

Review of the Effectiveness of Competition in Electricity and Gas Markets in South Australia

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INTRODUCTION

- The AEMC's role in the review of the effectiveness of competition in electricity and gas markets in South Australia is to:
 - Assess whether competition is effective in electricity and gas retailing
 - If competition is effective, provide advice to the South Australian Government and the Ministerial Council on Energy on ways to phase out retail price regulation
 - If competition is not effective, provide advice identifying ways to develop effective competition
- This public forum is an important part of the AEMC's consultation with South Australian communities

TODAY'S OBJECTIVES

Present our preliminary findings

Provide opportunity for stakeholders to ask questions

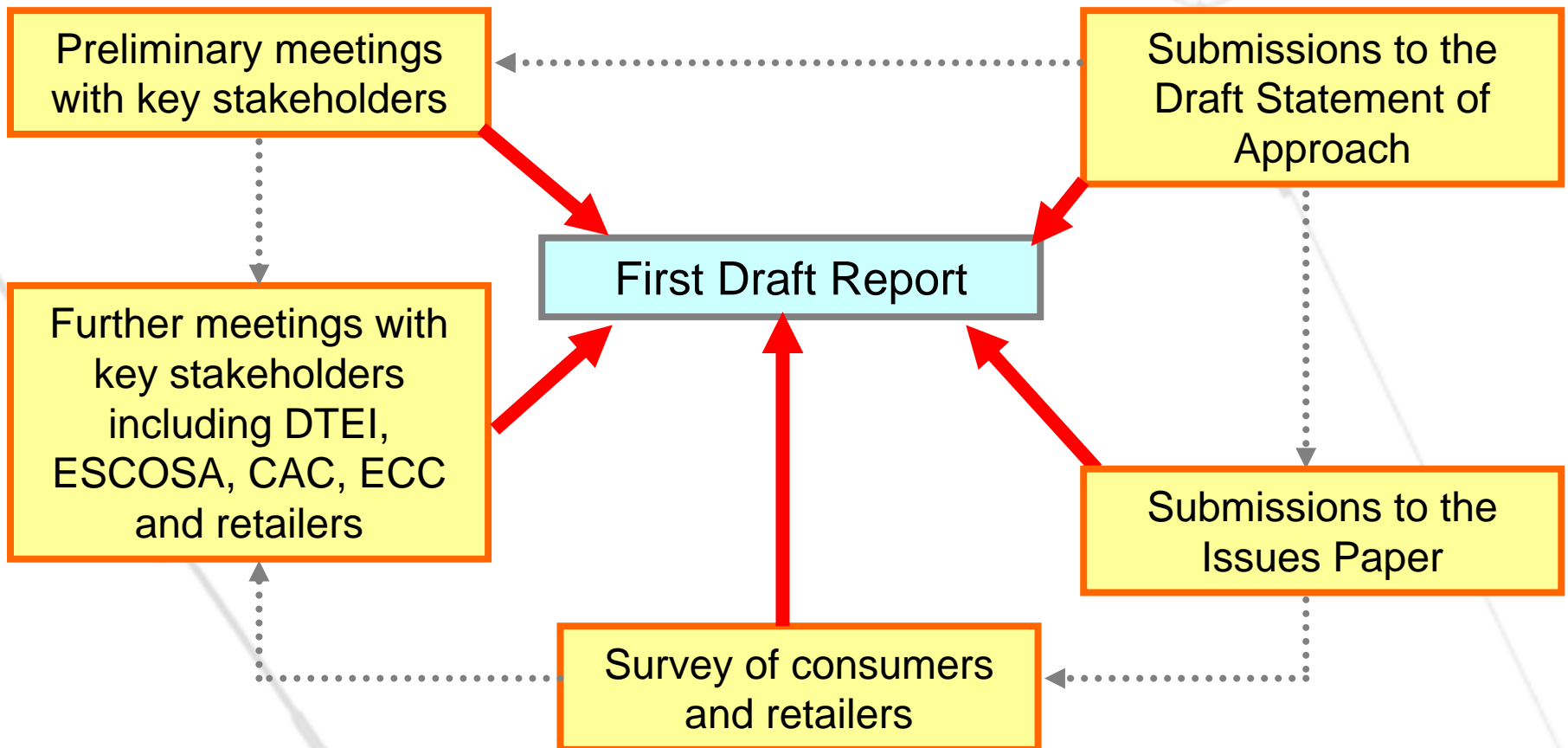
Assist stakeholders with preparing written submissions

TODAY'S AGENDA

- Overview of stakeholder involvement
- Preliminary findings about the effectiveness of retail competition
- What is effective competition?
- Evidence in support of the preliminary findings
- Future of energy retailing
- Review and questions
- Process for consultation on First Draft Report

STAKEHOLDER INVOLVEMENT

Extensive consultation with stakeholders to date



STAKEHOLDER INVOLVEMENT

- **Ongoing dialogue with key stakeholders**
 - DTEI, ESCOSA, Consumer Advisory Council, Energy Consumers' Council, energy retailers
- **Consumer Survey**
 - Representative telephone survey of 1,200 residential customers and 650 small business customers throughout South Australia
 - Focus groups with residential and small business customers
 - Two groups in Mt Gambier
 - Two groups in Whyalla
 - Four groups in Adelaide
- **Retailer Survey**
 - Quantitative and qualitative survey of 12 energy retailers licensed in South Australia and two additional energy businesses

LICENSED RETAILERS 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	✓	✓	✓	✓

PRELIMINARY FINDINGS

Competition is effective for small electricity and natural gas customers in South Australia, although relatively more intense in electricity than gas

- Strong rivalry between energy retailers competing on price and non-price offers
- Redistribution of customer share amongst retailers
- High level of customer awareness of FRC
- Customers willing to respond to offers when approached by retailers
- High levels of customer satisfaction

PRELIMINARY FINDINGS

- Stakeholders identified concerns with liquidity of electricity contract market and structure of wholesale electricity market
- Some structural limitations affecting the ability of regional gas customers to access the full benefits of competition
 - Affects approximately 4.5% of all SA gas customers
- Competitive energy retail market should accommodate prospective increases in energy costs if prices allowed to respond

WHAT IS EFFECTIVE COMPETITION?

- Informed customers “shopping around” and exercising choice based on price and service quality
- Strong rivalry between retailers to attract and retain customers by improving service quality and offering cost-reflective prices
- Entry conditions allow new retailers to participate freely in the market, increasing competitive pressure on competitors
- Retailers earn no more than competitive margins
- Prices respond flexibly to reflect changes in costs and market conditions

OVERVIEW OF ENERGY RETAIL COMPETITION IN SA

Active customer participation

- High awareness of FRC
- High rates of switching amongst electricity and metropolitan gas customers
- Customers respond to retailer contact rather than market search due to homogeneous/commodity nature of energy

Profit margins not inconsistent

- Margins under electricity and gas market contracts consistent with competitive market outcomes to date
- Recent increases in wholesale energy costs may have reduced available margins

Retail Competition

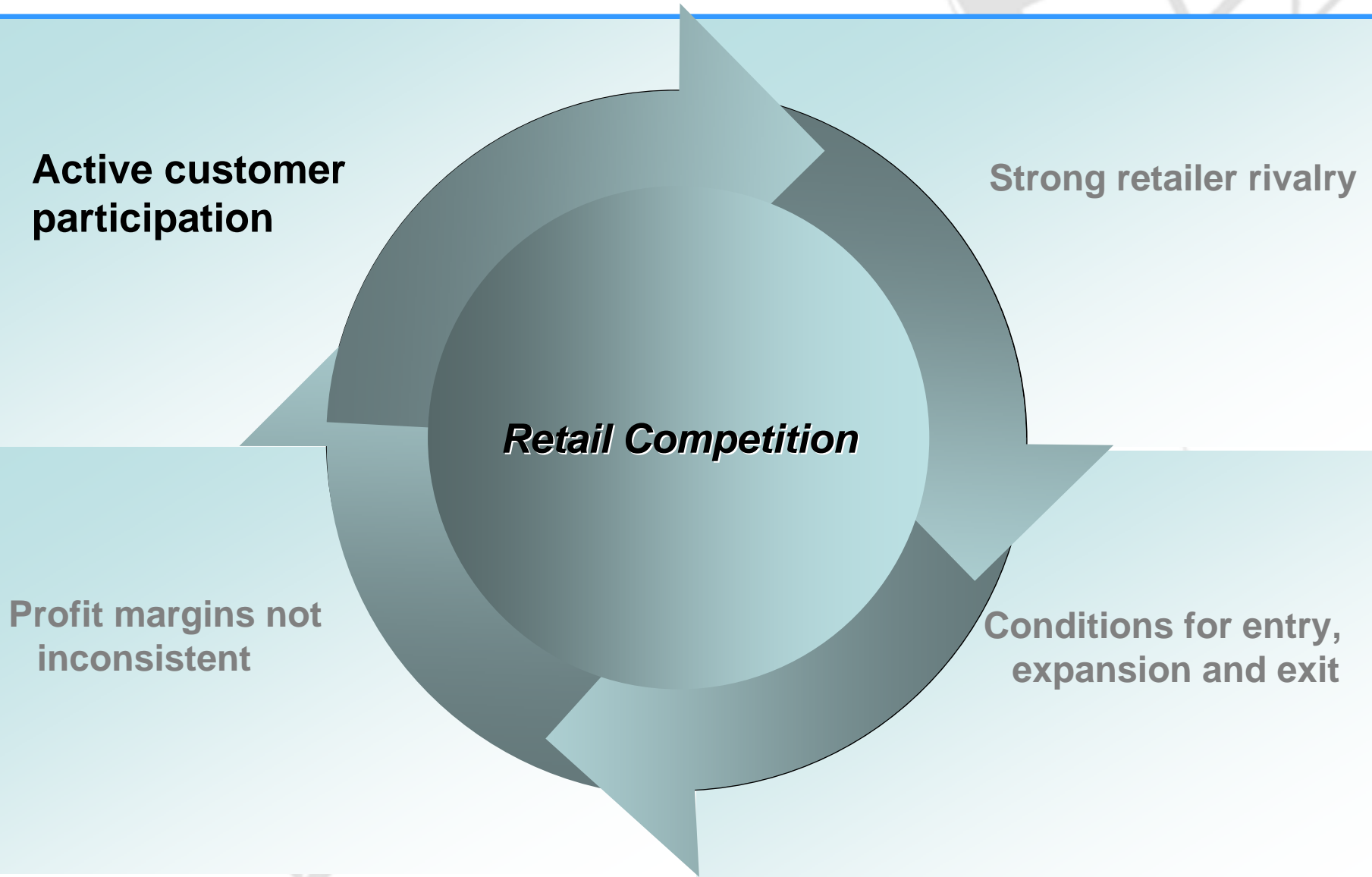
Strong retailer rivalry

- Evidence of active direct marketing by all retailers
- Price discounts, non-price benefits and green energy widely offered
- New retailers eroding customer bases of hosts
- Competition for gas driven by dual fuel

Conditions for entry, expansion and exit

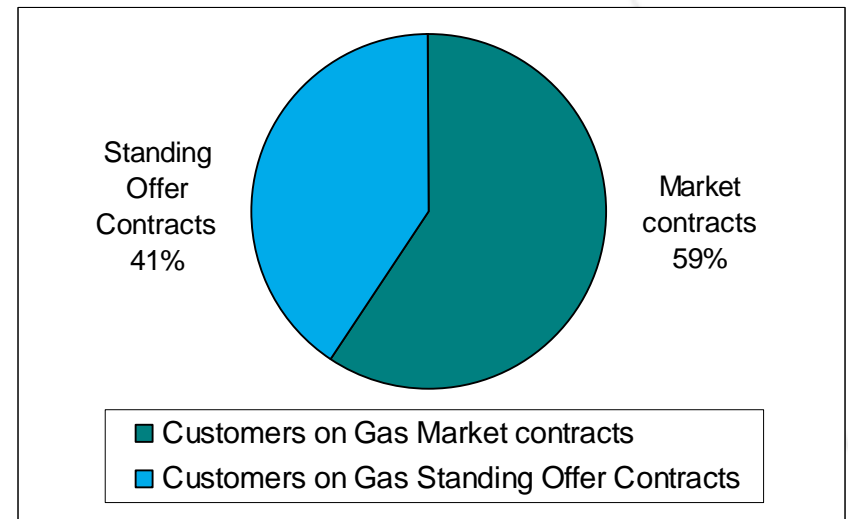
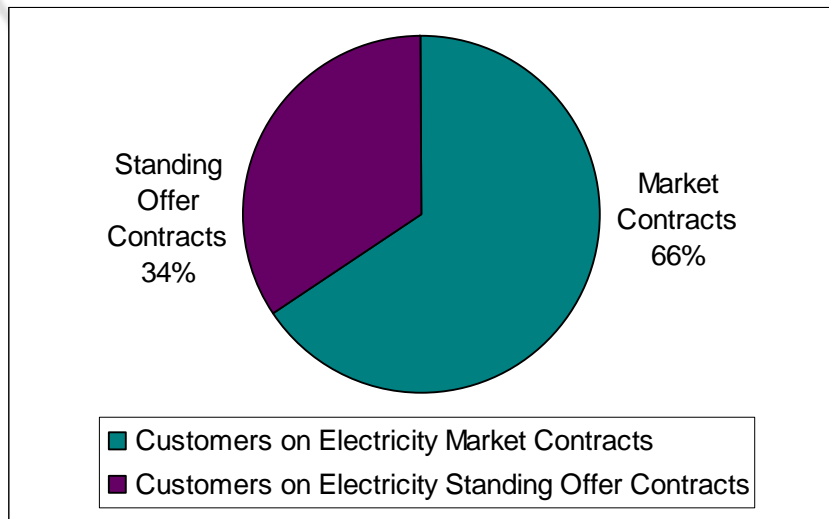
- Entry and expansion of new retailers has fostered competition
- Few barriers to entry for small electricity retailers
- Structural issues limit competition for regional gas customers

OVERVIEW OF ENERGY RETAIL COMPETITION IN SA



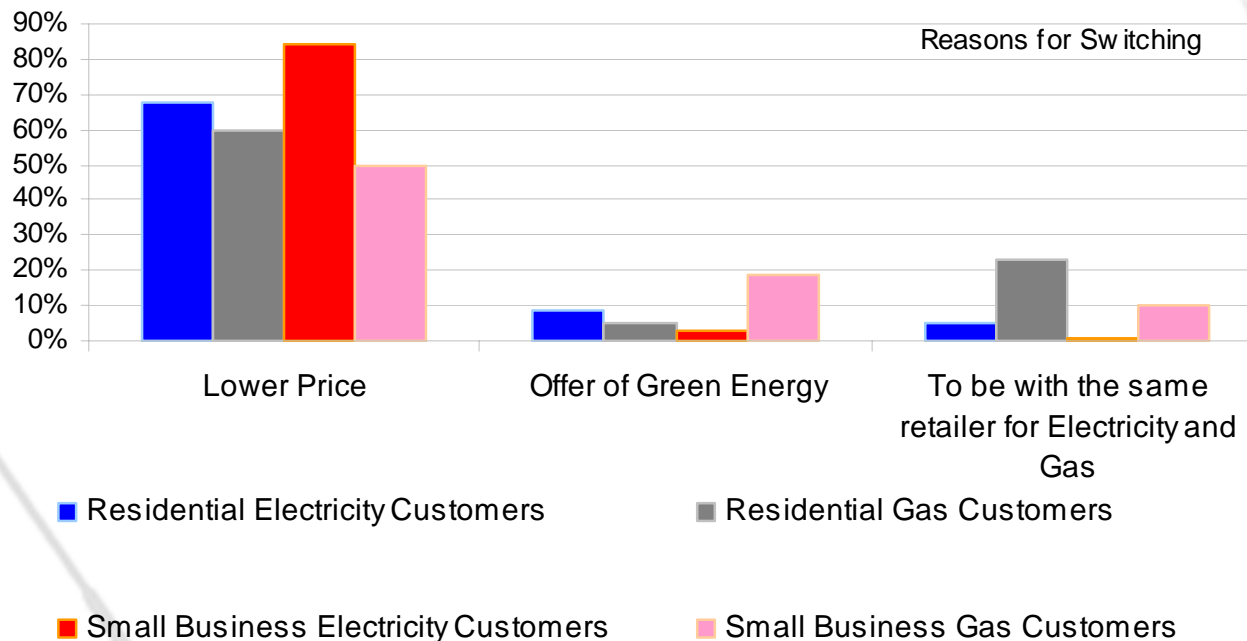
ACTIVE CUSTOMER PARTICIPATION

- High levels of awareness of FRC
 - 82% electricity and 84% gas for residential customers
 - 70% electricity and 78% gas for small business customers
- Large numbers of electricity and metro gas customers willing and able to switch



ACTIVE CUSTOMER PARTICIPATION

- Lower price the main driver for switching
 - As high as 84% for small business electricity customers
- Green energy or single retailer for dual fuel also important



ACTIVE CUSTOMER PARTICIPATION

- High proportion of customers quite or very satisfied with switching outcomes
 - 80% of residential customers
 - 70% of small business customers
- Main reason for not switching was that the respondent was happy with their current retailer
 - 72% of residential customers
 - 55% of small business customers
- Respondents generally considered that information about energy offers was easy to obtain, useful and easy to understand
- Small business customers had more difficulty comparing offers than householders

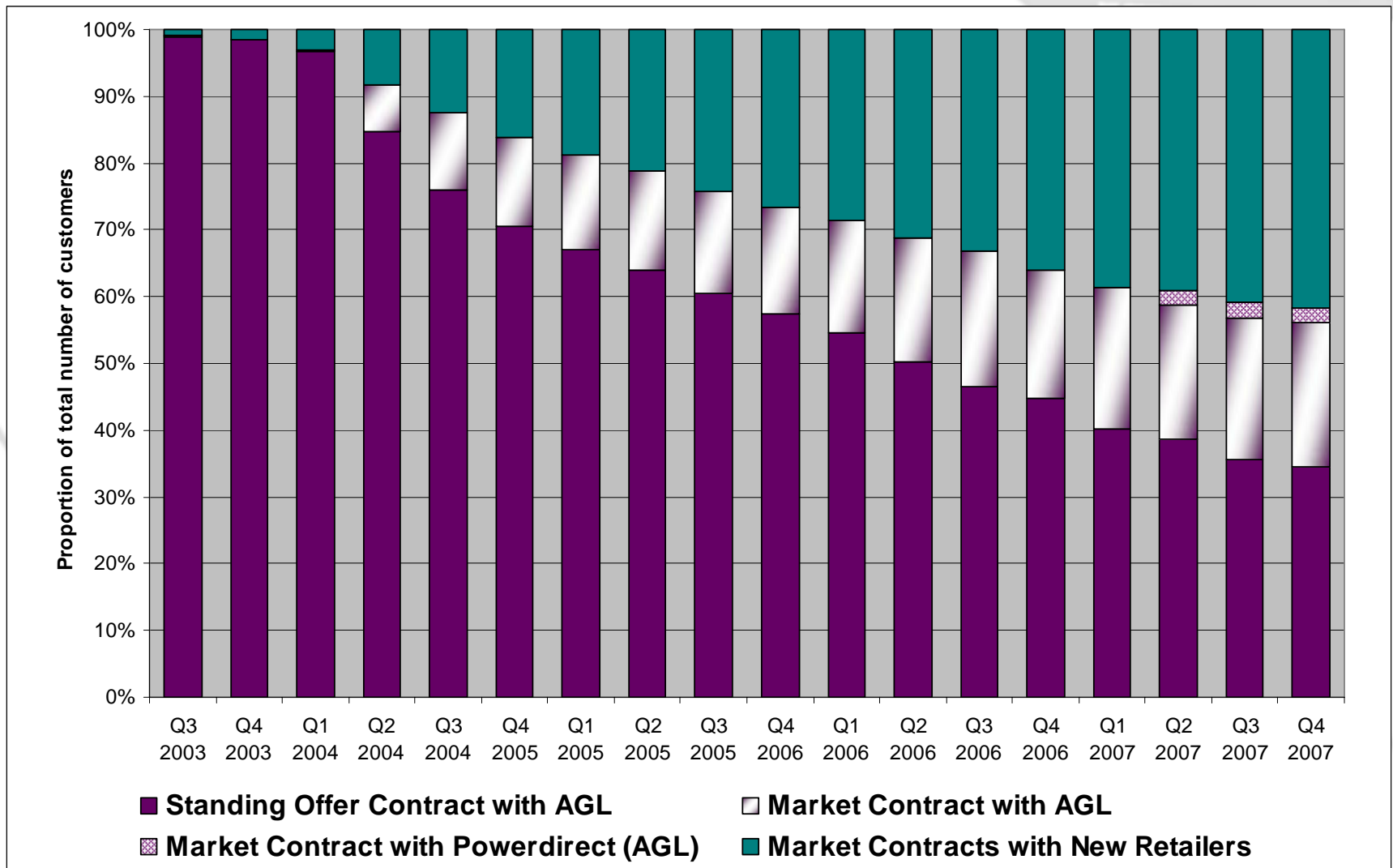
OVERVIEW OF ENERGY RETAIL COMPETITION IN SA



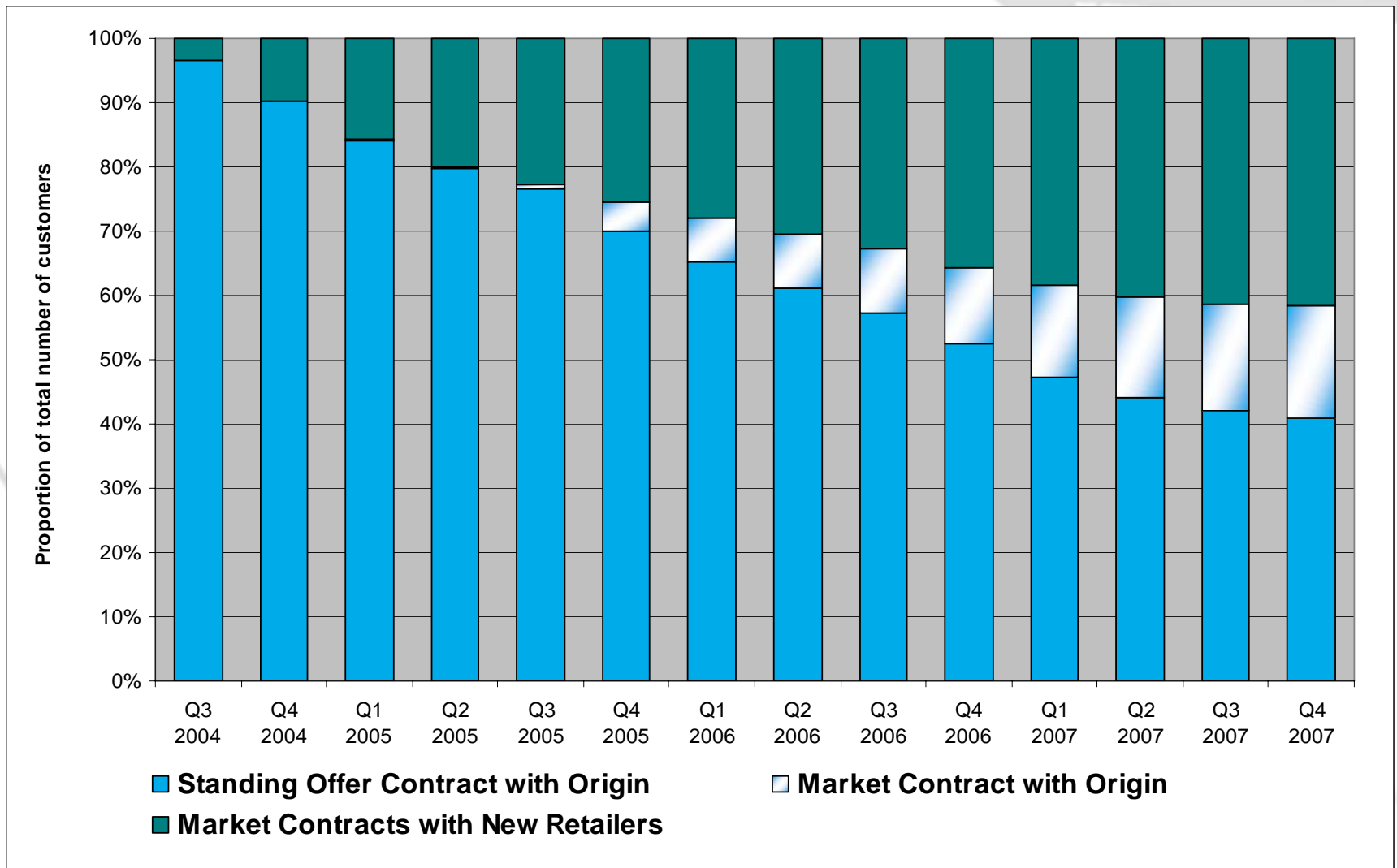
STRONG RETAILER RIVALRY

- Evidence of active marketing by retailers
- Direct marketing the principal means of contacting customers
 - Energy seen as a low-involvement commodity
 - Small customers are unlikely to actively search for better offers
- Retailers have an incentive to actively market their products
 - TV and radio used more often by larger retailers
 - Smaller retailers may use to launch a brand or product
 - Gas generally marketed as an “add on” to electricity
- New retailers have eroded the customer base of each host retailer, now supplying 42% of all small customers

MARKET SHARE OF ELECTRICITY RETAILERS



MARKET SHARE OF GAS RETAILERS



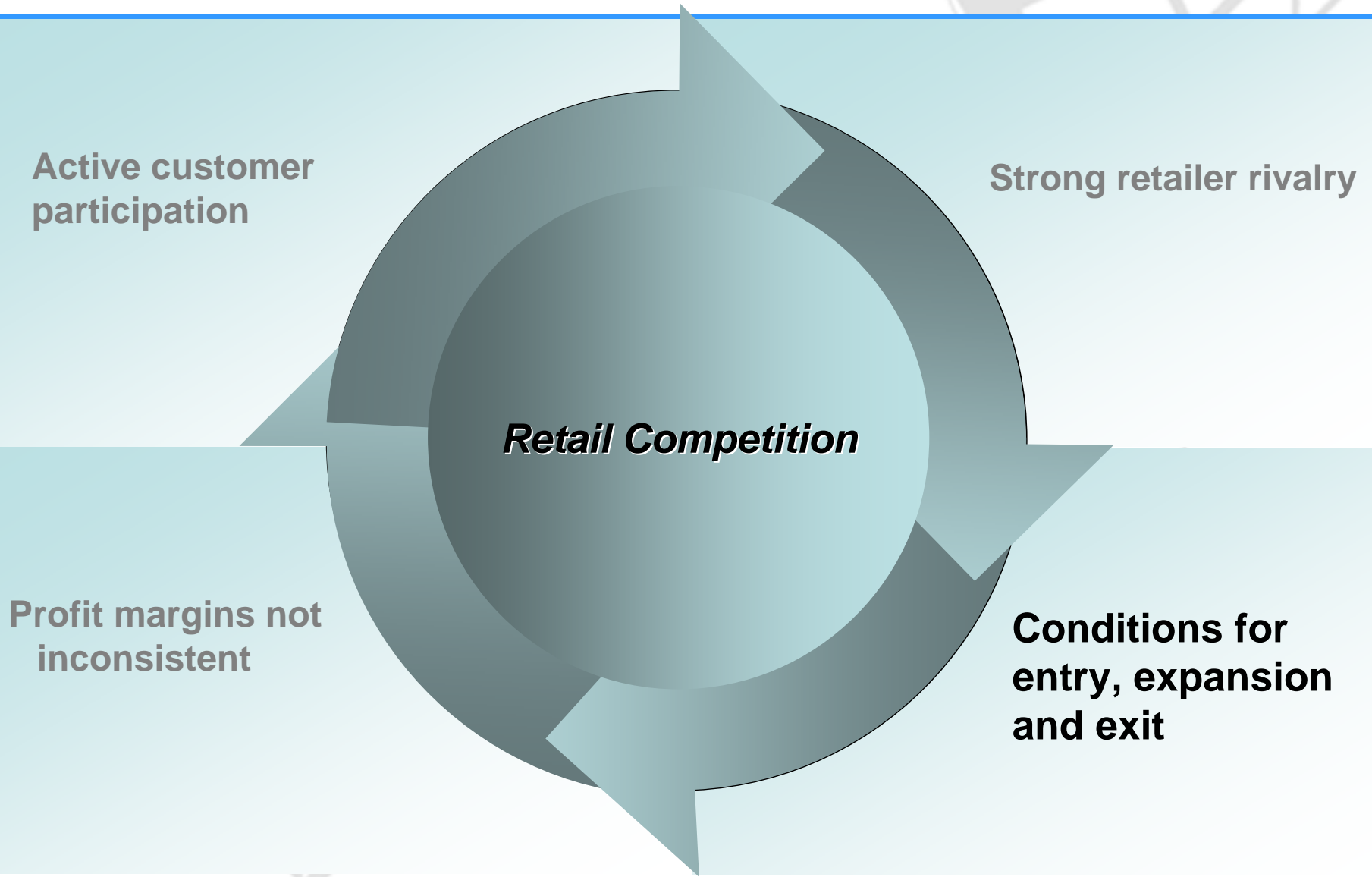
STRONG RETAILER RIVALRY

- Market contracts offer up-front discounts off standing contract prices
 - Up to 7% for residential electricity offers
 - Up to 4% for residential gas offers
 - Other discounts include pay-on-time discounts, direct debit discounts
- Retailers also compete on non-price discounts and incentives
 - Prepayment products
 - All retailers offer some form of green/renewable energy
 - Non-price incentives (e.g. club memberships, magazine subscriptions)
 - 7 electricity retailers and 4 gas retailers offered incentives in 2007

STRONG RETAILER RIVALRY

- Incentives offered changing over time
 - Consumer preferences and retailers' marketing strategies
 - Value of non-price incentives varies – average 5% of value of bill
- No evidence that mis-selling is widespread or systemic
 - Incentive for retailers to address issues to minimise compliance costs and maintain reputation
- Some retailers have ceased actively marketing to acquire customers due to increased input costs

OVERVIEW OF ENERGY RETAIL COMPETITION IN SA



ENTRY, EXPANSION AND EXIT

- Retailers of all sizes have been able to enter
 - Currently 10 electricity retailers and 4 gas retailers
- Few barriers to entry for small electricity retailers
 - Ability to outsource systems may have assisted entry
 - Entry into electricity characterised by small scale “pure” retailers and larger, vertically integrated “gentailers”
- Future electricity entry and expansion more difficult without vertical integration
 - Rising spot market and forward contract prices
 - Increased prudential obligations and working capital requirements

ENTRY, EXPANSION AND EXIT

- Entry into gas retailing easier on a larger scale
 - Large sunk costs to establish supply and transmission contracts
- Dual fuel products are important to success as a gas retailer
 - Marketing gas as an “add on” helps overcome scale limitations
- Upstream gas market structure restricts access to regional gas customers for new retailers
 - Firm capacity on MAPS laterals
 - Price of access to services on SESA Pipeline

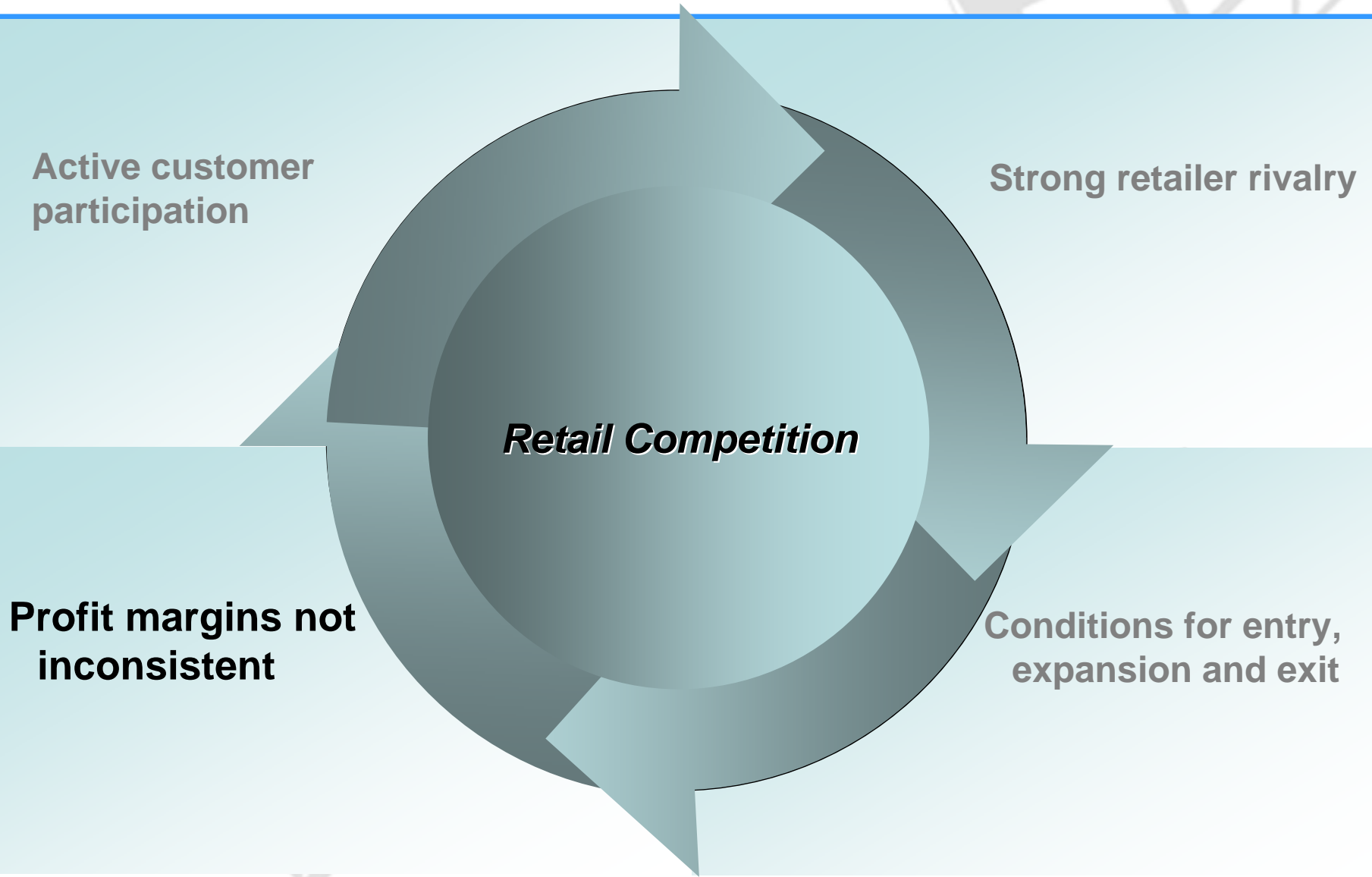
ENTRY, EXPANSION AND EXIT

- Impact of regulatory obligations
 - Standing contract price has become the focal point for competition
 - Ability of price regulation to keep pace with changing costs
- Regulatory compliance and consistency
 - Current legislative environment undergoing significant changes e.g. ETS and MRET
 - Introduction of new regulatory obligations e.g. Residential Energy Efficiency Scheme
 - Regulation of points of differentiation e.g. service standards

WHOLESALE ELECTRICITY MARKET CONDITIONS

- Concerns raised by stakeholders about liquidity of the contract market
 - Effects of spot price volatility
 - Impact of Heywood Interconnector de-rating
 - Increased prudential obligations and working capital requirements
- Bidding strategy of Torrens Island Power Station (TIPS)
 - AER investigation into rebidding behaviour in January/February
- Some participants expressed concerns about the impact of these issues on competition in the electricity retail market
- The AEMC will continue to assess further comments and information on TIPS/contracts market liquidity in coming to the final conclusions

OVERVIEW OF ENERGY RETAIL COMPETITION IN SA



PROFIT MARGINS

- Prices tend to converge towards the efficient economic cost of delivery where competition is effective
- One indicator of competition is whether revenue earned by retailers on market offers is consistent with the economic cost of delivery
- The AEMC considered margins under:
 - Standing contract; and
 - Market offers to residential customers
- Based on publicly available information and estimates of efficient cost of serving SA customers
- Inadequate response from some retailers to request for input cost data

PROFIT MARGINS

- Based on historic costs, “base case” margin analysis
 - Standing contract margins **within** those expected in competitive range
 - Gas market contract margins **within** competitive range
 - Electricity market contract margins **below** competitive range
- Sensitivity analysis to reflect prospective rising costs (given standing contract prices)
 - Market contract margins **below** competitive range
 - In case of electricity, margin is **negative**
- If margins can adjust in future to maintain competitive margins, viability / competition can be sustained

PROFIT MARGINS

Analysis (based on historic costs)		Margin within competitive range?
Base case	Electricity standing contract	Yes
	Gas standing contract	Yes
	Electricity market contract	No
	Gas market contract	Yes
Sensitivity analysis (rising input costs)	Electricity market contract	No – negative
	Gas market contract	No

- If margins can adjust in future to maintain competitive margins, viability / competition can be sustained

FUTURE OF ENERGY RETAILING

- Energy sector entering a period of transition
 - Tightening supply/demand balance
 - Rising energy input costs
 - Rising world oil and gas prices
 - Development of climate change policies
- These factors likely to change the real cost of inputs, impacting on cost structures
- However, effective competition can be expected to accommodate these changes provided retail prices can adjust

ISSUES FOR COMMENT AND QUESTIONS

- What is effective competition?
- Preliminary findings about the effectiveness of retail competition
 - Competition is effective for electricity and gas but relatively more intense in electricity than in gas
 - Consumer experience - awareness and participation
 - Retailer rivalry - marketing activity, price and non-price benefits
 - Conditions for entry, expansion and exit - entry of new retailers
 - Some structural limitations affecting regional gas customers
 - Stakeholders identified some issues of concern re wholesale electricity market

REVIEW AND QUESTIONS

Active customer participation

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REVIEW AND QUESTIONS

- Future of energy retailing
 - Emerging competitive risks and cost pressures
 - Narrowing retail margins
 - Cost changes can be accommodated if retail prices can adjust
- We welcome your comments and questions

PUBLIC CONSULTATION

Submissions due 13 August 2008

- AEMC welcomes views on all matters relevant to its preliminary findings
- Stakeholders may wish to address the effect of the following on retail competition:
 - Structure of wholesale electricity market
 - Current price regulation framework
 - Ability of price regulation to respond to changes in input costs
 - Access prices to the SESA Pipeline
 - The ability for new gas retailers to supply regional gas customers
 - Commerciality of regional gas customers

TIMETABLE

- September – Publish First Final Report
- October – Publish Second Draft Report
- November – Submissions on Second Draft Report due
- December – Publish Second Final Report