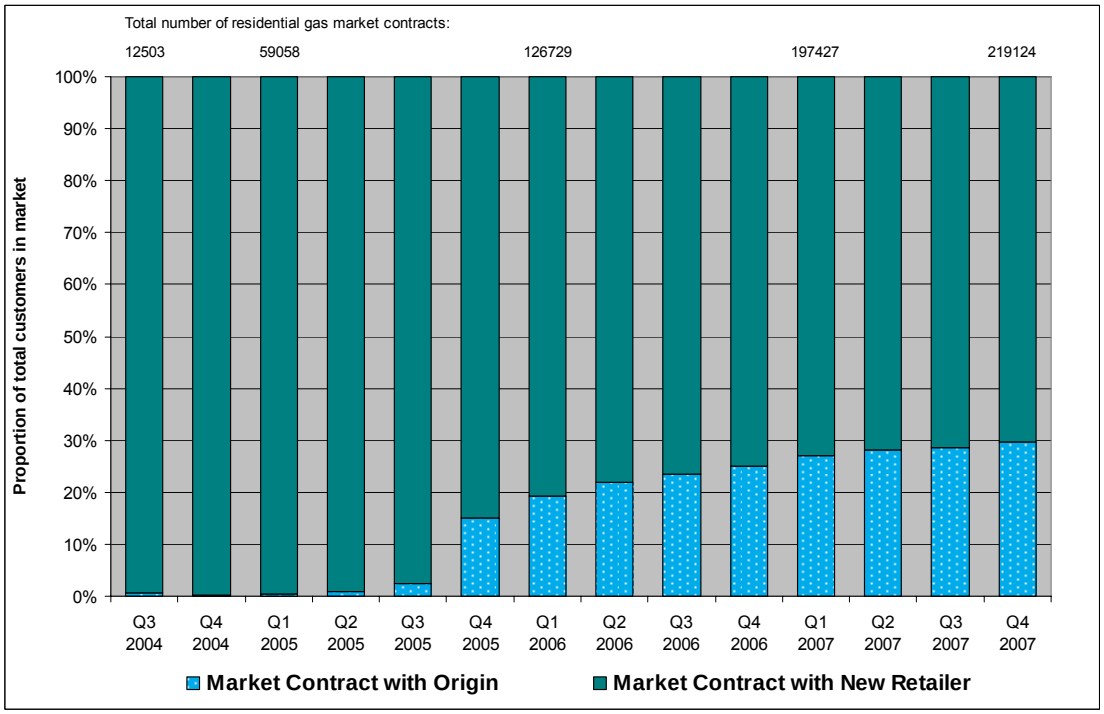
While Origin's share of small gas customers is substantially higher than those of its closest competitors, a large proportion of Origin's customer base remains on standing contracts. If this influence is removed and the number of customers on market contracts is compared, then the position changes substantially. For instance, in the small business segment Origin accounts for just 17 per cent of market contracts, while in the residential segment it accounts for less than 30 per cent of the market contracts.

Figure A.8 Customer shares: small business gas customers on market contracts



Data source: ESCOSA data reported under Guideline No 2

Figure A.9 Customer shares: residential gas customers on market contracts



Data source: ESCOSA data reported under Guideline No 2

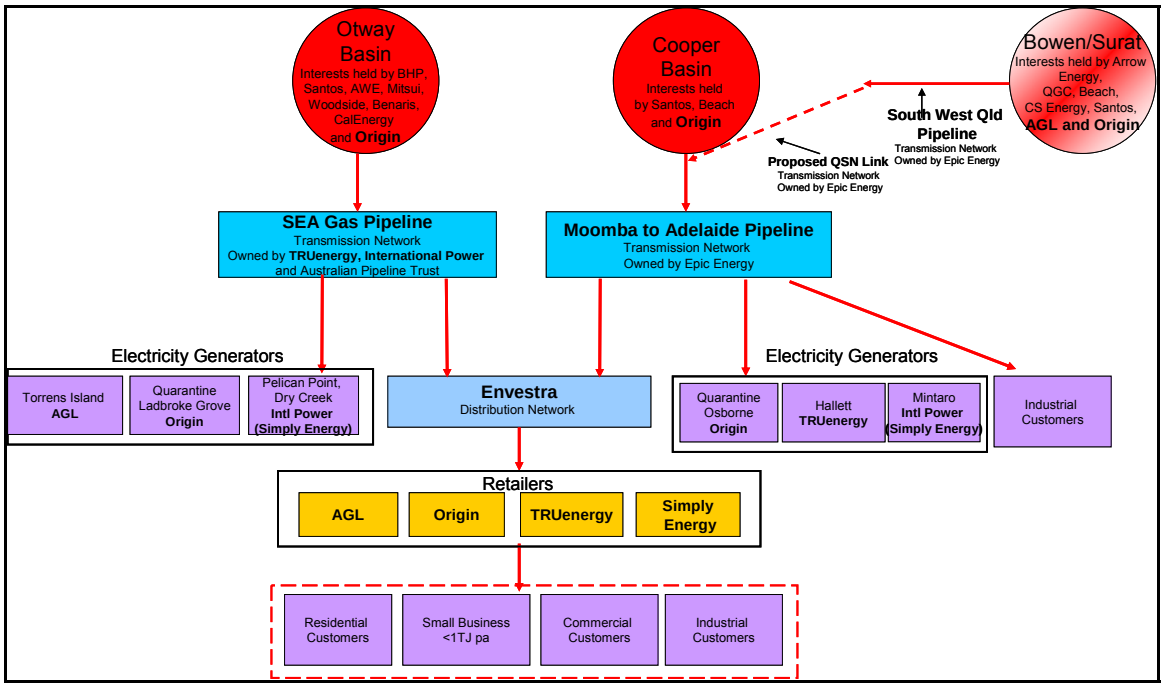
A.3.2.4. Current structure of the gas industry in South Australia

A retailer seeking to operate in South Australia will generally be required to enter into a long term contract with one producer which specifies the gas quantities it will purchase in each year over the term of the contract and establishes the minimum quantities that must be taken or paid for in each year. In effect, the "take or pay" provisions operate as a minimum bill which must be met by a retailer even if actual demand is below the take or pay quantities. Viewed in this way the minimum bill operates as a fixed cost for retailers. In addition to paying the wholesale price for gas, a retailer will incur negotiation and contracting costs at both the commencement of the contract and at each price reset. A retailer will also need to enter into a transportation agreement for firm transmission services. The agreement specifies the amount of capacity that is reserved on the pipeline to transport the retailer's gas and the locations to which gas will be delivered. Since transportation charges are predominantly capacity based, the transportation costs incurred by a retailer operating in South Australia will be fixed. A retailer will also be required to enter into transportation agreements with the owners of gas distribution networks for the transportation of gas from the city gate of the transmission pipeline to individual end use customers. Since distribution charges are predominantly capacity based, the distribution costs incurred by retailers will be largely fixed in nature.

Until 2004 the only source of gas for retailers operating in South Australia was the Cooper/Eromanga Basin. Gas from this basin is transported to Adelaide via MAPS. Following the construction of the SEAGas Pipeline, retailers can now source gas from Victoria, although this option may be limited somewhat by the haulage capacity constraints that exist on this pipeline.

The diagram below provides an overview of the current structure of the gas industry in South Australia and identifies the retailers currently selling and supplying gas to customers. Further information about the gas industry within South Australia is contained in the report prepared by NERA, on behalf of the Commission, entitled *Gas Supply Chain in Eastern Australia*.

Figure A.10 Structure of South Australian gas industry



As Figure A.10 illustrates, both Origin and AGL have equity interests in upstream gas production while International Power and TRUenergy have an equity interest in the SEAGas Pipeline. Another important factor to recognise is that the four retailers that currently have a gas customer base in South Australia also have interests in both electricity retailing and gas-fired power generation assets in South Australia. Given the fixed and sunk costs associated with acquiring gas supply and transportation agreements, these interests in electricity generation, plus their industrial and commercial gas customer base, can provide a broader base from which to market gas to small customers.

The importance of marketing gas on a dual fuel basis was also noted in the Retailer Survey.[91] Specifically, it was noted by new entrants and prospective entrant retailers that they would not consider retailing gas to small customers as a standalone business because the margins available in this area and the volumes of sales that could be made were too low.

A.3.3. Overview of electricity and gas retailers

The remainder of this appendix provides an overview of the host retailers and second tier retailers operating in South Australia.

91 LECG, *Retailer Survey Report*, p. 32.

A.3.3.1. Host retailers

A.3.3.1.1. AGL Energy

AGL Energy (AGL) was formed in October 2006, as a result of a merger of AGL's infrastructure assets with Alinta and the subsequent separation of AGL Energy. AGL is listed on the ASX.

AGL South Australia Pty Ltd is the host electricity retailer in South Australia and also retails gas to small customers. AGL's electricity retail business within South Australia is conducted pursuant to licences issued to AGL Sales (Queensland Electricity) Pty Ltd (issued in July 2005), AGL South Australia Pty Ltd (issued in November 1999) and Powerdirect Pty Ltd (issued in October 2003). AGL's gas retail business is conducted pursuant to the licence issued to AGL South Australia Pty Ltd in July 2005. AGL's shares of residential and small business electricity customers were 57 per cent and 70 per cent respectively at the end of the fourth quarter in 2007.[92] As at 31 December 2007, AGL's shares across residential and small business gas customers were 19 per cent and 3 per cent respectively.[93]

AGL's retail interests extend beyond South Australia into the Australian Capital Territory, New South Wales, Queensland and Victoria through its subsidiaries which hold retail licences in those jurisdictions. AGL's retail interests were expanded in 2007 when it purchased Powerdirect from the Queensland Government.

In addition to its retail interests, AGL owns, or has an interest in, a number of generation assets throughout South Australia, Victoria and New South Wales including the Torrens Island Power Station, the Loy Yang A Power Station, the Somerton Power Plant. AGL also owns a number of hydroelectric generating schemes in Victoria and NSW and has an interest in a number of wind farms in South Australia. As at 1 January 2008, AGL controlled 34 per cent of the generation capacity in South Australia[94] and operated the Angaston Power Station, on Infratil's behalf, through an "offtake arrangement".[95]

In addition to these electricity related vertical interests, AGL also has interests in the upstream production of coal seam methane in New South Wales and Queensland through joint venture arrangements with Sydney Gas and Arrow Energy and an equity stake in Queensland Gas Company.

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92 ESCOSA, data supplied under Guideline No 2. These estimates include AGL's interest in Powerdirect.

93 ESCOSA, data supplied under Guideline No 2.

94 NERA, *The Wholesale Electricity Market in Australia*, March 2008, p. 32.

95 AER, *Spot Prices Greater than $5000/MWh, 5-17 March 2008*; AGL Energy Ltd, *2008 Interim Results*, 29 February 2008.

A.3.3.1.2. Origin Energy

Origin was formed in 2000, following a decision by Boral to divest its gas production and retail interests. Origin was listed on the ASX in 2000.

Origin is the host gas retailer in South Australia and retails electricity to residential and small businesses throughout South Australia. Origin's gas retail business in South Australia is conducted pursuant to licences issued to Origin Retail Ltd (issued in September 1998) and its electricity retail business pursuant to the licence issued to Origin Electricity Pty Ltd (issued in October 1999). Origin's shares of residential and small business electricity customers were 14 per cent and 16 per cent respectively at the end of the fourth quarter in 2007.[96] As at 31 December 2007, Origin's shares of residential and small business gas customers, were 55 per cent and 87 per cent respectively.[97] Origin is currently the only retailer of gas to small customers in the Port Pirie, Mt Gambier, Whyalla, Riverland and Murray Bridge regions.

In addition to its retail interests in South Australia, Origin also has gas and electricity retail interests in Victoria, Queensland and New South Wales and retails electricity in the Australian Capital Territory. Origin's retail gas operations in the Australian Capital Territory are conducted through its subsidiary, Sun Retail Pty Ltd.

Origin also owns, or has an interest in, a number of electricity generation assets throughout South Australia, Victoria and New South Wales including the Quarantine, Ladbroke Grove, Osborne, and Bulwar Island Power Stations, the Mt Stuart Power Plant and the Roma peaking plant. Origin is currently in the process of developing two new gas fired power plants in Victoria (the Mortlake Power Station) and Queensland (the Spring Gully Power Station). Both of these developments will use gas from Origin's upstream gas production interests in the Otway Basin and the Spring Gully coal seam methane fields.[98] Origin has also committed to the development of the Darling Downs Power Station and has proposed an expansion of the Quarantine Power Station. As at 1 January 2008, Origin controlled approximately 4.4 per cent of the electricity generation capacity in South Australia.[99]

Origin's upstream gas production interests include a 13 per cent interest in the South Australian Cooper Basin joint venture, a 17 per cent interest in the South West Queensland joint venture, a 31 per cent interest in the Geographe and Thylacine gas fields, a 42.5 per cent interest in the Yolla field, a 76 per cent interest in the fields at Fairview, a 96-99 per cent interest in the Spring Gully field, a 100 per cent interest in the Peat field, a 50 per cent interest in the Denison Trough field and a 41 per cent interest in the fields at Argyle and Kenya East. In 2007 Origin's interests in Envestra

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96 ESCOSA, data supplied under Guideline No 2 data.

97 *Id*.

98 Origin website, http://www.originenergy.com.au/about/template.php?pageid=1376 and http://www.originenergy.com.au/about/template.php?pageid=1510

99 NERA, *The Wholesale Electricity Market in Australia*, March 2008, p. 32.

(including the operating and maintenance outsourcing arrangement), the SEAGas pipeline and the SESA Pipeline were sold to Australian Pipeline Trust.

A.3.3.2. Tier 2 retailers with a customer base

A.3.3.2.1. Aurora Energy

Aurora Energy is owned by the Tasmanian Government.

Aurora Energy was issued a licence to retail electricity in South Australia in May 2004. Aurora Energy is currently selling electricity to a limited number of small customers within South Australia. Aurora is not licensed to supply and sell gas in South Australia.

Aurora Energy also holds electricity retail licences in the Australian Capital Territory, New South Wales, Queensland, Victoria and Tasmania.

A.3.3.2.2. Country Energy

Country Energy is currently owned by the New South Wales Government.

Country Energy holds licences to retail both gas and electricity within South Australia but to date has focused on retailing electricity.[100] The electricity licence was issued in October 1999 while the gas licence was issued in April 2008. Country Energy's share of residential electricity customers was approximately 0.4 per cent and for small business customers was 0.7 per cent as at 31 December 2007.[101]

Country Energy has retail interests in other jurisdictions including the Australian Capital Territory, New South Wales, Victoria, Queensland and Tasmania. Country Energy owns gas distribution networks in New South Wales and electricity networks in New South Wales and Queensland.

A.3.3.2.3. Jackgreen

Jackgreen (International) Pty Ltd, launched in 2004, is a wholly owned subsidiary of Jackgreen Ltd, an Australian owned company listed on the ASX.

Jackgreen currently holds licences to retail electricity and gas in South Australia which were issued in September 2006. Jackgreen's share of small electricity customers was less than 0.02 per cent at the end of the fourth quarter of 2007.[102] Jackgreen does not currently retail gas in South Australia.

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100 LECG, *Retailer Survey Report*, p. 18.

101 ESCOSA, data supplied under Guideline No 2.

102 *Id*.

In addition to its South Australian retail interests, Jackgreen operates electricity retail businesses in the Australian Capital Territory, New South Wales, Queensland and Victoria.

A.3.3.2.4. Momentum Energy

Momentum Energy Pty Ltd was formed in 2002. On 3 September 2008, it was announced that Hydro Tasmania had purchased a controlling share (51 per cent) in Momentum Energy.

Momentum Energy holds both a gas and electricity retail licence but, to date, has focused on retailing electricity. The gas licence was issued in June 2007 while its electricity licence was issued in October 2005. As at 31 December 2007, Momentum Energy's share of residential customers was approximately 0.5 per cent and was approximately 1.3 per cent for small businesses.[103]

Momentum Energy also currently holds electricity retail licences in New South Wales, Queensland and Victoria.

A.3.3.2.5. Red Energy

Red Energy Pty Ltd was established in 2004 and is a subsidiary of Snowy Hydro Limited.

Within South Australia, Red Energy's retail interests have been limited to electricity. Red Energy's electricity licence was issued in February 2006. Red Energy's share of residential customers was approximately 1 per cent and for small business customers was approximately 1.3 per cent in the fourth quarter of 2007.[104]

Red Energy also holds licences to retail electricity to customers in the Australian Capital Territory, New South Wales, Queensland and Victoria.

A.3.3.2.6. Simply Energy

Simply Energy is a wholly owned subsidiary of International Power Australia.[105] International Power Australia is part of the International Power group which is listed on the UK stock exchange.

Simply Energy is licensed to retail both gas and electricity in South Australia. Simply Energy's electricity retail business in South Australia is conducted pursuant to licences issued to International Power (Retail) Pty Ltd in May 2004 and IPower Pty Ltd and IPower 2 Pty Ltd issued in June 2005. Simply Energy's gas retail business is conducted pursuant to a licence issued to IPower Pty Ltd and IPower 2 Pty Ltd in

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103 *Id*.

104 *Id*.

105 Simply Energy was formerly operated as a joint venture between Energy Australia and International Power but on 1 August 2007 ownership was transferred to International Power.

June 2005. Simply Energy's shares of residential and small business electricity customers were 4 per cent and 11 per cent respectively at the end of the fourth quarter in 2007.[106] Across residential and small business gas customers, Simply Energy's shares were 3 per cent and 10 per cent respectively.

International Power Australia owns generators and peaking plants in both South Australia and Victoria including the Port Lincoln, Mintaro, Dry Creek and Snuggery peaking units, the Pelican Point Power Station, Hazelwood and the Canunda wind farm in South Australia. As at 1 January 2008, International Power controlled 22 per cent of the generation capacity in South Australia.[107] In addition to these interests, International Power owns a one third share of the SEAGas Pipeline.

A.3.3.2.7. South Australia Electricity

South Australia Electricity commenced trading in 2004 and has been a wholly owned subsidiary of Infratil Limited since April 2007. Infratil Limited is listed on the New Zealand stock exchange.

South Australia Electricity was issued a licence to retail electricity and gas in September 2005 but, to date, has focused on retailing electricity. South Australia Electricity's share of residential customers was approximately 3 per cent and for small business customers was approximately 0.4 per cent at the end of the fourth quarter in 2007.[108]

Infratil also operates in other states through its subsidiaries Victoria Electricity, New South Wales Electricity and Queensland Electricity. Victoria Electricity is licensed to retail electricity and gas while New South Wales Electricity and Queensland Electricity are licensed to retail electricity only.

Infratil also owns Infratil Energy Australia (IEA), which provides wholesale risk management and energy trading support to Victoria Electricity. IEA owns a 40 MW generation asset at Angaston which, as at 1 January 2008, accounted for approximately 1 per cent of the generation capacity in South Australia. The Angaston facility is operated by AGL, on behalf of Infratil, under an "offtake arrangement".[109]

A.3.3.2.8. TRUenergy

TRUenergy is a subsidiary of the CLP Group which is listed on the Hong Kong stock exchange.

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106 ESCOSA, data supplied under Guideline No 2.

107 NERA, *The Wholesale Electricity Market in Australia*, March 2008, p. 32.

108 ESCOSA, data supplied under Guideline No 2.

109 AER, *Spot Prices Greater than $5000/MWh, 5-17 March 2008*; AGL Energy Ltd, *2008 Interim Results*, 29 February 2008.

TRUenergy is licensed to retail both gas and electricity in South Australia pursuant to the licences issued to TRUenergy Pty Ltd (issued in April 1998 for gas and October 1999 for electricity) and TRUenergy Yallourn Pty Ltd (issued in October 1999). TRUenergy's shares of residential and small business electricity customers were 13 and 8 per cent respectively at the end of the fourth quarter in 2007.[110] At the same time, it shares of residential and small business gas customers were 14 and 7 per cent respectively.[111]

TRUenergy owns a number of generation assets throughout South Australia, Victoria and New South Wales including the Hallett Power Station, the Yallourn Power Plant, and the gas fired power plant being constructed at Tallawarra. As at 1 January 2008, TRUenergy controlled approximately 4.6 per cent of the generation capacity in South Australia.[112]

In addition to these electricity related vertical interests, TRUenergy also owns a one third share of the SEAGas Pipeline and wholly owns the western underground gas storage facility in Victoria.

A.3.3.3. Licensed retailers not currently selling to small customers

A.3.3.3.1. Australian Power & Gas

Australian Power & Gas Pty Ltd was founded in July 2006 and is a wholly owned subsidiary of Australian Power & Gas Limited which is publicly listed.

Australian Power & Gas was issued a licence to retail gas and electricity in South Australia in November 2007 but is yet to commence its retail operations in the state.

Australian Power & Gas also holds gas and electricity retail licences in Victoria, New South Wales and Queensland. Australian Power & Gas does not currently have any upstream interests in either gas production or electricity generation.

A.3.3.3.2. Dodo Power & Gas

Dodo Power & Gas Pty Ltd was established in late 2006 and is a subsidiary of the privately owned company, Dodo.

Dodo Power & Gas was issued with licences to retail both gas and electricity in South Australia in January 2008 but has not yet started marketing within the state.

Dodo Power & Gas has also been issued electricity and gas licences in the Australian Capital Territory, New South Wales, Queensland and Victoria.

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110 ESCOSA, data supplied under Guideline No 2.

111 *Id*.

112 NERA, *The Wholesale Electricity Market in Australia*, March 2008, p. 32.

A.3.3.3.3. EnergyAustralia

EnergyAustralia is currently owned by the New South Wales Government.

EnergyAustralia's licence to retail electricity in South Australia was issued in 1999, and its gas licence issued in 2003. After the formation of a partnership between EnergyAustralia and International Power, the partnership traded as EnergyAustralia under its retail licences. EnergyAustralia surrendered its retail licences following International Power's acquisition of EnergyAustralia's interest in the partnership. In February 2008, ESCOSA issued new electricity and gas retail licences to EnergyAustralia. EnergyAustralia is yet to start actively marketing to small customers in South Australia.

EnergyAustralia has electricity and gas retail interests in the Australian Capital Territory, New South Wales, Victoria and Queensland. EnergyAustralia also owns an electricity distribution network in New South Wales.

A.3.3.4. Observations

The foregoing discussion brings to the fore the dichotomy that has emerged in South Australian retailing. On one side are the large scale dual fuel retailers that have established significant vertical interests in generation and/or upstream gas production (AGL, Origin, TRUenergy, and Simply Energy) and on the other side are the small scale, largely electricity-only, retailers, some of whom have more substantial interests in other jurisdictions and/or have some generation interests (for example, South Australia Electricity, Aurora Energy, Australian Power & Gas, Country Energy, Dodo Power & Gas, EnergyAustralia, Jackgreen, Momentum Energy and Red Energy).

The retailers also differ in their ownership structures. For example, Australian Power & Gas, AGL, Jackgreen and Origin are each part of a different corporate group whose ultimate holding company is listed on the ASX. South Australia Electricity is wholly owned by Infratil Limited, a company listed on the New Zealand stock exchange, TRUenergy is part of the CLP Group, which is listed on the Hong Kong stock exchange, and International Power is listed on the UK stock exchange. Country Energy, Energy Australia and Aurora Energy are currently government owned. The remaining retailers are incorporated and privately held.

B Regulation of Energy Retailing in South Australia

Both gas and electricity retailers operating in South Australia are required to comply with specific requirements prescribed by legislation and a range of subordinate instruments including regulations, licences, codes and guidelines (jointly, "regulation"). These requirements affect many aspects of energy retailing, including prohibiting the retailing of energy without a licence. The energy products and services offered by retailers must also comply with specific requirements, including the terms and conditions on which they are offered (including, for some products, the price), and the way in which information about products and services is communicated to prospective customers.

To assist the Commission in its general understanding of the regulatory requirements pertaining to retailers, the Commission engaged Allens Arthur Robinson to prepare a report outlining the current regulatory requirements prevailing in South Australia. This appendix provides a summary of the advice provided by Allens Arthur Robinson.

B.1. Principal legislation

The principal legislation regulating the retailing of electricity and gas in South Australia are the *Electricity Act 1996* (SA) (Electricity Act) and the *Gas Act 1997* (SA) (Gas Act). In accordance with the *Essential Services Commission Act 2002* (SA) (ESC Act), ESCOSA's functions include responsibility for administering the licensing system that applies to both electricity and gas retailers, and enforcing compliance with those licences. ESCOSA also has the power to regulate tariffs for the sale of electricity and gas to small customers under standing and default contracts.[113] The process by which these tariffs are determined is discussed further at B.3 below.

Another important regulatory instrument is the South Australian Electricity Pricing Order, which maintains parity between the tariffs charged to small country and small city electricity customers.[114] Under these arrangements, a retailer may not charge a small country customer a tariff for the sale of electricity that is more than 1.7 per cent higher than that offered to a small city customer and, subject to this restriction, the retailer (if it wishes to sell electricity to small country customers) must offer to small country customers tariffs that it offers to small city customers. There is no equivalent scheme operating for gas retailing.

B.2. Licensing

Unless otherwise exempt[115], a person may only retail energy in South Australia if that person is licensed to do so.[116] ESCOSA must not issue a retail licence unless it is satisfied that:

113 Electricity Act, s 35A(1)(a); Gas Act, s 33(1)(a).

114 Electricity Pricing Order, clause 8.2.

115 For example, see Electricity Act, s 80; Gas Act, s 77.

- the applicant is a suitable person to hold the licence (taking into account, among other things, the commercial and other dealings of, and standard of honesty and integrity shown in those dealings by, the applicant, its officers and major shareholders, the financial, technical and human resources available to the applicant, the duration of electricity retail contracts entered into by the applicant, and any previous breaches by the applicant of any retail licence or the legislation); and

- the applicant will be able to meet reasonably foreseeable obligations under contracts for the sale of electricity or gas.[117]

The Electricity Act requires an electricity retail licence to contain a number of prescribed conditions. Subject to these requirements, ESCOSA is able to determine the term of the licence and the other conditions which are to be included in it subject to the caveat that any condition imposed is not inconsistent with the requirements of the National Electricity Rules.[118]

The Gas Act requires a gas retail licence to contain a number of prescribed conditions. Subject to these requirements, ESCOSA is able to determine the term of the licence and the other conditions which are included in it.[119] A gas retail licence also requires that a retail licensee comply with the retail market rules which have been developed by the Retail Energy Market Company (REMCo).

By virtue of its licence, a retail licensee is required to comply with the Energy Retail Code, the Electricity Metering Code, the Energy Customer Transfer and Consent Code, the Energy Price Disclosure Code, the Energy Prepayment Metering Code and the Energy Marketing Code. These codes impose a range of (generally consumer protection-related) obligations on energy retailers. ESCOSA is specifically vested with the function of making, monitoring the operation of, and periodically reviewing such codes (however, before making, varying or revoking a code, ESCOSA must undertake a process of consultation).[120]

The licences also require the licensees to comply with applicable guidelines issued by ESCOSA.

B.3. Framework underpinning customer sale contracts

The Energy Retail Code regulates the terms and conditions upon which a licensed retailer may sell electricity and/or supply and sell gas to small customers under a standing contract, market contract or default contract. It also sets out the actual terms that must be included in a standing contract and a default contract and the minimum service standards to be met by retailers.

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116 Electricity Act, sub-s 15(1) and (2)(c); Gas Act, s 19(b).

117 Electricity Act, sub-s 17(2)(a), (d) and (3); Electricity Regulations, reg 7A; Gas Act, sub-s 21(2)(a), (c) and (3).

118 Electricity Act, ss 19, 21, 24 and 24B.

119 Gas Act, ss 23, 25 and 26A.

120 ESC Act, s 28.

B.3.1. Standing contract

A standing contract is a contract entered into by the host retailer and a small customer.[121] The terms of this contract are as set out in the Energy Retail Code and impose a number of obligations on the host retailer in relation to disconnections and customer bill payments. Under a standing contract ESCOSA is empowered to regulate the price at which electricity and gas is sold under such a contract (each such determination must be for a period of at least 3 years).[122]

AGL (for electricity) and Origin (gas) are required to enter into such a contract with a small customer where requested to do so by that customer.'

The standing contract prices for electricity have been fixed by ESCOSA in accordance with section 36AA of the Electricity Act. ESCOSA's 2007 Price Determination sets out the current prices. The standing contract price represents the maximum price that AGL can charge a small customer that enters into a standing contract.

The standing contract prices for gas have been fixed by ESCOSA in accordance with section 34A of the Gas Act. ESCOSA reviewed the prices to operate over the period 2008/09 to 2010/11 and released its final inquiry report and price determination in June 2008.

B.3.2. Market contract

A market contract is a contract between a retailer and a customer (including a small customer).[123] The terms of such a contract, where it is with a small customer, are regulated under the Energy Retail Code. The prices that may be charged under a market contract are not, however, subject to regulation by ESCOSA.

The minimum terms and conditions applicable to market contracts are described in Part A of the Energy Retail Code. Most of these minimum terms and conditions are the same as those that apply to standing and default contracts. However, under a market contract it is possible for the following minimum terms and conditions in the Energy Retail Code to be varied without ESCOSA's approval:

- the obligation to bill quarterly (clause 6.1.1);
- methods of payment (clauses 6.3.4(i) and 7.2);
- apportionment of payments where a bill contains charges for both gas and electricity (clauses 6.3.2(c) and 6.3.4(u));
- alternative tariffs or tariff options (clause 6.8.1);
- minimum time for payment of a bill (clause 7.1.1);
- minimum instalment payment options (clause 7.7.1); and

121 Electricity Act, s 36AA(1); South Australian Government Gazette, 12 September 2002, p. 3384.

122 Electricity Act, sub-s 36AA(4a) and (6); Gas Act, sub-s 34A(4a) and (6).

123 Electricity Regulations, reg 7D.

- payments in advance (clause 7.11).

Another important provision in the market contract is the requirement that small customers be provided with a ten business day cooling-off period during which time the customer may rescind the contract.

B.3.3. Default contract

A default contract is a contract between a retailer and a small customer that arises when that retailer is financially responsible for the small customer's connection or delivery point, and the customer does not have any existing contract with that retailer for that connection or delivery point but is being supplied with energy through that connection or delivery point.[124]

The terms of a default contract are set out in the Energy Retail Code and ESCOSA is empowered to determine the price at which electricity is sold under such a contract. The retailer must give written notice to a small customer within 5 business days of becoming aware that a default contract applies, setting out the terms and conditions of the default contract and describing the other contractual options available to the small customer for the purchase of energy. A default contract continues until the small customer becomes party to a market contract or standing contract in relation to the connection or delivery point, or another person becomes party to a retail contract in relation to that connection point[125] (or some other event as determined by ESCOSA occurs).[126]

The default contract price for electricity will be based on whichever of the following prices was last fixed:

- the price fixed for the sale of electricity to non-contestable customers by the Electricity Pricing Order immediately before 1 January 2003;
- the price fixed by the retailer by notice published in the Gazette and in a newspaper circulating generally in the State, where:
    - the price was fixed by the notice with effect from the end of the prescribed period from the date of publication of the notice;
    - the notice contained a statement of the retailer's justification for the price;
    - ESCOSA did not, within the prescribed period, fix the default contract price; or

124 Electricity Act, s 36AB(1); Electricity Regulations, reg 7F(1); Gas Act, s.34B(1); Gas Regulations, reg 8H(1).

125 Electricity Regulations, reg 7F(3).

126 Gas Regulations, reg 8H(3).

- the price fixed by ESCOSA as the retailer's default contract price.[127]

The default contract price for a gas retailer is whichever of the following prices was last fixed:

- the price fixed under the Gas Act for the sale and supply of gas to a class of customers to which the customer belongs;
- the price fixed by the retailer as the retailer's default contract price for a class of customers to which the customer belongs by notice published in the Gazette and in a newspaper circulating generally in the State, where:
    - the price was fixed by the notice with effect from the end of the prescribed period from the date of publication of the notice;
    - the notice contained a statement of the retailer's justification for the price; and
    - ESCOSA did not, within the prescribed period, fix the default contract price; or
- the price fixed by ESCOSA as the retailer's default contract price for a class of customers to which the customer belongs.[128]

The prescribed period is 14 days if the default contract price is the same as the price that will be in force as the standing contract price; in any other case it is 28 days.[129]

ESCOSA has not fixed any default prices for either electricity or gas retailers. Thus, in the event that an electricity retailer does not publish a notice in the South Australian Government Gazette stating its default contract price, the price will be the price fixed for the sale of electricity to non-contestable customers by the Electricity Pricing Order immediately before 1 January 2003. It is worth noting that most retailers have published notices in the South Australian Government Gazette stating that their default contract prices will be the same as the standing contract price offered by AGL.

In the event that a gas retailer does not publish a notice in the South Australian Government Gazette stating its default contract price, the price fixed for the sale of gas will be the last price fixed under the Gas Act in relation to small customers. On 23 July 2004 the Minister for Energy published a notice in the Gazette pursuant to clause 2 of Schedule 2 of the Gas Act (which is now expired) fixing the maximum prices for small customers supplied with gas under a default contract and small customers supplied with gas by Origin under a small customer contract (i.e. a standing contract). All retailers appear to have published notices in the South Australian Government Gazette stating that their default contract prices will be the same as the standing contract price offered by Origin.

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127 Electricity Act, s 36AB(3).

128 Gas Act, s 34B(3).

129 Electricity Regulations, reg 7F(6); Gas Regulations, reg 8H(6).

B.4. Minimum service standards for retailers

The Electricity Act, Energy Retail Code and retail licences set out some minimum service standards for retailers in relation to their dealings with small customers. In accordance with these provisions a retailer must comply with the minimum service standards set out in the Energy Retail Code and must monitor and report to ESCOSA on compliance with those minimum standards. By virtue of the Energy Retail Code, a retailer must use its best endeavours to:

- respond to 85 per cent of telephone calls from small customers between 8am – 6pm on business days within 30 seconds; and
- respond to 95 per cent of written enquiries from small customers within five business days.

If the retailer (other than for circumstances beyond its reasonable control) is more than 15 minutes late for an appointment with a small customer, the retailer must pay $20 to the small customer.

The retailer must keep sufficient records to monitor its performance level and must report to ESCOSA annually on its compliance with the service standards, rebates paid for non-compliance, the reasons for non-compliance and how the retailer will improve its performance so as to comply with those service standards.

B.5. Financial hardship provisions

The Energy Retail Code also contains provisions pertaining to payment difficulties. These provisions state that in the event that a residential customer[130] informs the retailer that he or she is experiencing payment difficulties, or the retailer's credit management processes indicate (or ought to indicate) that this is the case, the retailer must offer the customer an instalment plan and (where appropriate):[131]

- information about the right to have a bill redirected to a consenting third person;
- information about, and referral to, State government assistance programmes; and
- information on independent financial and other relevant counselling services.

The instalment plan offered by a retailer must include at least the following payment options:[132]

- payments in advance towards future bills; and

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130 The Energy Retail Code defines a "residential customer" as a small customer who acquires energy for domestic use. By reference to the Electricity Act and the Gas Act a "small customer" is a customer who consumes less than 160 MWh of electricity per year and/or less than 1 TJ of gas per year.

131 Energy Retail Code, clause 7.6.

132 Energy Retail Code, clause 7.7.1.

- an interest and fee free instalment plan (or other arrangement) under which the customer is given more time to pay a bill or to pay arrears.

A retailer may require a residential customer to pay by instalments in advance if the customer is in arrears, or as an alternative to the customer paying a security deposit. A retailer who offers an instalment plan to a residential customer must:[133]

- specify the period of the plan and the amount of the instalments (taking into account the customer's usage needs and capacity to pay), the number of instalments (generally not less than 4) and how the amount of each installment is calculated, the amount of the instalments which will pay the customer's arrears (if any) and estimated usage during the period of the plan;

- state that, due to seasonal fluctuations in usage, paying by instalments may result in the customer being in credit or debit during the period of the plan; and

- monitor the customer's compliance with the plan and have fair and reasonable procedures in place to address any payment difficulties.

B.6. Retailer of last resort arrangements

In accordance with provisions contained in the Electricity Act, the Gas Act, the Energy Retail Code and retail licences, each contract entered into by a retailer with a small customer (i.e. a market, standing or default contract) must expressly provide that:

- the contract will terminate in the event that the retailer is no longer entitled to sell electricity due to a last resort event in respect of that retailer; and

- when the retailer is no longer entitled to sell electricity due to a last resort event in respect of that retailer, that retailer must within one business day provide the name, billing address and associated assigned metering identifier and checksum of the customer to the entity appointed as the retailer of last resort.

In the case of electricity, ETSA Utilities (i.e. the distribution network service provider) is the retailer of last resort and will remain so until 30 June 2010. The retailer of last resort requirement is triggered when a retailer's licence is suspended or cancelled, its registration under the National Electricity Rules is suspended or terminated, or the retailer ceases to retail electricity in South Australia. If such an eventuality arise,s ETSA Utilities must sell electricity to the customers of that retailer for up to 3 months for a price, and on terms and conditions, that are regulated by ESCOSA.

While the Gas Act makes provisions that the Gas Regulations may prescribe a gas retailer/supplier as a retailer of last resort, no regulations have yet been made for that purpose.

133 Energy Retail Code, clause 7.7.4.

B.7. Greenhouse gas reduction

Provisions within both the Electricity Act and electricity retail licences require retailers to investigate strategies for:

- achieving a reduction in greenhouse gas emissions to targets set by the Environment Protection Authority or to such levels as are binding on the retailer; and

- promoting the efficient use of electricity and the sale of electricity produced through cogeneration or from sustainable sources.

The retailer must publish annual reports on the implementation of such strategies.

B.8. Regulation of marketing conduct

All retailers who sell energy to small customers are required to comply, and ensure that those who carry out marketing on their behalf comply, with the Energy Marketing Code.

The requirements of the Energy Marketing Code are summarised in the table below.

Table B.1: Energy Marketing Code requirements

General Conduct Standards (clause 4)	A marketer or salesperson must, while engaged in marketing: • comply with all applicable laws; • not engage in misleading, deceptive or unconscionable conduct; • not exert undue pressure on a small customer, nor harass or coerce a small customer; • use words and images that promote small customers' comprehension of customer sale contracts; • ensure that information provided to small customers is truthful and in plain language; • ensure that information provided to individual small customers is relevant to that small customer's circumstances; and • provide only timely, accurate, verifiable and truthful comparisons.
Time of Contact (clause 5)	Except by prior appointment, small customers cannot be contacted for marketing purposes: • at any time on a Sunday or public holiday; • on a Saturday, except between 9am and 5pm; or • on any other day except between 9am and 8pm.
Identification (clause 6)	As soon as practicable following contact, the marketer or sales person must advise the small customer the reason for the customer being contacted, and must use its best endeavours to provide the small customer with the name of the salesperson, marketer and (if different) retailer.
Provision of contact details (clause 7, 11, 12)	The marketer or salesperson must use its best endeavours to provide the small customer with contact details for the marketer and (if different) retailer.
Termination of marketing contact (clause 8)	If a small customer requests that a marketing contact be terminated, the marketer or salesperson must immediately:

	• comply with the request, refrain from contacting the small customer again for 20 business days (unless otherwise advised by the small customer); • advise the small customer of the existence of the retailer's dispute resolution service; and • if requested by the small customer, provide details (including contact details) of dispute resolution services.
Marketing in person (clause 9)	A marketer or salesperson who visits a small customer must wear an identification card on his or her chest containing photographic identification and the name of the salesperson, marketer and (if different) retailer. The marketer or salesperson must also provide the small customer with: • the retailer's telephone number for enquiries, verifications and complaints; and • if requested by the small customer, the address for service of the retailer.
Written Disclosure Statement (clause 14)	When a marketing contact results, or is intended to result, in a small customer entering into a customer sale contract, or when a small customer contacts a marketer for the purposes of entering into a customer sale contract, the following information must be provided in writing to the small customer by the marketer in a written disclosure statement at the time the customer sale contract is entered into: • the name and address for service of the marketer or (if different) retailer; • the contact details of the marketer or (if different) retailer; • the date of commencement of the contract; • the prices, charges, tariffs and service levels that will be applicable in respect of the contract; • if the prices, charges, tariffs or service levels are able to be changed by the retailer under the contract, the manner in which any such change may be effected; • the costs to the small customer associated with entering into the contract, other than the prices, charges and tariffs payable (including any costs associated with the provision of infrastructure such as meters); • the type and frequency of bills which will be rendered under the contract; • the payment methods and options which are available in respect of the contract; • the early termination charges which may apply if the small customer terminates a fixed-term contract prior to its expiry date and the method of calculation of those charges; • the enforcement expenses which may become payable if the small customer breaches the contract; • the dispute resolution options which are available to small customers; • details of the right conferred on the small customer to rescind the contract in accordance with the Energy Retail Code; and • if a commission, fee or reward is to be paid for the introduction of business to the retailer: – a statement of that fact; and – details of the person by whom the commission, fee or

	reward is payable; and – details of the person to whom the commission, fee or reward is payable.
Training and product knowledge (clause 17)	A marketer must ensure that the marketer's employees, agents and contractors have sufficient training and knowledge so as to be able to comply with the Energy Marketing Code and all other relevant legislative requirements.
Privacy (clause 18)	While engaged in marketing, a marketer must, in dealing with small customer information, comply with the *Privacy Act 1988* (Cth) and any instrument issued by ESCOSA regarding privacy. A marketer must inform a small customer of the marketer's privacy obligations at the request of the small customer.

B.9. Role of the Energy Industry Ombudsman

The Energy Ombudsman receives, investigates and facilitates the resolution of a range of customer complaints and disputes against retailers and other energy service providers, such entities being bound (as a licence condition) to be members of the energy industry ombudsman scheme. The scheme applies to electricity customers whose annual consumption is less than 750MWh and gas customers whose annual consumption is less than 10 TJ.[134] The Energy Ombudsman has the power to make a decision in relation to complaints or disputes within its jurisdiction, being a decision that is binding on the relevant retailer, up to a total value of $20,000 per complaint (or, with the consent of all parties to the complaint or dispute, up to a total value of $50,000).

B.10. Residential Energy Efficiency Scheme

In February 2008, the South Australian Government announced that a new scheme would be introduced to improve the energy efficiency of households in South Australia. This scheme, referred to as the Residential Energy Efficiency Scheme (REES), will commence on 1 January 2009 and will require each obliged retailer to achieve targets for:

- implementing energy efficiency activities (such as insulation, draught proofing, and more efficient lighting) in households. A proportion of these must be delivered to a "priority group" which essentially comprises low income households and those in hardship; and

- delivering energy audits to priority group households.

The scheme targets will be set by the Minister for Energy during the second half of 2008.

134 Electricity Act, s 24(2)(l).

ESCOSA is the scheme administrator. As such it must:[135]

- determine which retailers are obliged to meet the targets;
- allocate targets to each retailer;
- assess compliance with the targets; and
- maintain the list of approved energy efficiency activities which retailers can implement to achieve their targets.

135 Further information on the scheme is available at the REES website: http://www.dtei.sa.gov.au/energy/government_programs/REES.html

C Retailer Rivalry

Independent rivalry between existing retailers is an important pre-requisite for effective competition. In an effectively competitive market, retailers will seek to retain or increase their market share by offering products that meet the requirements of customers and by engaging in price and non-price rivalry with other retailers in the market. Viewed in this way it is clear that retailer rivalry can facilitate the delivery of those products most sought after by customers and at prices that reflect the long run efficient cost of supply.

Another benefit of retailer rivalry is that it can stimulate greater consumer participation in the market through the provision of marketing material and other information that increases consumers' awareness of product offerings. As noted in Chapter 2, many customers exhibit a low level of interest in retail energy products and thus there is an incentive for new and established retailers, seeking to win customers away from their existing supplier, to increase the awareness of customers about product offerings through marketing. Marketing in this environment can reduce a consumer's actual and perceived search and switching costs and in so doing overcome the inertia that customers may otherwise exhibit in relation to energy supply. If there are a sufficient number of consumers willing to switch in response to a price increase or a deterioration in the quality of service, and if retailers are unable to discriminate[136] between those customers that are likely to switch and those that are not, then the pricing, service and quality decisions of retailers will be constrained. Therefore, as long as retailers can motivate enough consumers to engage with the competitive market all customers will benefit from retailer rivalry.

The opportunity for retailers in South Australia to offer retail energy services to small customers began with the advent of FRC on 1 January 2003 for electricity retailers and 28 July 2004 for gas. Prior to this, electricity and gas retail services were provided to small customers under the single host retailer model. This model in effect accorded AGL a monopoly on retailing to small electricity customers and Origin a monopoly on retailing to small gas customers. Under this model the relevant host retailer provided retail services in accordance with the terms of the standing contract, including at the regulated standing contract prices.

At the commencement of FRC, new licensed retailers and the host retailers were accorded the right to offer to retail energy to small customers on terms and conditions (including price) that differed from those specified in the standing contract, subject to the offer (market offer) meeting the minimum terms and conditions specified in the Energy Retail Code (see Appendix B). Under this new competitive model, Origin and AGL have retained their host status and are therefore required to continue to provide retail energy services to customers under a standing

136 For discrimination to be effective, retailers need to be able to both identify those customers least likely to switch and be able to prevent arbitrage between customer groups. The latter condition is satisfied for retail energy products because they are distributed to and consumed at specified customer premises, with no opportunity for re-selling. Hence, the ability to price discriminate between retail energy customers will depend on the ability of retailers to identify those customers who are more or less likely to switch.

contract unless the customer elects to enter into a market contract. According retailers the ability to market an alternative product to the standing contract represented a significant turning point for energy retailing in South Australia and has paved the way for both the new retailers and the host retailers to engage in price and non-price rivalry.

To assist the Commission to ascertain the nature and extent of retailer rivalry that has emerged since the commencement of FRC, and is likely to exist in the future, the Commission engaged LECG to undertake a survey of gas and electricity retailers currently and potentially operating in South Australia (Retailer Survey). This survey was principally designed to provide the Commission with some insight into:

- the nature of price rivalry between energy retailers for the supply of electricity and gas;
- the extent of product and service differentiation and non-price rivalry between retailers;
- the nature of retail marketing of electricity and gas contracts;
- potential barriers to entry and expansion in energy retailing; and
- the extent to which retailers are providing information to customers to better enable them to make informed decisions in relation to their energy supply.

In addition to the Retailer Survey results, the Commission has had recourse to the submissions made by interested parties, information from the ESCOSA about the market contract offered by retailers, and information supplied by the Energy Ombudsman on the prevalence of misleading, deceptive or unconscionable selling practices. The remainder of this appendix sets out the Commission's findings on the nature of price rivalry, non-price rivalry, marketing practices and the provision of information.

C.1 Background

The table below provides a summary of the licensed retailers currently selling electricity, and selling and supplying gas to small customers in South Australia.

Table C.1 Retailers licensed to retail energy to small customers in South Australia

Retailer	Electricity		Gas	
	Licence	Sale to small customers	Licence	Supply and sale to small customers
AGL Energy (including Powerdirect)	✓	✓	✓	✓
Aurora Energy	✓	✓	×	×
Australian Power & Gas	✓	×	✓	×
Country Energy	✓	✓	✓	×
Dodo Power & Gas	✓	×	✓	×
EnergyAustralia	✓	×	✓	×
Jackgreen International	✓	✓	✓	×
Momentum Energy	✓	✓	✓	×
Origin Energy	✓	✓	✓	✓
Red Energy	✓	✓	×	×
Simply Energy	✓	✓	✓	✓
South Australia Electricity	✓	✓	✓	×
TRUenergy	✓	✓	✓	✓

Data source: ESCOSA and Retailer Survey Report.

Ten retailers currently sell electricity and four retailers currently sell and supply gas, however, at the time of the Retailer Survey, the number of retailers actively marketing to seek new customers had fallen to four for electricity and three for gas.[137] The decision by six electricity retailers to temporarily cease active marketing largely stemmed from the higher spot prices and the increased volatility in the wholesale market.[138] According to respondents to the Retailer Survey, this increased volatility has resulted in a material increase in the cost of acquiring both wholesale electricity and risk management instruments and in turn reduced the margin available to retailers which is effectively capped by the regulated standing contract price.[139] The respondents stated that as the margins available to electricity retailers have fallen, so too has the profitability of employing direct marketing techniques to encourage customers to switch[140] and the ability to offer discounts. Those retailers that had decided to cease their direct marketing activities indicated that they were unlikely to commence actively marketing again until either wholesale market conditions improved or the margin available to retailers improved. [141]

137 LECG, *Retailer Survey Report*, p. 5.

138 Most of the retailers that have ceased active marketing noted in the Retailer Survey that they would still accept walk ins but had ceased direct marketing strategies such as door-to-door sales and telesales. See LECG, Survey and interviews with South Australian electricity and gas retailers, June 2008, pg. 9.

139 LECG, *Retailer Survey Report*, p. 8.

140 *Id*.

141 *Ibid*, p. 9.

Wholesale market conditions also appear to have influenced the marketing activities of those retailers that are continuing to employ direct marketing techniques to attract new customers. While their marketing activities continue, these retailers have stated, in the context of the Retailer Survey, that their marketing activities are not as strong as they were a year ago and are not as strong as the marketing activities they are undertaking in other jurisdictions.[142]

The lower margins available in electricity have also caused one dual fuel retailer to temporarily cease its marketing activities in relation to gas. This decision brings to the fore the relationship between electricity and gas retailing. As the table above indicates there are no stand alone gas retailers. According to the retailers participating in the Retailer Survey, the margins available from gas retailing are lower than those available from electricity retailing and thus to ensure the overall retail business is viable, gas retailers have adopted a dual fuel strategy. The perceived importance of the dual fuel strategy is reflected in the following statement made in the context of the Retailer Survey:

> "it's hard to make money out of gas" and means that "you never chase a gas customer alone, you would only chase it in conjunction with the electricity."[143]

Given the interrelationship that exists between electricity and gas retailing in South Australia, any change in the margins available to electricity retailers will have direct implications for the marketing activities undertaken by gas retailers.

The reduction in marketing activities undertaken by electricity retailers and gas retailers already appears to be having implications for the level of switching undertaken by small electricity and gas customers. As noted in Appendix D, the annual rate of gross switching by small electricity customers fell from 24 per cent in September 2007 to 23 per cent by the end of 2007 while for small gas customers it fell from 18 per cent to 13 per cent over the same period.

C.2 Price rivalry

In an effectively competitive market that involves the sale of relatively homogenous products, rivalry will often be based on price. The nature and extent of this rivalry will, however, depend on the influence any price based regulation has on the pricing behaviour of retailers. For the most part, the standing contract prices in South Australia operate as a benchmark for the marketing of alternative price offers and retailers set their prices and price structures by reference to it, rather than by reference to the prices of their competitors. In the early stages of contestability such comparisons can be of some value to consumers because the relevant decision for most customers is whether to move from the standing contract to a market contract. While pricing by reference to the standing contract enables customers to make simple comparisons, it is important to recognise that the standing contract prices

142 *Id*.

143 *Ibid*, p. 32.

bear no necessary relationship to the competitive price and can potentially limit the extent of rivalry between retailers.

Given the tendency amongst South Australian retailers to price by reference to the standing contract prices, the Commission's assessment of price based competition has been undertaken having regard to the extent to which the discounts to the standing contract prices are being offered and the variation in discounts between retailers. This assessment has been based on information contained on ESCOSA's Estimator website and retailers' websites as at 11 June 2008. Another factor considered by the Commission in this context is the extent to which the level and structure of the standing contract prices may be affecting the level of rivalry currently occurring.

C.2.1 Market offers for residential customers

According to information contained on the ESCOSA Estimator on 11 June 2008:

- seven electricity retailers were offering a variety of market contracts to customers located throughout South Australia;[144]
- three gas retailers were offering a number of gas only market contracts to customers located in metropolitan Adelaide, the Barossa and Peterborough regions;[145]
- Origin was the only retailer offering market contracts to customers located in Mount Gambier, Port Pirie, Whyalla, Murray Bridge and Riverland; and
- four retailers were offering dual fuel products to customers in metropolitan Adelaide, the Barossa and Peterborough regions, and one retailer offering these products in regional areas.

C.2.1.1 Electricity market offers

Table C.2 provides a summary of the electricity market offers that appeared on ESCOSA's Estimator on 11 June 2008 (excluding green energy offers).[146] The Commission also used information appearing on retailers' websites to identify the terms and conditions of the market offers including any offers of discounts or the requirement to pay any exit fees.

As can be seen from the information contained in this table, each of the seven retailers that had submitted market offers to ESCOSA were offering at least one electricity market contract with an upfront discount to the standing contract prices.

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144 The seven retailers currently offering products were AGL (including Powerdirect), Momentum Energy, Origin Energy, Red Energy, Simply Energy, South Australia Electricity and TRUenergy.

145 The three retailers currently offering market contracts in Adelaide were Origin, AGL and TRUenergy.

146 The estimates for electricity offers were based on annual peak consumption of 5,014kWh and non-peak consumption of 1,504kWh.

The upfront discounts offered by these retailers range from 3 per cent to 7 per cent off the standing contract prices. A number of retailers also offered additional discounts and price based incentives such as pay on time discounts (offered by three retailers), direct debit discounts (offered by one retailer), gift vouchers (offered by one retailer) and a loyalty discount (offered by one retailer).

Taking into account all of the direct price benefits, the product that was offering the greatest discount is the Simply Click market contract offered by Simply Energy. Red Energy, TRUenergy and Simply Energy also offered market contracts with discounts of 7 per cent or more, while South Australia Electricity offered a discount of 6.3 per cent. Of the remaining products offered, AGL offers discounts of 4-6 per cent and has one product that has the same price as the standing contract price. Origin also markets one product that offered no discount to the standing contract price while its other product contains a 5 per cent discount of that price.

Across the spectrum of offers, retailers were offering discounts in the range of 4.5 per cent to 8.5 per cent (average 5.7 per cent). These discounts are lower than the 10-14 per cent range observed by NERA in March 2007 when it undertook its *Review of the Effectiveness of Energy Retail Market Competition in South Australia* (NERA Report).[147] There also appeared to be fewer products on offer than when NERA undertook its review. The reduction in discounts and the number of products available is likely to reflect a combination of the adverse wholesale market conditions and the fact that six retailers has temporarily ceased active marketing.

Of the seven retailers that were offering market contracts, two offered contracts with a two year fixed term that require customers to pay an exit fee (ranging from $45 to $95) if the contract is terminated in advance of the fixed period. A further two retailers require customers to pay exit fees for non-fixed term products, although both will waive the fee under certain conditions. For instance, one retailer requires notice of termination in writing while the other will waive the exit fee if it is not able to match an offer made by another retailer. Another retailer also charged its customers an account establishment fee of $19.80 for concession card holders and $39.05 for all other customers.

147 These estimates have been calculated using the information contained in Table 7.1 of NERA, *Review of the Effectiveness of Energy Retail Market Competition in South Australia – Phase 2 Report to ESCOSA,* June 2007, pp. 67-68.

Table C.2 Electricity market offers: residential customers[148]

Retailer and Tariff Offer	Price	Discount Relative to Standing Contract[149] ($)	(%)	Discounts/Fees
AGL Standing Contract	**$1,247**			
AGL				
Advantage 5% (fixed term 2 years)	$1,192	**$55**	**4.4%**	$50 voucher $75 early termination fee account establishment fee
Advantage Zero (fixed term 2 years)	$1,247	-	-	$50 voucher $75 early termination fee account establishment fee
Freedom 5%	$1,192	**$55**	**4.4%**	$50 voucher account establishment fee
Freedom Zero	$1,247	-	-	$50 voucher account establishment fee
Powerdirect Residential 110	$1,247	**$74**	**5.9%**	
Momentum Energy				
SA Open	$1,392	-	-	
Origin				
HomeChoice	$1,185	**$62**	**5.0%**	
HomeSupply	$1,247	-	-	
Red Energy				
Easy Saver	$1,185	**$62**	**5.0%**	Pay on time discounts
Let's Grow Trees	$1,210	**$37**	**3.0%**	Pay on time discounts
Red Fixed Term Saver (fixed term 2 years)	$1,160	**$87**	**7.0%**	Pay on time discounts $90 early termination fee year 1 $45 year 2
Simply Energy				
Power Saver	$1,181	**$66**	**5.3%**	$30 sign on rebate
Save with RAA	$1,192	**$55**	**4.4%**	
Save@Home	$1,170	**$77**	**6.2%**	
Save@Home (Direct Debit)	$1,159	**$88**	**7.1%**	
Simply Click (Online & Direct Debit)	$1,138	**$109**	**8.7%**	7% discount off consumption, 1% discount for direct debit , 1% for pay on time and 1% loyalty after 12 months
Simply Click (Online)	$1,148	**$99**	**7.9%**	7% discount off consumption, 1% discount for direct debit , 1% for pay on time and 1% loyalty after 12 months
South Australia				
Electricity	$1,168	**$79**	**6.3%**	$75 exit fee.
TRUenergy				
Go Easy	$1,210	**$37**	**3.0%**	3% pay on time discount
Go For More	$1,160	**$87**	**7.0%**	4% discount off bill and 3% pay on time discount. Exit fees for early termination $50-$90

Sources: ESCOSA Estimator and retailer websites.

C.2.1.2 Gas market offers

Table C.3 summarises of the gas market offers that appeared on ESCOSA's Estimator on 11 June 2008 for customers in Adelaide and regional areas of South Australia.

148 Savings and percentage discounts are as calculated from ESCOSA Estimator data. The savings represent savings off the total bill. The information was current as at 11 June 2008.

149 The ESCOSA comparator appears to have incorporated the "pay on time" discounts offered by some retailers into the price payable under a market contract but some of the "loyalty" discounts do not appear to have been included in these prices.

Table C.3 Gas market offers – residential customers[150]

	Retailer and Tariff Offer	Price	Discount Relative to Standing Contract[151] ($)	Discount Relative to Standing Contract[151] (%)	Discounts/Fees
Adelaide Metropolitan, Barossa and Peteroborough	**Origin Standing Contract**	**$626**			
	Origin				
	HomeChoice (Adelaide Metro)	$613	**$13**	**2.1%**	Account fee if moving house
	Everyday Saver	$603	**$23**	**3.7%**	$50 bonus $44 early termination fee
	HomeSupply (Adelaide Metro)	$626	-	**-**	Account fee if moving house
	AGL				
	Advantage 5% (fixed term 2 years)	$600	**$26**	**4.2%**	$50 voucher $75 early termination fee account establishment fee
	Advantage Zero (fixed term 2 years)	$623	**$3**	**0.5%**	$50 voucher $75 early termination fee account establishment fee
	Freedom 5%	$600	**$26**	**4.2%**	$50 voucher account establishment fee
	Freedom Zero	$623	**$3**	**0.5%**	$50 voucher account establishment fee
	TRUenergy				
	Go Easy	$604	**$22**	**3.5%**	3% pay on time discount
	Go For More	$579	**$47**	**7.5%**	4% discount off bill and 3% pay on time discount. Exit fees for early termination $50-$90
Regional	**Origin Standing Contract[152]**	**$629**			
	Port Pirie				
	HomeChoice	$616	$13	**2.1%**	Account fee if moving house
	Everyday Saver	$606	$23	**3.7%**	$50 bonus $44 early termination fee
	Home Supply	$629	-	**-**	Account fee if moving house
	Whyalla				
	HomeChoice	$616	$13	**2.1%**	Account fee if moving house
	Everyday Saver	$606	$23	**3.7%**	$50 bonus $44 early termination fee
	Home Supply	$629	-	**-**	Account fee if moving house
	Mt Gambier				
	HomeChoice	$617	**$12**	**1.9%**	Account fee if moving house
	Everyday Saver	$606	$23	**3.7%**	$50 bonus $44 early termination fee
	Home Supply	$629	-	**-**	Account fee if moving house
	Riverland/Murray Bridge				
	HomeChoice	$616	$13	**2.1%**	Account fee if moving house
	Everyday Saver	$606	$23	**3.7%**	$50 bonus $44 early termination fee
	Home Supply	$629	-	**-**	Account fee if moving house

Data sources: ESCOSA Estimator and retailer websites.

150 Savings and percentage discounts are as calculated from ESCOSA Estimator data. The savings represent savings off the total bill. The information was current as at 11 June 2008. The estimates for gas offers were based on an annual consumption of 24.066GJ.

151 The ESCOSA comparator appears to have incorporated the "pay on time" discounts offered by some retailers into the price payable under a market contract but some of the "loyalty" discounts do not appear to have been included in these prices.

152 The Commission understands that the difference in the standing offer tariffs applying in regional areas stems from differences in the costs of transporting gas to these locations relative to Adelaide.

Based on the information contained in this table it is apparent that all three retailers offered at least one gas market contract at a discount to the standing contract price to customers located in Adelaide. The upfront discounts to the standing contract prices contained in these contracts range from 0.5 per cent to 4 per cent. In addition to the upfront discounts one retailer supplying customers in Adelaide also offers a pay on time discount of 3 per cent, one offers a $50 gift voucher and one offers a $50 sign on bonus.

Taking into account all of the direct price benefits, the product that offered the greatest discount to customers in Adelaide is the Go For More market contract offered by TRUenergy. Market contracts containing discounts ranging from 3.5 per cent to 4.2 per cent include those offered by AGL, Origin and TRUenergy. Across all retailers, the discounts on offer range from 0.5 per cent to 7.5 per cent (average 3.2 per cent) in Adelaide. When compared with the discounts observed by NERA in the NERA Report[153] it would appear that the range of discounts offered by retailers are broadly similar to those that prevailed in March 2007, the number of products on offer has fallen. This reduction can largely be attributed to the fact that one gas retailer has temporarily ceased active marketing.

One retailer operating in Adelaide also offered a two year fixed term contract with a fee of $75 payable for early termination. This retailer charged an account establishment fee of $19.80 for concession card holders and $39.05 for all other customers. Another retailer supplying customers in Adelaide required customers to pay an exit fee ranging from $50 to $90 for a non-fixed term product, although it will waive the fee if it receives a notice of termination in writing.

In regional areas, Origin is the only retailer that offered market contracts to customers. Two of the three market contracts offered in these areas currently include an upfront discount to the applicable standing contract price. Specifically, the HomeChoice product offers customers an upfront discount of two per cent off while the Everyday Saver offers customers a discount of four per cent. Customers selecting the Everyday Saver product were also entitled to a $50 sign on bonus but must pay an exit fee if the contract is terminated within two years. While the discount offered by Origin in regional areas was the same as that offered in Adelaide, regional customers are currently unable to access the higher discounted products such as those offered by TRUenergy. However, as the market offers available in Adelaide are subject to more intense competitive pressures, the availability of the same level of discounting in Origin's regional gas market offers provide some of the benefits of competition to these customers.

C.2.1.3 Dual fuel market offers

Dual fuel market offers were being made to customers located in the Adelaide, Barossa and Peterborough regions by Origin, AGL, TRUenergy and Simply Energy, while customers located in regional areas can only obtain a dual fuel product from

153 NERA, *Review of the Effectiveness of Energy Retail Market Competition in South Australia – Phase 2 Report to ESCOSA*, June 2007, p. 70.

Origin.[154] Based on information obtained from the ESCOSA Estimator it would appear that dual fuel products that were being marketed with the same discounts as those offered under stand alone gas and electricity market contracts although retailers do offer additional incentives such as one month free electricity, free magazine subscriptions, additional direct debit rebates and "one off" sign on bonuses.

C.2.2 Market offers for small business customers

The ESCOSA Estimator has recently been expanded to include the electricity market offers made to small business customers. Due to the variability of their consumption requirements, the ESCOSA Estimator gives small businesses the ability to compare offers that have been received from different retailers. For this reason, a generic assessment of offers was not completed and the Commission has had recourse to the material available on retailers' websites to ascertain what market offers were available. The Commission's review of retailers' websites revealed that there was very little publicly available information on the general market offers made available to small businesses. One possible reason for this is that the Energy Price Disclosure Code currently only requires retailers to publish information on the market offers made to residential customers. Another factor may be that the consumption patterns of small businesses can vary markedly between customers and as a consequence retailers are less likely to be able to develop generic products.

Of the websites reviewed by the Commission, only Origin and TRUenergy provided a statement on the offers available to small business electricity consumers.[155] According to information contained on Origin's website, small business electricity consumers can obtain a ten per cent discount off the standing contract prices by signing up to the Business Choice market contract. A termination fee is payable under this contract during the first year. TRUenergy's website contained two market offers referred to as TRUenergy Business Edge and TRUenergy Business Now. TRUenergy Business Edge offered small business customers a ten per cent discount on electricity and gas bills (calculated using standing contract prices) but imposes exit fees if the contract is terminated within three years. TRUenergy Business Now offered small business customers an upfront three per cent discount, an additional three per cent discount if payments are received by the due date and termination fees are payable if the contract is terminated within the first year.

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154 For the purpose of this report, a "dual fuel" customer is a customer who has entered into a single contract with a retailer, or two contracts with the same retailer, for the retail sale and supply of electricity and gas. The Commission recognises that the Energy Retail Code ascribes a specific meaning to the term "dual fuel contract"; specifically, that the gas and electricity are supplied pursuant to a single contract. For the purpose of the Commission's analysis the term "dual fuel customer" should be taken to mean both a customer that is provided with electricity and gas retailer services under a single contract and a customer that is supplied the same under two separate contracts with a single retailer.

155 The websites of retailers were reviewed on 11 June 2008.

C.2.3 Tariff design

With the exception of Aurora Energy, retailers in South Australia have to date tended to adopt the same tariff structure as that specified in the standing contract prices when developing market offers for residential customers.[156] Any discounts offered by retailers have therefore tended to take the form of a discount on the overall bill or the energy usage charge (calculated using standing contract prices). The tendency for retailers to utilise the standing contract prices as the benchmark for their own product development has meant that to date there has been very little innovation in tariff design.

A large number of the retailers participating in the Retailer Survey were of the view that the lack of differentiation in tariff structures observed to date could largely be attributed to the existence of the standing contract prices.[157] Origin expressed a similar view in its submission to the Issues Paper but acknowledged the positive role that a benchmark, such as that provided by the standing contract prices, can play when marketing to customers:

> "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. "[158]

This view was also echoed by a number of retailers in the Retailer Survey. In this context retailers noted that offering 'a percentage off' the standing contract price was a simple and effective method of communicating their offers to customers and that customers were likely to respond more readily to price discounts than other more complex price offerings.[159]

Retailers participating in the Retailer Survey also observed that the removal of the standing contract prices would facilitate greater product innovation. A number also noted that they would look for another, easily understood, benchmark such as their competitor's tariffs:

> "If it [the standing contract price] wasn't there we'd probably have to use another benchmark; we're offering a discount off something so we're going to have to know what rate that person's on before we start offering them a

156 Country Energy had previously offered a fixed price market contract where the price was s constant over the life of the contract but this product is not currently available.

157 LECG, *Retailer Survey Report*, p. 25.

158 Origin, submission to the Issues Paper, p. 7.

159 LECG, *Retailer Survey Report*, p. 25.

discount … if it were a [retailer] dominated area you're probably start with the [retailer] rates … and have to be offering discounts on those …"[160]

The Commission appreciates the positive informational role a benchmark can play in a consumer's decision making process. However, it is important to recognise that the use of a benchmark can reduce the incentive and ability for retailers to develop and offer more innovative price structures and in so doing have a detrimental effect on product innovation. The potential for tariff innovation can be seen from the example provided by retailers in the UK, Sweden and Norway. Since the removal of the benchmark regulated price in the UK, retailers have responded to customer demand by offering more innovative tariff designs such as price guarantee deals, fixed price, capped price and tracker deals.[161] Retailers in Norway and Sweden have also sought to respond to consumer preferences by developing a range of products including that link the retail price to the spot price of electricity, that fix the retail price for one to five years, and products those that have a fixed component and a component that is linked to the spot price.[162]

In addition to reducing the incentive for product innovation, a benchmark can also act to dampen price based competition amongst retailers by virtue of being the high point of reference for market offers. That is, rather than prices being determined through competitive forces which push prices toward the long run efficient cost of supply, prices can tend to cluster around the benchmark. A benchmark can also facilitate tacit collusion amongst retailers by operating as a readily observable price around which prices can be coordinated.

Competition may also be adversely affected if the benchmark is fixed and fails to reflect the rising costs of energy supply. In these circumstances the reduction in profit margins available to retailers may result in a reduction in the scope for price competition and the viability of energy retailers. As noted in section C.1 there are indications that the standing contract prices, particularly in electricity, have over the last eighteen months had an adverse effect on competition with six out of the ten electricity retailers and one out of the four gas retailers deciding to temporarily cease active marketing until such time as margins improve.

As noted above, currently Aurora Energy is the only retailer that is currently offering a product that is differentiated on the basis of tariff design. This product, referred to as Aurora Energy Pay As You Go, is essentially a pre-payment product and requires customers to obtain a pre-payment electricity meter and a smart card. Customers must add funds to the smart card in order to activate the meter. The credit on the card is then reduced in accordance with their electricity usage. The meter used by Aurora Energy is a time of use meter and the charges currently offered to customers by Aurora Energy are based on time of use charges with prices varying during peak and off-peak periods. The Pay As You Go product developed by Aurora Energy

160 LECG, *Retailer Survey Report*, p. 25.

161 Ofgem, *Domestic Retail Market Report*, June 2007, pp. 12-15.

162 Professor George Yarrow, *Report on the Impact of Maintaining Price Regulation*, Oxford, January 2008, pp. 62-64.

represents one of the more significant product innovations that have occurred in South Australia to date and distinguishes Aurora Energy from its competitors.

C.3 Non-price rivalry

In addition to discounts off the standing contract prices, retailers may compete for customers by offering other non-price benefits that do not constitute a direct monetary rebate (i.e. benefits other than discounts from energy supply charges or specified monetary rebates). Retailers offer non-price benefits in an effort to differentiate their offers from those of their rivals and to attract those customers for whom a price discount does not offer sufficient motivation to switch. Non-price benefits can take a number of forms including improved environmental outcomes, in-kind incentives and customer service. The remainder of this section examines the rivalry that has occurred in these areas.

C.3.1 Green energy

The development of 'green energy' contracts has emerged as one of the more significant areas in which electricity retailers have sought to compete on the basis of product rather than price. A green energy contract provides for a specified proportion of electricity (generally between 10 and 100 per cent) to be generated from renewable energy sources such as solar or wind farms. These contracts are generally offered at a price premium to the standing contract prices, with the premium increasing with the proportion of renewable energy purchased. The emergence of these products has largely occurred in response to customer demand for environmentally friendly supply options.[163]

There are currently two different types of green energy contracts: accredited "GreenPower" and other green energy products. Contracts referred to as "GreenPower" are those accredited by the National GreenPower Accreditation Program. To be endorsed as GreenPower, electricity must be derived from accredited renewable energy sources that meet strict environmental standards from facilities built after January 1997. Retailers that sell electricity sourced from renewable energy facilities built prior to 1997 may not use the GreenPower logo but may still advertise their products as 'green'.[164]

The Commission's review of green energy products offered by retailers indicates that most of the electricity retailers operating in South Australia offered at least one product with a component of accredited green energy or renewable energy. Both Jackgreen and Red Energy have sought to distinguish their entire product line on the basis of green energy, with all of Jackgreen's products including a component of accredited green energy and Red Energy's products based on renewable energy

163 As at 31 March 2008, 71,037 South Australian residential customers and 1,817 small business customers were supplied under GreenPower accredited market offers, for whom GreenPower sales reached 44,367 MWh for the quarter ended 31 March 2008: GreenPower e-bulletin, Issue 25: May 2008 at www.greenpower.gov.au.

164 Non-accredited products generally source renewable energy from old sources such as large hydro-electric projects.

products. In addition to offering a component of green energy in all their products, these two retailers also offer a tree planting initiative. One gas retailer is also currently offering a 'green' gas product which 'neutralises' the greenhouse gas emissions associated with the gas consumed by investing in emission reduction programmes.

The premium above the standing contract prices typically charged for green energy products depends on the proportion of renewable energy offered in the product. Across the board, the premiums range from 2 to 27 per cent although there are at least two retailers offering a product with a component of accredited energy at standing contract price. While it appears that there is no premium payable on these products, the retailers offering these products do not offer the same discounts for these products as those offered for equivalent non-green energy products and thus the premium can be implied as the difference between the discounts that would otherwise be available and the standing contract price.

A number of retailers that made submissions to the Issues Paper and participated in the Retailer Survey noted that the emergence of green products reflected the responsiveness of retailers to consumer preferences. This view is reflected in the following statement made by TRUenergy in its response to the Issues Paper:

> "…the growth of green energy products is evidence that developments in consumer preferences are reflected in product offerings, to the extent the regulatory framework allows." [165]

A large number of retailers participating in the Retailer Survey also observed that while customers were interested in green energy products, they were generally not willing to pay much of a premium for the product although they were willing to forego a small discount.[166]

C.3.2 In-kind incentives

A number of other non-price benefits have been offered by retailers as part of their market offers. Most of these have a specified monetary value but may be valued differently by individual customers.

As part of the Retailer Survey, the Commission asked retailers to provide details of the in-kind incentives they had offered to date. Seven electricity retailers and four gas retailers indicated that they had offered at least one in-kind incentive in conjunction with their market offers in 2007. [167] The most common forms of in-kind incentives offered to customers included magazine subscriptions, DVDs, sporting club membership and voucher/loyalty rewards although the types of incentives

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165 TRUenergy, Review of Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia, 11 April 2008, p. 5.

166 LECG, *Retailer Survey Report*, p. 28.

167 *Id*.

offered to customers were continuously changing.[168] According to the responses received in the Retailer Survey the value of these in-kind incentives generally amounted to less than five per cent of the customer's energy bill. [169]

The Retailer Survey also revealed a mixed view of the value of these in-kind incentives in attracting customers. While six electricity retailers ranked the incentives as being important or very important in the overall marketing strategy, a number of retailers were of the view that the value placed on these incentives by customers were diminishing in favour of price based incentives.[170] This latter view is broadly consistent with the results of the Consumer Survey which found that less than two per cent of respondents had switched in response to a free gift or loyalty bonus compared to 43-85 per cent of customers that had switched in response to price. [171]

C.3.3 Customer service

The Energy Retail Code currently requires retailers to comply with the following minimum service standards:

- respond to 85 per cent of telephone calls within 30 seconds when calls are received between 8 am and 6 pm on business days; and
- respond to 95 per cent of written enquiries within five business days.

In its submission the Energy Ombudsman referred to these minimum service standards and concluded that:

> "It is not unreasonable that customers participating in a competitive market should expect to receive a base line level of service regardless of provider". [172]

The Energy Ombudsman went on to add that the base line service standards had effectively reduced the number of matters referred to it.

While the Energy Ombudsman viewed the minimum service standards as being beneficial, retailers participating in the Retailer Survey viewed the service standards as onerous. Retailers also viewed the service standards as limiting their ability to differentiate their products on the basis of customer service.[173]

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168 *Id*.

169 *Ibid*, p. 14.

170 *Ibid*, p. 29.

171 McGregor Tan, *Consumer Survey Report*, pp. 36 and 85. For electricity customers surveyed 70 per cent of residential customers and 85 per cent of small business customers switched in response to price. For gas customers surveyed 63 per cent of residential customers and 43 per cent of small business customers switched in response to price.

172 Energy Industry Ombudsman of South Australia, submission to the Issues Paper, April 2008, pp. 3-4.

173 LECG, *Retailer Survey Report*, pp. 31 and 65.

C.4 Marketing practices

In order for customers to take advantage of the price and non-price offers available from retailers, they must be aware of them. In markets involving the sale of relatively low involvement products such as energy, the costs incurred by customers in researching alternative products may be perceived to be too high given the potential benefits of switching. Retailers may therefore seek to ameliorate some of the perceived search and switching costs by employing direct marketing techniques that impart information directly to consumers. The extent to which retailers employ these techniques and respond to the marketing campaigns adopted by other retailers may provide a further indication of the level of rivalry that exists between them.

The marketing strategies adopted by retailers can vary markedly and may be focused on attracting a large range of customers or a sub-set of customers. While competition is likely to be stronger where suppliers compete for a wide range of customers, smaller niche players also have the potential to constrain the behaviour of larger firms, particularly in those markets characterised by low barriers to expansion or where particular groups of consumers have different requirements. As noted in Chapter 2, where there is sufficient rivalry between retailers for most types of customers and a sufficient number of marginal customers are switching, competition is likely to be effective in ensuring that retailers' price, quality and service offerings reflect their efficient costs and the preferences of customers.

The remainder of this section examines the sales and marketing channels used by retailers in South Australia and considers the extent to which retailers actively compete for different types of customers. This section also considers whether there is any evidence to suggest that misleading, deceptive or unconscionable marketing practices are prevalent in South Australia.

C.4.1 Sales and marketing channels used by energy retailers

The Retailer Survey indicates that retailers in South Australia are utilising a range of sales channels to market their offers to both residential and small business customers. The sales channels utilised to date include those that involve direct contact with prospective customers, i.e. door-to-door sales and telesales, and indirect contact i.e. mail outs, bill inserts, internet advertising, affinity retailing[174], television, radio, print and outdoor advertising.[175] The table below provides a summary of the perceptions held by the fifteen licensed or prospective electricity and gas retailers surveyed on the importance of twelve alternative direct and indirect sales channels in attracting customers.

174 Affinity retailing refers to advertising or selling products or services through an affiliated entity (e.g. RAA).

175 Outdoor advertising refers to advertising in public places such as at bus shelters and on billboards.

Table C.4 Retailer perceptions on relative importance of sales channels

Sales Channel	Not considered	Considered	Moderately important	Important	Very important	Total number ranking channel as moderately to very important
Door knocking	●		●	●●	●●●●●●● ●●	14
Inbound telesales			●●●●	●●●	●●●●●●●	15
Outbound telesales	●		●●●	●●●●	●●●●●●	14
Internet advertising		●●●	●●●●	●●●●●	●●●	12
Bill inserts	●●●	●	●●●●	●●●●	●	9
Direct mail	●	●●●●	●●●	●●●●●●●		10
Newspapers and other print media		●●●●●	●●●●●●	●●●●		10
Affinity retailing	●●	●	●●●●●●	●●●●●		11
Outdoor advertising		●●●●●	●●●●●●●	●●●		10
Television	●●●	●●●●	●●	●●●●●	●	8
Radio	●●	●●●●●●	●●●●	●●	●	7
Sponsorship	●●	●●●●●●	●	●●●●●		6

Data source: LECG, *Retailer Survey Report*, section 5.4.

As can be seen from the table above, direct marketing techniques such as door-to-door sales and telemarketing were viewed as being very important to attracting customers by the majority of retailers participating in the survey. Given the relative importance of this marketing technique in attracting customers, it is not surprising that competing retailers tend to respond relatively rapidly to decisions by their competitors to expand or otherwise enhance their direct marketing campaigns. However, submissions on the First Draft Report questioned whether direct marketing allowed consumers to achieve benefits from switching and effectively participate in the market.[176] The Alternative Technology Association noted:

> "Direct marketing by an electricity retailer will always be biased in favour of that retailer's product and as such, information gained via direct marketing cannot be taken by the astute consumer as a balanced appraisal of the best market opportunities."[177]

The Commission considers that the active marketing strategies implemented by retailers are reflective of the low-involvement nature of energy products where consumers generally have a low level of interest. Direct marketing is a legitimate form of marketing and by approaching customers, retailers increase customers' interests in energy products and customers become better informed about their options overall. Direct marketing can also overcome actual or perceived search and switching costs.

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[176] Including submissions received from Uniting*Care* Wesley, the Alternative Technology Association, The South Australian Minister for Energy.

[177] Alternative Technologies Association, submission on the First Draft Report, p. 2.

Marketing via the internet was another sales channel that was viewed as important by a large number of retailers. Other sales channels viewed as important by the majority of retailers included bill inserts, direct mail, newspapers and other print media, affinity retailing and outdoor advertising. Bill inserts were viewed as particularly effective by dual fuel providers in signing up existing customers to the second fuel.

Views on the importance of television and radio were somewhat mixed with eight of the fifteen retailers surveyed viewing television as important and seven retailers viewing radio as being important.[178] Of the retailers surveyed, larger retailers were more likely to use mass media advertising such as television, radio and print advertising on a regular basis. Smaller retailers were only likely to use these mediums when launching their business or a new product.

Retailers' perceptions on the importance of direct forms of marketing in preference to television, print and radio advertising is consistent with international experience in energy markets and is reflective of customer characteristics and attitudes to energy supply.[179] The relatively low use of television, radio and print advertising, particularly by new retailers is also consistent with retailers' views of the importance of brand recognition. Only two of the ten retailers that responded to the Retailer Survey rated brand recognition as one of the main reasons why customers entered into a market contract with their business. None of the retailers surveyed considered brand awareness to be a strong barrier to entry or expansion of new retailers.

The retailers participating in the Retailer Survey were also questioned on the methods used to retain customers. The methods cited by retailers in this context included matching offers made by other retailers, paying loyalty discounts to those customers that remained for a given period, using direct mail outs and bill inserts. Customer service was also referred to by a number of retailers as being of some importance in retaining customers, with a number of retailers stating that while customers switched in response to price discounts they were more likely to remain with a retailer if the customer service was of a sufficient quality.[180]

C.4.2 Target customers

The extent to which retailers actively compete for different types of customers is reflected in both the types of products they offer and the extent to which they target their marketing activities at particular customer groups or locations. In general, competition is likely to be more effective in those markets where a number of retailers target a wide range of customer groups across locations.

As noted in section C.2, most retailers operating in South Australia market generic contracts which feature price discounts off the standing contract prices, discounts for prompt payment, non-price incentives and/or green energy. With the exception of

178 LECG, *Retailer Survey Report*, pp. 38 and 42.

179 See Ofgem, *Marketing Gas and Electricity: Consultation Document*, January 2000.

180 LECG, *Retailer Survey Report*, p. 14.

gas customers located in regional areas, these offers are generally made available to all customers who are free to self-select products that contain the features of most value to them. For small gas customers located in regional areas, the structural conditions relating to access to transmission services, coupled with the relatively small number of customers, has limited the economic viability of new retailers operating in these areas. Hence customers in these areas are limited in their ability to access the offers made by new retailers.

While most of the products developed by retailers are generic in nature, a number of retailers do focus their door-to-door sales and telemarketing campaigns on locations that reflect their 'preferred customer' profile. Amongst those retailers surveyed, most viewed high energy consumers and consumers that have the capacity to pay their energy bills (i.e. income and creditworthiness) as fitting the 'preferred customer' profile which largely reflects the fact that customer acquisition costs are fixed and can be substantial.[181] To identify those customers that fit the 'preferred customer' profile for the purposes of door-to-door sales, a number of retailers participating in the Retailer Survey noted that they used sophisticated methods that enabled them to identify target streets (or parts of a street) within a particular location.[182] Although retailers would be expected to initially target those suburbs which are likely to prove most profitable, there is no reason to expect that marketing campaigns would not be extended to all customers, subject to the caveat that it is economically viable to market to particular customer groups or customers within certain locations.

One group of customers that may be less likely to be contacted by retailers are customers with a high credit risk. Although these customers may be ineligible for certain offers due to their personal circumstances, there is little evidence to suggest that they are more likely to be considered high credit risk have been excluded from the marketing activities of retailers.

On the basis of the foregoing, it would appear that apart from small gas customers located in regional areas the offers developed by retailers are available to all customers irrespective of their location, income or consumption levels and that there is active rivalry between retailers for the majority of customers.

C.4.3 Prevalence of mis-selling practices

A number of the submissions received by the Commission in response to the Issues Paper referred to the potential for the marketing practices employed by retailers in

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181 LECG, *Retailer Survey Report*, p. 42. Retailers suggest that the average acquisition cost for a residential electricity customer is between $101 to $207 and for a small business electricity customer ranges between $126 to $301. LECG Report, pp. 47-48. Retailers will make higher absolute returns from customers with high energy consumption over the course of their supply agreement where the variable component of the tariff structure (i.e. the charge per kWh or per GJ) exceeds the variable cost of supply. These returns can be used to recover the fixed costs of acquisition and supply. Retailers may be much more limited in their ability to recover their fixed costs from low use customers, particularly if the structure of the standing offer tariff is not reflective of the cost of supplying these customers.

182 LECG, *Retailer Survey Report*, p. 43.

South Australia to involve high pressure sales techniques, misleading, deceptive or unconscionable conduct. For instance, in its submission to the Issues Paper the South Australian Farmers Federation observed:

> "…the use of aggressive telephone and door to door marketing, misleading names and difficult to understand structures all lead to mis-selling in our view. The operators we have dealt with on the whole were ethical in their conduct although there were a couple of issues with several members where meter change over costs were not explained clearly. The details were in the contract but the sales pitch outlining the benefits of the deal failed to inform of these costs clearly." [183]

The Council on the Ageing (COTA) also raised concerns about the high pressure sales tactics employed by retailers:

> "Some churn has resulted from aggressive marketing strategies adopted by retailers where vulnerable consumers have either finally succumbed to 'get rid' of the retailer or where oral consent was assumed to be given but not actually given - not from a genuine desire by the consumer to switch to a product more beneficial to them".[184]

The results of the Consumer Survey indicated that over 90 per cent of respondents had not experienced any problems with the marketing activities although there were a small numbers of customers that had experienced problems such as:

- not being provided with written information on the offer;
- feeling pressured into signing a contract;
- being misled by sales people on price and terms and conditions of supply; and
- being transferred without explicit informed consent.[185]

The Commission recognises the potential for direct marketing in some cases to involve high pressure sales techniques, misleading, deceptive or unconscionable conduct which may undermine the effectiveness of competition within a market. The Commission has therefore considered the extent to which this may be occurring in South Australia having regard to information provided by the Energy Ombudsman in its submission to the Issues Paper.[186]

Figure C.1 illustrates the number of contacts made to the Energy Ombudsman on issues pertaining to competition between 2003/04 and 2006/07. The term competition in this context includes complaints made about:

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183 South Australian Farmers Federation, submission to the Issues Paper, April 2008, p. 11.

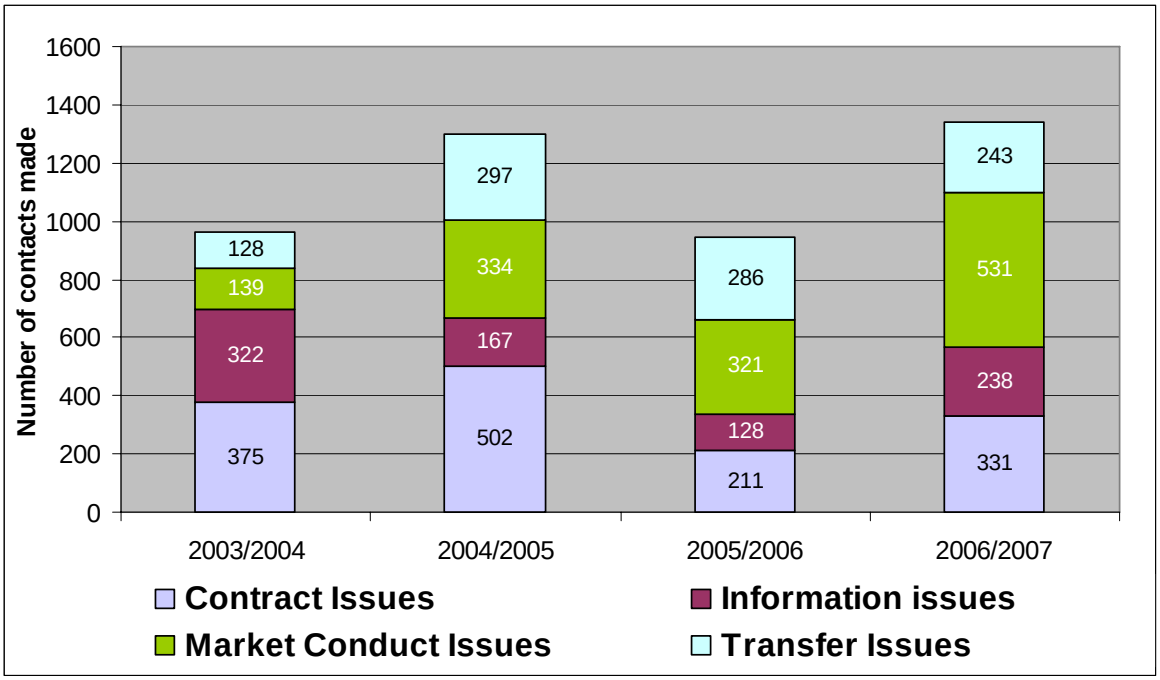
184 Council On The Ageing, submission to the Issues Paper, 11 April 2008, p. 8.

185 McGregor Tan, *Consumer Survey Report*, p. 112.

186 South Australian Energy Industry Ombudsman, submission to the Issue Paper, 10 April 2008.

- contracts – includes complaints relating to access to contracts, termination of contracts and contract conditions;
- information – includes complaints relating to the inability to compare offers and general enquiries on retailers;
- market conduct – includes complaints alleging coercion or pressure to enter into a contract, misleading conduct or failure to gain explicit informed consent; and
- transfer process – includes complaints relating to transfer delays and double billing.

Figure C.1 Competition contacts made to the Energy Ombudsman



Source: Energy Industry Ombudsman of South Australia, *submission to the Issues Paper*, April 2008, p. 2.

As this figure highlights, over the four year period the total number of contacts made with the Energy Ombudsman has not shown any noticeable trend with the number of complaints rising in 2004/05, falling in 2005/06 and subsequently rising in 2006/07. Using the total number of transfers in each year as a proxy for the intensity of marketing activity, the number of competition contacts made to the Energy Ombudsman per 100 customer transfers has actually fallen from 1.3 in 2003/04 to 0.6 in 2004/05 and down to 0.5 in 2005/06 and 2006/07. These results suggest that when the level of marketing activity is actually taken into account, the proportion of customers making complaints has actually fallen.

The Energy Ombudsman also provided the Commission with information on the number of complaints received in relation to each retailer and it would appear from this information that there is no substantial concentration of complaints against any particular retailer.

On balance, the information provided by the Energy Ombudsman indicates that while there have been a number of instances of misleading or deceptive marketing conduct by retailers or their agents, there is no evidence to suggest that adverse selling practices have been widespread or systemic in South Australia. Rather, it would appears that most complaints stem from misunderstandings between the retailer and customer. In its submission to the Commission, the Energy Ombudsman noted that retailers generally resolved these misunderstandings in a prompt manner by allowing the customer to return to their previous retailer without penalty and in some cases offered a small payment to the customer. The Energy Ombudsman also noted that in cases where misleading conduct or pressure to enter into a contract had been uncovered, the retailers had generally dismissed the staff involved or altered their marketing channels.[187]

The willingness of retailers to respond promptly and decisively to complaints regarding misleading or deceptive conduct reflects the broader incentive a retailer has to avoid the significant direct and indirect costs that bad marketing practices can impose on a retailer. These direct and indirect costs include both the time and expense incurred in processing and resolving the complaint and the effects on the retailer's reputation.

On the basis of the evidence currently before the Commission, there is nothing to suggest that retailers have been systematically employing misleading, deceptive or unconscionable marketing techniques. That is, while some members of the community have had a negative experience with the marketing techniques, these problems do not appear to be widespread and when they do arise retailers appear to resolve the issue relatively quickly in favour of the consumer. Notwithstanding the Commission's finding that adverse selling practices have not been widespread or systemic, the Commission continues to see a role for an effective consumer protection framework in deterring misleading or deceptive conduct and supporting the functioning of an effectively competitive market.

C.5 Provision of information

In competitive markets, suppliers have an incentive to provide customers with relevant information about their products and services and the advantages they offer relative to that of their competitors. However, in markets that are in transition from monopoly to competitive supply, or involve the sale of products with relatively complex pricing structures, information provided by suppliers independently of one another may not allow for easy comparison. In these types of markets, policy or regulation may mandate certain forms of information disclosure to assist customers in making informed choices regarding their supply options.

187 *Ibid*, p. 3.

C.5.1 Mandatory information disclosure

In South Australia, energy retailers are required to disclose information about their market offers in accordance with the Energy Marketing Code and the Energy Price Disclosure Code.

The Energy Marketing Code requires retailers to provide small customers that are about to enter into a market contract with a written disclosure statement. The content of this written disclosure statement is prescribed in clause 14 of the Energy Marketing Code. This clause requires retailers to provide information on the marketer, the date of commencement of the contract, the applicable prices, charges, tariffs and service quality levels, the manner by which prices or charges may change, any other costs payable upon entering into the contract, payment methods, early termination charges and details of the dispute resolution mechanism. Further information about the disclosure obligations contained in the Energy Marketing Code is set out in Appendix B.

In accordance with the Energy Price Disclosure Code, retailers are required to publish a price fact sheet for each market offer made to residential customers. This fact sheet must outline the estimated annual cost of energy across an array of low, medium and high energy consumption bands and identify any other exit fees or rebates applying to that contract. These price fact sheets must be provided to a residential customer on request and must also be published on the retailer's website and provided in combination with, or included within, the written disclosure statement required under the Energy Marketing Code.[188] In addition to requiring retailers to make information available to customers, the Energy Price Disclosure Code also requires retailers to make the same level of information available to ESCOSA. ESCOSA recently consulted on amendments to the Energy Price Disclosure Code to require retailers to make their fact sheets more accessible to consumers.[189]

The Energy Price Disclosure Code is currently limited in its operation to residential market offers and does not impose any requirements on retailers developing market offers for small businesses.

C.5.2 Retailer compliance with information requirements

ESCOSA monitors compliance with the specific codes and guidelines that apply to retailers. In its most recent compliance report spanning 2006/07, ESCOSA noted that it had some concerns with the apparent failure of a number of retailers to publish the fact sheets required under the Energy Price Disclosure Code on their websites.[190] ESCOSA stated that it would "vigorously" pursue this issue with retailers and would

188 Energy Price Disclosure Code, clause 1.

189 ESCOSA, *Proposed Amendments to the Energy Price Disclosure Code – Discussion Paper*, June 2008.

190 ESCOSA, *2007 Annual Regulatory Compliance Report*, p. 17.

move to "strengthen and clarify" the availability standards applying to the price fact sheets over 2007/08.[191]

The Commission shares the concerns expressed by ESCOSA and agrees that compliance should be actively monitored to ensure that retailers meet their information disclosure obligations on an ongoing basis. In the Commission's view, the importance of providing customers with information that can be used to make an informed judgement cannot be understated. It is therefore incumbent upon retailers to comply with the information provisions specified in any codes applying to them and to ensure that their employees (and any agents undertaking direct marketing activities on behalf of the retailer) are providing information to customers in accordance with these obligations.

C.5.3 Other information sources

Retailers involved in the Retailer Survey identified the internet as the principal method by which information is disseminated to prospective customers. For existing customers the principal avenues of information provision included bill inserts and outbound telesales.

In addition to evaluating the information provided by retailers, residential customers can compare market offers with their current arrangements (either the standing contract or a market contract) using ESCOSA's online Estimator or other commercial online comparator services.

ESCOSA's online Estimator estimates the annual charge that would be payable by residential customers under a range of alternative market offers available in the residential customer's location on the basis of their consumption profile and identifies the savings available relative to the standing contract offer. The only information a consumer requires to use this tool is a recent energy bill which provides the information required on the customer's consumption profile.

The Estimator was initially developed for use by residential customers only. It has recently been expanded to give small business customers the ability to review and compare alternative offers. In the Commission's view, this new functionality has the potential to encourage further participation by small business customers by ameliorating some of the search costs that have impeded their participation to date (see Appendix D). The Commission therefore views this as a welcome development.

C.6 Commission's findings

The results of the Commission's analysis of price rivalry indicate that rivalry to date has largely centred on discounts off the standing contract prices with very limited tariff innovation. The analysis also indicates that price based rivalry has been relatively strong between retailers seeking to attract residential customers, although

191 *Id.*

there are indications that this rivalry has diminished somewhat over the last 18 months in response to the wholesale market uncertainty. The extent of rivalry for small business customers is less clear. However, based on the information currently before the Commission, it appears that there is rivalry, as evidenced by the fact that the discounts offered by two of the larger retailers are higher than those offered to residential customers.

When all types of price offers are taken into account, available discounts off the standing contract prices for residential contracts range from 0.5 per cent to 7.5 per cent for gas market contracts and 4.5 per cent to 8.5 per cent for electricity market contracts. The discounts available for gas contracts are broadly in line with those that were observed in the NERA Report in March 2007, although there are fewer gas market contracts currently on offer following the decision by one retailer to cease actively marketing to gas customers.[192]

While the discounts available to gas customers remain broadly the same, the discounts currently available to electricity customers are lower than those observed by NERA in March 2007. [193] In addition to the reduction in discounts, the number of electricity market offers available to residential customers has also fallen. Both the reduction in the number of market contract offers and the discounts available to residential electricity customers, appear to be inextricably linked to the deterioration in wholesale market conditions and the decision by six electricity retailers to temporarily cease active marketing until the margins available under the regulated standing contract prices improve. The adverse effect of the standing contract prices on retail competition over the last eighteen months is likely to continue until wholesale market conditions improve or retail margins increase.

The Commission's assessment of non-price rivalry suggests retailers have been constrained in their efforts to differentiate themselves on the basis of customer service by the regulatory framework. Retailers have, however, sought to differentiate their products by developing products sought by a significant proportion of customers and by offering in-kind incentives. The level of rivalry occurring on these fronts is consistent with what the Commission would expect in an effectively competitive market.

The marketing tactics employed by retailers and in particular their preference for direct forms of marketing are also consistent with effective competition. Given the low customer involvement in energy supply, retailers cannot rely on advertising alone to attract new customers. Rather, retailers have an incentive to pro-actively market their products to customers in order to reduce search and transaction costs for those customers that may otherwise not take the initiative to investigate their supply options. In an environment where customers perceive the cost of searching for information to be relatively high compared to the benefit they could obtain from switching retailer, direct selling is likely to be the most efficient way for retailers to improve competitive outcomes for customers.

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192 NERA, *Review of the Effectiveness of Energy Retail Market Competition in South Australia – Phase 2 Report to ESCOSA*, June 2007, p. 70.

193 *Ibid*, pp. 67-68.

The evidence before the Commission also suggests that, on the whole, the marketing activities of retailers are pro-competitive. With the exception of a few customers that may not be eligible for offers and gas customers located in regional areas, the price discounts offered by retailers appear to be available to all customers, with no specific group of customers having been excluded from accessing competitive retail energy rates. In relation to regional gas customers that only have access to market contract offers from Origin, it is noted that regional gas customers enjoy the same discounts available under these contracts as Origin's Adelaide customers (adjusted for network charges) where the market offers for Adelaide are subject to more intense competitive pressures. This provides regional gas customers with some of the benefits of competition.

While complaints have been made in relation to the marketing activities of retailers, the Commission is not persuaded that marketing misconduct is widespread or systemic. It also considers that instances of non-compliance are adequately being dealt with by ESCOSA as the organisation responsible for addressing complaints and/or breaches of the Energy Marketing Code.

The current information requirements imposed on retailers developing market offers for residential customers also appear sufficient to ensure that those customers that wish to investigate their supply options and compare offers are able to do so. The only potential gap emerging at this time is the limited transparency surrounding small business market offers. This is likely to improve once awareness of ESCOSA's Estimator grows amongst small business customers.

Overall, the Commission's assessment of retailer rivalry suggests that rivalry amongst both gas and electricity retailers has been relatively strong to date and has resulted in substantial reductions in the proportion of customers, and in particular residential customers, held by the host retailers, AGL and Origin. By 31 December 2007 AGL was selling electricity to 57 per cent of all residential electricity customers and 70 per cent of all small business electricity customers while Origin was selling and supplying gas to 58 per cent of all residential gas customers and 87 per cent of all small business gas customers.

Going forward, the Commission recognises that the electricity industry is entering a period of transition that will require new investment to address the tightening supply/demand balance and will involve changes to cost structures in response to climate change policies such as the CPRS and the Mandatory Renewable Energy Target. Effective retail competition can be expected to accommodate these changes without adversely affecting retailers and retailer rivalry, if the standing contract and/or market contract prices are able to adjust to provide competitive retail margins.

D Customer Participation

An important pre-requisite for effective competition is customer participation in the market. In circumstances where consumers can be seen to respond to price or quality differences by switching to products that better meet their needs retailers will be prompted to respond or risk losing patronage and market share. In the absence of sufficient consumer based pressure, retailers may develop a degree of market power which, if exercised, could result in prices rising above the long-term efficient cost of supply, output falling below optimal levels and /or goods or services being of an inferior quality.

Before moving on to examine the extent of customer participation in South Australia, it is important to understand the nature of demand for gas and electricity. As noted in Chapter 2, energy is an essential requirement for modern day living. Although retailers can differentiate energy services on the basis of price, service and non-price terms and conditions, consumers generally regard energy supply as a homogenous and low involvement commodity. These characteristics of energy demand mean that consumers tend to have a low degree of interest in exercising choice between energy retailers and products. These characteristics can also contribute to a perception on the part of customers that the real or perceived costs of searching for information on alternative products and the transaction[194] costs associated with switching to the most suitable energy product outweigh the likely benefits of switching and as a consequence, discourage customers from switching to an alternative retailer or product.

Another factor that may discourage customers from switching is 'status quo bias'. This behavioural bias can result in consumers remaining with the default supplier notwithstanding the potential benefits available from switching.[195] This form of behavioural bias may be particularly prevalent in recently de-regulated markets traditionally supplied by a monopoly provider, but is likely to erode over time.

The extent to which customers are willing to switch to those contracts that best meet their needs, will also depend on the extent to which customers are able to make an informed choice. The ability to make an informed choice will depend on both the availability of relevant information and the ability of customers to process that information. In circumstances where information is inadequate or customers are unable to process the (possibly excessive) information, customers may switch to contracts that do not provide them with the maximum benefits available.

These demand conditions can provide energy retailers with a strong incentive to market the price and non-price advantages of their service offerings directly to

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194 Office of Fair Trading, *Switching Costs, Economic Discussion Paper 5, Part One: Economic models and policy implications*, A report prepared for the Office of Fair Trading and the Department of Trade and Industry by National Economic Research Associates, United Kingdom, April 2003.

195 See C. Camerer, S. Issacharoff, G. Lowenstien, T. O'Donoghue and M. Rabin, "Regulation for Conservatives: Behavioural Economics and the Case for "Asymmetric Paternalism", *University of Pennsylvania Law Review*, 2003, Vol 151:121, p. 1,224. The authors cite W. Samuelson and R. Zeckhauser, "Status Quo Bias in Decision Making", *Journal of Risk and Uncertainty*, 1988, Vol 7.

customers. By providing information directly to customers, retailers can differentiate their service offerings from those of their rivals, while at the same time minimising the search and transaction costs incurred by customers. This form of marketing can ameliorate any perceived impediments that may otherwise discourage consumers from exercising choice.

From a competition perspective, search and switching costs and status quo bias are only considered to be problematic where:

- they are not addressed, or cannot be addressed, effectively by the competitive activity of retailers; and

- they remain sufficient to deter a relatively significant proportion of customers, or particular subsets of customers, from seeking out and taking up alternative supply options that better suit their needs.

Therefore, the mere presence of search and switching costs, or status quo bias, should not be viewed as indicative of ineffective competition. As long as there are a sufficient number of consumers that are willing to engage with the competitive market and switch products or retailers to obtain a better deal, then all consumers can expect to benefit from competition.[196] Only where problems associated with search and switching costs or behavioural bias are widespread and/or retailers are able to discriminate between customers, would questions arise about the effectiveness of competition as a result of these consumer behaviour or market conduct issues.

To assess the extent to which customer participation in South Australia is active and consistent with effective competition, the Commission has examined the levels of awareness amongst customers of their ability to choose their own retailer and has had regard to measures of actual switching behaviour by small gas and electricity customers since the advent of FRC. The Commission also engaged McGregor Tan to undertake a survey of residential and small business gas and electricity customers located in Adelaide and regional areas of South Australia to gain some further insight into the factors influencing the switching patterns observed in South Australia. In its submission to the First Draft Report, the South Australian Farmers Federation suggested that the Commission provide additional analysis of the consumer survey results to investigate any differences in the experiences of regional and metropolitan customers.[197] The Commission has reviewed the survey results

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[196] In most situations, including energy retailing, less than half the total market is required to be a switcher in order to constrain retailer behaviour. The number of switchers that are required before they are sufficient in number to impose a competitive discipline on retailers will be determined by how much each retailer's price exceeds its marginal costs (i.e. the contribution margin). The lost profit from switchers (A) is the contribution margin multiplied by the number of sales lost; that is, A = (p1-MC)*(q1-q2). However, what is gained (B) is the difference between the lower and higher price which has been charged to 'non-switchers' multiplied by the retained sales; that is, B = (p2-p1)*q2. For any given price increase, the bigger the contribution margin on the lost sales, the fewer sales will need to be lost for the amount of profit lost on the 'switchers' to exceed the profit gained on the 'non-switchers', making the price increase unprofitable.

[197] South Australian Farmers Federation (SAFF), submission to the First Draft Report, August 2008, pp. 2-3.

and, where appropriate, has included additional discussions through out this appendix.

In addition to the Consumer Survey results, the Commission has had recourse to the submissions made by interested parties on issues pertaining to customer switching and the equality of access to the benefits of competition. The Commission has also considered information obtained from retailers in the context of the Retailer Survey. These sources of information have enabled the Commission to form a view on the extent to which small gas and electricity customers in South Australia have been willing and able to respond in an informed manner to the product offerings made by retailers. The remainder of this appendix sets out the Commission's findings in relation to customer participation.

D.1 Awareness of FRC

Retail competition in South Australia was introduced progressively over six years commencing in 1998 with the largest consumers and ending on 1 January 2003 for electricity retailing and 28 July 2004 for gas retailing. From these dates all small electricity and gas customers were accorded the right to select their own retailer.

The ability to select a retailer represented a significant change from the single host retailer model that prevailed in the lead up to FRC. Under the single host retailer model, small customers were required to purchase all of their electricity requirements from AGL and their gas requirements from Origin. The advent of FRC therefore represented a significant turning point for gas and electricity customers in South Australia and retailing more generally.

Given the significant change that has occurred in the manner by which customers are able to obtain energy services, a critical point to test before looking at the level of participation is whether customers are actually aware that they can participate in the competitive market by choosing their own retailer. This issue was canvassed in the Consumer Survey and the survey results indicated a high level of awareness amongst small gas and electricity customers. Specifically:

- 82 per cent of residential electricity customers surveyed were aware that they could select their own retailer and 84 per cent of residential gas customers were similarly aware of their ability to select their own retailer; and
- 70 per cent of the small business electricity customers and 78 per cent of small business gas customers were aware of their ability to select their own retailer.[198]

D.2 Customer participation

An important measure of customer participation is the rate at which customers are actively switching to, and between, market contracts. Where a sufficient number of customers are willing to switch to contracts with more attractive price or non-price

198 McGregor Tan, *Consumer Survey Report*, pp. 71 and 81.

terms, retailers are likely to be constrained in the extent to which they can obtain or exercise market power in respect of any particular customer group.

When switching to, or between, market contracts, customers may switch to a new retailer ('gross switching')[199] or from the standing contract to a market contract with their host retailer ('internal switching'). Evidence of both types of switching is important for effective competition. That is, in an effectively competitive market, customer switching patterns should reflect both the acquisition strategies of new retailers, as well as the retention strategies of host retailers. Moderate to high rates of internal switching suggest that host retailers are constrained by the conduct of new entrants (i.e. they need to actively market to their own standing contract customer base in order to maintain their market share).

Submissions from consumer groups to the First Draft Report expressed the view that customer awareness and churn rates were not effective indicators of competition.[200] The submissions referred the Commission to a study of UK consumer experiences by Wilson and Price,[201] which concluded that consumers do not always select the best offers available. In addition, submissions noted that there appeared to be a reducing interest for consumers to switch retailers. For example, the Alternative Technology Association (ATA) noted:

> "ATA remains sceptical of customer awareness and churn as strong indicators of market effectiveness … Simply because a customer may be aware that they can change electricity retailers bears little relationship as to whether they may be able to source an improved market offer."[202]

The Commission notes that customer awareness and churn rates are components in one strand of the Commission's analysis of whether or not competition is effective. The results of these aspects of customer participation have been considered with the other indicators of customer participation as well as the results of analysis of retailer rivalry and conditions for entry, expansion and exit.

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199 Gross switching is a measure of the total number of switches completed within a given period e.g. a quarter. It includes all instances where there has been a change in the retailer allocated to a connection point, i.e. switches from the host retailer to a new retailer, between new retailers, and from a new retailer to the host. Gross switching also includes move-in transfers, i.e. transfers that occur when a customer moves house. Because move-ins include some switches prompted by the occupier of a new premises contracting for supply with the same retailer they had at the vacated premises, gross switching numbers can be inflated. However, moving house or office trigger many customers to investigate competitive energy offers and can result in active decisions to switch retailers. Furthermore, where a consumer actively chooses to switch to the retailer previously supplying their new residence, this will not be recorded as a switch, and hence there can be under-recording as well as over-recording of switching. Move-in transfers account for approximately 20 per cent of gross switching.

200 Including submissions from Uniting*Care* Wesley, COTA & SACOSS, The South Australian Minister for Energy.

201 *Do Consumers Switch to the Best Supplier?* CM Wilson & CW Price, CCP, April 2007.

202 Alternative Technology Association, submission on the First Draft Report, pp. 1-2.

The Wilson and Price study of customers in the UK found that 82 per cent of customers that switched retailers did not get the *best* deal and 31 per cent became worse off. However, the Commission notes the study also shows that 18 percent of customers realised perfect gains and 69 per cent of customers were at least as well, if not better, off after they switched. In addition, the study did not find obvious evidence of mis-selling deceptive information to explain the inaccuracy of some consumers' switching decisions. These appear more likely to have been caused by decision errors.

While not all consumers achieve *ex post* savings from switching retailers, it is unlikely that a decision to switch was not expected to make a consumer better off at the time the decision was made. The cost of searching for and acquiring additional information may be perceived to outweigh the benefits of having that information to make more beneficial decisions for this reason, consumers will rationally limit their search effort while accepting that they may not achieve the best outcomes available in the market.

South Australian consumers have shown a willingness to switch when they have been presented with an offer, as indicated by more than 60 per cent of small residential consumers having switched to market contracts for both electricity and gas. In addition, the Consumer Survey indicates that over 80 per cent of residential gas and electricity customers and 70 per cent of small business electricity customers were quite or very satisfied that their new retailer had met their expectations.[203] It is noted that these percentages are consistent with the level of satisfaction across both regional and metropolitan areas. Although only small proportions of the consumers surveyed responded that they were anticipating changing retailers in the next year, this does not indicate that these consumers would be unwilling to take up a better offer if one was presented to them. It is also important to note that it is likely that the response was based on existing price and service. If the relative price of their existing supply arrangements were to rise and/or service quality deteriorate, it is likely that more customers would switch if a more beneficial service could be achieved.

Considering the proportion of small customers that have been approached by a retailer, the fact that more than 60 per cent of residential customers are on market offers, and the high level of satisfaction, on balance suggests that there have been benefits to consumers from participating in the market.[204]

The remainder of this section examines the level of switching to, and between, market contracts that has occurred to date in South Australia. Commencing with an examination of the proportion of customers that have switched to a market contract, the analysis then turns to the underlying gross and internal switching data to ascertain the extent to which customers on market contracts have switched to a new retailer or have remained with the host retailer. This section also examines the prevalence of multiple switching.

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[203] McGregor Tan, *Consumer Survey Report,* pp. 38, 37 and 47.

[204] From the results of the Consumer Survey 68 per cent of residential and 54 per cent of small business electricity customers responded that they have been approached by a retailer.

D.2.1 Electricity

D.2.1.1 Customers switching to market contracts

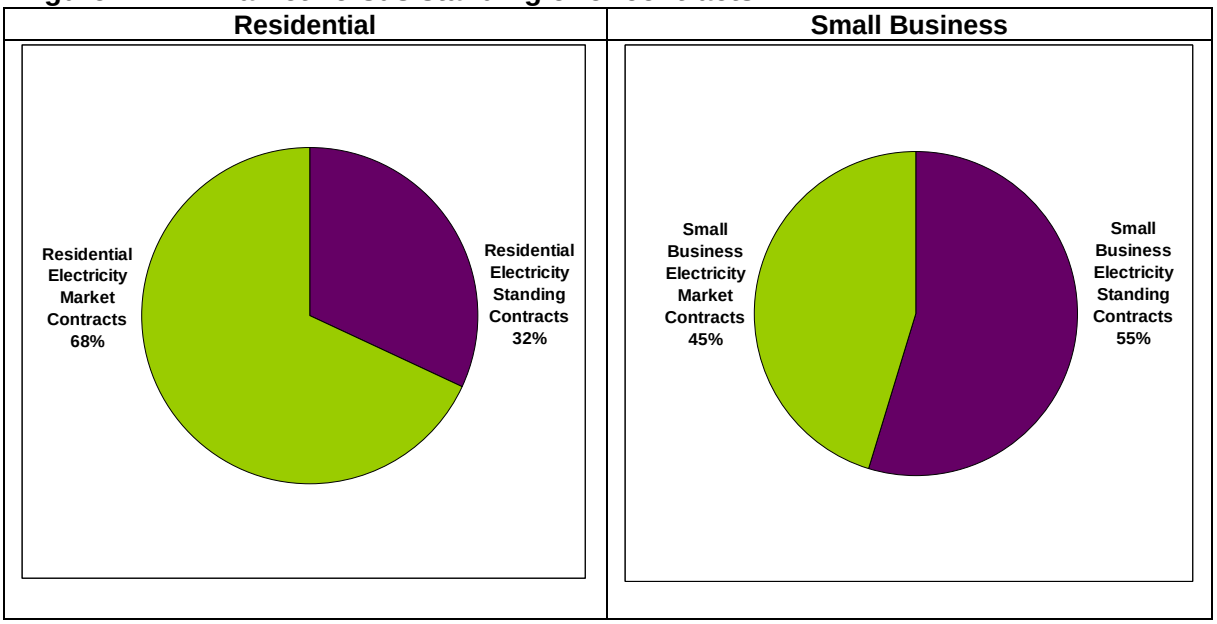
Figure D.1 illustrates the proportion of residential and small business customers that were being supplied electricity under the terms of a market contract as at 31 December 2007. As this figure demonstrates residential customers have exhibited a greater propensity to take up a market offer than small businesses, with over 68 per cent of residential customers having switched compared to 45 per cent of small business customers. The results of both the Retailer Survey and Consumer Survey provided some insight into the factors that have contributed to the difference observed between residential and small business customers. The two principal factors viewed as contributing to this difference include:

- a perception on the part of retailers that the costs of acquiring small business customers were higher than the acquisition costs associated with residential customers (see section D.3 and Appendix C); and

- a perception held by some small businesses that the costs (including both time and effort) incurred in undertaking the research required to make an informed decision and the costs incurred in switching products or retailers outweighed the benefits of switching (see section D.3.3).

A fuller discussion on these issues is set out in section D.3.5.

Figure D.1 Market versus standing offer contracts

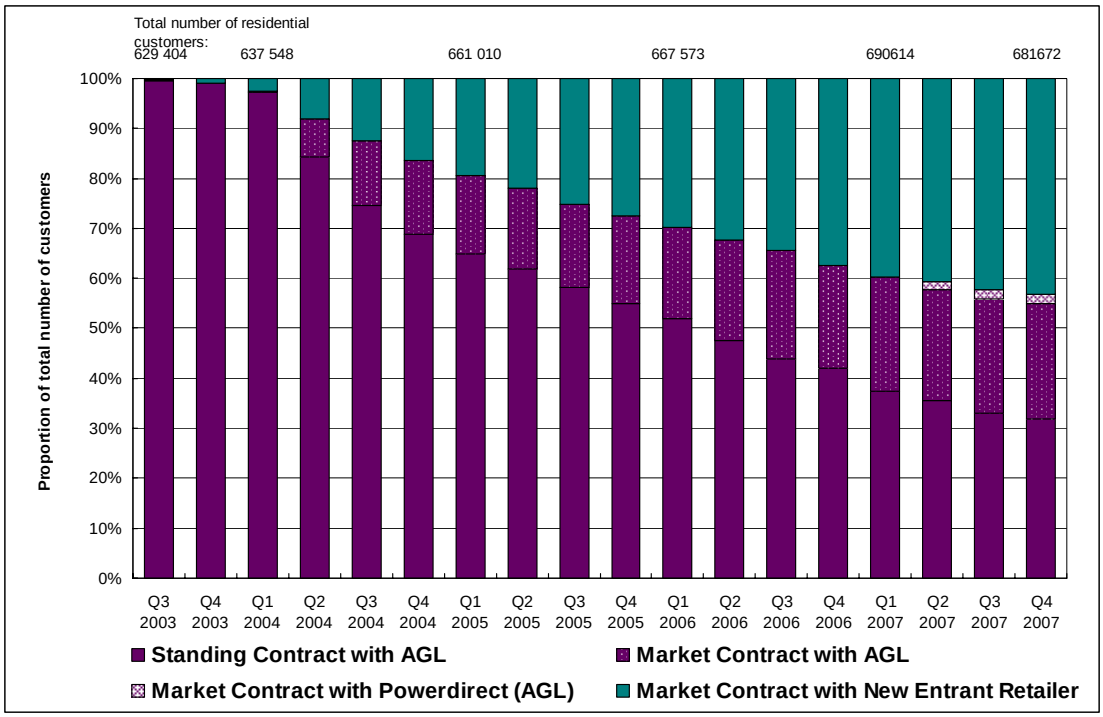


Data source: ESCOSA data reported under Guideline No 2

The difference between the proportion of residential and small business customers on standing contracts, as opposed to a market contract with AGL or a new retailer, is illustrated in Figure D.2 and Figure D.3. As these figures illustrate, the proportion of customers that are supplied pursuant to market contracts offered by new retailers continues to grow, reaching approximately 43 per cent of all residential and 30 per cent of all small business customers by the end of 2007. The proportion of AGL's

customers on a market contract has also grown over the period and was supplemented by the acquisition of Powerdirect in 2007. Combining both the interests in Powerdirect with AGL's original customer base, the proportion of AGL's customers on a market contract (as opposed to a standing contract) reached approximately 44 per cent for residential customers and 22 per cent for small business customers by the end of 2007.

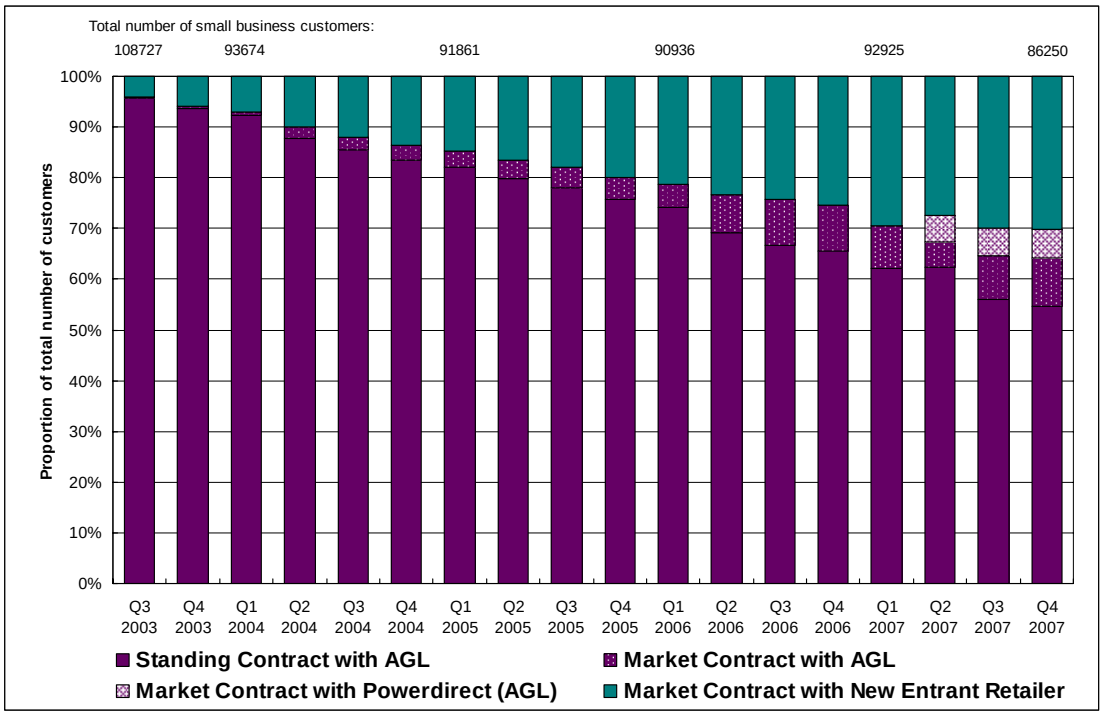
Figure D.2 Residential customers: market versus standing offer contracts



Data source: ESCOSA data reported under Guideline No 2[205]

205 Notes to charts: ESCOSA's definition of a customer changed in June of 2006 from being counted as the number of NMIs allocated to each retailer to the number of NMIs billed by each retailer in a given quarter. This results in different market totals and potentially some other, relatively minor data distortions. As of March 2007, Powerdirect became a wholly owned subsidiary of AGL.

Figure D.3 Small business customers: market versus standing offer contracts



Data source: ESCOSA data reported under Guideline No 2[206]

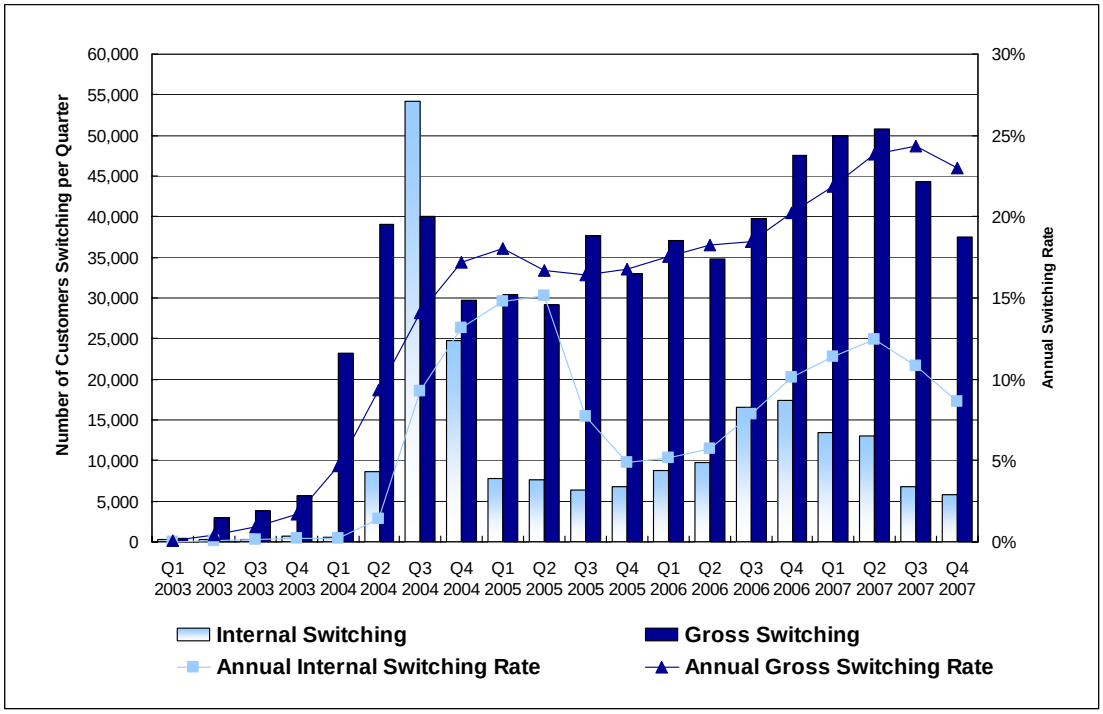
D.2.1.2 Gross and internal switching

Figure D.4 illustrates both the number of gross and internal switches that have occurred in each quarter since the commencement of FRC and the annual gross and internal switching rates over the same period.[207]

206 *Ibid*.

207 In this context, the annual gross switching rate is calculated by dividing the number of gross switches that have occurred in a 12 month period by the total number of connection points during that period. The annual internal switching rate is calculated by dividing the number of customers that have switched from a standing contract to a market contract in the previous 12 months by AGL's averaged customer base for that period. Since accurate information about the total number of connection points was not available prior to December 2003, the number of connection points in December 2003 has been used.

Figure D.4 Gross and internal switching for small electricity customers



Data source: NEMMCO transfer data (MSATS) and retailer reporting of internal switching to ESCOSA.

As this figure highlights, gross switching rates have generally increased in the period following the introduction of FRC from an annual rate of 9 per cent for the year ending 30 June 2004 (71,718 transfers) to a peak of 24 per cent in the third quarter of 2007 (192,673 transfers). In the fourth quarter of 2007 the gross switching rate fell to 23 per cent (182,556 transfers) which corresponds with the period during which six retailers decided to temporarily cease marketing to new customers (see Appendix C). Since a large proportion of switching is linked to the direct marketing activities of retailers, the decline in switching observed in the latter half of 2007 appears, at least in part, to be attributable to the decision by these retailers to temporarily cease their marketing activities.

Between 2003 and the end of 2005 there was a marked difference in the pattern of internal switching and gross switching. Since that time, internal and gross switching have moved broadly in line with one another. This suggests that AGL has been responding to the marketing strategies of new retailers and vice versa. Over the entire period it can be seen that the internal switching rate peaked in the second quarter of 2005 at 15 per cent before falling to five per cent at the end of the fourth quarter of 2005. Over 2006 and the first half of 2007 the internal switching rate increased to 12 per cent before falling to 9 per cent at the end of 2007. This decline in internal switching mirrors the decline in gross switching and suggests that AGL has also reduced its marketing activity over the period.

The patterns in gross and internal switching observed to date have been influenced by:

- the level of direct marketing undertaken by retailers which has been stimulated by both the entry of new retailers and the decision by existing retailers to actively increase their market share through marketing campaigns;[208] and

- the South Australian Government's Electricity Transfer Rebate (ETR) programme which operated between November 2003 and August 2004 and was designed to stimulate switching activity by offering eligible electricity customers a one off $50 payment to switch from a standing or default contract to a market contract with any retailer (including AGL). [209]

While switching in South Australia initially focused on movements from the standing contract to market contracts, a growing number of customers are now switching between market contracts with different retailers (i.e. switching from one new retailer to another new retailer or from a new retailer back to the host retailer, AGL) as demonstrated by the increased prevalence of multiple switching (see Table D.1).

Table D.1 Gross, internal and multiple switches for electricity

			Multiple Switching	
Year ending	Gross	Internal	New retailer to New retailer	New retailer to Host
30 June 2004	71,718	10,079	1,283	2,440
30 June 2005	129,265	94,229	8,586	12,637
30 June 2006	142,496	31,642	25,446	19,793
30 June 2007	188,221	60,428	51,228	28,201

Data source: NEMMCO transfer data (MSATS) and retailer reporting of internal switching to ESCOSA.

The prevalence of multiple switching has prompted a number of interested parties to question whether multiple switching is really indicative of effective competition or whether it arises because customers do not understand the market process. [210] The results of the Consumer Survey suggest that the increased prevalence of multiple

208 In the Retailer Survey, respondents were asked how they take into account the competitive threat posed by other retailers. Retailers responded by stating that they took into account the marketing activities of other retailers as measured by churn, door-to-door sales and competitor activity reports. See LECG, Survey and interviews with South Australian electricity and gas retailers, June 2008, pp. 76 and 82.

209 It has not been possible to determine the proportion of switching during this period that can be attributed to the scheme. However, the pattern of switching in the lead up to the end of the programme and in the quarters following its removal suggest that the scheme had the effect of temporarily inflating switching activity, particularly internal switching, to a level above what would otherwise have been observed. The Commission notes the ECC's argument that the primary effect of the scheme was to artificially stimulate a non-competitive market, but would point to the fact that, after the cessation of the scheme in August 2004, gross switching rates have, on average, continued to increase. The Commission also understands that it is possible that NEMMCO's introduction of a new NMI discovery system in early 2004 may also have increased the number of transfers recorded during 2004.

210 COTA, submission to Issues paper, April 2008, p. 6.

switching is a reflection of the competitive process rather than some broader market failure. In the words of one small business customer participating in the consumer focus group:

> "I've changed supplier three times in the last five years, mainly to get a better price each time." [211]

This statement highlights the preparedness of some customers to switch retailer more than once to ensure that they can obtain the best price and product offering available to them.

In the Commission's view the growing rate of multiple switching suggests that retailers will face continued pressure to develop and market attractive offers in order to retain customers at the end of their contract term. If consumers continue to be able to switch between retailers or products with relative ease then this pressure is unlikely to abate.

D.2.1.3 Conclusion – electricity switching

Overall, the level of gross and internal switching observed to date in South Australia suggests that a significant proportion of small electricity customers have been willing to switch from a standing contract to a market contract and, in so doing, have exerted some degree of pressure on retailers.

The gross switching patterns observed to date are also indicative of a market in which new retailers have been active in acquiring customers. The relatively high levels of internal switching and the growth in the number of customers switching back to AGL further suggest that AGL has been responding to the competitive constraint imposed by the new retailers. While there has been a recent reduction in the level of switching brought about by the decision of a number of new retailers to temporarily cease marketing, it is important to recognise that the overall level of switching still remains high by international standards (see section D.2.3).

Going forward, the level of switching is likely to depend on a range of factors on both the supply and demand sides. On the supply side the level of switching will be inextricably linked to the level of marketing undertaken by retailers which will in turn depend on:

- the costs incurred in marketing;
- wholesale market conditions;
- the margins available from acquiring new customers;
- the extent of rivalry between retailers; and
- the entry of new retailers or the expansion of existing retailers.

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211 McGregor Tan, *Consumer Survey Report*, p. 143.

On the demand side, the level of switching will depend on the extent to which the perceived benefits of switching exceed the search and switching costs. Since customers are principally motivated by price they are likely to switch in response to a small but significant and non-transitory increase in price subject to the caveat that the discount offered outweighs the search and switching costs. If this caveat is not met then customers are likely to remain with their current supplier.

D.2.2 Gas

D.2.2.1 Customers switching to market contracts

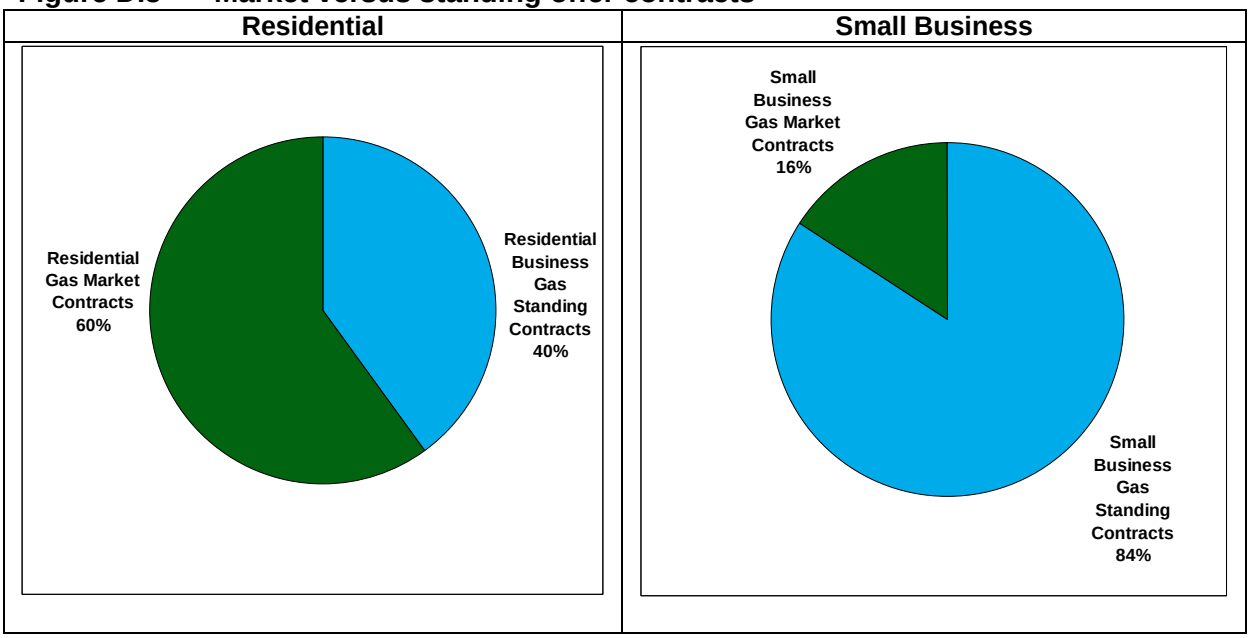
Figure D.5 illustrates the proportion of residential and small business customers that were being supplied with gas in accordance with the terms of a market contract as at 31 December 2007. As this figure demonstrates, small gas customers have exhibited a lower propensity to take up a market offer than their electricity counterparts. Based on the results of the Retailer Survey and Consumer Survey it appears that the difference in the observed level of participation between electricity and gas customers has been principally driven by differences in:

- the level of marketing activity undertaken by electricity retailers relative to gas retailers. There are currently less than half as many retailers marketing gas as electricity and in general gas tends to be marketed as an add-on to electricity rather than being marketed in its own right. These factors, combined with the fact that retailers have greater difficulties in identifying gas customers, appear to have resulted in fewer gas customers being actively approached (see section D.3);

- the proportion of income spent on electricity versus gas. It appears that gas customers spend a lower proportion of income on gas than their electricity counterparts and; as a consequence, the dollar value of any gains from switching are likely to be lower for gas customers than electricity customers (see section D.3).

Figure D.5 also demonstrates that residential gas customers have exhibited a greater propensity to take up a market offer than small business gas customers. It appears that this divergence is driven by the same factors identified as contributing to the divergence between the take up rates of residential and small business electricity customers in section D.2.1.1. That is, the perception on the part of retailers that the costs of acquiring small business customers are higher than the acquisition costs associated with residential customers (see section D.3 and Appendix C) and the perception held by a large number of small businesses that the search and switching costs outweigh the benefits of switching (see section D.3.3).

Figure D.5 Market versus standing offer contracts[212]



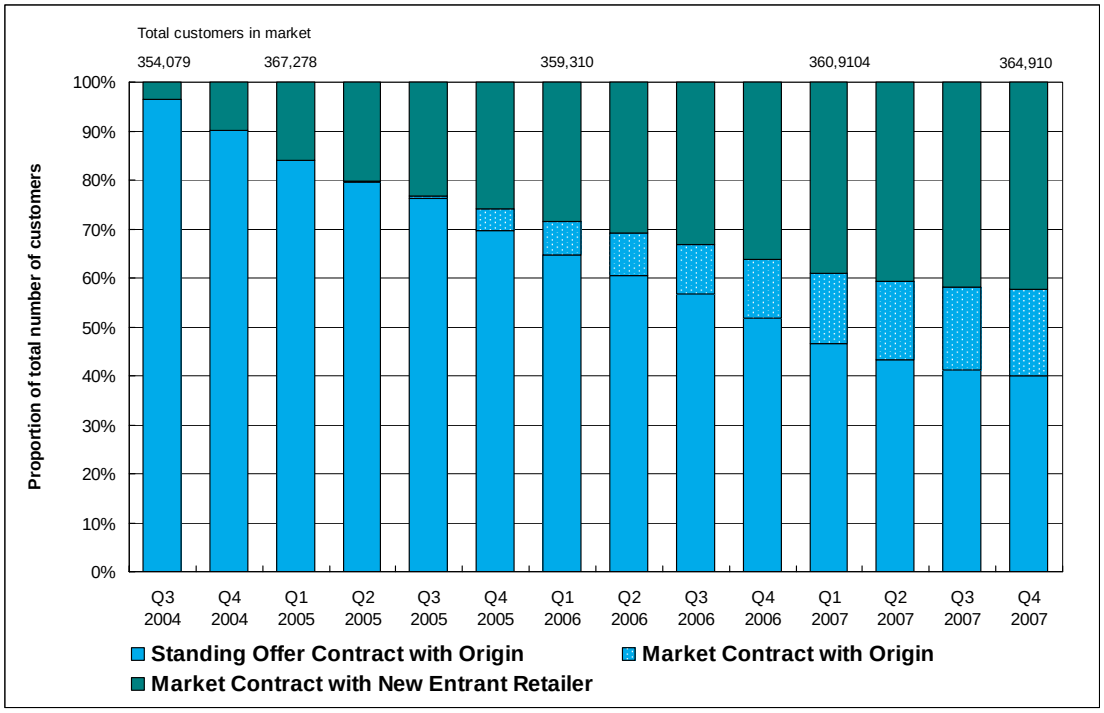
Source: ESCOSA data reported under Guideline No 2

Since the advent of FRC, the proportion of gas customers on a market contract has steadily increased (see Figure D.6 and Figure D.7). This growth has been particularly pronounced amongst residential customers where the number of customers on market contracts has increased from less than 10 per cent in the fourth quarter of 2005 to approximately 60 per cent by the end of 2007. The proportion of small business gas customers on a market contract has also increased, albeit at a considerably slower rate than that exhibited by residential customers. In the fourth quarter of 2005 less than three per cent of small business customers were on a market contract and by the end of 2007 this had increased to just 16 per cent.

As illustrated in Figure D.6 and Figure D.7, new retailers have been relatively successful in encouraging customers to move to a market contract and at present account for the greatest proportion of customers on market contracts. Origin has also had some success in encouraging its residential and small business customers to switch from the standing contract to a market contract with approximately 31 per cent of its residential customers and three per cent of its small business customers having entered into a market contract.

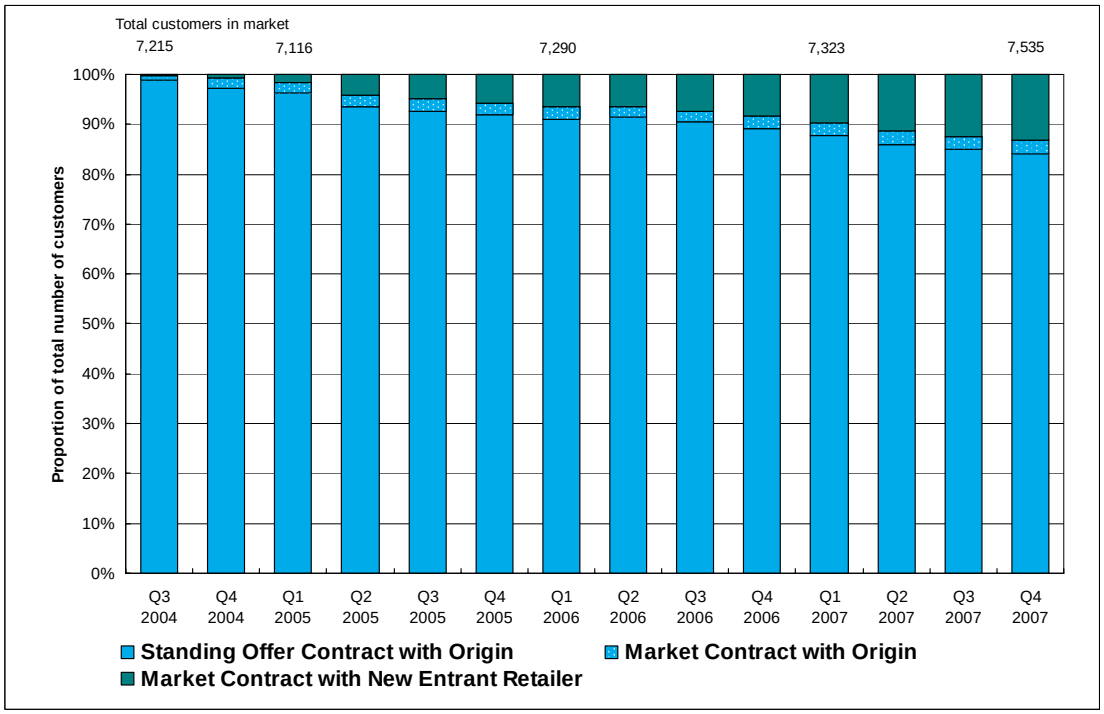
212 The Commission understands from the data contained in ESCOSA's 2008 Gas Price Path review (at p. A-19) that the proportion of customers on a market contract have increased by approximately 2 per cent for residential customers and 1 per cent for small business customers in the first quarter of 2008.

Figure D.6 Residential customers: market versus standing offer contracts



Data source: ESCOSA data reported under Guideline No 2.[213]

Figure D.7 Small business customers: market versus standing offer contracts



Data source: ESCOSA data reported under Guideline No 2.[214]

213 ESCOSA's definition of a customer changed in June of 2006 from being counted as the number of MIRNs allocated to each retailer to the number of MIRNs billed by each retailer in a given quarter. This results in different market totals and potentially some other, relatively minor data distortions.

The data contained in Figure D.6 and Figure D.7 is based on all gas customers in South Australia and therefore includes customers located in Adelaide and in regional areas. While it has not been possible to obtain a break down of this data on a regional basis, the Commission is aware that ESCOSA has recently examined this issue in the context of its 2008 inquiry into standing contract prices. In its 2008 Gas Price Path Review, ESCOSA observed that there had been some degree of variation in the proportion of customers taking up market contracts across the regions with customers in Adelaide and Mt Gambier regions exhibiting the greatest level of switching followed by customers in Port Pirie and Whyalla. For customers located in the Riverland area, the number of standing contract customers has actually increased as a result of the customer base increasing in this region and thus the proportion of customers on market contracts has been declining in this area.[215]

On the basis of data provided by Origin, ESCOSA reported the annual net switching rates by region set out in Table D.2 and observed that switching rates observed in regional areas "almost exclusively" related to internal switching, i.e. customers moving from a standing contract to a market contract with Origin.[216]

Table D.2 Net switching rates by region 2007

Year ending	Adelaide	Mt Gambier	Port Pirie	Whyalla	Riverland
Residential	-27.1%	-23.4%	-18.6%	-16.2%	42.9%
Small business	-2.3%	-1.9%	-1.5%	1.8%	11.1%

Data source: Origin and ESCOSA, *Final Inquiry Report & Draft Determination, Gas Standing Contract Price Path Inquiry*, June 2008, p. A-19.

D.2.2.2 Gross and internal switching

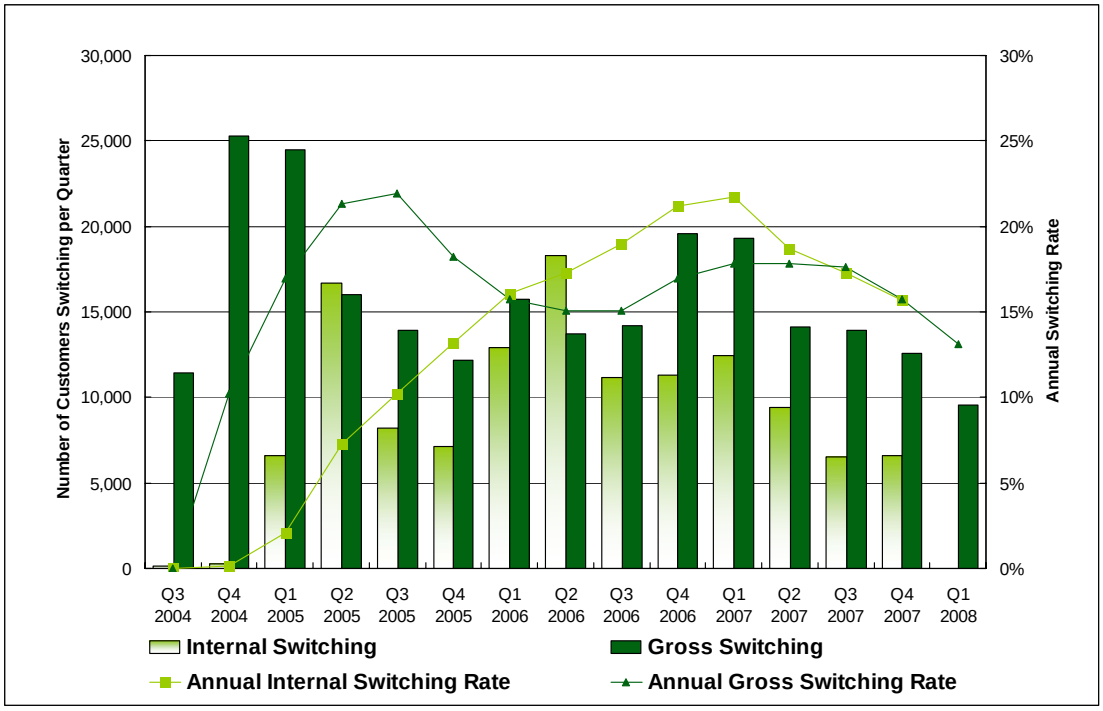
Figure D.8 illustrates the number of gross and internal switches that have occurred in each quarter since the commencement of FRC and the annual gross and internal switching rates over the same period.

214 ESCOSA's definition of a customer changed in June of 2006 from being counted as the number of MIRNs allocated to each retailer to the number of MIRNs billed by each retailer in a given quarter. This results in different market totals and potentially some other, relatively minor data distortions.

215 ESCOSA, *2008 Gas Standing Contract Price Path Inquiry: Final Inquiry Report and Final Price Determination*, June 2008, p. A-19.

216 *Id.*

Figure D.8 Gross and internal switching for small gas customers



Note: Internal switching data was only available up until Q4 2007.

Data source: REMCo transfer data and retailer reporting of internal switching to ESCOSA.

As this figure highlights, gross switching rates increased rapidly up to the third quarter of 2005 to 22 per cent (79,724 transfers) before falling to 15 per cent (55,849 transfers) in the third quarter of 2006. The gross switching rate improved somewhat over the latter half of 2006 and early 2007 and remained steady at 18 per cent before falling to 13 per cent (50,113 transfers) by the end of the first quarter of 2008. This decline mirrors the decline observed in electricity and brings to the fore the interrelationship between gas and electricity marketing and, in particular, the tendency for retailers to market gas as an add-on to electricity. Given this relationship any reduction in marketing activity undertaken by electricity retailers will have direct implications for the levels of switching observed in gas retailing.

Although internal switching commenced a little later than gross switching, the pattern of switching has been a little smoother, growing from a rate of 10 per cent (31,669 transfers) in the third quarter of 2005 to a peak of 22 per cent (53,229 transfers) in the first quarter of 2007. Over the remainder of 2007, the internal switching rate declined to 16 per cent (34,996 transfers) which is consistent with the fall observed in gross switching. When compared with the level of gross switching that has occurred, it is apparent that Origin has responded directly to the threat imposed by new retailers by actively encouraging its customers to sign up to a market contract.

In a similar manner to electricity customers, most gas customers have only switched retailer once. The prevalence of multiple switching has, however, increased since 2005 as demonstrated in Table D.3. Consistent with its observations about multiple switching amongst small electricity customers in South Australia, the Commission considers these statistics are consistent with the process of competition and

demonstrate the preparedness of customers to switch retailer more than once to ensure that they can obtain the best price and product offering available to them.

Table D.3 Gross, internal and multiple switches for gas

			Multiple Switching	
Year ending	Gross	Internal	New retailer to New retailer	New retailer to Host
30 June 2005	77,205	23,267	1,243	1,267
30 June 2006	55,583	46,546	7,098	4,748
30 June 2007	67,177	44,335	15,740	8,745

Data source: REMCo switching data and figures provided by ESCOSA

D.2.2.3 Conclusion – gas switching

The level of gross switching and the annualised gross switching rates observed in gas retailing to date have shown a gentle decline since market start. This is in contrast to the relatively steady increase seen in electricity retailing. Although both fuels saw a downturn in switching levels throughout 2007, the rate of annual gross switching for gas has dropped to a substantially lower level than for electricity.

However, the averaged level of gross switching[217] over time suggests that gas customers have been willing and able to exert pressure on both new retailers and the host retailer, Origin, wherever competition is feasible. Only in those regional areas where competition from new retailers has not been possible have consumers been unable to switch to another retailer. While small business customers have exhibited significantly lower switching rates than residential customers, it seems likely that they would be willing to switch in the event that the expected gains exceed the perceived costs in time and effort.

In a similar manner to AGL, Origin appears to have had some success in encouraging its standing offer customers to switch to a market contract, evidenced by the fact that levels of internal switching in gas are equivalent to (and in some cases, in excess of) those seen in electricity.[218] This success, coupled with the fact that there has been an increase in the number of customers switching back to Origin, suggests that Origin's market contracts are meeting the needs of small gas customers in South Australia.

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217 The averaged monthly level of gross switching for electricity is roughly twice the averaged monthly level of gross switching for gas. This reflects the relative sizes of both markets and indicates that overall levels of gross switching in both markets are comparable.

218 Analysis of quarterly internal switching figures show that from Q1 2005 through to Q2 2006, levels of internal switching in gas were higher than in electricity. Additionally, the average monthly internal switching figure for gas is only slightly lower than the average monthly internal switching figure for electricity. These figures indicate that a higher proportion of gas customers are switching internally in gas than in electricity.

Going forward, the level of switching undertaken by small gas customers will depend on the same demand and supply factors as those identified in section D.2.1.3. The only additional factor that will have a significant influence on the level of switching undertaken by small gas customers is the level of marketing undertaken by electricity retailers. As noted above, gas tends to be sold as an add-on to electricity and thus any changes in the marketing activity undertaken by electricity retailers will have direct implications for the levels of switching observed in gas retailing. Switching in the future will therefore depend on both the conditions prevailing in the gas supply chain and the conditions prevailing in the electricity retail market.

D.2.3 International comparison of switching behaviour

In July 2007, First Data Utilities and VaasaETT released a comparative report which ranked over 30 contestable energy markets by reference to switching rates and in accordance with the following rating scheme:[219]

- 'hot' market – over 15 per cent of customers switching per year;
- 'active' market – between five per cent and 15 per cent of customers switching per year;
- 'slow' market – between one per cent and five per cent of customers switching per year; and
- 'dormant' market – less than one per cent of customers switching per year.

According to the research undertaken by First Data Utilities and VaasaETT, the South Australian electricity retail market is a 'hot' market and the third most active market in the world behind Victoria and Great Britain. [220] Although the annualised rate of switching has fallen somewhat since this report was finalised, the 23 per cent switching rate is still, according to the ranking scheme developed by First Data Utilities and VaasaETT, considered a 'hot' market and high by international standards.

Applying the same rating scheme to the South Australian gas retail market, the 13 per cent switching rate observed in the first quarter of 2008 would imply that it is an 'active' market. Other markets classified as 'active' by First Data Utilities and VaasaETT include Texas, Norway, New South Wales, New Zealand, Sweden, Finland and the Netherlands. Like South Australia, most of these markets have been open to competition for at least five years.

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219 The researchers note that the Project's customer switching rate metric is calculated by dividing the number of customers who switched suppliers in a given period by the number of customers in the market.

220 First Data Utilities and VasaaETT, *Utility Customer Switching Research Project, World Energy Retail Market Ranking*, 3rd Edition, July 2007

D.3 Consumer Survey results

As noted in the introduction to this appendix, the Commission engaged McGregor Tan to undertake a survey amongst small gas and electricity customers located in Adelaide and regional areas. The Consumer Survey consisted of a telephone survey involving 1,200 households and 650 small businesses[221] and eight consumer focus groups. The survey was principally designed to provide the Commission with some insight into the factors underlying the switching patterns observed in South Australia and, in particular, to provide some insight into:

- the factors motivating small customers to exercise choice amongst retailers and product offerings;
- perceptions surrounding the ability to make an informed decision;
- the extent to which search and switching costs and brand loyalty may be preventing customers from switching; and
- the satisfaction of small customers with FRC.

The remainder of this section provides an overview of the results of the Consumer Survey, including notable distinctions between the experiences of metropolitan and regional customers.

D.3.1 Factors motivating customers to participate

Despite the high level of awareness amongst small gas and electricity customers of their ability to choose a retailer, consumers continue to view energy as a low involvement product and place little importance on actively seeking out market offers. These attitudes are reflected in the relatively low proportion of those customers surveyed that had actively sought information from a retailer on their product offerings, as can be seen in Table D.4.

Table D.4 Survey results

	Residential Customers		Small Business	
	Electricity	Gas	Electricity	Gas
Customers that have actively sought information from a retailer	13%	4%	9%	6%
Customers approached by a retailer and offered a market contract	68%	20%	54%	11%
Customers that have changed retailers	48%	27%	44%	11%

Data source: McGregor Tan, *Consumer Survey Report*, pp. 6, 9, 10, 13, 33, 82 and 91.

Since customers are unlikely to initiate contact, retailers have tended to employ direct marketing practices to convey information about their products and to encourage customers to switch. Amongst the small electricity customers surveyed, 54 per cent of small businesses and 68 per cent of residential customers had been

221 Of the 1,200 residential customers surveyed, 800 were located in Adelaide while 400 were located in regional areas. Of the 650 small business respondents, 400 were located in Adelaide and 250 in regional areas.

approached by a retailer and offered a market contract.[222] The survey found that a higher proportion of regional electricity small business customers had been approached compared to metropolitan small business customers. Regional customers were more likely to have been approached through telesales whereas door-to-door marketing was more prevalent for metropolitan customers. The incidence of being approached and offered products was substantially lower amongst gas customers, with just 11 per cent of small businesses and 20 per cent of residential customers having been approached.[223]

The differences observed in these survey results suggest that the levels of retailer marketing activity have been higher for electricity than for gas, and to a lesser extent for residential compared to small business customers. These observations are consistent with the results obtained from the Retailer Survey which indicated that retailers have had greater difficulties accessing the decision makers within small businesses which has resulted in the cost of marketing to these customers being higher than the costs incurred in marketing to residential customers.[224] The Retailer Survey also revealed that gas is principally marketed as an add-on to electricity rather than being marketed in its own right.[225] Since less than half of all energy retailers in South Australia are selling gas as well as electricity, it is not surprising that fewer small gas customers have been contacted by a retailer than small electricity customers.

In addition to being more likely to have been offered a market contract, electricity customers were also more likely to have changed retailers with 48 per cent of residential electricity customers and 44 per cent of small business electricity customers having switched compared to just 27 per cent of residential gas customers and 11 per cent of small business gas customers.[226]

According to the small customers surveyed, the principal motivation for their decision to switch to a market offer was to take up a lower priced product. Offers of green energy were also viewed as being of some importance to customers, although the emphasis placed on this factor differed across customers. The opportunity to have the same retailer for both electricity and gas was also cited as being important by gas customers. As the survey results in Table D.5 demonstrate, over 80 per cent of residential customers and 70 per cent of small business customers that have switched to a market contract switched for one of these three reasons. These percentages were consistent across both metropolitan and regional customers. The commonality of these factors suggests that price competition, green and dual fuel offers will be important in the development of competition going forward.

222 McGregor Tan, *Consumer Survey Report*, p. 6.

223 *Ibid*, p. 10.

224 LECG, *Retailer Survey Report*, p. 42.

225 *Ibid*, p. 46.

226 McGregor Tan, *Consumer Survey Report*, pp. 33 and 82.

Table D.5 Reason for switching

	Residential Customers		Small Business	
Motivating Factor	Electricity	Gas	Electricity	Gas
Lower price	68%	60%	84%	50%
Offer of Green Energy	9%	5%	3%	19%
To be with the same retailer for electricity and gas	5%	23%	1%	10%
Other	19%	12%	12%	20%

Data source: McGregor Tan, *Consumer Survey Report*, pp. 36, 46, 85 and 92.

The 'other' category in this table included a number of other reasons including being unhappy with a former retailer (cited by one to three per cent of respondents), moving house (cited by two per cent of respondents), incentive payments (cited by one to three per cent of respondents), gifts, loyalty bonuses and discounts (cited by two per cent of respondents). As these results indicate, free gifts, loyalty bonuses or discounts for prompt payment were not considered to be significant motivation to switch for most customers. Another interesting feature of these results is that very few customers stated that they had switched to an alternative retailer to obtain the $50 incentive payment. These results are somewhat surprising given the apparent surge in switching observed in the period leading up to the removal of the incentive payment (see section D.2.1.2).

One per cent of respondents involved in the survey also stated that they had switched to get a sales person to leave. COTA also referred to this motivating factor in its submission to the Commission:

> "Some churn has resulted from aggressive marketing strategies adopted by retailers where vulnerable consumers have either finally succumbed to 'get rid' of the retailer…not from a genuine desire by the consumer to switch to a product more beneficial to them".[227]

As noted in Appendix C retailers will generally have a strong incentive to avoid high pressure and misleading marketing activity, because of the direct costs and reputational effects on themselves. The Commission recognises, however, that agents marketing retail products on behalf of the retailer may face very different incentives to those faced by retailers and, as a consequence of the commission based reward structure, may engage in high pressure sales tactics which causes customers to switch just to 'get rid' of the salesperson. While it is possible that this may occur, the results of the Consumer Survey would tend to suggest that this applies to a very small proportion of customers with less than one per cent of respondents stating that they had switched for this reason. As discussed in Appendix B the consumer protection framework developed by the South Australian Government requires retailers to incorporate a ten business day cooling off period during which customers may terminate the market contract without incurring any termination fees and has established the Energy Ombudsman to facilitate the resolution of disputes. These forms of consumer protection should help to protect customers remaining on contracts that are not in their interests. Appendix C sets out the Commission's

227 COTA, submission to the Issues Paper, April 2008, p. 8.

examination of the complaints that have been made to the Energy Industry Ombudsman.

D.3.2 Ability to make an informed decision

Another important point flowing from the Consumer Survey is that the respondents were generally satisfied that they could easily access the information required to enable them to make an informed decision.[228] The most common sources of information cited by respondents were written and verbal information provided by the retailer, the internet and historic energy bills. Survey respondents were also asked whether they were aware of the independent comparator service provided by ESCOSA, however, only a limited number of respondents appeared to be aware of this service.[229]

While information was viewed as readily accessible by those surveyed, there was some disparity of views amongst residential and small business customers about the overall usefulness of the information provided. That is, while residential customers generally agreed with the statements that the information they reviewed was easy to understand, the information enabled them to compare offers and the information provided them with a sufficient basis to make an informed choice, small business customers and, in particular, small business gas customers, were less likely to agree with these statements.[230] When asked if the information provided could be improved, those surveyed were largely of the view that the information provided was adequate and did not require improvement.

The difficulties faced by small businesses seeking to compare offers were also raised in submissions made by Business SA and the South Australian Farmers Federation. Business SA observed that small business customers found it difficult to understand the entirety of a retailer's offer and noted that there was no comparator service which allowed small businesses to easily compare offers. [231] This view was supported by The Corporate Rate Group:

> "It is our experience that consumers, often including sophisticated small business operators, are easily confused by the current methodology of tariff charging methods by retailers."[232]

The South Australian Farmers Federation similarly noted that while most retailers provided all of the mandated information, its members often had difficulty assessing the relative benefits of deals.[233] To overcome some of these difficulties, the South Australian Farmers Federation has acted as an intermediary between its members

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228 McGregor Tan, *Consumer Survey Report*, pp. 55 and 102.

229 *Ibid*, p. 98.

230 *Ibid*, pp. 59 and 143.

231 Business SA, submission to the Issues Paper, April 2008, p. 2.

232 The Corporate Rate Group, submission to the First Draft Report, August 2008, p 4.

233 South Australian Farmers Federation, submission to the Issues Paper, April 2008, p. 14.

and retailers and has obtained deals on behalf of its members. A number of small businesses participating in the consumer focus groups also noted that they had hired brokers to determine the optimum package for their energy needs.

Although small business customers appear to have had greater difficulties interpreting the information provided to them, only two to three per cent of small business survey respondents that had remained on a standing contract stated that they had done so because of their inability to understand the information. This apparent inconsistency may simply reflect rational decision making on the part of small businesses, for whom the opportunity cost of time is high. If the perceived gains available from taking more time to understand the information provided are low, small businesses may simply decide it is not worth it. Going forward, ESCOSA's online estimator for small businesses may go some way to reducing the higher search costs faced by these customers, however it is important to recognise that the opportunity cost of time will remain a significant issue for them.

Another issue raised by COTA is that retailers appeared reluctant to provide written details of the offer which, when coupled with the fact that a large proportion of older customers do not have access to the internet, limited the ability of older customers to make an informed decision.[234] The Energy Consumers Council (ECC) also stated that a proportion of the South Australian population are 'information poor' and may be unable to access and make use of suitable information resources to make an informed decision.[235] The Commission understands the concerns raised by COTA and the ECC and notes that ESCOSA has sought to address this issue by providing a freecall telephone service which provides residential customers with the same comparator services as those provided through its online estimator service.

Based on the foregoing it appears that some customers are having difficulties obtaining access to appropriate information to enable them to make an informed decision. Whether or not this poses a significant problem for competition largely depends on whether the informed decisions of those customers with sufficient understanding of market offers constrains the behaviour of retailers. If enough customers have sufficient understanding of the implications of different offers and are willing to switch, retailers will face continued pressure to develop competitive market offers that would benefit a wide range of customers. However, if retailers are able to differentiate between well informed and ill-informed customers, they may be able to persuade customers that do not understand contract information to agree to contracts that either do not provide them with the greatest net benefit or may even make them worse-off. On the basis of the analysis contained in Appendix C, the Commission has found no evidence of such discrimination.

Another important factor to recognise in this context is that even where some customers make what appear, *ex post*, to be ill-informed decisions in relation to their energy supply, this does not necessarily mean that competition for these customers is not effective. Those choices may have appeared optimal *ex ante*. Furthermore, customers that switch to contracts that make them better off but do not provide them

234 COTA, submission to the Issues Paper, April 2008, p. 6.

235 Energy Consumers' Council, submission to the Issues Paper, April 2008, p. 3

with the greatest possible savings may simply be making a rational utility maximising decision given the existence of search costs (i.e. the customer may know they may not be getting the best deal but consider the cost of looking for other offers to be more effort than it is worth). Some customers may also place greater value on smaller gains received earlier in the contract and therefore have a preference for contracts that involve the receipt of a free gift, even though they may end up paying more for their energy over the life of the contract.

D.3.3 Perceptions surrounding status quo bias and switching costs

To understand the extent to which the perceptions of search and switching costs or status quo bias may be influencing the decision of customers to switch, survey respondents were asked to identify the reasons for not changing retailers. Table D.6 provides a summary of the responses to this question.

Table D.6 Reason for not switching

	Residential Customers		Small Business	
Motivating Factor	Electricity	Gas	Electricity	Gas
Happy with current retailer	69%	75%	60%	49%
Can't be bothered, too much effort	21%	13%	24%	29%
Insufficient Information or couldn't understand	6%	5%	3%	2%
Waiting for better offers	1%	2%	3%	7%
Inadequate potential savings	3%	2%	6%	5%

Data source: McGregor Tan, *Consumer Survey Report*, p. 43 and 90.

As these survey results demonstrate, a significant proportion of the customers that had not switched retailer did so because they were happy with the host retailers, Origin or AGL.[236] Those consumers that were more likely to state that they were happy with the host retailer were customers located in Adelaide and customers that are elderly, concession card holders or from lower income households. While these results appear to suggest that some consumers do exhibit brand loyalty or status quo bias, it should not simply be assumed that customers who fit into this category are not receiving, or are unable to receive, the benefits of effective competition. The 'stickiness' of customers will only be a problem if host retailers are able to identify those customers that display that characteristic and offer prices which are not competitive. On the basis of the analysis contained in Appendix C, the Commission has found no evidence of such discrimination.

The survey results also revealed that a relatively high proportion of customers had stayed with the host retailer because switching entailed too much effort. A number of customers also stated that there was insufficient information to make an informed decision, they were waiting for a better offer, or the potential savings were inadequate. These survey results indicate that the decision to switch is heavily

236 The following quotes from the focus groups also indicate the perceptions regarding the host retailers:
"I've stuck with AGL ever since ETSA was deregulated, and I've never seen any reason to change" and "We connected with Origin for our gas, because it seemed the obvious thing to do".

influenced by the magnitude of the savings available from switching relative to perceived search and switching costs.

As the results in Table D.6 indicate, small business customers were more likely to view switching as involving too much effort given the potential benefits. This view is reflected in the following statements made by a number of small business participants in the consumer focus groups:

> "Frankly, it's not worth the time and effort involved to change."
>
> "I haven't done anything about it because I am too busy."
>
> "No-one has presented me with a convincing argument that my business will gain by changing my supplier of electricity."
>
> "I can't be bothered to save only a marginal cost."[237]

These responses suggest that the search and switching costs currently faced by some small business customers are perceived to outweigh any savings currently offered to them.

The results of the survey also indicated that small business gas customers were more likely to view the search and switching costs as being too high to warrant change than small business electricity customers. One potential reason for this difference is that while the search and switching costs incurred by gas and electricity customers is likely to be the same, the dollar value of any benefits available to small electricity customers will generally be higher. The higher benefits available to small electricity customers simply reflects the fact that these customers spend a considerable amount more in each month on electricity than their small business gas counterparts spend on gas (i.e., $350 or more per month versus less than $100 per month).[238] Given this divergence it is not surprising that a greater proportion of small business electricity customers have made the effort to switch to a market contract.

As discussed in the introduction, the presence of 'status quo bias' or search and switching costs will only be problematic if they remain sufficient to deter a significant proportion of customers from seeking out and taking up alternative supply options or if they enable retailers to discriminate between customers. Based on the switching data and Consumer Survey results it appears that these factors have not impeded the ability of a significant proportion of residential and small business customers from exercising choice. The Retailer Survey also indicates that retailers are not currently able to discriminate between those customers that are likely to switch and those that are not (see Appendix C). The only potential problem is that maintaining the standing contract may create or enhance retailers' ability to identify 'non-switchers', if the retailer is able to use the standing contract to identify those customers who have been unwilling to switch to a market contract, either due to

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237 McGregor Tan, *Consumer Survey Report*, pp. 141, 146 and 179.

238 *Ibid*, p. 20 and 70.

status quo bias or the existence of high perceived search and/or switching costs. As competition develops and a greater number of customers switch in response to the offer of discounts or as a result of retailers effectively reducing perceived switching costs, the proportion of customers remaining on the standing contract that are non-switchers will increase.

D.3.4 Other impediments to customer participation

The structural conditions prevailing in the gas supply chain in regional areas of South Australia have acted as a further impediment to the participation of gas customers located in Whyalla, Port Pirie, Riverland, Murray Bridge and Mount Gambier. As discussed in Appendix E, these structural conditions have limited the ability of new retailers to market products in these regions and Origin remains the dominant retailer. In effect these structural conditions have meant that customers in regional areas have been limited in their options to simply moving from Origin's standing contract to one of its market contracts unlike and their counterparts in Adelaide, are unable to purchase their gas requirements from another retailer. However, as further discussed in Appendix C, Origin's market offers to regional gas customers offer the same level of discounting as Origin's market offers available in Adelaide. As the market offers in Adelaide are subject to more intense competition, some of the benefits of that competition are passed through to regional gas customers.

This issue was also raised by the South Australian Farmers Federation in its submission to the Issues Paper. Within that submission the South Australian Farmers Federation stated:

> "…our members cannot get a competitive deal on gas supplies. Our current retailer provided a member with a gas deal which they could not fill due to the incredible entry costs. In fact it was so prohibitive that the member is back with the original supplier, the retailer out of pocket due to paying out the contract so as to honour their agreement.
>
> So while city dwellers can access gas deals the regional areas are at a significant disadvantage and in our experience often are charged government mandated rates. The costs of gas provision in these areas are therefore unlikely to be competitive – ever in the South Australian context." [239]

Hence, while consumers in these regional areas may be equally willing to change their gas retailer, they have not been able to do so because alternative retailers have not been able to expand into these locations due to structural limitations, some of which may be resolved in the near term. While the majority of small consumers in South Australia are not affected by these structural limitations, the Commission will continue to consider whether there are any appropriate improvements that may be recommended.

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239 South Australian Farmers Federation, submission to the Issues Paper, p. 5.

D.3.5 Observations from the Consumer Survey and submissions

Based on the foregoing, the awareness amongst small customers of their ability to select their own energy retailer is relatively high. Notwithstanding the high level of awareness, small customers continue to view energy as a low involvement product and place little importance on actively seeking out market offers. This characteristic of demand is reflected in the Consumer Survey, with only a limited number of surveyed customers having actively sought out information on market offers from a retailer.

Although consumers are unlikely to actively seek out a market offer, they do appear willing to respond to market offers made directly by retailers. The propensity to participate does, however, differ between:

- residential and small business customers;
- electricity and gas customers; and
- gas customers located in Adelaide and gas customers located in regional areas.

Based on the results of the Consumer Survey and the submissions received from interested parties, the differences in the propensity of residential and small business customers to switch appear to stem, in part, from differences in the level of marketing activity targeting small businesses. As noted in section D.3.1, retailers have, for a number of reasons, found it comparatively harder to market products to small business customers than residential customers and as a consequence a greater proportion of residential customers have been offered a market contract than small business customers.

Another factor contributing to the difference in the propensity of residential and small business customers to switch is the difference in perceptions surrounding search and switching costs and the magnitude of benefits available. It appears from the results of the Consumer Survey and submissions made by interested parties that information is less accessible for small business than residential customers. The limited availability of information coupled with the fact that small business customers face a higher opportunity cost when undertaking the research required to evaluate alternative offers, means that the overall search and switching costs may be higher for small business customers than residential customers. In addition to facing higher search and switching costs, small business customers also tend to perceive that the benefits of switching as being relatively small and as a consequence their propensity to switch will generally be lower than residential customers. In its submission on the First Draft Report, TRUenergy did not believe that small businesses faced higher search costs or that this was an accurate reflection of business participation in the market. It submitted that:

> "[small businesses facing higher search costs] does not reflect the experience of those businesses contacted by retailers or those who have gone through the transfer process. The available quantitative evidence demonstrates that the

opportunity costs of businesses participating in the competitive market are no higher than for residential customers."[240]

The Commission notes that its assessment is based on the consideration of the Consumer Survey results as well as submissions from consumer groups representing small business customers. Taking into account of both direct and indirect costs, particularly the opportunity cost of small business owners' time, there do seem to be higher search costs associated with small business customers. This is indicated by the higher percentage of small business consumers compared to residential consumers that indicated "could not be bothered/too much effort" as the reason for not switching (24 per cent compared to 21 per cent for electricity and 29 per cent compared to 13 per cent for gas). However, the Commission acknowledges that many small businesses have had positive experiences with switching retailers, which is reflected in the results of the Consumer Survey where the majority of small business consumers have been very or quite satisfied that their new energy company has delivered what they were looking for.[241] In addition, with the implementation of the ESCOSA Estimator for small business consumers, it is anticipated that the Estimator will improve the ability of small business customers to compare any offers they receive.

Although the propensity for small business customers to switch has been lower than residential customers, there is no evidence before the Commission to indicate that there are structural impediments that mean small business customers are less able than others to participate in the market. If the cost-benefit assessment were to change in the future, either through an increase in the discount offered or through a reduction in search and switching costs, then small business customers could be expected to respond in a similar manner to residential customers by switching.

Similarly, there do not appear to be any structural factors impeding gas customers located in Adelaide, which make up more than 95% of the gas customer base, from participating in the market. In this case the difference between the observed level of participation between electricity and gas customers appears to have been driven by differences in the level of marketing activity and differences in the proportion of income spent on energy. As noted in section D.3, there are less than half as many retailers marketing gas compared to electricity and gas tends to be marketed as an add-on to electricity rather than being marketed in its own right. This tendency coupled with the difficulties retailers have had in locating customers with gas has meant that fewer gas customers have been actively marketed. Another potential reason for the differences observed between electricity and gas is that the proportion of income spent on gas tends to be substantially lower than electricity and thus the dollar value of any gains to be made from switching are likely to be lower for gas customers than electricity customers.

The only group of customers that appear to have been impeded by structural factors are those gas customers located in regional areas who have been constrained in their ability to exercise choice between retailers by the structural conditions, some of

[240] TRUenergy, submission to the First Draft Report, August 2008, p. 1.

[241] McGregor Tan, *Consumer Survey Report*, pp. 38 and 87.

which may be near term issues, prevailing in the gas supply chain. Given the example provided by small electricity customers in regional areas, there is no reason to believe that these consumers would not be as willing to switch as their counterparts located in Adelaide in the event that alternative retailers were able to supply them.

D.4 Satisfaction with FRC

Customer satisfaction with market outcomes is another indicator of the extent to which competition is effective. Although customers may not investigate every potential energy offer that is available to them, a customer that is largely satisfied with the outcome of his or her decision to switch has experienced the benefits of effective competition.

The Consumer Survey canvassed this issue with those customers that had switched energy retailers and according to the survey results, over 80 per cent of residential gas and electricity customers and 70 per cent of small business electricity[242] customers were quite or very satisfied that their new retailer had delivered what they were looking for.[243] These percentages were consistent across both regional and metropolitan customers surveyed. High levels of satisfaction were reported by similar proportions of electricity customers who remained with the same retailer but had changed their supply arrangements (67 per cent of residential customers and 79 per cent of small business).[244] Amongst the residential gas customers that had stayed with the same retailer but had changed supply arrangements, the level of satisfaction was slightly lower at 50 per cent. [245] Since the principal motivator for switching for the majority of customers is to achieve a price or cost saving, these survey results suggest that customers participating in the competitive market are experiencing the benefits of price-based competition.

The experience customers have had to date with switching has also been positive with over 55 per cent of small business customers and 90 per cent of residential customers stating that the transfer process was easy.[246]

Another indicator of customer satisfaction with FRC is the propensity of customers to change their electricity supply arrangements or retailer in the next 12 months. This question was raised with the customers participating in the Consumer Survey and approximately eight to 10 per cent of residential customers and 13 to 14 per cent of small business customers reported that they were quite or very likely to actively participate in the competitive market in this time.

The proportion of consumers indicating that they intend to switch may appear relatively low. However, it is important to recognise that these intentions would

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242 The number of responses given by gas small business customers is too small to draw conclusions about their attitudes.

243 McGregor Tan, *Consumer Survey Report*, pp. 38 and 87.

244 *Ibid*, p. 47.

245 *Ibid*, p. 93.

246 *Ibid*, p. 8.

have been formed on the basis of existing price and service relativities. If relative prices were to rise and/or service quality to deteriorate, it is likely that many more consumers would in fact switch. It is important to recall that in most situations, less than half the total market is required to be a switcher in the event of a significant price rise in order to constrain retailer behaviour. That is, as long as there are a sufficient number of consumers that are willing to engage with the competitive market and switch retail supply to obtain a better deal, then all consumers can expect to benefit from competition.

Overall, the survey results indicate that customers are generally satisfied with the outcomes of retail competition and are willing to exercise their right to maximise the benefits available to them given the products on offer.

D.5 Equitable access to the benefits of competition

In the Issues Paper the Commission invited interested parties to provide information on any classes of customers that may be constrained in their ability to participate in the competitive market, or otherwise limited in their capacity to access the full benefits of competition.

The submissions on the Issues Paper and the First Draft Report on this issue principally focused on those customers viewed as being most vulnerable to higher gas and electricity prices and therefore in need of the 'protection' afforded by retail price regulation. Those customers viewed as being particularly susceptible to higher energy prices included lower income earners, the elderly, the disabled, carers and farmers. The following extracts highlight the specific concerns of Uniting*Care* Wesley, COTA and the South Australian Farmers Federation:

> "Uniting*Care* Wesley Adelaide is concerned that a premature removal of energy (electricity and gas) retail price caps could lead to many South Australian (SA) energy consumers (residential and small businesses) paying higher costs for the supply of the essential services of electricity (and also of gas). UCW is also concerned that small consumers in rural areas, outer suburban areas (with low SEIFA index) and low income and disadvantaged households (specifically households including aged, carer and physical disabled members) are highly likely to suffer increasing financial and other hardships with the removal of the protections, including those provided by appropriately regulated retail energy price caps."[247]

> "COTA notes that around 30% of the South Australian population is on fixed incomes, including a large proportion of its constituents. To protect these consumers, COTA believes that a standing contract price should be maintained." [248]

247 Uniting*Care* Wesley, submission to the Issues Paper, April 2008, p. 7.

248 COTA, submission to the Issues Paper, April 2008, p. 10.

> "Farmers have experienced rising costs in fuel supplies and at the same time have been in drought conditions for a significant time thus reducing their incomes. If electricity prices keep rising they may be excluded from the market financially leading to a loss of business and maybe livelihood…..
>
> …Other sectors of the community may also be affected, regional centres, low income earners and the aged sections of the community."[249]

These parties suggested that retail price regulation be maintained to provide confidence and protection to consumers.[250]

The Commission understands that the inability to pay for consumption of energy when bills are due is the principal reason why certain customers are unable to participate effectively in the competitive retail energy market. For customers that are already facing temporary or permanent financial hardship, higher energy costs can impose an additional source of financial stress with customers foregoing other necessities in order to maintain energy supply or resorting to costly means of raising money to pay energy bills, such as 'pay day' loans. The Commission appreciates that financial hardship is an area of particular concern in South Australia, given the higher than average proportion of South Australian's living on a fixed income and/or receiving some form of government assistance.

While the Commission recognises that issues of financial hardship and energy affordability are significant, it does not agree that price regulation is the most appropriate, or efficient way, of addressing issues of financial hardship. Price regulation is a relatively blunt instrument that has the potential to distort the efficient operation of the market to the detriment of all consumers including those customers facing financial hardship. In the Commission's opinion, measures that provide direct assistance to those customers facing financial hardship are the most effective and efficient way of addressing issues of poverty and energy affordability.

The Commission understands that the South Australian Government has already introduced a number of initiatives in this area including the Energy Concession scheme. This scheme provides eligible customers with an annual rebate of $120 on their electricity bill. Customers that are eligible for this concession include individuals that have a pensioner concession card, a state concession card, a Commonwealth Seniors Health Care Card, Centrelink Health Care Card or a veteran's Gold Card. Additional assistance is also available through the South Australian Government's Emergency Energy Assistance Scheme and from a number of non-government organisations.

Another scheme that may offer assistance to customers facing financial hardship is the Residential Energy Efficiency Scheme. This scheme requires retailers to undertake energy audits and implement energy efficiency improvements in households, such as ceiling insulation, draught proofing and more efficient

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249 South Australian Farmers Federation, submission to the Issues Paper, April 2008, p. 15.

250 Including submissions to the First Draft Report from Uniting*Care* Wesley, COTA & SACOSS as well as The South Australian Minister for Energy.

appliances. The Commission understands that a proportion of these improvements must be delivered to low income households.

Provisions within the Energy Retail Code also impose a number of requirements on retailers in relation to residential customers experiencing payment difficulties. In accordance with the Energy Retail Code, retailers are required to offer the customer an instalment plan and, where appropriate, information on:

- the right to have a bill redirected to a consenting third person;
- government assistance programmes; and
- independent financial and other relevant counselling services.

The initiatives undertaken in this area to date demonstrate that while the development of hardship policies is principally within the realm of policy makers, retailers can play a key role in the delivery of these programmes. As noted by Origin:

> "… Origin, and other retailers, provide comprehensive hardship programs to assist vulnerable customers and that assisting customers in financial difficulty is a responsibility shared across all relevant stakeholders."[251]

Areas in which retailers can provide assistance include: identifying customers experiencing financial hardship; providing and facilitating access to payment plans for those experiencing bill payment difficulties; appropriately managing customer disconnection and reconnection; and directing customers to other support mechanisms.

Submissions on the First Draft Report[252] also queried whether competition was effective for regional gas customers when Origin is the only retailer. The Commission recognises that although the South Australian retail energy market is effectively competitive for the majority of customers, regional gas customers may not be benefiting fully from the competitive energy market. This is due to structural limitations identified in the gas supply chain that affect retailers' ability to obtain access to firm gas transmission services on the pipelines servicing the regional areas. As further discussed in Appendix E these limitations relate to legacy transmission contracts. Market participants have noted that some of these legacy contracts are due to expire in the relatively near term and the market is likely to resolve these issues in due course. [253]

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[251] Origin Energy, submission to the First Draft Report, p. 2.

[252] Including submissions from COTA and SACOSS, the South Australian Farmers Federation and the South Australian Minister for Energy.

[253] As noted by AGL in its submission to the First Draft Report, p. 6.

D.6 Commission's findings

In summary, the Commission's analysis indicates that while customers do not generally initiate contact with retailers, they have been prepared to participate in the market by switching in response to the direct marketing initiatives of retailers, particularly in response to offers of lower prices. The willingness of small customers to participate in the market is reflected in the level of switching that has occurred to date. According to First Data Utilities and VaasaETT, South Australia is the third most active jurisdiction in the world for electricity switching and while the rate of switching observed amongst gas customers has been slightly lower, it is still significant.

While the overall rates of switching exhibited by small electricity and gas customers have been relatively high to date, small business customers have exhibited a lower propensity to switch than residential customers, especially for gas. There is no evidence before the Commission to suggest that there are structural factors that mean small businesses customers are generally less able than others to participate in the market. Rather, it would appear that small businesses are less willing to switch to a market contract because of the costs that would be incurred, particularly in terms of time, to achieve what may ultimately be a relatively small financial benefit. Going forward, the propensity to participate is likely to improve if the search and switching costs fall and/or the discount available to small businesses increases.

As noted in section D.3.5, the only group of customers that appear to be facing a structural impediment to competition are small gas customers located in areas such as Whyalla, Port Pirie, Riverland, Murray Bridge and Mount Gambier; however some of these impediments are likely to be alleviated, at least in part, in the short to medium term. This regional variation can also be impacted by both the high fixed costs faced by gas retailers seeking to supply gas to these areas and the small number of customers residing in these regional areas. Combined, these factors have limited the economic viability of retailing gas to these regions and, as a consequence, small customers located in these areas have only had the choice of moving from the Origin standing contract to an Origin market contract and have not had the opportunity to choose between alternative product offerings made by other retailers. However, as outlined in Appendix C, that Commission notes that Origin's market contract offers to regional gas customers provide the same rate of discounts as the market contracts offered in Adelaide. The Commission will further consider the availability of any options to improve the access of regional customers to the competitive gas retail market. If appropriate, it will present proposals to that effect in the Second Draft Report.

Setting aside the regional variation, the overall rates of switching observed in South Australia have been relatively high to date, motivated largely by price, which suggests that small customers in South Australia have been able to exert pressure on retailers to develop and market attractive offers to the benefit of consumers. The high levels of satisfaction with switching decisions cited by both residential and small businesses gives further weight to the conclusion that customers have, to date, been one of the principal beneficiaries of retail competition in South Australia. Going forward the Commission expects that customers will continue to place pressure on retailers.

E Conditions for Entry, Expansion and Exit

This appendix focuses on the third of the Commission's three key strands of analysis: the impact of entry, expansion and exit conditions on competition, including the extent to which new entry or potential new entry constrains retailer behaviour. In response to issues raised by stakeholders, this appendix also incorporates additional analysis about some stakeholders' perception that AGL has market power in the wholesale electricity sector and the impact this has on retail competition.

A new entrant who can establish itself, or a firm who can expand its existing business, within a reasonable period of time and on a sufficient scale can impose a competitive discipline on its competitors. This discipline constrains the pricing and output decisions of other retailers, encouraging them to supply customers with a better price-product-service package than their rivals and potential rivals. It also encourages businesses to facilitate the flow of information about their products to consumers, who exercise choice on the basis of this information. Conditions that enable a retailer to establish or expand its business and impose constraints of this nature on other retailers encourage effective competition.

Conversely, where new entry or expansion is difficult, retailers' behaviour is less constrained. This can lead to one or more retailers accumulating market power, resulting in prices being maintained above competitive levels, and/or output and service delivery being below competitive levels. The absence of competitive discipline may also lead to a failure by retailers to distribute to customers the information that is necessary to enable them to make informed decisions about their energy supply. Market conditions that protect retailers from the threat of new entry and expansion can stifle the development of effective competition.[254]

This appendix sets out the Commission's assessment of entry into, expansion within, and exit from, energy retailing in South Australia. This appendix divides the discussion of the Commission's analysis into two sections:

- non-regulatory factors affecting entry into, expansion within, and exit from, energy retailing (**section E.1**); and
- the legislative and regulatory structure for energy retailing, which can impact on the incentives for and cost of entry and expansion in South Australian energy retailing (**section E.2**).

E.1 Non-regulatory conditions for entry, expansion and exit

A barrier to entry refers to any market characteristic or condition that places an efficient potential new entrant at a disadvantage relative to an established business. A barrier to entry does not properly include a cost or other impediment that applies

254 However, it is important to note that even in the presence of barriers to entry or expansion, there can still be effective competition, providing there are enough suppliers actively competing with each other and consumers willing to engage with competitive supply.

more or less equally to any party wanting to participate in the retail market, irrespective of whether it is an established retailer or a new retailer. Barriers to entry are an important element of an assessment of the effectiveness of competition because, where they are high, new entrants will not be likely to enter the market and erode any excess profits. As a result, the behaviour of the participants already in the market will not be constrained by the threat or actual entry of new participants.

Once a business has begun trading, it may also face costs or impediments that prevent it from expanding, or limit its ability to expand within or exit from the industry relative to its established competitors. These restrictions are known respectively as barriers to expansion and exit. Barriers to expansion exist where fringe or niche entry may be possible but there are obstacles to expanding to a size that would allow a new entrant to compete effectively against larger, more established businesses. In such circumstances, established large retailers may still not be fully constrained by the threat of entry. Barriers to exit can affect entry decisions if the costs of exiting the market are so prohibitive that the incentive to enter is reduced or destroyed altogether. For example, where entry requires substantial capital investment which cannot be recovered on exit (i.e. there are sunk costs) entry may be discouraged. In some situations, exit itself may involve further sunk costs, e.g. associated with rendering a site or premises suitable for alternative uses.

Barriers to entry, expansion or exit in retailing gas and electricity in South Australia could take a variety of forms. They could be structural, strategic or be related to the legal and regulatory framework. The issues to be analysed in this section of this appendix are:

- the ease or difficulty of access to and the cost of contracts for energy supply and risk management facilities (**sections E.1.1** and **E.1.2**);
- access to network infrastructure (**section E.1.3**);
- the presence of economies of scale and scope (**section E.1.4**);
- the perceived advantages accruing to legacy retailers (**section E.1.5**);
- entry costs associated with customer behaviour, marketing and brand loyalty (**section E.1.6**); and
- exit costs (**section E.1.7**).

The arrangements for retailers to obtain wholesale energy supply and to access the required infrastructure are different for electricity and gas and, as such, the ability to access the requirements for one fuel does not guarantee access to the other. In recognition of these differences, the Commission has presented its analysis of the arrangements for electricity and gas separately.

E.1.1 Access to wholesale electricity supply and risk management tools

The ability to commence and operate a competitive retail energy business is affected by the extent to which a retailer can access wholesale energy and appropriate risk management tools to manage exposure to price and volume risk in those markets, particularly in the case of electricity. The prevailing market conditions at any particular point in time affect the cost at which wholesale electricity and risk management tools are available.

Wholesale electricity is purchased through the spot market operated by NEMMCO.[255] During 2006-07, approximately 196,000 gigawatt (GW) hours of electrical energy was traded in the NEM, with a value in excess of $11.4 billion.[256] The price at which electricity is bought and sold varies on a half hourly basis and can range from –$999 to a maximum of $10,000 per MWh. The potential for such extreme variations exposes retailers to two main types of risk:

- price risk, which results from the volatility of the spot price; and
- volume risk, which arises when the customer load exceeds the retailer's contracted load and the retailer has not hedged the additional load.

E.1.1.1 Retailers and risk management

The central function of an Australian electricity retailer is to act as an intermediary between the electricity generator and the end use customer which, because of fluctuations in the wholesale price of electricity compared to committed retail prices, can expose the retailer to price risk. Accordingly, retailers enter into forward contracts and a range of derivative instruments to hedge their exposure. In this sense, retailers provide risk management services to end-use customers which enable the retailer to offer longer term contracts at specified prices and limit customers' exposure to price fluctuations in the wholesale market. The costs incurred by retailers include the cost and risk of providing these risk management services and must be recovered in retail prices. The Retailer Survey showed a consensus among retailers that risk management was the key to success for retailing in South Australia.[257]

The most common strategy to manage price and volume risk is to enter into financial contracts with generators to effectively lock in the future price of electricity that will be supplied by a generator or purchased by a retailer through the use of the financial instruments.[258] These contracts are known as derivatives and include swaps, options, caps and futures. Although the interconnection of the NEM regions allows

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255 The National Electricity Market Management Company (NEMMCO) fulfils the dual roles of market operator and system operator for the NEM. This means that NEMMCO is responsible for managing both the wholesale spot market in electricity and the transmission elements of the physical power system that underpins the operation of the NEM.

256 NEMMCO, *Annual Report 2007*, 2007, p. 4.

257 LECG, *Retailer Survey Report*, Section 2.2.

258 NEMMCO, *Australia's National Electricity Market: Trading Arrangements in the NEM*, 2004, p. 25.

retailers to utilise settlement residues as a risk management tool[259], settlement residues are likely to form only one part of the risk management portfolio.

South Australian retailers have limited ability to enter into financial contracts with generators located outside the state. South Australia is a net importer of electricity and, at times of peak demand, constraints on the interconnectors preclude South Australian retailers from importing more competitively priced electricity from Victoria. The de-rating of the Heywood interconnector at the end of 2007 reduced its maximum limit, potentially increasing the number of times the interconnection may become constrained between South Australia and Victoria.[260] This network constraint imposes a corresponding limitation on the ability for South Australian retailers to hedge their loads with interstate generators, thereby principally limiting the choice of counterparties to South Australian generators. There are five major generation companies located in South Australia: AGL, International Power, Babcock and Brown, TRUenergy and Origin who collectively provide approximately 80 per cent of the state's scheduled generation capacity.[261] Together, AGL and International Power own more than 50 per cent of South Australia's generation capacity.[262] The Energy Consumers' Council noted its concern regarding the interconnection in its submission:

> "At times when there are interconnector outages (or when the available interconnector capacity is fully utilised), additional lower priced electricity is unable to be imported from Victoria, thereby removing or increasing the risk for retailers operating in South Australia." [263]

The effectiveness of derivatives as a risk management tool is contingent upon retailers being able to purchase a financial contract which in turn requires there to be sufficient liquidity in the contract market. Lack of market depth also makes the price of contracts vulnerable to the effects of large purchases and increases the risk associated with retail entry. The 2007 report by ERIG into the way forward for the Australian energy industry noted that there is a lack of depth of products and

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259 A settlement residue is any surplus or deficit of funds retained by NEMMCO upon completion of settlements to all market participants in respect of a trading interval. Auctions run by NEMMCO to sell the rights to the settlements residue associated with inter-regional transfers are referred to as Settlement Residue Auctions (SRAs). Participants may use the settlements residue for hedging and underwriting inter-regional trading in electricity: NEMMCO, *Statement of Opportunities 2007*, 2007, p. 19.

260 The ESIPC noted, in its submission to the First Draft Report, that the Heywood interconnector was historically used for importing electricity into South Australia. However, the ESIPC notes that the use of the interconnector was significantly changing. Although the interconnector is now constrained for less hours than experienced in the past, the impact of the constraint on South Australian wholesale supply and prices can be large.

261 NERA, *The Wholesale Electricity Market in Australia*, March 2008, p. 32. As at 1 January 2008, these companies accounted for 80 per cent of South Australia's 4.0 GW of generation capacity.

262 Reference to AGL's ownership of scheduled generation capacity does not include the Angaston power station that is owned by Infratil and controlled by AGL.

263 Energy Consumers' Council, submission to the Issues Paper, p. 2.

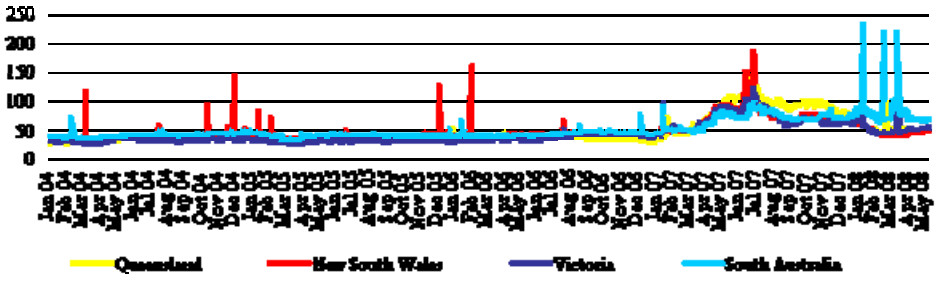
liquidity in the financial markets of South Australia.[264] Simply Energy expressed a similar view in its submission to the Issues Paper:

> "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." [265]

E.1.1.2 Current & future market conditions

The Retailer Survey indicated that the costs of wholesale energy and, in particular, risk management tools, had increased over the past 12-18 months, affecting the ability of retailers to access supply and risk management tools at reasonable cost.[266] The cost increases are depicted in Figure E.1 below, which shows the wholesale electricity price index (WEPI)[267] for each NEM region.

Figure E.1 Wholesale Electricity Price Index 2004-2008



Source: AER Weekly Market Analysis 10 May 2008, d-cypha

There appears to be a range of factors contributing to the increase in the WEPI for South Australia.[268] Compared to other regions in the NEM, demand in South Australia is highly weather-dependent and variations in summer temperatures can

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264 ERIG, *Energy Reform – the way forward for Australia*, January 2007, p. 207.

265 Simply Energy, submission to the Issues Paper, p.1.

266 LECG, *Retailer Survey Report*, p. 8.

267 The wholesale electricity price index (WEPI) was developed for the Australian electricity market by d-cyphaTrade working in collaboration with the Federal Department of Industry, Tourism and Resources in November 2002. The WEPI is intended to be a simple, easily reportable index that reflects daily changes to contract and spot market conditions and their effect on the stability of the underlying wholesale price for electricity in the market. The index, which was launched on 13 November 2002, is intended to provide a proxy for the underlying wholesale market trends on a daily basis. It reflects changes in exchange traded contract and spot prices, load conditions and the proportion of total load contracted at any one time. The index is calculated for each region separately. As yet, no index exists for Tasmania.

268 Uniting*Care* Wesley, in its submission to the Issues Paper, noted that there are distinct regional differences in the NEM (pp. 19-20) and that demand in South Australia is very dependent on weather (p. 31).

result in large swings in demand levels from year to year.[269] This is a contributing factor to the spikes in the South Australian index readily observable in December 2006, January 2007 and in the period January 2008 to March 2008, where South Australia experienced several extreme weather conditions. Drought conditions have also affected wholesale electricity prices throughout the NEM, particularly in the eastern states. With a high proportion of gas-fired generation and the use of sea water for cooling in some of South Australia's thermal power plants, the overall impact of the drought (or the easing of the drought) on wholesale supply in South Australia is lower. However, for most of the time the interconnectors between South Australia and Victoria are unconstrained and prices in South Australia are determined by overall supply and demand conditions across the NEM.

A direct consequence of the changes in the wholesale electricity price is that, notwithstanding that hedge contracts are available, the price at which they are offered has risen and is now at a level that makes it difficult for many retailers to remain profitable, given the standing offer price with which they must compete. One retailer noted:

> "… in South Australia [the cost of hedge products] have gone up so it's got to the point now where there are no margins, we can't offer competitive retail prices to customers in South Australia and for a profit based on using those hedging products so basically we're not competing in South Australia any more." [270]

It is likely that longer-term expectations about the supply/demand balance in South Australia, and across the NEM as a whole, will affect the price of wholesale electricity. Although South Australia currently has sufficient generation capacity to meet its demand and reserve requirements, NEMMCO has forecast that by 2010/2011 South Australia will fail to meet the minimum reserve requirements.[271] Tightening supply conditions are likely to place further upward pressure on wholesale electricity prices, as reflected in the current outlook for prices (see Figure E.2 below). Expected environmental policy initiatives, such as the introduction of a "carbon cost" for electricity generation and increasing use of intermittent non- or semi-scheduled generation capacity such as wind, are also likely to affect the wholesale electricity price and the price of risk mitigation instruments. Some retailers have indicated to the Commission that the major difficulty in negotiating hedge contracts in the current environment is uncertainty about how to factor in the carbon price that will be associated with the CPRS.[272]

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269 ERIG, *Energy Reform – the way forward for Australia*, January 2007, p. 60.

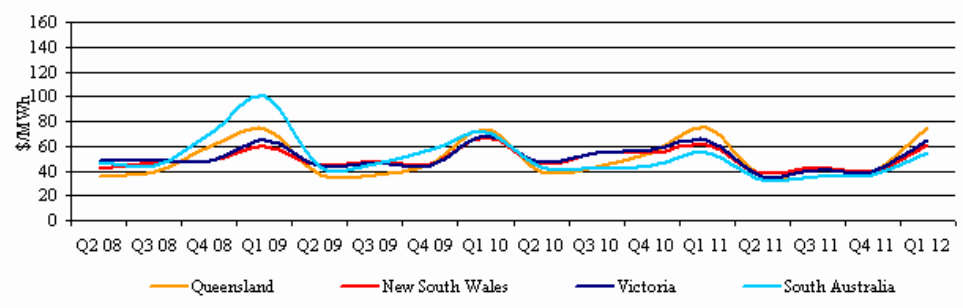
270 Retailer Survey.

271 NEMMCO *Statement of Opportunities* 2007, pp. 2-12 and 2-20; ESIPC, *Annual Planning Report 2007*, 2007, p. vii.

272 The ESIPC, in its submission to the First Draft Report, also notes that carbon price and international fuel prices will have implications on South Australia energy requirements going forward.

In its submission to the First Draft Report, Uniting*Care* Wesley asserted that the Commission's assessment of the tightening supply and demand balance as having contributed to increases in the spot and contract prices was erroneous as it believes there is adequate supply in South Australia.[273] The Commission notes that although the nameplate capacity of generating units in South Australia may suggest generation capacity is greater than demand, regard must be had to the capacity factor of generation units.[274] The consideration of capacity factors is particularly important for South Australia where there is a high, and increasing, proportion of wind generation. Due to its intermittent nature, wind generation typically has a capacity factor of 20-40% (compared to thermal generation which could have a capacity factor greater than 90%). Taking this into consideration, the Commission notes that the supply/demand balance in South Australia does not indicate there is any significant excess generation capacity. In addition, the intermittency of wind generation units limits the ability of wind generators to offer hedges, as noted by Uniting*Care* Wesley in its submission on the Issues Paper.[275] This factor would also potentially impact contract prices.

Figure E.2 d-CyphaTrade regional quarterly base futures prices



Source: AER Weekly Market Analysis 10 May 2008, d-cypha

E.1.1.3 Vertical integration

A second risk management strategy that is becoming increasingly prevalent in Australian energy markets is vertical integration between generation and retail operations, which typically requires high sunk costs. Vertical integration provides the retailer with a natural hedge against price volatility and some protection against contract market illiquidity. Importantly, it may reduce the transaction costs associated with obtaining forward cover and hence promote efficiency in electricity supply. Furthermore, a large unintegrated retailer would require large scale hedge contracts. A generator entering into large scale contractual commitments with the retailer would likely seek to use those contracts to underwrite generation investment

273 Uniting*Care* Wesley, submission on the First Draft Report, p. 27.

274 The capacity factor for generation units is the ratio of the actual energy output in a specific period compared to the maximum hypothetical output possible. Capacity factors are affected by issues including fuel availability, maintenance requirements and, in the case of wind generation, environmental factors.

275 Uniting*Care* Wesley, submission on the Issues Paper, p. 32.

and hence would require the retailer to have a large balance sheet to back its contractual commitments. Vertical integration may therefore increase the risk management options available to a retailer. However, it would be unlikely to eliminate the requirement for the integrated business to enter into hedge contracts. It is not commercially realistic to assume that a vertically integrated generator will engage in less hedging by an amount that simply reflects the extent of its retail load. Retailers typically rely on a portfolio of risk management tools which would include contracts with base load, intermediate and peaking generators.[276] Being vertically integrated would still require a party to enter into contracts for the type of hedges that it cannot efficiently provide to itself.

Responses to the Retailer Survey indicated that vertical integration into generation is an important consideration for retailers and would be expected to provide them with improved access to risk management strategies. Although vertical integration may not be required for a small retailer to enter, some retailers believed that the ability of smaller retailers to expand would be limited without it. One retailer noted:

> "when you're small you can actually manage your wholesale position quite easily. When you become large … you've got a huge portfolio to manage, and it's best to have a generator behind you to actually manage that risk properly." [277]

If the risks of exposure to the wholesale market and concerns about liquidity in the South Australian contract market continue, vertical integration may become increasingly necessary to facilitate entry and/or expansion into South Australia. In this case, the high sunk costs may also limit opportunities for expansion. One retailer observed:

> "The wholesale market in South Australia is a … tougher market, the liquidity available in the marketplace would be one of our primary concerns. You start to have a more perfectly integrated market in South Australia where you do see some of the retailers integrating with generation a lot more so than you see in some of the other states and I think that makes it a little bit more difficult for the electricity retailers to operate in the market place."[278]

Retailers that already had access to some level of vertical integration expressed contrary views, suggesting that risk mitigation products would always be obtainable at a competitive market price.[279]

Vertical integration can, however, affect the liquidity of the contracts market, thereby increasing reliance on integration for viable entry or expansion. Some retailers and

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276 Retailers requiring a portfolio of supply provisions is also noted in UnitingCare Wesley's submission to the Issues Paper, p. 31.

277 Retailer Survey.

278 Retailer Survey.

279 LECG, *Retailer Survey Report*, p. 9.

consumer groups expressed concern that AGL's ownership of the TIPS was exacerbating already poor liquidity in the South Australian contract market.

E.1.1.4 AGL and the Torrens Island Power Station (TIPS)

Uniting*Care* Wesley in its submissions to the Issues Paper and the First Draft Report expressed the view that AGL has market power in the wholesale electricity market, and that this was undermining the effectiveness of competition in the retail market. The views put forward by Uniting*Care* Wesley may be summarised as:

- AGL has wholesale market power through its ownership of TIPS;
- The wholesale prices are not efficient, due to TIPS' market power, and therefore retail prices are not efficient as a consequence and therefore retail competition cannot be effective; and
- AGL is able to leverage its wholesale market power into the retail market to the detriment of retail competition and its retail competitors.

These views have also been supported by other stakeholders.[280] In order to further analyse the issues raised, the Commission obtained and reviewed analysis and information provided by market experts and stakeholders, including confidential information provided by AGL. The Commission's analysis is set out below.

AGL has wholesale market power through the ownership of TIPS

Market power involves the ability of a supplier in a market to sustain prices above long run costs, including a return on capital and accounting for risk, without excessive margins being eroded by the competitive activity of rivals and/or entry of new competitors. Other than raising prices, market power may involve the power to engage in predatory pricing or other exclusionary conduct, but these actions are ultimately directed at maintaining or increasing the supplier's power over prices. Most, if not all, exclusionary conduct of this type involves the supplier incurring a cost in the short term with the expectation of being able to recoup that cost through maintaining or increasing market power in the long run.[281]

Under Uniting*Care* Wesley's proposition, AGL has market power because:

- it can withhold the capacity of TIPS and/or raising the price at which TIPS capacity is bid into the pool (as evidenced by the periods of high wholesale prices in the South Australian region in the first quarter of 2008) and that AGL is able to do this to such an extent and sufficient frequency that it has a material effect on the long run wholesale price for the region;

[280] As noted in their joint submission to the First Draft Report, COTA and SACOSS support Uniting*Care* Wesley's submission on these issues.

[281] Market power, in an economic, in-principle sense, as described in this paragraph defines the concept of market power as used in the Commission's analysis.

- which then affects the price and availability of hedging instruments available in South Australia (as evident by the reported increase in price and reduction in the availability of hedging instruments in the last 12 month period).

The Commission notes that the pricing outcomes over the recent summer period, as well as in March 2008, that Uniting*Care* Wesley refer to were impacted by the combined effect of the unprecedented weather and demand conditions and the derating of the Heywood interconnector. Origin's submission on the First Draft Report noted that the derating of the interconnector was not expected by retailers as it had not been appropriately communicated to the market.[282,283] It was also noted during meetings with stakeholders that some retailers may have faced higher than expected risk exposure as the unexpected interconnector derating and the timing and duration of the extreme weather events may not have been incorporated into their risk management portfolios.[284] As AGL was also responding to these unexpected and uncontrollable events, it raises doubts about whether AGL could use TIPS to predictably and sustainably raise wholesale prices over the long run. This is not to say that TIPS did not enjoy temporary *ex post* price setting power during these particular periods of time, as the AER has found.[285] The potential *ex post* power would have been the same regardless of the ownership of TIPS. However, the derating of the interconnector and the extreme and unusual weather events, may have combined to give the new owner of TIPS greater opportunities to exploit those conditions. As noted by the AER:

> "It would appear likely that the recent combination of record demand and reduced interconnection would have led to high prices in South Australia regardless of whether the asset swap proceeded."[286]

To the extent that AGL's acquisition affected the availability of hedge contracts, consistent with the public competition assessment by the Australian Competition and Consumer Commission (ACCC), a number of stakeholders have indicated that this is likely to be a transitory situation that can be expected whenever new generation assets are acquired.[287] AGL indicated in its supplementary submission to the First Draft Report that it was already substantially hedged in the South Australian market when it acquired TIPS resulting in a "long" position which exposed it to the spot market.[288] AGL also indicated that as a prudent retailer and

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[282] Origin energy, submission on the First Draft Report, p. 4.

[283] The Commission notes that the AER is investigating this compliance issue regarding the reporting requirements for interconnector capacity changes. This investigation was outlined in AER, *Spot prices greater than $5000/MWh: South Australia 5-17 March 2008*, May 2008, in relation to the events that affected South Australia in March 2008.

[284] It is noted that the AER is investigating ElectraNet's compliance of the reporting requirements for the augmentation of the Heywood interconnector.

[285] AER, submission to the First Draft Report, September 2008, p. 1.

[286] *ibid*, p. 2.

[287] ACCC, *Public Competition Assessment – AGL Energy Limited and TRUenergy Pty Ltd proposed swap of South Australian electricity generation assets*, 20 April 2007, para. 58.

[288] AGL, supplementary submission to the First Draft Report, September 2008, p. 6.

generator, it would have preferred to have the TIPS capacity hedged rather than being exposed to spot prices. Further, AGL expects that its contract positions will realign going forward.[289] This is supported by the confidential information provided to the Commission by AGL. To the extent that AGL was "over hedged" at the time of acquiring TIPS, it is unlikely to be a sustainable commercial position.

New generation projects have also been committed in the South Australian region including a 120MW expansion at the Quarantine Power Station due to come online in 2008/2009 and more than 300MW of wind generation projects.[290,291] This suggests that the market conditions have not deterred new investment. Consistent with the anticipated operation of a competitive market, new entry, and the threat of further entry, should constrain the future behaviour of the existing generators including AGL. The new investment also suggests that the market outcomes of the recent summer have not resulted in any sustained increase in barriers to generation entry. Clarification of the parameters of climate change policy by the end of 2008 should provide a further stimulus to generation investment in South Australia and elsewhere.

These observations provide support for the view that the supply of generation capacity in the electricity wholesale market is continuing to respond to competitive price signals in the spot and contract markets but may do so with a lag. Consistent with the behaviour of other commodity markets, there can be periods of relatively high prices, reflecting a tightening of the supply/demand balance, followed by investment responses and the potential for periods of excess capacity and lower prices. This view is supported by the AER:

> "…in an energy only market like the NEM, wholesale price outcomes provide signals for future investment in generation capacity. To date, it appears that these signals have proven very effective in attracting new generation investment in South Australia, where capacity has grown by over 50 percent since NEM commencement. High spot prices around 1999 – 2000 fuelled new investment in peaking and intermediate generation in South Australia."[292]

Wholesale prices not efficient, therefore retail prices cannot be efficient

Competition, broadly defined, drives markets towards efficient outcomes. If TIPS had enduring wholesale market power (and the Commission has not been persuaded that it has), it would be in a position to sustain excessive prices and margins in the long run. Where prices can be sustained at levels above long run marginal cost, insufficient resources are devoted to the activity, and consumers would value additional output more than its opportunity cost of supply. Absent sufficient competitive pressures, TIPS may also not be driven towards cost and dynamic efficiency. It does not follow, however, that retail competition will be ineffective in these circumstances.

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[289] Including in Origin Energy's submission on the First Draft Report, p. 4.

[290] NEMMCO SOO 2007, pp. 4-16, 4-26.

[291] ESIPC, submission to the First Draft Report, September 2008, p. 2.

[292] AER, submission to the First Draft Report, September 2008, p. 2.

Retail competition drives the price of the retail electricity service, not the wholesale price of electricity. The retail electricity service comprises the bundle of services involving the procurement of wholesale electricity and network services, managing wholesale price risk on behalf of consumers,[293] billing and other aspects of customer service. The price of this service is the gross retail margin over the sum of wholesale prices, network charges and ancillary charges such as NEMMCO participant fees. Strictly, the retail service does not involve the supply of electricity itself, and its price does not include the price of the electrical energy, which is determined at the wholesale level (and, in principle, can be accessed directly by any customer).

While retail customers pay for both the energy supplied and the retail service, wholesale competition (or lack thereof) drives the price of the energy, and retail competition (or lack thereof) drives the price of the retail service. Retail competition will drive retail margins towards efficient levels but is unlikely to impact on the wholesale prices. If competition at the wholesale level is not effective, wholesale prices will be sustained above efficient levels. Although this inefficiency will be included in the price paid by retail customers this does not imply that retail competition is ineffective. Wholesale competition could affect retail competition if one or more firms were in a position to leverage wholesale market power into the retail market, for example by raising their rivals' costs of risk management. Rather than assessing the competitiveness of the wholesale market, which is outside the terms of reference of this review, the Commission has examined the extent to which any wholesale market power may be leveraged into retailing.

Leverage wholesale market power into retailing

If AGL had enduring market power in the wholesale sector, its market power could potentially be leveraged into the retail sector in two ways by:

i) Imposing a price squeeze on its retail rivals by increasing wholesale prices for energy and hedging contracts and not making any adjustments to its own retail prices; or alternatively reducing retail prices to below competitive levels without adjusting wholesale prices. Thereby forcing a material number of retailers to exit the market; or

ii) "Bypassing" the wholesale market through vertical integration, producing an intrinsic and sustained cost advantage and creating long term barriers to retail entry.

In the first scenario, a critical element is that AGL would need to sacrifice short run profits with the expectation of being able to recoup that loss in the long run. This sacrifice would arise either in the form of wholesale prices being forced above profit maximising levels, i.e. AGL would be forgoing profitable output from TIPS in order to drive the wholesale market price beyond that which it would choose to do otherwise, and/or in the form of setting retail prices that did not fully reflect the wholesale cost of electricity.

293 Where retail competition is effective and not constrained by price regulation, an important aspect of retail competition is tariff innovation, offering consumers a range of products involving different risk management strategies.

Such a strategy can only be rational if the sacrifice of profits in the short run is accompanied by the expectation of recoupment in the long run. AGL's ability to recoup the losses must rest on its ability to create and sustain retail market power to recoup these losses by increasing its customer share and an ability to sustainably increase the retail price above what it would be absent the conduct.

However, the presence of four vertically integrated dual fuel retailers and multiple small and inter-state retailers, who have generally expressed a willingness and ability to enter/expand in the retail market where profit opportunities arise, suggests that any attempt by AGL to recoup its sacrificed profits through higher retail prices would not be successful. As described in the Retailer Survey, retailers generally viewed electricity retailing in South Australian as having low barriers to entry, provided they could access hedge and risk management contracts at acceptable prices:

> "Those retailers that had ceased actively marketing (and those that have not yet entered the market) were for the most part keeping a watching brief on the market and indicated they would return to active marketing (or actively consider entering the market) should they perceive improved margins either from a reduction in wholesale prices or through lifting of the standing offer rates."[294]

Furthermore, the argument is not supported by actual market outcomes as AGL's discounts off the standing contract price are not as high as the discounts available under its competitors' market offers.[295] In addition, AGL's customer share has been decreasing since the start of FRC thereby reducing the number of customers from which it can recoup its losses.[296]

To put this analysis another way, the assumption of market power in wholesaling is not sufficient in itself to establish a threat to the competitiveness of the electricity retailing. The assumption also rests on the ability to create and sustain barriers to entry or expansion by other, potentially competing retailers. Otherwise TIPS would need to continue engaging in profit sacrificing conduct indefinitely and would be better off simply exercising its wholesale market power by pricing to maximise wholesale profits.

In the second leveraging scenario, it is suggested that AGL, as a vertically integrated entity, will engage in less hedging and provide a cost advantage to its retail business. However, as outlined above, it is not realistic to assume that a vertically integrated generator will engage in less hedging by an amount that simply reflects the extent of its retail load. The ownership of one major, intermediate generator inevitably means that AGL's retail operation would need to enter into hedge contracts with other generators (say, for base load or peak output) that it cannot efficiently provide itself. Likewise, TIPS would also need to enter into hedge contracts with other retailers in order to realise the greatest value from the intermediate output that it produces. The

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294 LECG, *op.cit.*, 18 June 2008, p.9.

295 Retailer's market contract offers are discussed in Appendix C.

296 Customer share and switching rates are discussed in Appendix D.

net effect of this activity may mean that, in seeking to raise its rivals hedging costs, AGL will also be raising its own hedging costs. The risk of increasing its own costs by at least as much as its rivals would seem to be significant for AGL, given its apparent position of having a much larger share of the retail market than it does of generation output. In addition, in terms of retail competition, all retailers would then be exposed to the same cost increases. If these costs can be effectively passed through, there would not necessarily be any impact on the effectiveness of retail competition. As discussed above, to the extent that there may be wholesale market inefficiencies in this scenario, these inefficiencies would need to be addressed at the wholesale level.

Any express or implied allocation of TIPS' capacity to AGL's own load portfolio forgoes the opportunity to sell hedge contracts to other retailers. Once this opportunity cost is recognised, the natural advantage of vertically integrated electricity gentailers is likely to be much less than it appears. This view is supported by Simply Energy, who noted that the recent changes in market conditions have affected all retailers and vertically integrated firms did not necessarily have any significant advantages:

> "Integrated retail and generation businesses typically transact at arm's length. In any event, transfer pricing would not explain why retailers have recently suspended or lessened their marketing activities. That is, even if a gentailer engaged in transfer pricing, so long as the overall operations of a gentailer were sufficiently profitable, it would have no incentive to suspend or lessen its marketing activities."[297]

As AGL noted in its supplementary submission to the First Draft Report, as a prudent commercial operator AGL would have preferred to have the TIPS capacity contracted rather than risk exposure to the pool. Further, AGL believes that had TIPS been contracted over the first quarter of 2008, it would have earned higher revenue from contracts than it actually did from the pool.[298]

In conclusion, even under the assumption that TIPS does possess a significant and sustained degree of power in the wholesale electricity market, the analysis outlined above shows that AGL is unlikely to be able to leverage that power into electricity retailing. To do so would require an ability to recoup the profit sacrificed in the long run which is a high risk strategy and is not supported by the evidence available to the Commission. AGL faces competitive constraints from both significant (and vertically integrated) rivals already in the market and from potential entrants. The proposition that vertically integrated gentailers somehow bypass the wholesale market and so have an intrinsic and sustained cost advantage over specialist retailers represents an overly simplistic view of the implications of vertical integration, and ignores the opportunity cost to generators of supplying hedging services to its affiliated retailer. This analysis, and the evidence before the Commission, does not

[297] Simply Energy, submission on the First Draft Report, p. 2

[298] AGL, supplementary submission to the First Draft Report, p. 6.

support the hypothesis that any wholesale market power could be leveraged into retailing.

E.1.1.5 Impact of current conditions

Notwithstanding the causes, higher wholesale energy prices and the increased cost of financial contracts, which have not been passed through in revised standing contract prices, appear to be affecting decisions about entry and expansion. Currently, six retailers are not actively marketing to new customers, including three who ceased marketing in mid-2007.[299] These retailers have attributed the high increase in prices and the inability for these costs to be recovered at current retail prices as the reasons for the suspensions. As one retailer noted:

> "… when that [a period of volatility] happens in the spot market that means that all the hedging products that are available become far more expensive … in South Australia [hedging products] have gone up so it's got to the point now where there are no margins, we can't offer competitive retail prices to customers in South Australia and earn a profit based on using those hedging products so basically we're not competing in South Australia any more, we used to but we actually don't have any sales teams operating..."[300]

At least two prospective new entrants have also deferred plans to enter the market until conditions improve.[301] However, these retailers and those who have suspended marketing activities are monitoring the market and expect to enter or recommence active marketing once the available margins improve. This view is supported by South Australia Electricity:

> "… there are several retailers including South Australia Electricity, ready and able to re-enter the market at relatively short notice."[302]

The Commission recognises that access to competitive wholesale energy contracts and risk management tools are necessary requirements for the entry and ongoing viable operation of energy retail businesses. It also notes that the cost of contractual tools to mitigate price and volume risk are placing increasing pressure on the ability of some retailers to continue to acquire new customers profitably given the level of the standing offer prices with which they must compete. These circumstances are also adversely affecting the decisions of prospective retailers to enter the market. Retailers are likely to face further pressure as the tightening supply/demand balance and the implementation of climate change policies increase energy retailing input costs. The Commission believes, however, that effective competition in the energy retail market will be able to efficiently accommodate these developing market conditions provided retail prices are able to respond flexibly to future changes in energy input costs. Such price changes will be needed to maintain competitive retail

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299 LECG, *Retailer Survey Report*, pp. 57-59.

300 *Ibid*, p. 24.

301 LECG, *Retailer Survey Report*, p. 9.

302 South Australia Electricity, submission on the First Draft Report, p. 2.

margins and so the viability of efficient retailers. To the extent that the current standing contract pricing arrangements are constraining such price adjustments there can be unintended consequences for the ongoing viability of energy retailers and potential implications for future competition in the energy retail market.

E.1.2 Access to wholesale gas supply and risk management tools

The process by which retailers acquire wholesale gas differs from the process for acquiring wholesale electricity. Unlike Victoria, in South Australia there is no wholesale pool that enables retailers to purchase small quantities of gas at spot market prices. Rather, South Australia operates a contract carriage model which means that a prospective gas retailer must negotiate and enter into:

- one or more bilateral supply contracts with gas producers for the purchase of wholesale gas; and
- bilateral contracts with the owners of the transmission and distribution pipelines to transport the gas from the gas field to the end use customer.

Natural gas is supplied to South Australia from the Cooper/Eromanga Basin via MAPS, the Otway Basin via the SEAGas Pipeline, or the Gippsland and Bass Basins via the Victorian Principal Transmission System and the SEAGas Pipeline.[303] The Otway Basin has sufficient reserves and, although production in the Cooper/Eromanga Basin (Moomba) is declining, there is the potential for an additional source of supply of coal seam methane (CSM) from the Queensland fields to be provided via MAPS. Subject to pipeline capacity constraints, retailers in South Australia have the option of contracting supply with producers in any of these basins.

Wholesale gas supply contracts are typically long term, including "foundation contracts" which were used to underpin the original investment in the pipelines. Large users (such as retailers or large commercial and industrial customers) contract to purchase large quantities of gas for long periods, typically 10 to 20 years. These contracts typically include "take or pay" provisions, with some provision for carry over of unused capacity between years. Prices are usually subject to some sort of regular review mechanism. In 2005, it was estimated that approximately 95 per cent of the retail market was supplied under long term supply contracts.[304] As NERA notes:

> "The wholesale supply of gas in eastern Australia is dominated by long-term, highly customised bilateral gas supply contracts entered into on an infrequent

303 NERA Economic Consulting, *The Gas Supply Chain in Eastern Australia: A report to the Australian Energy Market Commission*, March 2008, p. 48.

304 *Ibid*, p. 25.

basis with a limited number of end-users. Invariably, these contracts are highly confidential."[305]

NERA's observation is echoed by one retailer's comments about the contracting challenges facing new entrants:

"[In South Australia there] is a very limited pool of counterparties you can do deals with and most of them are going to be your retail competition. And then there's the whole 'you're just not having to buy gas, you're having to buy the rights to move it around'." [306]

The duration and contracted gas quantities of many foundation contracts and other similar contractual arrangements mean that new retailers or retailers with a small load may be unable to contract for access to wholesale gas as readily as a larger retailer. Such contracts may not be appropriate in the circumstances. This view is supported by a number of retailers and prospective new entrants, one of whom noted that gas supply contracts were not readily available for small volumes and, in any event, often contained terms and conditions that imposed significant risk on the retailer.[307] This view was shared by Simply Energy, who stated:

"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."[308]

Similarly, one new retailer advised that it was difficult to contract for small volumes of gas at competitive prices. However, most retailers expected that entry and expansion by small retailers would be facilitated by the introduction of the Bulletin Board[309] and the Short Term Trading Market[310], which are intended to provide a more transparent process for purchasing smaller volumes of gas and accessing spare pipeline capacity, and facilitating trading of small quantities of gas.

Accordingly, retailers who are affiliated with a gas-fired generator or who have existing contracts to supply large gas customers may be at a competitive advantage relative to their competitors. By having a larger and less peaky load, the retailer may be able to negotiate more competitively priced wholesale gas supply. It is no surprise that the four retailers who currently retail gas to small customers in South Australia are each part of a corporate group that also owns gas-fired generation assets. It is unclear whether any such competitive advantage exists.

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305 *Id.*

306 Retailer Survey.

307 LECG, *Retailer Survey Report*, p. 12.

308 Simply Energy, submission to the Issues Paper, p. 3.

309 The main purpose of the Bulletin Board is to provide readily accessible and updated information on the physical and available pipeline capacity, pipeline tariffs, production and storage capacities and three-day demand forecasts: AER, *State of the Energy Market 2007*, pp250-251.

310 The Short Term Trading Market is intended to replace existing gas balancing arrangements by facilitating daily trading through establishing a mandatory price-based balancing mechanism: *id.*

As is the case in electricity, gas retailers face both price and volume risk. The price risk arises because the price payable for wholesale gas under a supply contract is typically specified for an initial period and is periodically reviewed. The risk borne by the retailer is that the contract price will increase above that which it can pass on to its customers. Bilateral contracts can also expose retailers to volume risk, which arises when demand deviates from contracted volumes. While there are tools available to manage these risks, they are less sophisticated and less liquid than for electricity. One retailer noted:

> "Generally the gas contracts are bought with fairly rigid terms so they're a little bit harder to risk manage when you are a small retailer … Managing take-or-pay is quite difficult when you're penetrating a market and your volume is growing."[311]

Some larger retailers have sought to offset their price risk by acquiring an equity interest in the gas field that supplies their gas, or in other gas fields. For example, Origin holds equity interests in the Cooper/Eromanga, Otway and Bass gas basins and the Bowen/Surat CSM basin in Queensland.[312] Similarly, AGL Energy holds interests in CSM basins through joint venture arrangements with each of Sydney Gas Company and Arrow, and through its interest in the Queensland Gas Company.[313]

Volume risk arises from the potential misalignment between the forecast demand specified by a retailer in its bilateral contract and actual demand, both within a contract year and over the life of the contract. These risks are typically managed through the inclusion of contractual mechanisms (such as swing factors and "park and loan" services with the pipeline operator). However, they are unlikely to alleviate the retailer's risk entirely.

The Commission considers that new entrants may face costs in building an understanding of the arrangements required in South Australia and in negotiating the required contract arrangements. However, the contract carriage arrangements are not unique to South Australia as they apply in other Australian jurisdictions and managing commercial contracts is a requirement that all retailers must face. Nevertheless, entry into gas retailing clearly requires a commitment of volume and costs, with associated risks, into the future. The situation for smaller retailers may be improved to an extent by the Bulletin Board and the Short Term Trading Market (when it is implemented). However, while entry by small scale gas retailers is not out of the question, the pattern of effective entry has consisted of a number of vertically integrated dual fuel retailers, who can underpin their retail gas requirements with a base demand for gas used in electricity generation and/or to supply large commercial and industrial customers. Subject to being able to gain access to the transmission network (see below) these entrants can and have provided an effective competitive constraint on the pricing and other conduct of the host retailer.

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311 Retailer Survey.

312 Department of Mines and Energy, Queensland, www.dme.qld.gov.au

313 *Id.*

E.1.3 Access to network infrastructure

Access to transmission and distribution networks has the potential to impede entry or expansion where the infrastructure owner restricts or hinders access to relevant network services. The detrimental effects that refusing access to monopoly infrastructure can have on the development of competition has lead to the introduction of mandatory access requirements for essential services. Currently, access regimes apply to electricity distribution services, prescribed electricity transmission services under the National Electricity Rules and to certain transmission and distribution pipelines under the National Gas Law.

While no issues concerning network access for electricity were raised, submissions to the Issues Paper and the First Draft Report and the Retailer Survey did identify difficulties with access to gas infrastructure.

E.1.3.1 Access to gas transmission pipelines

The two principal transmission pipelines supplying gas to South Australia are MAPS and the SEAGas Pipeline. As neither pipeline is covered by the National Gas Law, a retailer wishing to transport gas to end use customers from the gas producer must negotiate terms and conditions for access to capacity (i.e. transmission haulage services) with the relevant pipeline owner.

Retailers that supply gas to small customers are required under the Energy Retail Code[314] to provide four business days' notice to customers of any planned interruption to the gas supply. The effect of this obligation is that retailers require firm capacity on transmission pipelines so as to ensure continuous supply and to enable sufficient notice to be given in the event of a planned outage. There is currently sufficient firm transmission capacity on the MAPS mainline to allow a retailer to supply customers located in Adelaide.[315] Firm capacity on the SEAGas Pipeline is contracted to the foundation shippers Origin, International Power and TRUenergy until 2019, with AGL contracting for capacity with TRUenergy. Without undertaking expansion works, the only capacity currently available on the SEAGas pipeline is interruptible. A new entrant would therefore need to contract for capacity on MAPS or, alternatively, invest in expanding the capacity on the SEAGas Pipeline which is likely to require high sunk costs that may not be recoverable from a customer base comprising only small gas customers.

Access to gas customers in Whyalla and Port Pirie and in the Riverland and Murray Bridge areas requires access to the Port Pirie and Angaston laterals connected to MAPS. Obtaining access to these laterals is considered to be problematic by some retailers because all firm capacity is fully contracted to the host retailer, Origin under legacy contracts. New retailers may negotiate with Origin for access to any firm capacity not used by Origin and Origin has entered into a Memorandum of

314 Energy Retail Code, clause 15.3.

315 Although supplies at the Cooper Basin are diminishing, no retailer identified this as an issue affecting decisions to enter or expand.

Understanding (MoU) with the South Australian Government[316] which sets out the principles governing negotiations for access. However, the MoU preserves Origin's existing contract arrangements and as such the capacity that is actually available may still be limited. Simply Energy noted this issue and it stated:

> "… obtaining access to delivery point [on MAPS] 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 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."[317]

Some retailers have noted that these capacity limitations will gradually be resolved as legacy contracts on the MAPS laterals expire.[318]

Access to the SESA Pipeline[319], which connects to the South East Pipeline, is necessary to supply gas to customers connected to the Mt Gambier regional network. The SESA Pipeline is owned by the APA Group. The capacity on that pipeline is fully contracted to Origin but is not part of the infrastructure covered by the MoU. Retailers wishing to supply Mt Gambier gas customers must negotiate for firm capacity with Origin, which they regard as problematic given that they are, in effect, negotiating with their competitor. TRUenergy noted this issue as a factor which it believes impedes retail competition:

> "Pipeline access to customers on lateral pipelines to the north of Adelaide (and SESA pipeline) requires separate negotiations with the incumbent retailer. Retail products that are based upon interruptible haulage are not commercially viable for large customer sites and potentially non-compliant with regulatory instruments for mass market customers."[320]

Further, retailers indicated that the financial and resourcing costs of access to the MAPS laterals and the SESA Pipeline may be high and require a "disproportionate market share"[321] to cover the costs. The South Australian Farmers Federation noted that access costs were preventing competitive entry:

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316 http://www.originenergy.com.au/1265/SA-Govt-Origin-Memo-of-Understanding

317 Simply Energy, submission to the Issues Paper, p 2.

318 AGL, submission on the First Draft Report, p. 6; Origin Energy, submission on the First Draft Report, p. 4

319 The SESA Pipeline is an underground gas transmission pipeline. Approximately 45km long, it commences at a SEAGas pipeline valve near Poolaijelo in western Victoria and terminates at Ladbroke Grove, near Penola in eastern South Australia.

320 TRUenergy, submission to the Issues Paper, p. 2.

321 Retailer Survey.

> "Our providers in the past have found gas provision in the city to be possible but in regional areas to be impossible to provide at any really competitive price due to the huge costs levied against them for access. From their perspective the initial costs were far too high to spread over the user base to make it worthwhile to enter the market in any form. Even charging the full regulated rate wasn't considered profitable due to the wholesale costs associated with the provision of service."[322]

The effects of these structural limitations are that small gas customers in regional areas are unable to obtain competitive supply from retailers other than Origin. This issue was noted by the Energy Consumers' Council:

> "The Council believes that, due to their location, some consumers may be limited in terms of the number of gas retailers from whom they can obtain supply."[323]

The challenge of offering competitively priced market contracts is heightened by the relatively small number of customers located in regional areas. Based on figures provided by the Office of the Technical Regulator, approximately 4.5 per cent of all South Australian gas customers, including unmetered and large customers (around 16,990 customers), are located in the regional areas of Whyalla, Port Pirie, Murray Bridge, Riverland and Mt Gambier. Supplying these areas may not be viable without a local base load of commercial and industrial customers to support the fixed costs associated with capacity commitments under pipeline carriage contracts. While the costs of marketing in regional areas may be relatively high, it has not prevented the penetration of competition in electricity retailing, with greater reliance on telesales. Gas is generally marketed as a dual fuel product, so the incremental cost would be minimal. As further discussed in Appendix D regional electricity customers have shown themselves to be as willing to switch to an alternative retailer as electricity customers in Adelaide, thus regional gas customers could be expected to exhibit the same propensity to switch if they were in a position to actually make such a choice.

Further, as noted in Appendix C, market offers from Origin available to regional gas customers provide the same level of discounting as market offers available in Adelaide, which are subject to more intense competition.

Although the difficulties retailers face in accessing firm capacity (in the case of the MAPS laterals) or firm capacity at competitive prices (in the case of the SESA Pipeline) appear to be limiting the opportunities for new retailers to expand into regional areas at present, some of these issues are likely to be resolved in the near term. While these issues do not impact the majority of gas customers in South Australia and regional gas customers are able to exercise choice between the standing offer and the market contracts offered by Origin, the structural limitations facing new retailers are affecting the ability of regional customers to access the full benefits of competition. The Commission will further consider whether there are any additional steps that may be taken to address these structural limitations and, if

322 South Australian Farmers Federation, submission to the Issues Paper, p. 8.

323 Energy Consumers' Council, submission to the Issues Paper, p. 2.

appropriate, it will provide appropriate draft recommendations to that effect in the Second Draft Report.

E.1.3.2 Access to gas distribution networks

Retailers also identified problems with obtaining access to the distribution networks servicing Adelaide and the regional areas.

The design of the Adelaide distribution network and the location of delivery points has resulted in capacity constraints which limit the flow of gas delivered from the SEAGas Pipeline to the northern suburbs of Adelaide and the Le Fevre Pennisula.[324] It is understood that a project to develop the distribution network including the construction of an additional gate station[325] is planned for 2010/2011 but it is unclear whether this new gate station will alleviate the problem. However, the Commission understands that the flow constraints have a limited effect on retailers wishing to supply small customers in these areas via the SEAGas Pipeline.

To access a regional network, access to transmission capacity on the lateral pipeline servicing the regional network is required. However, due to the issues associated with obtaining transmission capacity outlined above, it is difficult for retailers to expand to offer services to consumers in the regional areas.

E.1.4 Economies of scale and scope

In the Statement of Approach, the Commission foreshadowed that it would consider the effect of economies of scale and scope on the effectiveness of competition in energy retailing in South Australia.[326] Economies of scale exist if the long-run average cost of production declines as the rate of output increases.[327] Economies of scope are present where the unit costs of a business producing two related but distinct products is lower for a given output than if those products were produced by two separate businesses.[328] Economies of scale may deter entry if entry on an efficient scale requires significant sunk costs and/or would be likely to result in post-entry prices that depress expected profits below an acceptable level. In this section, the Commission examines the various measures used by energy retailers to realise scale and scope economies and the effect these economies may have on entry, expansion and exit.

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324 NERA, *Review of the Effectiveness of Energy Retail Market Competition in South Australia – Phase 2 Report for ESCOSA*, July 2007, p. 36.

325 http://www.envestra.com.au/operational_info/reg_regime.html#AAmain

326 Australian Energy Market Commission, *Review of the Effectiveness of Competition in the Gas and Electricity Retail Markets - Statement of Approach*, 19 April 2007, p. 12.

327 Jeffrey Church and Roger Ware, *Industrial Organization: A Strategic Approach*, McGraw Hill, Boston, 2000, p. 54.

328 Robert S. Pindyck and Daniel L. Rubinfeld *Microeconomics*, 5th ed, Prentice Hall, New Jersey, 1995, p. 231.

Realising economies of scale can result in tangible benefits for both retailers and customers. Economies of scale may reduce average fixed costs, improve the utilisation of fixed assets and potentially contribute to a higher margin. In a competitive market, a reduction in the average cost is reflected in a lower price to customers. This may enable the retailer to attract more customers, further reducing the average cost and allowing the retailer to become more competitive.

E.1.4.1 Critical mass

The Retailer Survey asked respondents whether there was a "critical mass" or a minimum scale of operation that a retailer needs to achieve in order to compete effectively in electricity and/or gas retailing in South Australia. Retailers' views varied greatly, with one multi-jurisdictional retailer indicating that an incremental number of 5,000 customers would provide a reasonable return for investment, whilst another suggested that a new entrant would require 100,000 electricity customers. [329] The disparate retailer views indicate that critical mass will vary according to the business model adopted by the individual retailer but is also likely to be influenced by the scope of the retailer's operations in other jurisdictions:

> "AGL submits that the majority of new entrant retailers in a given market are already active in other jurisdictions. Therefore, these retailers may already be enjoying some benefits from economies of scale."[330]

Although economies of scale do exist, no evidence has been presented to suggest that larger or existing retailers held significant advantages over new entrants or smaller retailers. The economies available at different scales will vary with the business model adopted by each retailer.

E.1.4.2 Scalable fixed costs

Host retailers typically invest in in-house billing and call centre services and can benefit from economies of scale in recovering these costs across a large customer base. However, a number of new retailers are adopting business models that render these fixed costs "scalable" by outsourcing the performance of the underlying functions to third parties. This enables the retailer to benefit from the scale of the contracted service provider without the need for a large customer base.

The use of outsourcing enables a retailer to increase the scale of the outsourced services at the same (or at a similar) rate as its customer base is growing, thereby avoiding the need to purchase infrastructure or other resources that provide capacity in excess of current demand. Larger, multi-jurisdictional or host retailers perceived the opportunity to adopt such a strategy as advantageous compared to their own positions. They considered that their acquisition of legacy businesses can result in diseconomies of scale because the IT and billing infrastructure of each business is

[329] LECG, *Retailer Survey Report*, p. 78.
[330] *Id.*

unlikely to be compatible with existing systems.[331] The Retailer Survey indicated this was the general consensus among retailers surveyed.

One of the key competitive benefits of implementing business models that rely on outsourcing is that it facilitates viable entry by small retailers. By reducing the capital outlay necessary to commence retail operations, scalable fixed costs assist in reducing the sunk costs of entry. This can lower the barriers to exit which, in turn, can further encourage entry.

Direct sales and marketing functions (such as door-to-door selling and telesales) may also be outsourced to third parties.[332] As discussed in Appendix C, direct contact strategies such as door-to-door marketing and telesales are the most commonly used and most effective channels for marketing energy products in South Australia. By engaging third parties to perform these functions, the retailer can scale its expenditure on these activities as appropriate. Again, this enables the retailer to receive the benefits of the economies of scale realised by the third party service provider while minimising its own sunk costs.

The Commission considers that developments in technology and outsourcing that enable new entrants to adopt more flexible business models has reduced the cost of entry and the size of the customer base necessary to compete effectively with larger retailers. While economies of scale remain important for sustainable growth and will continue to drive competition, the Commission does not consider that economies of scale and scope currently operate to deter entry or restrict competition.

E.1.4.3 Dual fuel

The opportunity to offer dual fuel products affords retailers the chance to benefit from economies of scope. By spreading the retailer's fixed costs over a larger number of customer connections, dual fuel products lower the average cost to serve.

Retailers agreed that economies of scale and scope may be achieved by offering dual fuel products and dual fuel was seen as an important strategy.[333] The cost to acquire customers for the second fuel is lowered and the incremental cost to serve is relatively low. As one retailer noted:

> "It's a simple proposition; if we've got a competitive operating cost platform that's scaleable, then we're going to try and earn as much revenue off that cost base as we can. Dual fuel is the most logical single setup in that direction."[334]

However, South Australia's low gas penetration and low volume consumption relative to other jurisdictions (e.g. Victoria) means that the magnitude of the benefits

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331 *Ibid*, pp. 78-79.

332 More strategic marketing functions such as the development of a marketing strategy, brand management and product design are typically directed and performed by the retailer.

333 LECG, *Retailer Survey Report*, p. 32.

334 *Id*.

available from dual fuel is lower. A retailer may need a large customer base to be able to sustain its operations and recover its costs of marketing and supply, in light of low volumes of consumption and the low margins available. Two retailers observed:

> "You're looking at a gas customer that's using an average of around 20 to 25 GJ of gas per annum versus 60 to 65 GJ per annum of gas in Victoria, and your costs to serve are pretty much the same."[335]

> "A 25 GJ customer just doesn't pay for itself, it's a very small consumption, you need a lot of those customers … so you need access to the whole of Adelaide to try and get a reasonable customer base."[336]

For this reason, retailers mostly see gas as an add-on product to electricity, with only the larger retailers offering standalone gas products. The Retailer Survey suggests that almost all retailers would only market gas in combination with electricity (as a dual fuel).[337] None of the smaller retailers or prospective new entrants surveyed would consider retailing gas as a standalone business.[338] The implications for retailing gas is further discussed below in Appendix F.

The Commission notes that the risks of adopting a dual fuel strategy in South Australia are likely to be lower for a retailer who is affiliated with a gas-fired generation asset, compared to a stand alone retail competitor. As discussed above, the opportunity to increase the volume of gas contracted to a generator incrementally to service a number of small gas customers is likely to be important in reducing the costs of entry and expansion.

Although adopting a dual fuel strategy does offer economies of scope, the Commission considers electricity-only retailers are unlikely to experience any significant disadvantage relative to their dual fuel competitors. This is supported by the number of smaller retailers that are currently electricity-only retailers in South Australia. Rather, the availability of economies of scope provides a basis for the development of effective competition in gas retailing. The volume of gas consumption in South Australia and the current margins available to retailers suggest that the scale of operations required to operate a successful gas retail business is likely to deter entry by gas-only retailers. However, the economies of scope that can be achieved by offering dual fuel products reduce the costs and risks of entry. Further, marketing gas as an "add-on" fuel in a competitive electricity environment helps to overcome the scale limitations imposed by the low volume consumption and low penetration.

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335 *Ibid*, p. 46.

336 Retailer Survey.

337 LECG, *Retailer Survey Report*, p. 46.

338 *Id*.

E.1.5 Host retailer advantages

A business that operates in an industry prior to the introduction of competition may possess a range of competitive advantages relative to businesses who enter after liberalisation. The apparent competitive advantage that these factors confer, or are perceived as conferring, upon host retailers may deter entry by potential new retailers. In the course of conducting its analysis in the South Australian Review, the Commission sought to understand whether host retailers possess a competitive advantage relative to new retailers. The key areas of focus were brand recognition and brand loyalty, and any impediments to entry or expansion that may arise because the host retailer had an established customer base at the commencement of FRC.

It is reasonable to expect that, at the commencement of FRC, a host retailer will have a recognisable brand and that at least some of the customer base will be loyal to that brand. Where brand recognition and loyalty is strong, new retailers will be forced to spend significant time and resources promoting their business in order to overcome the reluctance of customers to switch from an established, known retailer. Where significant expenditure is required, a new retailer may face higher customer acquisition costs than a host retailer, thereby making competitive entry more difficult.

New retailers did not suggest that the host retailers experienced any significant relative advantage. While some second tier electricity retailers believed that AGL, as the host retailer, had a more well-known brand they did not necessarily consider this an advantage.[339] Most retailers indicated that "brand" did not have any impact on the ability of a retailer to enter the market and establish a customer base.[340] New retailers said that a lack of awareness of their brand did not hinder their ability to acquire customers. This is supported by the Consumer Survey which shows that brand is not a principal factor in customers' decisions to switch and, in any event, customers were able to identify a number or retailers offering electricity and gas.[341] As discussed in Appendix D, the absence of customer loyalty to a particular brand means that many customers are willing to switch when directly approached, i.e. through door-to-door marketing or telesales. Although some South Australian residents demonstrated a preference for South Australian owned companies, this was not a factor raised by retailers in the Retailer Survey.

However, brand recognition in gas may provide an advantage to the host retailer due to general consumer concerns relating to gas safety. A retailer of gas may be expected to have gas expertise whereas the same concern may not apply to electricity. As one retailer noted:

> "And then there are other concerns about gas sign up … there are safety and other issues that sit in the back of the mind so when we think … about

339 *Ibid*, p. 34.

340 *Ibid*, p. 33.

341 McGregor Tan, *Consumer Survey Report*, pp. 21 and 71.

> switching suppliers, particularly the one that no one's ever heard of before, you know, new entrant; that's okay with electricity because nothing could go wrong with electricity. Electricity is a staple, it's a commodity, and everybody supplies it, that's easy. When it comes to my gas, mmm should I be worried about the pipes or what about smell? Those things pervade our research. We see more involvement [by the customer] in gas and therefore lower level of churn…"[342]

Some new retailers suggested that Origin, as the gas host retailer, may have an advantage by being able to easily identify the location of small gas customers. New retailers reported that their inability to readily identify gas customers increased their marketing costs relative to Origin. The Commission notes retailers' comments that gas is typically marketed as an add-on fuel in the course of making an offer to an electricity customer rather than as a single fuel (discussed above). On this basis, it appears that the ability to identify gas customers per se is less relevant to retailers' marketing strategies and is therefore unlikely to afford Origin any significant advantage. Further, given Origin's falling customer share, any difficulties in locating customers does not appear to have restricted the ability of new entrant retailers to win customers.

As discussed in Appendix D, consumer reluctance to engage in search activities and status quo bias[343] can operate in favour of a host retailer because some customers will prefer to remain with their default supplier. The propensity for these customers to remain with the host retailer may impede competition if it deters entry and rivalry for those customers and/or if the host retailer can effectively discriminate against them.

However, an inherited customer base in a competitive environment may also disadvantage a host retailer. Although a host retailer possesses a substantial customer base at the commencement of FRC - and in South Australia's case the entire customer base - switching rates will increase as new retailers grow their shares of customer connections over time.[344] By virtue of their obligations to offer to supply, the host retailers may be left with the burden of serving customers that are commercially less attractive to new retailers, for example, by reason of the customers' load profiles, demographics, locations or credit risk profiles. AGL submitted:

> "…it is not always possible for an incumbent retailer to benefit from all of the potential cost advantages one would expect from having a greater market share. To the contrary, AGL as incumbent electricity retailer is obliged to offer contracts to all customers while other new entrant retailers are free to

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342 LECG, *Retailer Survey Report*, p. 39.

343 See, for example, C. Camerer, S. Issacharoff, G. Lowenstien, T. O'Donoghue, and M. Rabin, "Regulation for Conservatives: Behavioural Economics and the Case for 'Asymmetric Paternalism'", *University of Pennsylvania Law Review*, 2003, Vol. 151 No. 121, p. 1,224. The authors cite W. Samuelson and R. Zeckhauser, "Status Quo Bias in Decision Making", *Journal of Risk and Uncertainty*, 1988, Vol. 7.

344 Origin, in its submission to ESCOSA on the 2008 draft gas price path review (pp. 9-12), the costs associated with the "loss of scale" incurred by Origin is an important consideration in its operations.

'cherry pick' particular market segments. Thus leaving the incumbent with the remaining higher cost customers."[345]

Similarly, host retailers currently bear the obligation to act as the retailer of last resort (RoLR).

The Commission considers that the host retailer does not have any significant competitive advantage. Consumers are encouraged to switch based on offers presented to them through direct marketing and consumers recognise a number of retailers as being able to provide electricity and gas services. Although some retailers perceive the host gas retailer may have an advantage in having the reputation for gas expertise, this does not seem to be an issue in South Australia with three of the large retailers having experience in gas retailing.

E.1.6 Marketing costs

As discussed in previous chapters, energy is a homogenous service which is treated by a large proportion of retail energy consumers as a low involvement commodity. Customers may undertake limited search activity on their own behalf and may also exhibit status quo bias. However, as noted above and in Appendix D, customers exhibit limited brand loyalty and do not indicate significant concerns regarding switching costs. When approached by retailers offering attractive prices through direct marketing, many customers are willing to switch retailers.

These features of energy retailing have significant implications for entry conditions. For instance, it can be a substantial deterrent to entry if entry requires considerable sunk costs to be invested in mass market advertising, e.g. through television and print media advertisements, in an attempt to overcome entrenched brand loyalty but with no guarantee of success. However, energy retail brand loyalty does not appear to be strong and these forms of advertising are not generally regarded as important or effective by new retailers. Instead, as discussed in Appendix C, the nature of customer demand encourages retailers to primarily engage in direct marketing through door-to-door sales and telemarketing. These types of marketing activities are inherently more scaleable than mass market advertising, and particularly so when they can be contracted out. Furthermore, the willingness of customers to switch when presented directly with an attractive offer means that retailers can be more confident of achieving success by employing them.

By providing information directly to customers, retailers can differentiate their service offerings from those of their rivals, while at the same time economising on the search and transaction costs of customers which may otherwise discourage many from exercising choice. However, the decisions taken by a number of retailers to cease actively marketing to acquire new customers underlies the need to ensure that the actual costs incurred are recovered under the prevailing contract prices.

345 AGL, submission to the Issues Paper, p. 4.

E.1.7 Exit costs

At the commencement of this Chapter, the Commission noted that barriers to exit may exist where entry requires substantial capital investment which cannot be recovered on exit (i.e. there are sunk costs) and, in some cases, exit itself may involve further sunk costs.

Through the Issues Paper and the Retailer Survey, the Commission sought stakeholders' views on the existence, and effect, of exit costs on competition in energy retailing. Neither the submissions to the Issues Paper nor the observations made by retailers during the survey process addressed this matter in any detail. While the Commission notes that there are some costs associated with exiting from energy retailing, such as the costs incurred in negotiating for the sale of its customer base, it does not consider that exit costs constitute a material barrier to competition.

E.2 Legislative and regulatory obligations

The regulatory obligations governing energy retailing have an important influence on the way competition develops. Where it is prescriptive or the compliance costs are high, regulation can operate as a barrier to entry or expansion. The purpose of this section is to set out the results of the Commission's analysis of the regulatory obligations relevant to the South Australian Review. The regulatory obligations are summarised in Appendix B.

The Commission's analysis in this section is divided into three parts, examining:

- the effects of retail price regulation on the willingness or ability of new retailers to enter or expand (**section E.2.1**);
- the effect of the obligation to hold a licence and the costs and obligations incurred in complying with licence conditions (including costs associated with regulatory (in)consistency between jurisdictions) on the ability for new retailers to enter or expand in energy retailing (**section E.2.2**);
- the capacity of retailers to comply with the prudential requirements of wholesale market participation and credit support arrangements required by distribution system agreements (**section E.2.4**); and
- the effect of the South Australian gas retail market rules on the ease of entry (**section E.2.5**).

E.2.1 Retail price regulation

The price at which a good or service is bought and sold provides important signals to the market. Pricing indicators enable resources to be allocated in the most efficient manner and signal demand for investment. If these pricing signals are distorted, for example through retail price regulation, the market (or parts of the market) may appear unattractive to potential entrants or to existing participants considering expansion. The risk facing energy retailing in South Australia is that retail price regulation may distort the pricing signals and deter potential entrants or make it

appear unattractive for potential or existing retailers to serve some customers. Accordingly, the Commission has sought to understand the effect of the standing contract prices on entry into and expansion within the energy retail sector.

E.2.1.1 Focal point for competition

The maximum price that a host retailer may charge a customer on a standing contract in South Australia is determined by ESCOSA in accordance with a process prescribed by legislation.[346] Retailers are free to determine their own prices for market contracts. However, to be competitive and overcome customer inertia, retailers typically offer their market contracts at a discount to the standing contract price. As such, the standing contract price operates as the focal point for competition (or lack thereof). While the standing contract price is viewed favourably as a benchmark against which consumers can compare competing offers[347], it does give rise to a number of disadvantageous effects.

Retailers tend to price their product offers by reference to the standing offer price. During the interviews conducted as part of the Retailer Survey, retailers advised that wholesale gas prices are high and that the margin available to retailers is diminishing.[348] In relation to gas, most retailers noted that ESCOSA was in the process of finalising the gas price path review and were concerned that the regulated price should provide an adequate margin. One retailer suggested that it may consider exiting South Australia if this was not the case.[349] It is noted that the final price path determination has recently been published by ESCOSA[350] where, in relation to the retail operating margin, a 13 per cent margin has been approved (which is higher than the 12 per cent margin in the draft determination). The increase in the margin provided may go towards alleviating some of the concerns raised by retailers.

E.2.1.2 Impact of a focal point and information available to stakeholders

Where retailers focus their competitive efforts on a price structure that is directly or easily comparable with the price (and other terms and conditions) of the standing contract, the amount of choice and information available to customers is reduced. Although comparable information may improve consumers' understanding of the available offers overall, standardisation by definition reduces variety in the products available. It may reduce the amount of information available across the market.[351]

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346 See further Appendix B.

347 AEMC, *Review of Effectiveness of the Competition in Gas and Electricity Retail Markets in Victoria: First Final Report*, pp. 57-58.

348 LECG, *Retailer Survey Report*, p. 65.

349 *Ibid*, p. 10.

350 ESCOSA, *2008 Gas Standing Contract Price Path Inquiry: Final Inquiry Report &Final Price Path Determination*, June 2008.

351 Professor George Yarrow, *Report on the Impact of Maintaining Price Regulation*, Oxford, January 2008, p. 26.

Business SA noted the effect of the standing contract price on incentives for further price discounting:

> "Furthermore, standing offer prices often fail to depart from the benchmark, which disadvantages many consumers."[352]

By acting as a focal point for prices, the standing contract prices could limit discounting and potentially encourage price co-ordination.

Chapter 2 posited that one of the reasons why regulated prices will almost always be an imperfect substitute for prices determined by a competitive market is because the regulator setting the price will have imperfect information. As TRUenergy noted:

> "It is the role of retailers in the competitive market to manage wholesale risk, and retailers compete on this basis. However, the ability of regulators to accurately forecast, in some cases years in advance, movements in wholesale markets when setting retail prices is problematic in the extreme. The regulatory risk this imposes on retailers diminishes the benefits of competition that would otherwise flow to customers."[353]

E.2.1.3 Retail price regulation and wholesale "market power"

In its submissions to the Issues Paper and the First Draft Report, Uniting*Care* Wesley expressed the view that AGL has market power in the wholesale sector (as discussed above in section E.1.1.4) and that retail price regulation should be retained as a means of constraining AGL's market power. Uniting*Care* Wesley suggests that removing retail price regulation will allow AGL "to set its own prices, with other retailers following the price setter up till the point these retailers cannot supply any further."[354]

The Commission notes that retail price regulation is only appropriate as a tool to regulate retail market power. To the extent that wholesale market power issues exist they need to be addressed directly at the wholesale level.[355] As discussed above, wholesale prices are determined at the wholesale level reflecting the competitiveness of the sector at any given time. If AGL was to possess sustained market power in the wholesale sector, imposing a retail price cap calculated on the basis of competitive wholesale prices (assuming these could be determined) would not be effective in influencing the pricing outcomes in the wholesale sector. Further, it is unlikely that retail margins would be sufficient for retailers to recover the cost of supplying the retailing service. As a result, there is the potential for retail competition to be reduced or eliminated, leaving AGL or a small number of vertically integrated retailers as the only retail suppliers.

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[352] Business SA, submission to the Issues Paper, p. 2.

[353] TRUenergy, submission to the Issues Paper, p. 4.

[354] Uniting*Care* Wesley, submission on the Issues Paper, p. 29.

[355] The ESIPC, in its submission to the First Draft Report, noted that "retail price regulation may not be the most effective instrument to apply to a wholesale market issue."

E.2.1.4 Ability of price regulation to keep pace with changing costs

Submissions to the Issues Paper expressed concerns about the current legislative frameworks for determining the gas and electricity standing contract prices. They suggested that the regulated price has not had the flexibility to keep pace with recent increases in input costs.[356] Origin noted:

> "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."[357]

As Origin observes, a mis-match between the forecast and actual wholesale energy costs directly affects potential margins and incentives for retailers to compete. The effects are borne out by the recent decisions of a number of retailers to cease actively acquiring small customers in South Australia. While this is a natural competitive response to an environment of increasing input costs and a retail price ceiling, it underscores the threat to competition: if retailers are unable to charge cost-reflective prices, the incentive to market their offers disappears.

At least one larger retailer noted that its current marketing was not as active now compared to the previous year.[358] Retailers have indicated that their abilities to pass through increasing wholesale energy and other costs have been decreasing. This makes it unattractive for retailers to expand their businesses as well as deterring new entry.

The effects of retail price regulation on energy retailing in South Australia were also observed by Business SA, who stated:

> "… the primary barrier within the market is price regulation. Price regulation is inefficient in that it is inflexible, and inhibits the introduction of new retailers, tariffs, services and products … Business SA believes that if price regulation was removed and more independent information about electricity

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356 This view was generally supported by retailers that lodged submissions to the Issues Paper. In its submission, AGL (p. 3 and p. 6) noted that it supported the phasing out of price regulation and that market forces were the best mechanism for producing efficient prices. Australian Power & Gas (p. 1) and the ERAA (p. 1) also believed price regulation should be removed. TRUenergy (p. 4) noted "The ability of retailers to recover their efficient costs, and thus the future competitiveness of the retail energy market, remains problematic within a price regulated framework".

357 Origin, submission to the Issues Paper, p. 5.

358 LECG, *Retailer Survey Report*, p. 8.

retailers were available, we could expect to see more effective competition in the South Australian energy markets."[359]

E.2.1.5 Overall impact of price regulation

Significantly, retail price regulation can also impact on the price signals necessary to encourage new investment. As noted above, the tightening supply-demand balance in South Australia means that new generation investment is required by 2010/11 to ensure the state is able to meet the minimum reserve conditions set by NEMMCO. If retail price regulation appears to be reducing, or has the potential to reduce, the financial viability of retailers and the retail market, generators may be reluctant to commit to new investment.

The Commission considers that the standing contract price acts as a focal point and market offers are based on a discount to the standing contract price. Where the tariff is set at a level that does not allow retailers to recover their efficient costs, the incentives to pursue strategies to actively acquire new customers abates. The current conditions have also deterred prospective new entrants from entering. The effects of the decrease in retailing activity could also accumulate over time and have longer-term impacts on retailer viability and upstream investment. As noted in section E.2.1.3 above, the Commission does not consider that retail price regulation is an appropriate tool for addressing wholesale electricity prices.

E.2.2 Regulatory compliance and consistency

South Australian retail energy businesses must comply with a range of regulatory obligations.[360] Some of these obligations are prescribed by legislation or regulations, others are contained in licence conditions or in other regulatory instruments (such as codes and guidelines) which apply by virtue of a licence condition. Where the regulatory costs facing established retailers differ from those facing potential entrants, this may create a barrier to entry. This section focuses on whether the scope and compliance costs of the regulatory obligations that apply in South Australia affect the willingness of potential entrants to enter or impact adversely on the capacity of existing retailers to compete. This section identifies the main issues raised by retailers: namely, the impacts of environmental legislation; consistency in regulatory requirements; and regulation of information and service standards.

E.2.2.1 Impacts of environmental legislation

Currently there are a number of initiatives that have been implemented or are being developed to address climate change and other environmental issues. Retailers questioned how the costs of implementing these requirements would be reflected in the regulated price.[361] The introduction and implementation of new policies

359 Business SA, submission to the Issues Paper, p. 2.

360 The principal obligations that are relevant to South Australia are contained in Appendix B.

361 LECG, *Retailer Survey Report*, p. 80.

addressing climate change policies, such as the CPRS, would add administrative costs for retailers but, in addition, it is likely that the CPRS will increase the cost of wholesale energy supply by adding a "carbon" cost to electricity generation. The concerns of retailers were summarised by one retailer:

> "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."[362]

AGL identified the need for certainty about the interaction between retail price regulation and environmental policy to encourage investment:

> "We are currently developing a number of new generation assets, which are consistent with a carbon-constrained future and premised on the ability to earn an appropriate rate of return in a competitive energy market. Removal of regulatory constraints on retail pricing and certainty with respect to greenhouse mitigation measures are critical for these investments."[363]

E.2.2.2 Impact on gas supply and gas prices going forward

The implementation of new climate change polices such as the CPRS will also impact on gas supply and gas prices going forward. It is likely that by adding a carbon cost to electricity generation, the use of gas-fired power generation will increase as it would have lower emissions compared to coal. As the need for renewable forms of generation such as wind and solar increase, which would provide intermittent generation, there would also be an increased demand for gas to manage the increased "peaky" generation profile. This outlook for gas indicates that gas prices are likely to increase. As noted in the Electricity Supply Industry Planning Council (ESIPC) 2007 Annual Review:

> "As a result of environmental and economic issues, gas is considered to be the most likely fuel for any major new scheduled generation project planned in South Australia in the short to medium term and, as a consequence, there will be continuing pressure to ensure sufficient gas is available and potentially leading to increasing upward pressure on gas prices. At the same time the increased gas demand is likely to place upward pressure on gas prices resulting in an economic governing of the penetration of gas for electricity

362 Simply Energy, Submission to the Issues Paper, p.2.

363 AGL, submission to the Issues Paper, p. 1.

generation. Any increase in gas price is likely to make additional gas reserves economically viable."[364]

As global demand for gas increases, there is also potential for export demand to increase. Western Australian gas prices increased significantly during 2006 due to increased demand and links to international markets through LNG exports.[365] A number of development proposals for LNG facilities in eastern Australia have been considered. Although it is uncertain when any of these LNG proposals will go ahead, were they to be undertaken the supply and demand conditions for gas in eastern Australia could change such that domestic prices would reflect international LNG prices.[366] Continued growth in the global LNG market is likely to impact on the gas prices in other regions, including in South Australia.

E.2.2.3 Residential Energy Efficiency Scheme (REES)

The Residential Energy Efficiency Scheme (REES), which will require energy retailers to deliver energy audits to low income households and implement energy efficiency improvements to households, was also of particular concern to a number of retailers.[367] Smaller retailers indicated that they will be disadvantaged by this scheme because they will face a higher incremental cost in proportion to their overall revenue. South Australia Electricity believes the scheme "can be a serious discouragement for smaller new entrants involving disproportionately large fixed costs"[368]. Larger retailers, such as AGL, with retail outlets for energy appliances were seen by some to have an advantage. One retailer noted:

> "…you've got to then, as a retailer, take on the whole range of initiatives at your own cost in regard to looking at perhaps a significant change over the customer's installation and a whole range of other things that were never foreseen when independents were applying for retail licences."[369]

Australian Power & Gas expressed the concern that the introduction of REES will result in retailers moving away from their core activities of retailing energy services:

> "We consider the proposal for REES to be inequitable and burdensome on small new entrant retailers, given the size, scope and resource requirements for delivery of the obligations, particularly that of retrofitting, home auditing and appliance provision. Furthermore the proposed scheme would force

364 Electricity Supply Industry Planning Council (ESIPC) 2007 Annual Review, p. 92.

365 *Ibid*, p. 88.

366 NERA, *The Gas Supply Chain in Eastern Australia*, March 2008, p. 1.

367 LECG, *Retailer Survey Report*, p. 66.

368 South Australia Electricity, submission to the First Draft Report, p. 3.

369 Retailer Survey.

retailers to move away from their core activities of retailing energy services."[370]

The Commission notes that in the emerging energy resource and carbon constrained global environment, it is likely that all stakeholders would increasingly take an interest in implementing initiatives to improve energy efficiency and demand-side participation. Some retailers acknowledged the role that retailers will have in promoting energy efficiency. For example, Origin noted:

> "Origin believes that it has a role to play in managing [the transition to an emissions trading scheme] by empowering households with information to help them understand their energy usage and by offering products to help households reduce their carbon footprint (household emissions).
>
> In addition to financial support, Origin believes that some of the strain households will feel can be mitigated by changing the pattern of energy use around the home."[371]

The regulatory obligations that apply to energy retailers are, in a large part, shared by all retailers. The Commission notes however, that REES is likely to involve relatively high implementation costs for smaller retailers and could therefore have a bearing on their competitive positions in the market in circumstances of rising energy costs and tightening retail margins. While REES is likely to have some impact on retailer cost structures and would be a consideration for businesses contemplating energy retailing in South Australia, on balance and based on the evidence before it, the Commission considers that this effect is not of such a magnitude that it would deter new entry or expansion.

E.2.2.4 Overall compliance and consistency considerations

The Commission acknowledges that the current regulatory environment is undergoing significant changes and developments in relation to the requirements for mitigating climate change. The Commission notes that REES was developed following extensive consultation with market participants and that it may be possible to outsource the provisions to alleviate some of the concerns that have been raised.

E.2.3 Other regulatory issues

E.2.3.1 Regulatory consistency

A number of retailers noted that there should be greater consistency in regulatory requirements to allow retailers to maximise opportunities to realise economies of

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370 Australian Power and Gas, submission to the Issues Paper, p. 2.

371 Origin, *Households need help to manage the transmission to emissions trading*, ASX/Media Release, 15 July 2008.

scale across jurisdictions and to minimise the incremental costs of inter-state expansion. As Australian Power & Gas noted:

> "…[it] is concerned with the level of divergence in regulations between the jurisdictions, however, we believe this to be a national issue and not distinct to South Australia. South Australia's regulatory regime has differing rules surrounding protection of customers, information provision, marketing and consent, and these do impede the ability of smaller retailers to optimize the economies of scale in the delivery of services."[372]

Although the differences in regulatory requirements to date do not appear to have deterred entry, further divergence could result in increased market separation, e.g. if smart meters were implemented in Victoria but not South Australia. As one retailer stated:

> "…were Victoria to proceed with installing smart meters and South Australia to retain non-interval meters, retailers operating in each state would receive vastly different information flows and would begin to package retail products in Victoria and South Australia differently; and eventually the operations across different jurisdictions may become segmented."[373]

E.2.3.2 Service standards

Most retailers noted that the Energy Retail Code[374] sets out service standards, such as the time within which incoming consumer telephone calls must be answered, as being overly prescriptive. Retailers believe that service standards should not be regulated as the requirements add costs without necessarily providing any real benefits to consumers and that consumers should be able to choose the type/standard of service that is appropriate to them. Retailers would then be able to use service standards as a differentiating product characteristic.[375]

In addition, the mandatory billing information is also seen as onerous and does not add to the experience of customers. One retailer noted:

> "we looked at simplifying the bill only to find that 98 per cent of the information there is mandatory, so actually you've got choice over colour and you've probably got choice over the type of paper you use… I think it is that crazy… by [removing overly prescriptive regulation] you create the

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372 *id.*

373 Retailer Survey.

374 Clause 2.2 of the Energy Retail Code requires 85 per cent of telephone calls to be answered within 30 seconds during business hours.

375 For example, TRUenergy in its submission to the Issues Paper (p. 5) noted that that price regulation and the requirements of the Retail Code restricted the dimensions upon which retailers compete.

opportunity where people will be more engaged and then you drive genuine innovation and the customer benefits over time."[376]

In contrast, the Energy Industry Ombudsman noted that mandated services standards have reduced complaints:

"Our observation is that the basic customer service standard retailers have to comply with have assisted in reducing the number of matters referred to EIOSA that directly relate to access to retailers and response to written enquiries."[377]

E.2.3.3 Hardship policies

Retailers who participated in the Commission's survey recognised the importance of hardship programs.[378] A number of retailers noted that they were supportive of customers that "cannot pay" and had processes in place to provide assistance to these customers. However, retailers generally questioned the appropriateness of these obligations and raised concerns regarding the cost impact on retailers. Retailers suggested that it would be more appropriate and effective for Government agencies to take a greater role in assisting customers experiencing financial hardship. As the ERAA noted:

"The ERAA believes welfare policy objectives are better addressed through a suite of programs targeted to provide direct and transparent payments to those in genuine hardship."[379]

The Commission recognises the legitimate and important public policy rationale for providing assistance to customers experiencing financial difficulty in meeting their energy bills and that the hardship policies implemented by retailers are providing important support for these customers. Although the requirements would place an additional cost on prospective new entrants, there is no evidence to suggest the requirement for hardship policies to be in place has been a significant deterrent to entry.

E.2.3.4 Summary of other regulatory issues

The Commission notes that while regulatory requirements across jurisdictions may add to a retailer's compliance costs, the requirements do not appear to have been a significant barrier to entry to date. Although there is potential for divergent regulatory requirements to cause segmentation, the Commission notes that national reform is continuing through the MCE reform processes. In considering the

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376 LECG, *Retailer Survey Report*, p. 68.

377 Energy Industry Ombudsman of South Australia, submission to Issues Paper, p. 4.

378 LECG, *Retailer Survey Report*, pp. 50-51.

379 ERAA, *Retail Price Regulation Policy Position Paper*, p. 2.

information that has been provided to the Commission during the Review, the regulatory compliance requirements are not considered to be a major deterrent to potential new entrants. However, the Commission is concerned at the level of regulation of service standards, which reduce the ability of retailers to differentiate themselves and compete through offering better and/or different service standards.

E.2.4 Prudential requirements and credit support arrangements

As noted in Appendix A, retailers are required to satisfy the prudential requirements administered by the market operators and to provide credit support to distribution network owners. This section considers whether compliance with these requirements limits new entry or restricts existing retailers from expanding.

Retailers expressed concern about the framework for providing both prudential and distribution security. Simply Energy characterised credit support as the "key barrier to entry and expansion in the South Australian electricity market".[380] The primary apprehension centres on the lack of flexibility for retailers to negotiate and implement alternate arrangements to satisfy the credit support requirements.

E.2.4.1 NEMMCO requirements

NEMMCO's prudential requirements were raised by a number of smaller retailers as an area of concern including difficulties with the reallocation arrangements.

One means of reducing the cost of the credit support required by the market operator is through the application of the NEM reallocation arrangements which permit market participants to offset their spot positions with their contract positions, thereby reducing their net market exposure to NEMMCO. However, the responses of retailers surveyed suggest that these arrangements are not widely used. At least one smaller retailer suggested that generators were not willing to disclose information relating to their contract positions and hence the potential for the reallocation provisions to alleviate the requirements for smaller retailers were not being fully realised. Simply Energy identified the consequences of the under utilisation of reallocations contracts:

> "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."[381]

However, it is noted that the "Futures Offset Arrangements" rule change is currently before the Commission which sets out a proposal to allow retailers' futures positions with the Sydney Futures Exchange to offset liabilities and credit support required by NEMMCO. In addition, the rule change requests for the maximum credit limit calculation methodology to be amended.

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[380] Simply Energy, submission to the Issues Paper, p. 1.

[381] *Id.*

E.2.4.2 Distributor requirements

A number of smaller retailers noted that the inflexibility associated with the distributors' prudential requirements increased the difficulty of commencing an energy retail business in South Australia. ETSA Utilities' prudential requirements were thought to be onerous and placed smaller retailers at a disadvantage compared to the larger retailers where cash-backed guarantees are required from retailers without an investment grade credit rating. The value of cash-backed guarantees could be substantial, placing a smaller retailer "at a disadvantage"[382] and potentially operating as a deterrent to entry. Retailers have noted that distributors in Victoria accept alternate forms of security such as insurance products and that ETSA should also consider adopting these provisions.

Gas retailers raised similar issues in relation to Envestra's prudential requirements[383], although the concern was not as significant as for ETSA's requirements.

E.2.4.3 Summary of prudential requirements

The Commission notes that retailers are required to commit a proportion of their working capital to meet bank guarantees and credit support arrangements. However, the costs are scaleable and safeguard the financial integrity of the energy market. Smaller retailers do have less flexibility as to the types of guarantees/instruments that are acceptable to distributors and, as such, there is scope to introduce additional flexibility. The Commission understands that retailers are working with the distributors and ESCOSA to consider developing the distributor prudential requirements. In addition, a rule change is in progress to improve the NEMMCO prudential provisions. For these reasons, the Commission has not been persuaded that these obligations are of such a magnitude that they are a material barrier to entry or expansion.

E.2.5 Gas retail market requirements

During the interviews conducted as part of the Retailer Survey, retailers identified the REMCo Retail Market Rules (RMR) as a potential deterrent to entry into gas retailing. Concerns focused on the general complexities of the RMR and, more specifically, on the practical operation of the rules governing swing gas.

One prospective entrant advised that significant financial and human resource costs were required to comprehend the complexities of the RMR.[384] In addition to the time and resources required to negotiate access to wholesale gas and capacity, and to acquire appropriate risk management tools, the costs of acquiring the necessary skills and expertise to participate effectively in gas retailing were considered too great.

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382 Retailer Survey.

383 See, for example, Simply Energy, submission to the Issues Paper, p. 2.

384 LECG, *Retailer Survey Report*, p. 72.

Of particular concern to several retailers were the rules governing swing gas.[385]

The RMR require each retailer to nominate its daily gas demand in advance to REMCo. If the actual demand on a day differs from the nominated amount, the retailer is required to purchase "swing gas" to balance the difference. The swing gas concept is a notional concept[386] under the RMR that applies for distribution network sections that are supplied by two pipelines (i.e. metropolitan Adelaide by MAPS and the SEAGas Pipeline), as it is possible for imbalances to occur between the two pipelines. When a retailer incurs an imbalance, swing gas is used to address the imbalance and the retailer must then "repay" the swing gas. This is done through either an "off market" agreement with a swing service provider or using the "on market" bid stack where swing service providers bid in to sell swing service offers. If a retailer's off market provisions and the swing service through the bid stack are insufficient, the swing gas is purchased from the swing service provider of last resort (SSPOLR). The price for SSPOLR swing gas is $1600/GJ, therefore retailers face a substantial price risk potential if they do not have sufficient off-market swing arrangements in place.

Retailers surveyed indicated that the swing service requirements under the RMR are complex and the potential exposure to SSPOLR price is disproportionate to the actual price of gas. To make any "off market" arrangements for swing service, retailers may need to negotiate with competitors for swing service provisions, which complicates the negotiation process.[387] In addition, there do not appear to be many swing service providers that actively bid into the bid stack, which increases the potential for retailers to be exposed to the SSPOLR price. The risks associated with swing gas provisions were outlined by Simply Energy:

> "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 the Swing [Service] Provider of Last Resort (a VoLL pricing principle) of $1600/GJ." [388]

To minimise the exposure to swing service, retailers need to maximise the accuracy of their nominations and ensure adequate off market swing service arrangements are in place. New entrants may find it relatively more difficult to nominate accurately due to limits in experience and the "peakier" load profile of most new entrants. As such, new entrants with a smaller load profile might find their risks more difficult to

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[385] See, for example, Simply Energy, submission to the Issues Paper, p. 2; TRUenergy, submission to the Issues Paper, p. 2.

[386] REMCo Retail Market Rules, Rule 2 states that "[swing gas] involves the supply of a gas capacity service and it does not involve the physical supply of gas".

[387] TRUenergy, in its submission to the Issues Paper (p. 2) noted that "commercial risks for new entrant retailers arising from potential exposure to swing gas, which are not recognised in ESCOSA's retail price determinations."

[388] Simply Energy, submission to the Issues Paper, p. 2.

manage with potential fluctuations in the demand profile representing a higher percentage of their total load.

In considering the information provided, the Commission notes that retailers find the swing service requirements complex and that processes are not transparent. Due to these complexities a new entrant might need time to build up expertise in managing their price and volume risks in relation to swing gas. Although these factors may be a deterrent to entry, the Commission does not believe they are insurmountable if a new entrant is willing to make the investment, provided that it believes it is able to recover its costs.

E.3 Commission's findings

Although the conditions for entry into electricity retailing in South Australia have provided opportunities for a number of retailers to enter, the current cost of wholesale electricity and related risk management products has reduced the margin available to retailers who must compete effectively with standing contract prices. The lack of margin available has resulted in some retailers ceasing to market to new customers. Prospective new entrants that have been issued a licence but have not yet entered the market have also stated that they would be unlikely to enter until margins improved. Notwithstanding the deterioration that has occurred to date, the underlying conditions for entry and expansion going forward remain positive, provided standing contract and/or market contract prices can be adjusted to reflect the increased costs of hedge contracts.

Entry into gas retailing in South Australia requires large scale and sunk costs in supply and transmission requirements, as well as costs in developing expertise required to compete effectively as a gas retailer in South Australia. The low volume of consumption by small customers may also deter entry by a smaller retailer, especially if the margin available to retailers is not sufficient. Cost synergies from offering dual fuel may reduce the potential barriers, however the current low margins available in both electricity and gas may limit this potential in the short-term. Despite these limitations, there has been significant new entry into gas retailing in South Australia by dual fuel vertically integrated retailers who can take advantage of economies of scale and scope. Notwithstanding the Commission's finding that competition is effective, the Commission has identified structural features of the gas supply chain, affecting access to firm transmission haulage capacity, which have limited the ability of new retailers to expand their retail operations into regional areas of South Australia.

Developments in technology and outsourcing have reduced the need to attain a significant "critical mass", particularly for electricity retailing and improved the ability for retailers to enter and expand. New retailers are able to adopt business models that embody more flexible approaches to managing costs, enabling them to more easily realise the benefits of economies of scale. However, as the South Australian electricity market is a net importer of electricity and there is limited liquidity in South Australian hedge contracts, large scale expansion may require high sunk costs to invest in generation. In addition, large scale expansion in gas retailing

would also require high sunk costs for investments in gas supply and transmission capacity.

Although the host retailers possessed the full customer base at the commencement of FRC, the new entrant retailers have gained a significant share of those customers in a relatively short space of time. In addition, there appears to be limited brand loyalty with customers switching based on the offers that are presented to them.

The different regulatory requirements across jurisdictions may add to a retailer's compliance costs. While the range of obligations has the ability to impact on retailer cost structures, the Commission considers the effect is not of such a magnitude that it has deterred either entry or expansion.

The Commission acknowledges that climate change policies, such as the CPRS, have the potential to impact on energy prices and retailers' operational costs. The Commission notes that these policies are being developed in consultation with stakeholders and it is therefore not possible to draw firm conclusions at this time about the precise impacts on competitors or competition. However, as noted elsewhere, to the extent that the cost structure implications of climate change policies impact on all retailers in the energy market and prices are able to respond flexibly to absorb them, those policy changes should be able to be accommodated in an effectively competitive retail market.

Retailers are required to commit a proportion of their working capital to meet bank guarantees and credit support arrangements, these costs are scalable and provide a safeguard to the financial integrity of the energy market. Distributors in Victoria may provide different processes, allowing greater flexibility in the types of products and arrangements accepted. The Commission notes that retailers in South Australia are working with the distributors and ESCOSA to further develop more flexible options to manage this obligation. In addition, a rule change request is in progress to amend the NEMMCO prudential provisions in the National Electricity Rules. For these reasons, the Commission does not believe these obligations are of such a magnitude that they are a material barrier to entry or expansion.

The Commission's conclusion is that provided there are sufficient margins for retailers, barriers to entry have not been such as to deter entry from occurring to date or to protect incumbents from competitive constraint. Although entry to gas retailing may require higher sunk costs, the limitations do not preclude large scale entry or entry by a dual fuel retailer. A large number of retailers have entered South Australia, including some substantial dual fuel retailers, providing an effective competitive constraint on market outcomes. However, in the case of gas supply in regional areas, even the large dual fuel retailers have been unable to effectively compete due to structural limitations affecting retailers' ability to access transmission capacity on the laterals supplying regional areas and the SESA Pipeline. The Commission notes that some of these structural issues may be resolved in the near term as legacy contracts on the laterals expire. The Commission will consider whether there are options that could improve the opportunity for new entry into regional areas and, if appropriate, will make recommendations to that end in the Second Draft Report.

F Measured Profit Margins

In markets characterised by effective competition, rivalry amongst retailers and the threat of new entry will provide retailers with an incentive to match and improve upon the price and non-price offers of their rivals. Over time these competitive pressures will cause prices to converge toward the efficient economic cost of delivery. The term 'economic cost' in this context includes all those costs incurred in supplying a good or service, including a return that is commensurate with the prevailing conditions in the financial markets and the risks involved in delivering the good or service. In circumstances where prices fall below the level where efficient firms are able to recover their economic costs, some firms will be forced to exit the market. This will continue to occur until prices reflect the economic cost of delivery once more. In contrast to prices observed in an effectively competitive market, a market in which firms exhibit and exercise a substantial degree of market power[389] may support prices that exceed the economic cost of delivery over a sustained period.

It follows that one indicator of whether competition is effective in South Australian energy retailing is whether the revenue earned by retailers on market offers is consistent with, or in excess of, the economic cost of delivery. A convenient means of measuring the extent to which retailers' revenues align with their economic costs is to measure retailers' profitability. Measures of profitability are simply the residual that remains after certain categories of cost have been recovered. The measured profit can then be compared to the level that would be expected to occur in a competitive market (the 'competitive' margin) which would include a return that is commensurate with the prevailing conditions in financial markets and the risks involved in delivering the service. The purpose of this appendix is therefore to consider the extent to which the retail margins earned by retailers to date on market contracts are consistent with the outcomes that would be expected in an effectively competitive market. Since the standing contract prices in South Australia also play an important role in influencing competition amongst existing retailers and encouraging entry, this appendix also considers the extent to which the retail margins available under the standing contract prices have facilitated or deterred competition and entry.

To undertake this analysis the Commission has used the standard measure of profit that is generally applied to retail businesses; namely, profit measured as earnings before interest and taxation (EBIT) expressed as a percentage of sales revenue. This measure of profitability is referred to as the profit margin (or margin) in the discussion below. The logical starting point for estimating the margins that have been earned by retailers to date would be to obtain information on the actual costs incurred and revenues received from this activity. While the Commission sought this information from retailers the information was not made available by all retailers

[389] For substantial market power to exist, customers need to have limited or no alternatives to their current supplier (including for there to be barriers that dissuade new suppliers from entering and/or customers from switching) so that the process of customers 'voting with their feet' and hence disciplining the terms offered by suppliers is muted or absent.

and thus the Commission's analysis of revenue, retail costs and margins has been based upon publicly available information on the market offers in existence and estimates of the efficient cost of serving customers in South Australia.

There are several caveats that need to be borne in mind when interpreting the estimates of margins that are reported herein and drawing any inferences about the effectiveness of competition.

First, as discussed above, the expectation is that the process of competition will lead to prices converging to economic costs (and the margin converging to the competitive level) over time. However, the margin that is observed at any point in time may be materially higher or lower than the competitive level as the market responds to changes (for example, a step change in costs) or to other new information, and as entry and exit of new retailers occurs.

Retailers may also offer prices that are fixed for a period of time, based upon their forecasts about future costs (as discussed below, retailers inevitably bear an exposure to the spot market). Thus, even if the prices that retailers offer included a competitive margin over the forecast cost of serving that customer, the observed margin – which will reflect the actual costs that retailers incur – inevitably will differ to the intended margin merely as a result of the difference between forecast and actual costs.

The implication of these two points is that it is difficult to draw strong inferences about the extent of competition from the margins that are observed at any point in time. Rather, the appropriate focus is upon the trend in margins over a number of years.

Secondly, even though variable costs[390] make up a higher proportion of a retailer's cost structure than they do, for example, for a network business, some retail costs are incurred jointly across customer segments. Retailers would need to recover all of their costs to remain in business over time, including costs that are incurred jointly across customers and customer groups. However, there is no reason to expect that all customers and customer groups would be charged the same pro-rated share of these costs. Rather, it would be expected that retailers would seek to recover joint costs by applying a different mark-up over marginal cost depending on the price sensitivity of demand by the relevant customer segment (often referred to as Ramsey pricing). A result of this efficient recovery of joint costs is that, while a competitive margin would be expected across all customers, a higher or lower margin would be expected across particular customer segments.

Thirdly, the assessment of the retailers' margins is subject to a potentially material measurement error. The Commission does not have a formal power to gather revenue and cost information from the retailers. Instead it has relied upon publicly available information on prices and the assumptions in regulators' decisions and voluntary disclosure of information as (imperfect) proxies for costs, which potentially are subject to significant measurement error. Moreover, even if

390 Variable costs are costs that vary with the number of customers served or with the amount of energy consumed.

information on actual costs and revenue were available, measurement error of actual costs remains.[391] In addition, the relevant question is whether the measured margin is consistent with the margin that would be earned by an *efficient* retailer; that is, one that effectively managed its input costs, price structures and its risk exposures. A further matter to be addressed, therefore, is whether that efficiency standard has been met.

Fourthly, the standard against which margins should be benchmarked – the competitive margin – is also subject to significant measurement error. The level of imprecision in the analysis discussed above means that it may be difficult to draw a strong inference from the computed margins (based on imperfect cost and revenue data) regarding the degree of competition in the market.

Indeed, the difficulty that is involved in attempting to estimate the efficient cost and the efficient price level is one of the reasons for preferring competition over regulation where the former is feasible. In competitive markets, no single entity is required to estimate efficient cost. Rather, efficient costs and the efficient price levels are revealed over time by the process of offer and counter offer and entry and exit from the market.

It follows from the discussion above that the margins that are of most relevance to the assessment of competition in South Australian energy retailing are the margins made when energy is sold to customers under market contracts, as this provides an insight into where the 'market' has settled. However, it is also relevant to examine the margins that are able to be earned under the prevailing standing contract prices. If the margin that is earned under these prices is found to be low – either generally or for specific locations or customer types – then an implication may be that the standing contract price is impeding entry or foreclosing competition to those regions or customers types. This information is relevant to considering the nature of any impediment to competition and assessing the costs of continuing to regulate.

Finally, it should be recognised that any analysis of margins will necessarily be historic in nature and may not reflect expectations about future revenue, prices or costs. Some care must therefore be exercised when drawing inferences from historic analysis about the future.

The remainder of this appendix sets out the Commission's findings on whether the profit margins generated in South Australia are consistent with effective competition. The discussion includes consideration of retail cost components and their impact on prices and profit margins, margins that are available under the standing contract prices and market contracts and the margins that are available for specific regions and customer types.

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391 For example, the presence of costs that are incurred jointly with other customer groups or in common across other activities means there is no single, correct observation of cost for retailing to this group of customers. In addition, the combination of extreme volatility in spot prices, material volatility in the prices of derivatives instruments and volatility in customer consumption imply material bounds of error in estimates of the wholesale electricity purchase cost incurred to supply a customer.

F.1 Measuring average retail costs, revenues and margins

F.1.1 Economic costs

The economic costs that are incurred by retailers to supply energy to end-users include:

- Energy Costs: These are the costs associated with purchasing wholesale electricity and gas for end-use customers. The size of these costs and the manner in which they are managed differ between electricity and gas. However, in each instance factors other than the basic cost of energy need to be considered, such as the risks faced in purchasing energy, the costs of mitigating risks and network losses (for electricity). In addition, the costs of participating in the market for energy (such as market participant fees) fall into this category, as well as the cost of meeting legislative obligations with respect to energy purchases (such as purchasing the required amount of renewable energy under the MRET scheme).

- Transmission and distribution network charges: These are the costs incurred by retailers for the transportation of energy from the point of production to the site of the relevant customer (including losses for gas). The distribution and electricity transmission functions are effective monopolies, and the prices for transportation in South Australia are regulated by the AER. Accordingly, retailers are not able to manage the size of these costs. In contrast, the gas transmission pipelines that serve South Australian customers are not regulated and retailers must negotiate prices and access directly with the pipeline owner. Unlike gas transmission pipelines, the gas distribution system in South Australia is still regulated.

- Retail operating costs: These are the costs associated with providing the services of energy retailing. They typically include billing and revenue collection, call centres, financing costs, IT systems, fulfilling regulatory obligations, and overheads and indirect costs. Retailers either provide these services internally or outsource them to third parties.

- Retail margin: This is the additional revenue that retailers earn over the costs described above by supplying energy to customers. The role of the retail margin is to compensate retailers for: the cost of financing the stock of capital required to provide retail services (such as IT costs); the working capital required; the risk incurred in retailing; and the investment that is made to acquire their customers (acquisition costs are discussed further below). Firms require compensation for these financing costs (investments) and risks in order to remain commercially viable (and hence to remain in operation) over the long term.

Another category of costs incurred by retailers are customer acquisition costs. Customer acquisition costs are those costs that retailers incur to attract new customers and to retain existing customers, including both direct marketing and the back-office cost of transferring a customer onto the new retailer's billing system. Unlike other costs, the amount a retailer spends on customer acquisition is at its own discretion. However, without retailers attempting to draw customers from rivals –

and hence incurring acquisition costs – it is unlikely that competition would be effective.

The Commission notes that there has been some contention in regulatory retail pricing decisions about the appropriate treatment of customer acquisition costs. In particular, there is some contention surrounding whether these costs should be treated as an operating expense or part of the margin, with the tangible issue being whether they should be recovered in the year in which the costs are incurred or spread over time.

When a retailer acquires a customer, it receives an expected stream of revenue from that customer over a future period of time.[392] Accordingly, the Commission considers that customer acquisition and retention activities are properly interpreted as an investment by a retailer, with the cost of this investment recovered from the relevant customer over the expected life of that customer. Consistent with the treatment of retailers' other investments, the recovery of customer acquisition costs should form part of the retail margin.

That said, the appropriate treatment of customer acquisition costs raises a number of issues, which include the following:

- first, the annual allowance for customer acquisition costs depends on the cost of acquiring a customer and the expected time period for which a customer remains with the acquiring retailer. Both of these inputs are subject to substantial uncertainty; and

- secondly, if it is assumed that the recovery of customer acquisition costs should be observed in the margin, care must be taken to ensure that the retail operating expenses and margin are measured appropriately (that is, that retail operating expenses exclude customer acquisition costs and that the target margin includes an allowance for customer acquisition costs).

These issues are discussed further in section F.1.4 below.

Another source of contention surrounding customer acquisition costs is whether they would be borne by a 'standing contract retailer' when it is offering the standing contract service and therefore reflected in the standing contract price. If standing contract prices do not include customer acquisition costs[393] then there is a risk that the prices could foreclose retail competition because, unlike the assumption made regarding the standing contract retailer, new entrant retailers will need to recover the efficient costs of customer acquisition in the prices they charge under market contracts. Care must therefore be exercised when considering customer acquisition costs.

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392 Activities to retain customers have an equivalent purpose, that is, to prevent a loss of revenue that otherwise would occur.

393 Irrespective of the cash-costs incurred by standing contract retailers, as customers can be traded, there is an opportunity cost associated with serving a particular customer.

F.1.2 Revenue

Two key inputs into the margin analysis are:

- the revenue that is available under the market offer prices, which is relevant to the assessment of whether the observed margins are consistent with effective competition; and

- the revenues that would be available under prices equal to the standing contract price, which is required to test whether these prices may be a barrier to competition.

The second of these price assumptions is straightforward since the standing contract prices in South Australia are approved by ESCOSA each year and are publicly available. To estimate the prices available under market offers, the Commission has utilised ESCOSA's online Estimator which compares the current market offers available to residential customers from retailers for electricity, gas and dual fuel energy supply. In accordance with the Energy Price Disclosure Code, retailers are required to notify ESCOSA of their market offer prices for residential customers and the associated price and non-price inducements on a continuous basis. The Commission understands that this information is then used by ESCOSA to update the Estimator. While the Commission understands that the Estimator is unable to incorporate every tariff structure available, the Estimator does provide a near-comprehensive coverage of the market offer prices for residential customers. The data obtained from the Estimator may therefore be viewed as a reliable indicator of the manner in which market offers have changed over time, as well as providing an indication of the cross-section of the market offers that are available from different retailers at any point in time.

The amount of information available to the Commission in the South Australian review is vastly superior to that which was available during the Victorian Review.[394] There are, however, some shortcomings in the data obtained through the Estimator.

First, at the time this analysis was undertaken, the Estimator only coverd price offerings to residential customers and excluded price offerings to small business customers. The analysis of margins contained in this appendix is therefore limited to the residential segment. The Commission did attempt to obtain information from retailers on the costs and revenues associated with small business customers, however, this information was not made available by all retailers and thus the Commission has not been able to undertake the margin analysis for small business customers.

Secondly, while the Estimator includes information on non-price inducements[395], many of these are difficult to assign a monetary value. The margins reported exclude the price offerings where the cost of the non-monetary inducements is likely to be most material – namely the 'green' products – which should minimise the potential

394 In the previous review, the Commission was forced to rely upon information on historical market offer prices that was incomplete and largely based upon anecdotal evidence.

395 These include frequent flyer points, magazine subscriptions and football club memberships.

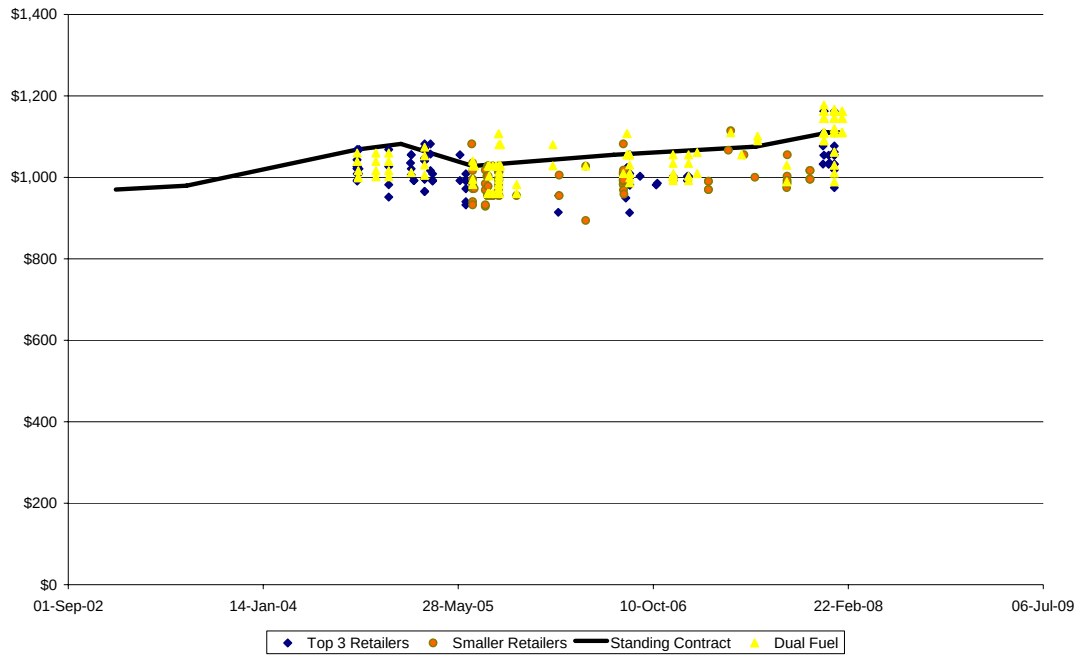
bias. The main effect of ignoring the value to customers of the non-monetary inducements is that customers may opt for price offers that appear higher than what is available from other retailers or under the standing contract. The calculated margin will be affected to the extent that the cost of providing the non-monetary inducement is not included in the assumed retail costs, and will therefore be upwardly biased.

In addition, the following methodological choices or simplifications have been made:

- the observation for each market offer price in Figure F.1 below is reported as at the time that the new tariff was first entered into the Estimator, or as at the time at which a pre-existing tariff was changed. The figure does not record how long each of those tariffs remained in effect;
- upfront monetary inducements have been smoothed over a three year period when calculating the effective (annual) price offer;
- only prices for the standard electricity service are considered, which means that the off-peak (controlled load or hot water) prices have been ignored;
- prices that were materially higher than the standing contract prices were ignored. Several tariffs offered over the period appear to have been set at a level that was intended to dissuade customers, and presumably as an alternative to withdrawing the offer. Including such tariffs in the sample would lead to the margins actually available during the period being overstated; and
- revenue is calculated for the average sized customer, which is taken as approximately 5 MWh for electricity (non-off peak only) and 22 GJ for gas.

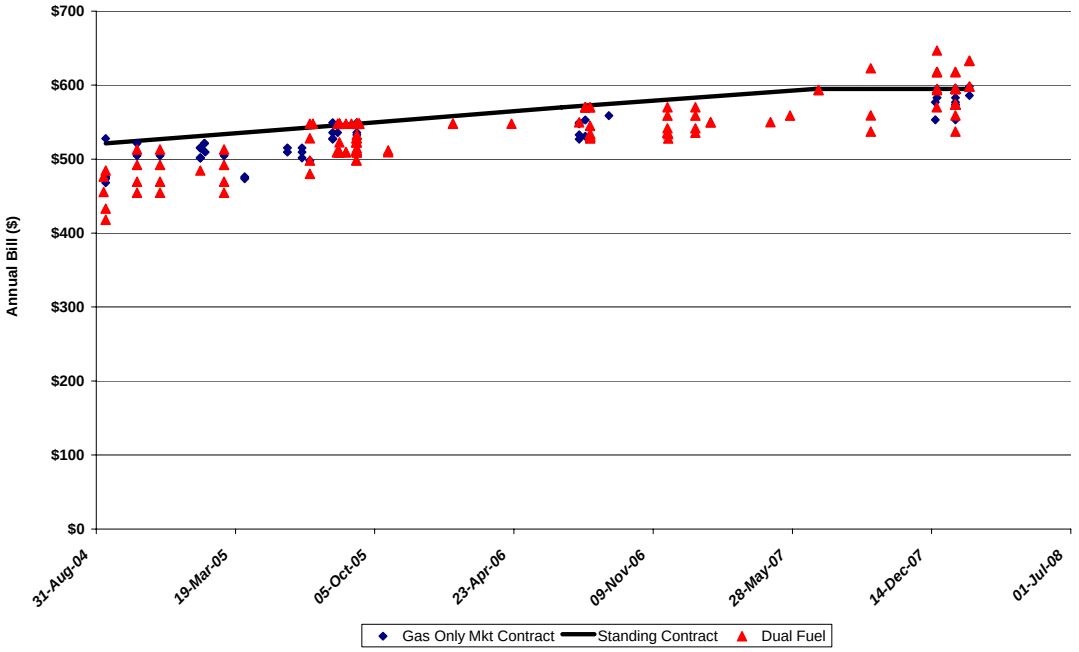
Figures F.1 and F.2 illustrate the annual revenue for the average residential electricity and gas customer that is implied by the market offer prices taken from the Estimator and the standing contract price as it existed from time to time. Single and dual fuel offerings are separately identified in both of these figures.

Figure F.1 Annual revenue for the average electricity customer: standing contract and market offers



Data source: Commission's analysis of data from the ESOSA Estimator.

Figure F.2 Annual revenue for the average gas customer: standing contract and market offers



Data source: Commission's analysis of data from the ESOSA Estimator.

It is clear from Figures F.1 and F.2 above that substantial discounts against the standing contract prices have been available, at different times from both large and

small retailers, and across single fuel and dual fuel offers. If a simple average is taken of each of these offers over the period, the average discount for single fuel electricity and gas was 5.0 per cent and 2.9 per cent respectively[396], and 2.9 per cent and 4.0 per cent for dual fuel electricity and gas respectively.[397]

It also follows from these figures that, as well as discounts, there have been a number of market offers that are higher than the standing contract prices (albeit not by a large margin). While this may appear to suggest that customers have not understood the terms available under the standing contract, it may be that this customer choice is explained by the value of non-monetary inducements provided, or that the market offers are more attractive at different levels of consumption.

F.1.3 Retail costs

To estimate retail costs the Commission has principally had recourse to the information contained in ESCOSA's gas and electricity standing contract price determinations (excluding customer acquisition costs).[398] These estimates have been utilised because they have been produced through a transparent regulatory process, where the assumptions have been tested and robust review options existed.

ESCOSA's assumptions for the relevant period about retail operating costs for electricity and gas, and upstream costs for residential customers are set out in Table F.1. The electricity cost estimates contained in this table were been made in December 2004 while the gas cost estimates were made in June 2005.

396 These exclude "green" products. If all offers that contain non-monetary inducements are excluded, the average discount rises to 5.4 per cent and 3.7 per cent, respectively.

397 These average discounts rise to 3.7 per cent and 5.0 per cent for dual fuel electricity and gas if all offers containing non-monetary inducements are excluded.

398 The one adjustment that has been made is to remove from the gas retail operating expenditure the allowance that ESCOSA provided for FRC-related capital expenditure. The Commission does not question the validity of the allowance, but prefers the 'return of' and 'return on' all investments to be reflected in the retail margin.

Table F.1 ESCOSA's retail and upstream cost assumptions

	2004/05	2005/06	2006/07	2007/08
Electricity				
Wholesale electricity purchase costs ($/MWh)	68.5	73.33	72.45	72.94
Retail operating costs ($/Customer)	84.00	87.70	92.12	96.26
Gas				
Well-head gas cost ($/GJ)	**	3.54	3.75	3.88
Transmission cost ($/GJ) *	**	1.43	1.59	1.62
Retail operating costs (excl. FRC, $/Customer)	**	71.40	72.83	74.28
FRC operating cost allowance ($/Customer)	**	7.71	7.71	7.71

Notes: * Cost of transmission to Adelaide.
** The 2004/05 gas standing offer contract price components were set by the South Australian Government and its assumptions have not been released publicly.

In utilising these estimates the Commission is aware that:

- the costs are historic in nature and do not reflect the recent increases in the wholesale price of electricity or risk management products; and

- the costs are designed to reflect those costs that would be incurred by the standing contract retailer and may differ from those costs incurred by a new entrant retailer.

The Commission also recognises that the use of benchmark assumptions for the costs, particularly for the wholesale energy cost, creates an additional degree of imprecision in the analysis, particularly for the wholesale energy purchase cost. The essential function of an energy retailer is to act as an intermediary between final consumers and the wholesale market and to manage the associated price and volume risk on their behalf. The efficiency of risk management is one of the key areas where a retailer may obtain a competitive advantage over others, given that different portfolios of contracts and purchasing strategies can have a material effect on the retailer's average cost of energy and risk exposure. Since any estimate of a benchmark wholesale energy purchase cost is based upon an assumed risk management strategy and an estimate of the value of the residual risk exposure of the retailer, the potential for material error in the estimate of the wholesale purchase cost exists. Another potential source of error in the cost estimates is that regulators generally need to make assumptions about efficient retail operating costs.

Given these shortcomings, the Commission has taken into account the precision of these inputs into the calculation of margins when deciding how much weight to place upon this source of evidence. The Commission has also tested and had regard to the sensitivities surrounding the cost assumptions.

The specific sensitivities tested by the Commission are as follows:

- Wholesale electricity purchase costs: Arguments can be made that the host retailer would have a higher or a lower wholesale electricity purchase cost. On the one hand, larger retailers are likely to have a more predictable future customer base, which may permit lower cost hedges to be used, with a resulting reduction in cost. Larger retailers may also be able to accept more spot market

risk, which would reduce the risk-adjusted purchase cost if the hedges contained unnecessarily high margins and/or liquidity premia. On the other hand, the South Australian host retailer is obliged to accept customers onto the standing contract at any time, and can lose customers at any time. As customers are likely to opt for the standing contract when they are less profitable under that tariff (e.g. when high wholesale costs force other retailers to raise their prices) and to leave when they are more profitable (e.g. when low wholesale costs lead other retailers to reduce their prices), the host retailer may bear a liability that is not borne by new entrant retailers.[399]

The wholesale electricity costs relied upon by ESCOSA may also be lower than the costs currently facing retailers given the recent increase in the cost of wholesale electricity and risk management products. The Commission has received analysis suggesting that these estimates were a close proxy for the host retailer's costs until the end of calendar year 2007. From that point on they began to understate the wholesale energy costs incurred by the host retailer. Given new entrants have less capacity to hedge in advance for their loads, the new entrants' wholesale electricity costs were likely to have risen more rapidly in the wake of the increase in contract prices in March 2007 than the increase faced by the host retailer.

To account for these two potential variations in wholesale electricity prices and the cost of risk management products, a range for the wholesale electricity purchase cost of plus and minus 10 per cent of ESCOSA's estimate for the standing contract retailer has been.

- Wholesale gas costs and transmission costs: ESCOSA's estimates of these cost items were based, in part, on the price payable by Origin under long term contracts. The costs may therefore understate the cost that would be incurred by a new entrant seeking to obtain gas supply or transmission capacity today. Another potential benefit enjoyed by the host retailer is that larger gas retailers may be able to achieve a greater degree of 'diversification' in the demands across their customers. As gas transmission costs and part of the cost of gas depends on the maximum demand across a portfolio of customers, smaller retailers may face a higher average cost of gas.

  A scenario for the wholesale gas and transmission costs of 15 per cent greater than ESCOSA's estimate for the host retailer has been tested to accommodate the

399 A further difference between the host (large) retailer and new entrants is the time at which hedges are purchased, with large retailers typically commencing their purchase of hedges for a particular period some years prior to the relevant period (which ESCOSA did assume when estimating the wholesale electricity purchase costs set out above). In contrast, the uncertain load of small retailers is likely to lead them to purchase hedges closer to the relevant period. However, over the period analysed in this report prior to March 2007 contract prices were fairly constant, and so the timing of the purchase of hedging is unlikely to have had a large impact on the wholesale electricity purchase cost. The cost of all electricity hedges for the remainder of 2007 and calendar year 2008 rose sharply from about March 2007 due to the drought, and hence the timing of purchase of hedges for the second half of 2007-08 would have had a material impact on a retailer's cost structure.

potential difference between the host retailer and a new entrant retailer's wellhead gas and transmission costs.

F.1.4 Retail margin

Taking the difference between the revenue and cost assumptions discussed above results in an estimate of the 'surplus' received by retailers, which can then be converted into a 'margin on sales'. The purpose of this margin is to compensate the retailer for the investments made in its retail business (including the acquisition of customers) and for other financing costs incurred. If retailers are able to exercise market power and raise prices above the long run efficient cost, then the margin will also include an element of monopoly rent. It follows that the principal questions for the Commission are whether:

- its calculated margins are consistent with what would be earned in a competitive market or whether the margins under market offer prices may be excessive which is suggestive of continued market power; and

- the margins that would be possible under standing contract prices are sufficient to encourage profitable entry and competition or are too low and therefore act as a deterrent to competition and entry.

As this discussion highlights, a key element of the margin analysis is what margin would be earned in a 'competitive market'. Rather than using a single point estimate the Commission has had recourse to a plausible range for the 'competitive market'. This plausible range has been established having regard to:

- the decisions made by a number of jurisdictional regulators in relation to retail margins which are generally informed by benchmarking across businesses and from bottom-up studies (i.e. explicit estimates of the different components of the required margin);

- information regarding the costs of acquiring customers; and

- the influence of other factors prevailing in the gas industry which imply that a different margin would be required by South Australian gas retailers to that required by South Australian electricity retailers.

F.1.4.1 Influence of customer acquisition costs on margins

The retail margin that has been provided in recent jurisdictional regulators' decisions on standing contract prices has converged toward 5 per cent as an appropriate margin for both electricity and gas. There are, however, differences in the manner in which regulators have measured these margins and have recognised customer acquisition costs in the margin estimate.

ESCOSA's decisions for both electricity and gas assume that the 5 per cent margin already includes an appropriate allowance for these investments. The New South Wales Independent Pricing and Regulatory Tribunal (IPART) and the Queensland Competition Authority (QCA), however, assume that the 5 per cent margin excludes

any allowance for a return on customer acquisition investments. The Commission's advisors in the Victorian Review also assumed that the 5 per cent 'regulatory norm' margin excluded any allowance for customer acquisition investments.

Given the divergence that has emerged on this issue the Commission has tested a lower bound and an upper bound. The lower bound assumes that the 5 per cent margin includes an appropriate allowance for a return on customer acquisition investments, following the views of ESCOSA. The upper bound assumes that the 5 per cent margin does not include an allowance for a return on customer acquisition investments and thus an additional allowance is required to reflect this aspect. To estimate the additional allowance required for the return on customer acquisition investments the Commission has had to make assumptions about the cost of acquiring customers, the period of time for which the customer is expected to be retained and the cost of capital for a retail business.

A figure that has been quoted and used in several regulatory decisions for customer acquisition costs is $200 per customer. This estimate was used by IPART in its 2007 retail price decision, however, it would appear that a substantial portion of IPART's estimate relates to the back office processes required to effect a customer transfer.[400] While these back office costs may be an important part of the incremental cost of transferring a customer, an allowance for these costs is already included in ESCOSA's operating expenditure allowance. To include them in the target margin calculation would therefore lead to 'double counting' and hence understate the profitability of energy retailing.

Retailers participating in the Retailer Survey also provided estimates of customer acquisition costs (the majority ranged from $101 to $150 per acquired customer), however these costs also included back office costs and hence would also be likely to include some double counting of costs.[401] A more relevant figure that was revealed during the survey was the cost of commissions paid to door-to-door sales teams which excludes the costs associated with back office functions.[402] The commissions referred to in the Retailer Survey were:

- $80 for a single fuel (electricity) customer; and
- $110 for a dual fuel customer which implies an incremental commission of $30 for a gas customer on a dual fuel arrangement.

The Commission has therefore assumed a range of $80 to $150 per acquired customer, with the lower value considered to be the more relevant given the upper

400 IPART noted that two thirds of its estimate of $200 per customer was associated with back-office functions (IPART, *Regulated electricity retail tariffs and charges for small customers 2007 to 2010 – Final Report and Determination*, 2007, pp. 101-102).

401 If the objective is to gauge the extent of acquisition activity by retailers, then it is appropriate to estimate the full incremental cost of customer acquisition activities, which includes back-office functions. However, where margins are to be estimated and tested, care must be taken to ensure consistency between the operating expenditure allowance and the calculated target margin.

402 LECG, *Retailer Survey Report*, p. 32.

bound includes an allowance for back office functions. The Commission has also had regard to the cost of customer acquisitions of $30 per acquired gas customer when acquired as part of a dual fuel deal, which is discussed separately below.

Table F.2 sets out the increment to the target margin that would be implied by these different customer acquisition costs.[403] The different incremental margins for electricity and gas reflect the fact that the average customer bill in electricity is almost twice that of gas.

Table F.2 Effect of customer acquisition investment on the required margin

	Customer acquisition investment ($/customer acquired)		
	$30	$80	$150
Electricity	0.6%		3.0%
Gas	1.1%	2.9%	5.4%

The results in this table imply that for an electricity customer, the recovery of the investment to acquire the customer would add 1.6 percentage points to the required margin if this was proxied by the $80 sales commission payable or would add 3.0 percentage points if the $150 estimate is utilised. Adding these premiums to the 5 per cent base margin implies a range of 6.6 per cent to 8.0 per cent.

F.1.4.2 Other factors influencing the margin required by gas retailers

There are a number of features of the gas industry that imply that gas retailers would require a different margin to that required by electricity retailers.

First, the terms of payment for gas distribution charges in South Australia differ to all other jurisdictions in that these charges are paid in advance rather than in arrears. Information provided by ESCOSA suggests that the working capital requirement of this prepayment of distribution charges adds approximately 0.8 percentage points to the required margin, implying a lower bound required margin of 5.8 per cent.

Secondly, as with electricity, the Commission has had regard to margins that include a recovery of the cost of customer acquisition investments. For gas, customers that are acquired just for gas, an increment to the margin of 2.9 to 5.4 percentage points would be required, implying a target margin of 8.7 per cent to 11.2 per cent. However, the Retailer Survey suggests that new entrant retailers in particular will only market gas as part of a dual fuel offering, with gas clearly being the marginal fuel. If this marginal acquisition cost is again proxied by the commission that is paid

403 An expected customer term of 8 years has been assumed, following from the assumptions of IPART in its recent review and a real, pre-tax weighted average cost of capital (WACC) of 9 per cent has been used, although the WACC is not material to the calculation. The annualised amount has been calculated as a real annuity, which assumes that the 'return' to the retailer from the customer is constant in real terms over the life of the customer.

to door-to-door sales teams, then an increment to the margin of just 1.1 per cent would be required, implying a total target margin of 6.9 per cent.

Thirdly, if a gas retailer was operating on a stand alone basis, the fact that average annual gas revenue is only just over half that of an electricity customer means that that the retailer's required margin would be expected to be higher again. This reflects the fact that while some elements of the margin do vary with revenue (such as components of working capital) others (such as IT costs) are likely to depend on customer numbers irrespective of the size of bills. That said, retailers may also be able to achieve economies of scope in IT costs by serving customers with both electricity and gas (i.e. to the extent, if any, that the long term IT cost for a dual fuel customer is less than the sum of the stand alone costs for an electricity and gas customer).

F.1.4.3 Conclusion

The Commission recognises that the appropriate 'competitive' margin is subject to material estimation error. The Commission has therefore sought to test the observed margins against a plausible range for the 'competitive market' margin. The plausible range for the 'competitive market' margin is bounded at the lower end at 5 per cent for electricity retailers and 5.8 per cent for gas retailers.

The upper end of the Commission's plausible range includes an explicit allowance for the return on the investment in acquiring customers. This implies a competitive margin of:

- 6.6 per cent for electricity if the cost of acquiring customers is proxied by the commission paid to door-to-door sales teams, or 8 per cent if the full customer acquisition cost of $150 per customer is used (albeit with a risk of double counting); and

- 6.9 per cent for gas if gas is marketed as the marginal product in a dual fuel offering, or 8.7 per cent if gas is marketed on stand alone basis (or 11.2 per cent if the full customer acquisition costs is used, again with a risk of double counting).

F.1.5 Impact of location and customer size on the achieved margin

As well as assessing the state of retail competition generally, the Commission must also assess whether the observed margins indicate that there are varying levels of competition (or barriers to competition) across market segments. The two dimensions of most relevance to this analysis are customer size and location.

Regarding customer size, it has been common for the structure of energy prices (particularly in electricity) to be misaligned with retailers' cost structures, with the variable (per kWh) element in prices exceeding the variable retail costs and vice versa for the fixed (per customer) element. An implication of this misalignment between prices and costs is that the level of profitability of a customer would be expected to increase with its size – with small customers potentially unprofitable and large customers generating large margins. A particular issue is whether the structure

of standing contract prices may make it unprofitable for new entrant retailers to serve small customers, and potentially act as a barrier to competition. The same potential problem exists for small gas customers.

Turning to geographic location, the standing contract prices for electricity are common across South Australia, even though there is the potential for costs to differ between locations (the extent of this potential is addressed further below). In addition, the Electricity Pricing Order requires a retailer that wishes to service country customers to offer the same prices as they do in the city, albeit with the ability to increase some or all of the price components by no more than 1.7 per cent.[404] Depending on the extent to which the cost to serve differs across regions, this requirement has the potential to act as a barrier to competition in higher cost areas of the state.

Notwithstanding the potential for differences in costs across regions, it is not clear whether differences in the cost to serve alone would be sufficient to make entry uneconomic in certain regions. Nor is it clear that the restriction on pricing in country areas would make these areas economic. The main difference in the cost to serve between regions relates to transmission losses, and transmission losses outside of Adelaide typically do not exceed the Adelaide loss factors by more than 3 per cent.[405]

For gas, the cost of transmission does vary materially across regions, with ESCOSA's estimates of the cost of transmission being materially higher in Port Pirie compared to Adelaide, and even higher still in Whyalla, the Riverland and Mt Gambier. However, in contrast to electricity, the standing contract prices do differ across regions, but again it is an empirical question about whether these price differences fully reflect cost differences. Accordingly, even if the standing contract prices for customers in Adelaide provide scope for new entry, a separate examination is required to confirm whether this remains the case outside of the major metropolitan area.

F.2 Results of the Commission's analysis

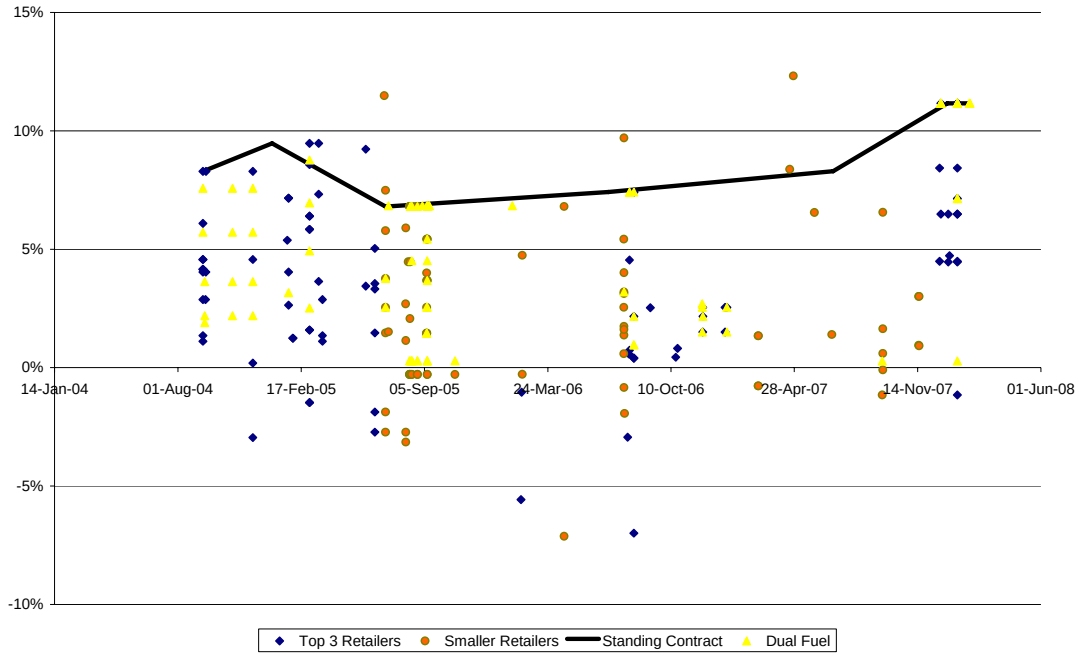
F.2.1 Base case cost assumptions

The margins that have been estimated from the data sources outlined above for both the standing contract and market contract prices are illustrated in Figure F.3 and Figure F.4 below. These margins have been estimated for average sized electricity (assumed to consume 5MWh per annum with no off-peak hot water component) and gas (assumed to consume 22 GJ of gas pa) customers.

404 This is referred to as the Country Equalisation Scheme, clause 8.2.

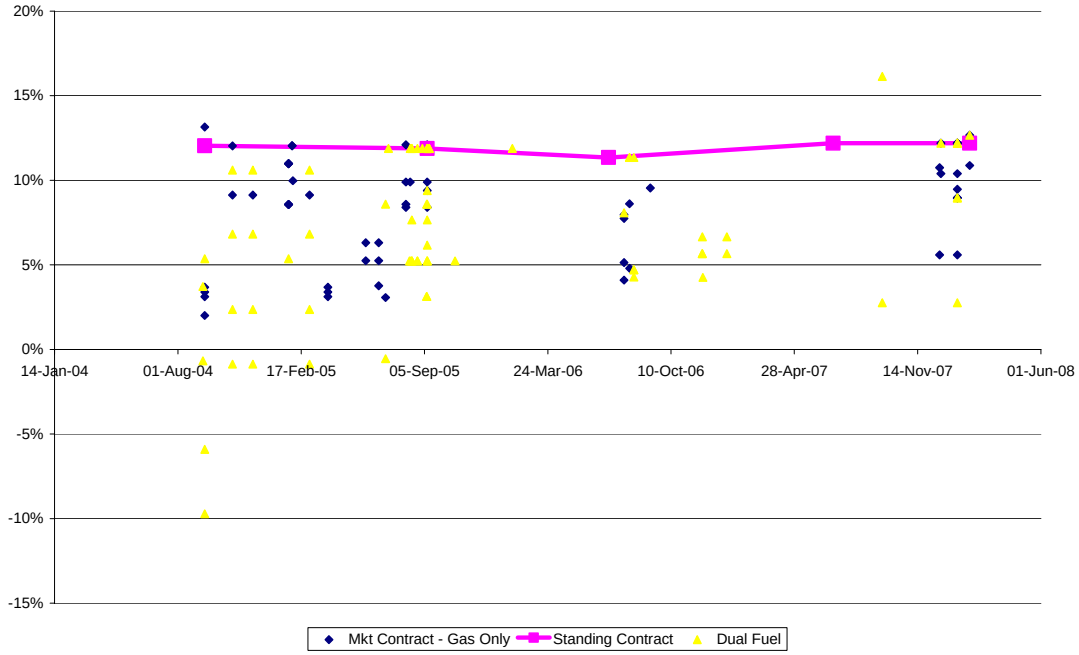
405 The loss factor for Port Lincoln has varied substantially from year to year, deeming customer losses of -7.4 per cent in 2006/07, 4.2 per cent in 2007/08 and 0 in 2008/09. Given that wholesale electricity purchase costs account for about 40 per cent of the cost of delivered electricity, even the highest of these loss factors would not have required prices to be more than 1.7 per cent higher than the price offered in Adelaide.

Figure F.3 Electricity margins – 5MWh customer, base case cost assumptions (excluding 'green' products)



Data source: Commission's analysis of data from the ESOSA Estimator.

Figure F.4 Gas margins – 22GJ customer in Adelaide, base case cost assumptions (excluding 'green' products)



Data source: Commission's analysis of data from the ESOSA Estimator.

For electricity, the margin that is implied by the vast majority of the market offers is below 7 per cent with the majority of margins being lower than 5 per cent. Taking the simple average of the margin generated across single fuel electricity offers over the period results in a 3.3 per cent margin while the average for dual fuel offers was 5.3 per cent. If all offers containing non-monetary inducements are excluded, the average margins generated across single fuel electricity offers over the period is 2.9 per cent compared to 4.3 per cent for dual fuel offers.

For gas, the implied margins were higher than electricity with the average over the period being 8.4 per cent for single fuel and 7.0 per cent for dual fuel offers. If all offers containing non-monetary inducements are excluded, the average margins for dual fuel offers falls to 6.3 per cent.

This analysis suggests that many, if not the majority, of the market offers that have been observed imply margins that are consistent with what would be observed in a competitive market for the Commission's base case cost assumptions.

Turning to the margins that are available under the standing contract prices it would appear from Figures F3 and F4 that the margin has varied over the period. Over the period the average margin available under the standing contract prices for electricity was 7 per cent which is within the range that the Commission would expect would not act as a deterrent to competitive entry. The margin available under the standing contract prices for gas retailers in Adelaide averaged almost 12 per cent over the period, which again is at a level that should not act as a deterrent to competitive entry.

F.2.2 Sensitivity analysis

The margins presented in the preceding section have been calculated on the basis that new entrant retailers' costs are the same as those estimated by ESCOSA for the host retailer. As noted previously, new entrant electricity retailers may face higher or lower wholesale electricity purchase costs than the host electricity retailer while new entrant gas retailers' are more likely to face higher wholesale and transmission costs than those faced by the host gas retailer. To account for these possibilities the Commission has assessed the sensitivity of the results presented in the preceding section to:

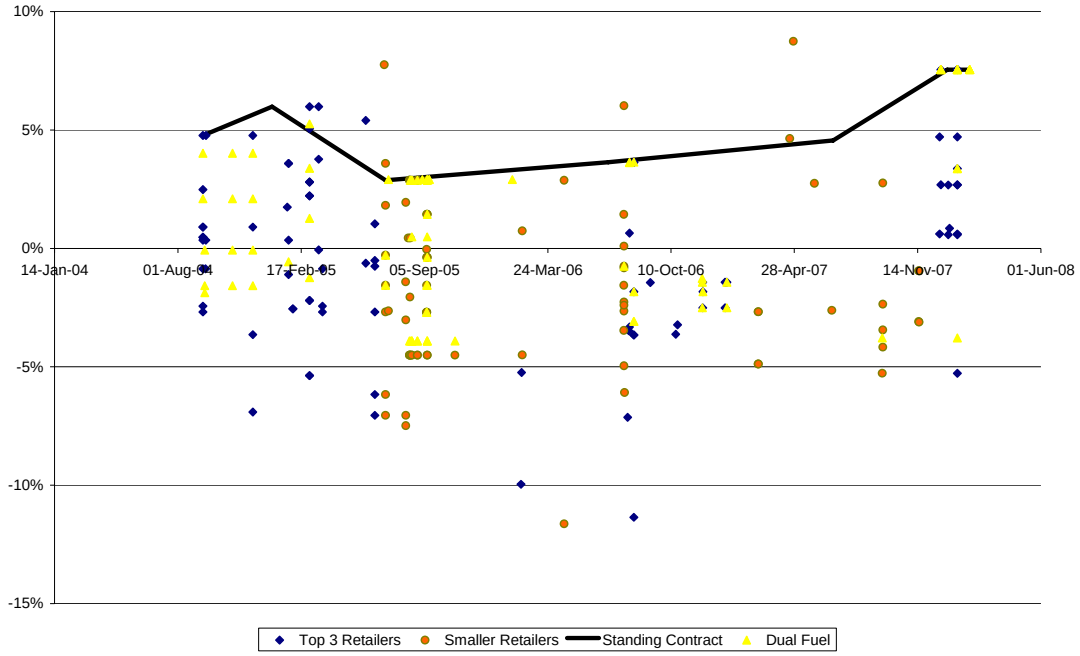
- a wholesale electricity price that is 10 per cent higher or lower than that incurred by the host electricity retailer (see Figure F.5 and Figure F.6); and

- a wholesale gas price and gas transmission costs that are 15 per cent higher than that incurred by the host gas retailer (see Figure F.1).

While the Commission has considered the sensitivity of the margin analysis to both a 10 per cent increase and decrease in wholesale electricity prices, higher rather than lower future electricity wholesale prices now appear to be more likely given the continuing tight supply/demand balance prevailing in South Australia and the prospective policies arising in response to the risks of climate change (see Chapter 3 and Appendix E). Accordingly, the estimated margins under the high energy price

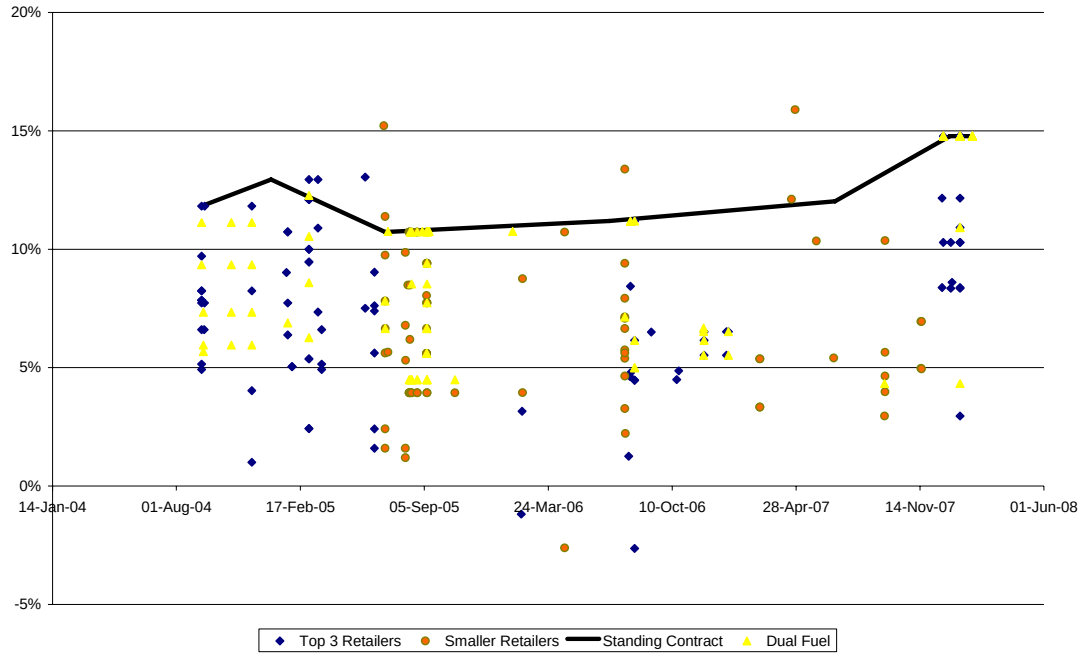
scenario are more likely to reflect current and future retail margins in the presence of the current standing offer price regulation arrangements.

Figure F.5 Electricity margins – 5MWh customer, high wholesale electricity purchase cost (excluding 'green' products)



Data source: Commission's analysis of data from the ESOSA Estimator.

Figure F.6 Electricity margins – 5MWh customer, low wholesale electricity purchase cost (excluding 'green' products)

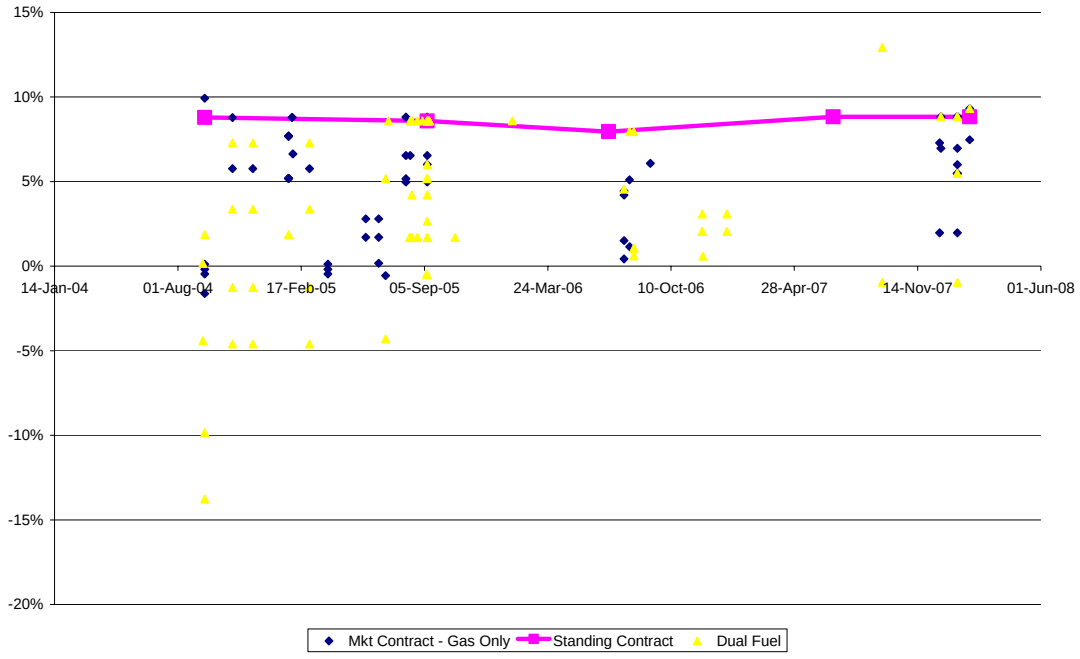


Data source: Commission's analysis of data from the ESOSA Estimator.

As Figure F.5 demonstrates, a wholesale electricity price that is 10 per cent higher than that assumed by ESCOSA implies a reduction in the average margin across the single fuel market offers from 3.3 per cent to -0.7 per cent. In contrast, a 10 per cent reduction in the assumed cost implies an increase in the measured margin from 3.3 per cent to 7.2 per cent. Under the more likely high energy price scenario, the average margin under standing contract price falls to the bottom of the benchmark range for a competitive retail market of 5 per cent. However, the average margin under market offers (single fuel offers) falls to approximately zero (-0.7 per cent). Margins of this order would be unsustainable in the competitive electricity retail market and would impose financial stress on existing retailers and deter entry by prospective new entrants. Interestingly, under the low energy price scenario, the measured margin remains within the 5 per cent to 8 per cent range that could be expected in a competitive market rather than permitting the emergence of excessive prices and profits relative to the lower assumed cost structure. This outcome would remain consistent with that expected in an effectively competitive retail market

Figure F.7 illustrates the sensitivity of the measured margins for gas assuming a 15 per cent increase in the wholesale price of gas and transmission costs. Under these assumptions the single fuel margin falls from 8.4 per cent to 5.0 per cent. These results suggest that the margins being earned by new entrant gas retailers in South Australia may be towards the lower end of the range that would be observed in a competitive market.

Figure F.7 Gas margins – 22GJ customer in Adelaide, high wholesale gas and transmission cost assumptions (excluding 'green' products)



Data source: Commission's analysis of data from the ESOSA Estimator.

F.2.3 Effect of customer size and location

The previous discussion related to the margins that are available when averaged across customers and across locations. Since some customers are more costly to serve than the average customer and the revenue received under some offers may be lower than the average, it is possible that while the standing contract prices have permitted competition for most of the customers, it may foreclose competition for part of the market.

As retailers enter the market, it would be expected that they would first seek to target the most profitable customers. However, over time one would expect that the process of competition would place pressure on margins across customers and locations to converge to efficient levels for all customer and tariff types. One would also expect that the process of competition would lead to prices offered to different customer segments reflecting the cost to the retailer of serving that segment, at least to the extent that differentiation is permitted and administratively feasible.

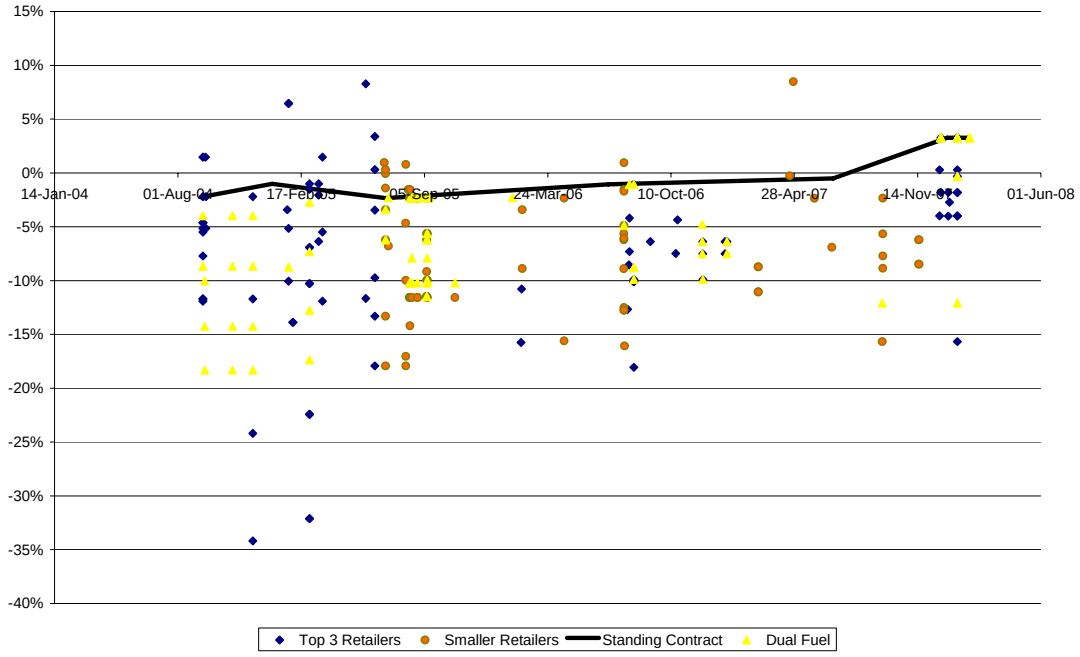
However, the potential exists for the margins available under standing contract prices to vary across customers if the cost to serve varies but a single tariff is available. Equally, margins will vary across the different standing contract prices if the average revenue that is available under the different tariff types does not mirror the average cost that retailers incur. The potential therefore exists for the average margins available under the standing contract price to be sufficient to encourage new entry, but may be insufficient and possibly foreclose competition for some customers or tariff types. The two factors considered in this context are customer size and location, which are discussed in turn below.

F.2.3.1 Customer size

The economics of serving a particular customer can be affected by a customer's level of consumption where the structure of the standing contract price is not aligned with the structure of costs incurred. Retailers face both fixed and variable costs to serve a customer. Where a tariff type is efficiently structured, retailers will be able to recover those fixed costs which are directly attributable to the customer in the fixed charge and those variable costs which are directly attributable to the customer in the variable charge. Where this is not the case there will be an impact on the profitability of some customers based on their level of consumption.

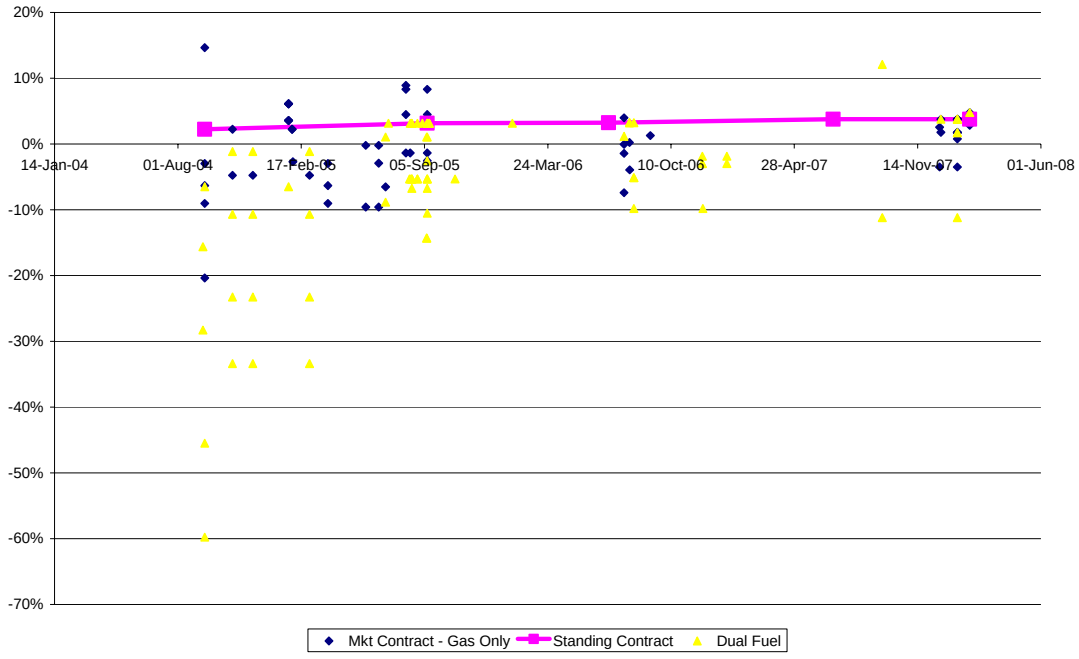
Figures F.8 and F.9 show the margins observed under market offers and standing offer prices for small electricity and gas customers, a customer who consumes 2MWh of electricity and 6 GJ of gas annually, respectively.

Figure F.8 Electricity margins – 2MWh (small) customer, base case cost assumptions (excluding 'green' products)



Data source: Commission's analysis of data from the ESOSA Estimator.

Figure F.9 Gas margins – 6GJ (small) customer in Adelaide, base case cost assumptions (excluding 'green' products)



Data source: Commission's analysis of data from the ESOSA Estimator.

Turning first to electricity, the margin that is available under the standing contract was negative over much of the period, averaging -2.4 per cent. However, the margin available under the market offer prices for these customers would have been even lower, averaging -7.4 per cent over the period. For gas, the margin available under the standing contract prices was positive, but averaged just 3.2 per cent over the period. The margins available under the market offer prices were also lower, averaging -0.1 per cent across the single fuel offers.

As noted above, the fact that margins may vary across customers, or are even negative in some instances, does not imply that those customer segments are necessarily unprofitable to serve and hence that competition is foreclosed. Rather, when assessing whether a particular customer is profitable, an efficient retailer would ensure that the revenue expected from the customer covers at least the additional (or marginal) cost incurred. To the extent that some of the costs that retailers face are fixed in nature, there is no reason for retailers to seek the same rate of contribution to these costs from each customer segment.

Accordingly, the most relevant question is whether there are customer segments where retailers would not expect to recover the marginal cost of serving those segments. While wholesale energy purchase costs and network charges would be expected to be marginal to additional customers, a substantial portion of retail operating costs are likely to be fixed and hence provide some scope for margins under the standing contract price to differ across customer segments before competition is foreclosed. Nevertheless, based on the results presented above, there

is some risk that the standing contract price may inhibit the development of competition for some customers, particularly in electricity.[406]

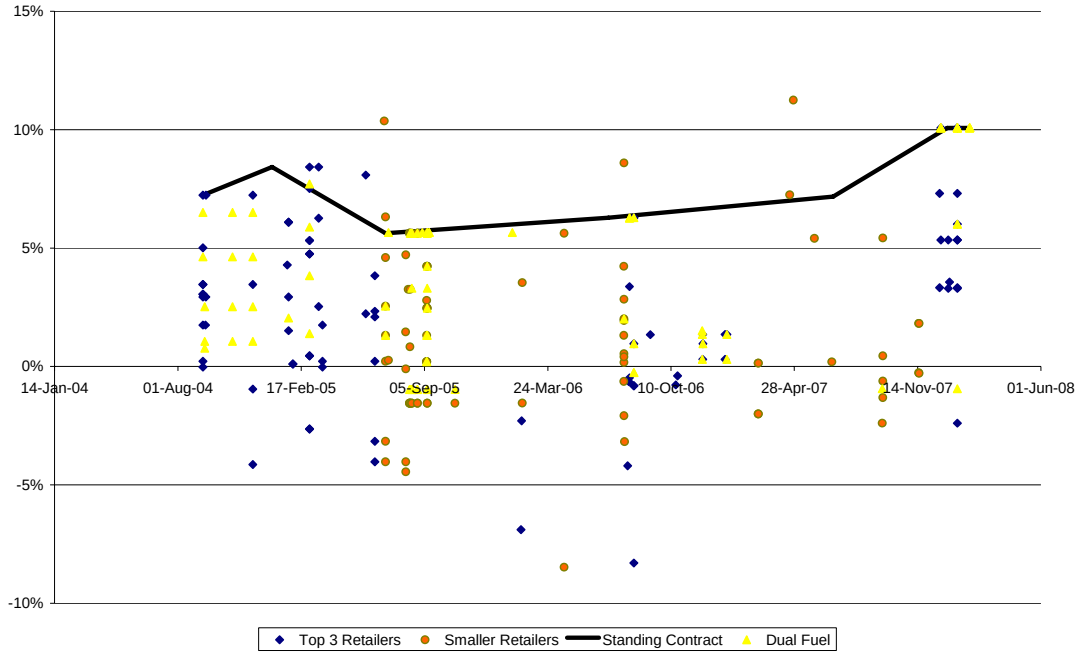
F.2.3.2 Customer location

Electricity

It was noted above that the profitability of electricity customers across South Australia may not be affected substantially by differences in the costs incurred in servicing alternative areas. In particular, it was noted that the main difference in the cost of service between regions is transmission losses, and transmission losses outside of Adelaide typically do not exceed the Adelaide loss factors by more than 3 per cent.

Figure F.10 shows the margins implied by the standing contract and market offer prices on the assumption that the relevant location has a transmission loss factor that is 3 per cent greater than in Adelaide (which equates to a 3 per cent higher wholesale electricity purchase cost).

Figure F.10 Electricity margins – 5MWh customer, 3% transmission loss factor (excluding 'green' products)



406 While the margins available under the market offer prices are even lower than those available under the standing offer, this does not mean that retailers are actively seeking customers at those prices. Rather, the survey conducted for the Commission revealed that many retailers employ sophisticated techniques to target the desirable customers, and that customer size is a key factor that retailers target.

Data source: Commission's analysis of data from the ESOSA Estimator.

The average margin available under the standing contract prices in this region is estimated to have fallen from 7.0 per cent to 6.1 per cent which, while less attractive, remains within the range that could be observed in a competitive market. Accordingly, there is no evidence that setting a single standing contract price would be expected to foreclose competition in some areas.

Gas

While the cost of serving gas differs materially across different locations – reflecting transmission charges – the standing contract prices for different regions are also allowed to vary. It is therefore an empirical question as to whether the standing contract prices differ sufficiently to permit competition in all locations. The Commission has reviewed confidential information on this issue and based on this information it would appear that the margins available in:

- Port Pirie would not be expected to deter entry;
- Whyalla are within the competitive market range; and
- Mt Gambier and the Riverland are below what would be observed in a competitive market and hence may deter entry.

The information reviewed by the Commission assumed that the cost of retailing in regional centres was the same as in Adelaide. To the extent that the costs of acquiring customers is higher in regional centres than in Adelaide then it is possible that the margins observed in these areas may be acting as a deterrent to competitive entry.

F.3 Commission's findings

The Commission recognises that estimating margins is an inherently imprecise exercise and that care must be exercised when interpreting the estimates of margins and when drawing inferences about the effectiveness of competition in the past and the likely effectiveness of competition going forward. Bearing this in mind, the Commission has considered the extent to which:

- the margins earned by retailers to date on market contracts appear to be consistent with the outcomes that would be expected in an effectively competitive market; and
- the margins available under the standing contract prices appear to have facilitated or deterred entry and competition.

The Commission's analysis of these two issues indicates that until recently:

- the margins available under both electricity and gas standing contract prices appear to have fallen within the plausible range expected in a competitive market

and have been sufficient to enable competition and profitable entry by new retailers seeking to supply the average customer; and

- in the presence of the standing contract prices competition appears to have constrained retailer market offers to be within or below the plausible range for a competitive market with electricity margins being pushed below the plausible range (i.e. 3.3 per cent versus 5-8 per cent).

It is important to recognise in this context that the foregoing analysis does not explicitly incorporate the effect of:

- variations in the costs that retailers may face across locations, tariff type or levels of consumption;

- the recent increase in the cost of acquiring wholesale electricity and risk management instruments or the increase in the level of residual risks borne by retailers which has prompted:

  – six out of ten electricity retailers and one out of four gas retailers to temporarily cease active marketing (see Appendix C);

  – prospective new entrants to postpone their plans to enter the South Australian market (see Appendix E);

  – the remaining electricity and gas retailers to reduce their marketing activity (see Appendix C);

- policies addressing climate change may have on the costs incurred by retailers going forward (see Appendix E); or

- tightening supply/demand conditions in both the wholesale electricity and wholesale gas markets (see Appendix E).

As noted in section F.2.2 electricity retailers are likely to face higher rather than lower wholesale energy costs into the future given the tightening supply/demand balance in the State and the introduction of climate change policies, including the CPRS. These policies are also likely to result in higher wholesale gas prices and if the LNG proposals in Queensland go forward, there may be further pressure on wholesale gas prices into the future. As outlined in Chapter 3, an effectively competitive energy retail market can be expected to accommodate significant changes in energy input costs so long as the standing contract prices are able to adjust to continue to provide competitive retail margins. However, if future standing contract prices, which currently provide the reference point for competitive market offers, are unable to adjust to reflect rising energy costs, the sensitivity analysis presented in section F.2.2 above suggests that retail margins would fall to such a low level that continuing retailer viability and effective competition could be placed at risk. These conditions would also be likely to deter prospective entry by new competitors.