



Australian Energy Market Commission

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

Second Draft Report

14 October 2008

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## **About the AEMC**

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy markets. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market and, from 1 July 2008, concerning access to natural gas pipeline services and elements of the broader national gas markets. The AEMC is a statutory authority. Its key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council on Energy as requested, or on AEMC initiative.

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## Foreword

Changing economic and market conditions and new economic policy settings are an ongoing reality for the Australia's energy market. We now face the prospect of significant increases in energy costs due to a tightening of the balance of supply and demand, requirements for new generation and network investment and the impact of prospective climate change policies.

Promotion of competitive energy markets continues to be the most effective means of providing flexible and timely responses to such changes. Consistent with the underlying premise of energy policy, Australia's energy markets have demonstrated that effective competition between energy producers and retailers and, where necessary, effective regulation of monopoly networks will deliver efficient, reliable and safe supplies of energy, and maintain the balance between energy supply and demand over the long term.

Against this background, the Australian Energy Market Commission (Commission) is reviewing the effectiveness of competition in electricity and natural gas retail markets in each jurisdiction in the National Electricity Market and advising on whether to retain, remove or reintroduce retail price regulation. The reviews, are an important contribution towards implementation of the Council of Australian Government program of the national energy market reform.

The Commission completed its assessment of the effectiveness of retail energy competition in South Australia in September 2008, finding that competition is effective for small electricity and natural gas customers.

In this report, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – Second Draft Report* (Second Draft Report), the Commission provides its draft advice on ways to remove retail price regulation such that competition has the flexibility to deliver prices that reflect the efficient costs of energy supply while continuing to protect the interests of consumers.

The Commission has conducted its own analysis of ways in which retail price regulation could be removed and of the accompanying oversight arrangements that will be needed to ensure that the interests of consumers continue to be protected. It recognises, however, that market participants, consumer representatives, industry bodies and market experts will have interests in and comments to offer on the Commission's draft advice. The Commission wants to hear and respond to these views in finalising its recommended actions in its Final Report. In publishing the Second Draft Report, the Commission now commences a period of public consultation and encourages all stakeholders and interested parties to participate in this process.

John Tamblyn  
Chairman  
for and on behalf of the  
Australian Energy Market Commission

## Contents

Foreword .....	iii
Abbreviations.....	vi
Executive Summary .....	viii
1 Purpose of the Second Draft Report .....	1
1.1 Provide draft advice on the future of retail price regulation .....	1
1.2 Invite stakeholders to comment on the draft advice .....	2
2 Framework for Developing Advice .....	5
2.1 Findings from the Commission’s First Final Report .....	5
2.2 The benefits of competitive markets.....	6
2.3 Criteria for developing the Commission’s advice .....	7
2.4 Key design features.....	13
3 Regulating Retail Prices in South Australia.....	15
3.1 Legislative framework for retail price regulation.....	15
3.2 ESCOSA’s price regulation role.....	16
3.3 Existing price determinations.....	17
3.4 Evaluating the existing regulatory framework .....	23
4 Advice on the Removal of Retail Price Regulation.....	31
4.1 Summary of the Commission’s draft advice .....	31
4.2 Obligation to agree to supply and sell to apply to the FRMP .....	33
4.3 Retailers set and amend their own standing contract prices.....	34
4.4 Price monitoring role for ESCOSA.....	38
4.5 Introduction of a conditional reserve pricing power .....	42
4.6 Additional competition reviews by the AEMC.....	43
4.7 AEMC review after three years on the effectiveness of the framework and the form of regulation that should apply .....	44
4.8 Commission’s observations .....	44

5	Consequential Amendments Following the Removal of Retail Price Regulation .....	47
5.1	Pricing the Energy Obligation .....	47
5.2	Default contract pricing.....	49
5.3	Pricing energy sold following a RoLR event .....	51
5.4	Consumer awareness and education.....	52
6	Assessing South Australia's Compliance with the AEMA .....	55
6.1	Obligations against which compliance is to be assessed .....	55
6.2	Assessment of South Australia's compliance with the AEMA .....	56
A	Framework for Retail Price Regulation in South Australia .....	61
A.1	Overview .....	61
A.2	Standing contract prices and price setting .....	62
A.3	Market contracts .....	71
A.4	Default contracts.....	72
A.5	Electricity Pricing Order .....	73
A.6	Obligation to supply .....	73
A.7	Retailer of Last Resort.....	74

## Abbreviations

AEMA	Australian Energy Market Agreement
AEMC	see Commission
AER	Australian Energy Regulator
AGL	AGL Energy
CES	Country Equalisation Scheme
Commission	Australian Energy Market Commission
CPI	Consumer Price Index
CPRS	Carbon Pollution Reduction Scheme
CSO	Community service obligation
ECRD Act	<i>Electricity Corporations (Restructuring and Disposal) Act 1999 (SA)</i>
EDPD	<i>ESCOSA, 2005-2010 Electricity Distribution Price Determination, April 2005</i>
EEPS	Emergency Electricity Payment Scheme
Electricity Act	<i>Electricity Act 1996 (SA)</i>
Electricity Price Determination 2007	<i>ESCOSA, 2007 Electricity Standing Contract Price: Final Inquiry Report and Final Price Determination, November 2007</i>
Energy Price Disclosure Code	<i>Energy Price Disclosure Code, made by ESCOSA under section 28 of the ESC Act</i>
Energy Retail Code	<i>Energy Retail Code made by ESCOSA under section 28 of the ESC Act</i>
EPO	Electricity Pricing Order 1999
ESC Act	<i>Essential Services Commission Act 2002 (SA)</i>
ESCOSA	Essential Services Commission of South Australia
ESIPC	Electricity Supply Industry Planning Council
First Final Report	<i>AEMC, Review of the Effectiveness of Competition in Electricity and Gas Markets in South Australia – First Final Report, 19 September 2008, Sydney</i>
FRC	Full retail competition
FRMP	Financially responsible market participant
Gas Act	<i>Gas Act 1997 (SA)</i>
Gas Price Determination 2008	<i>ESCOSA, 2008 Gas Standing Contract Price: Final Inquiry Report and Final Price Determination, June 2008</i>

Industry Acts	Together, the Electricity Act and the Gas Act
MAPS	Moomba to Adelaide Pipeline System
MCE	Ministerial Council on Energy
MWh	Megawatt hours
NCF Policy Paper	Ministerial Council on Energy Standing Committee of Officials, <i>A National Framework for Regulating Electricity and Gas (Energy) Distribution and Retail Services to Customers: Policy Response Paper</i> , June 2008, Canberra
NCP	National Competition Policy
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
New retailer	A retailer that is not a standing contract retailer
Energy Obligation	The obligation borne by the standing contract retailer to agree to (as appropriate) supply electricity under section 36AA(2) of the Electricity Act or sell and supply gas under section 34A of the Gas Act
OECD	Organisation for Economic Co-operation and Development
Origin	Origin Energy
RoLR	Retailer of Last Resort
RoLR Guideline	<i>Retailer of Last Resort Pricing Guideline - Electricity Industry Guideline No. 8</i> , made by ESCOSA under section 28 of the <i>Essential Services Commission Act 2002</i>
SCO	Standing Committee of Officials
Second Draft Report	AEMC, <i>Review of the Effectiveness of Competition in Electricity and Gas Markets in South Australia – Second Draft Report</i> , 14 October 2008
SESA Pipeline	South East South Australian Pipeline
South Australian Review	Review by the Commission of the effectiveness of competition in electricity and gas retail markets in South Australia
Standing contract retailer	A retailer declared to be an entity to which section 36AA of the Electricity Act or section 34A of the Gas Act applies. In the case of electricity this is AGL Energy and, for gas, Origin Energy
TJ	Terajoule
Victorian Review	Review by the Commission of the effectiveness of competition in electricity and gas retail markets in Victoria

## Executive Summary

In accordance with the terms of the Australian Energy Market Agreement (AEMA) and terms of reference issued by the Ministerial Council on Energy (MCE), the Australian Energy Market Commission (Commission) is reviewing the effectiveness of competition in electricity and natural gas retail markets in the National Electricity Market (NEM). If it finds competition is effective, the Commission is required to advise on ways to remove retail price regulation. Where competition is found not to be effective, the Commission's advice must identify ways to develop effective competition.

In September 2008, the Commission publicly reported its assessment of retail competition in South Australia, concluding that competition is effective for small electricity and natural gas customers, although relatively more intense in electricity than in gas.<sup>a</sup> The Commission's finding was based on evidence that competition has been effective in constraining retailers' prices to reflect real input costs and that margins were at or below competitive levels. However, the Commission foreshadowed that increasing energy costs and prices due to the tightening supply/demand balance and the introduction of climate change policies could impede the effectiveness of competition in the future unless standing and market contract prices were sufficiently flexible to accommodate future cost increases. It noted that the regulated standing contract price had become a constraint on such market price responses.

Having concluded its assessment of competition, the Commission is now required to provide advice to the Government of South Australia and the MCE about the future of retail price regulation. This report, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – Second Draft Report* (Second Draft Report), sets out the Commission's draft advice on that matter.

In light of its finding that competition is effective, and in the absence of evidence before it of sustained market power, the Commission has concluded that retail price regulation should not be continued in South Australia and should be replaced by competitive market pricing accompanied by a comprehensive price monitoring regime and a reserve power to re-impose price regulation should competition deteriorate in future.

In developing its draft advice, the Commission has had particular regard to the competitive outcomes in the South Australian energy retail sector. While competition has kept market contract prices in line with real costs of supply and margins at or below competitive level, in recent times, the regulation of standing contract prices has prevented retailers from passing through rising costs. Price regulation has also eroded margins, thus impeding competitive activity. While there is currently some capacity for the South Australian regulator, the Essential Services

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<sup>a</sup> AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – First Final Report*, 19 September 2008.

Commission of South Australia (ESCOSA) to adjust standing contract prices to reflect some change real input costs, the process is restrictive, time consuming and information intensive. The significant changes to energy markets now in prospect are likely to involve increasing energy costs and retail energy prices in the coming years. Even if increased flexibility to pass through cost increases could be introduced into the regulatory arrangements, retaining direct price regulation by the regulator in a rapidly changing and uncertain future regulatory environment is likely to harm the viability of existing retailers, discourage entry and impede the effectiveness of energy retail competition.

Under the price monitoring and reporting approach recommended by the Commission, each standing contract retailer and each new retailer would be required to determine and publish a standing contract price that is available to small customers at each connection point for which that retailer is the financially responsible market participant (FRMP). The published prices, and published default contract prices, would form the basis of a half-yearly monitoring report prepared by ESCOSA. By reporting on changes in standing and default contract pricing trends, ESCOSA's monitoring reports would contribute important information about the continued competitiveness of energy retailing in South Australia. Where there was evidence that competition had substantially deteriorated, it would be open to the South Australian Government to exercise a reserve power to re-impose price regulation following an expedited review and recommendations to that effect by the AEMC. The specific recommendations contained in the Commission's draft advice, summarised in Box ES.1 below, are explained in detail in Chapter 4.

In light of its principal recommendation that retail price regulation be replaced by a price monitoring regime, the Commission has prepared draft advice about the consequential amendments necessary for the pricing of default contracts and electricity supplied following a retailer of last resort (RoLR) event. This draft advice is contained in Chapter 5.

In accordance with the requirements of the AEMA, the Commission has also reviewed South Australia's energy-specific community service obligations (CSOs) to determine whether they materially impede competition. The Commission's preliminary assessment, detailed in Chapter 6, is that there is currently no evidence before it to indicate that the CSOs have an anti-competitive effect on energy retailing.

The more flexible regulatory arrangements the Commission has recommended will allow the competitive retail market to continue to establish cost-reflective prices in response to changing market and cost conditions, but will be accompanied by transparent monitoring and reporting on the resulting pricing performance together with the capacity to reintroduce price regulation should evidence emerge that competition and competitive pricing is deteriorating. Under these arrangements, the South Australian Government would retain a prudent, transparent and effective regulatory oversight framework. Consumers' interests would continue to be protected by the effective operation of the competitive market, the transparency of the monitoring and information disclosure regime, the reserve power to re-regulate if necessary and by the ongoing non-price consumer protection regime. In summary, the recommended arrangements will allow South Australia to ensure that energy retailing remains competitive and viable at a time of significant change and uncertainty while continuing to ensure that the interests of consumers are protected.

The publication of the Second Draft Report marks the commencement of the public consultation process. The Commission invites detailed written submissions on all aspects of its draft advice. It also invites all stakeholders and interested parties to register to participate in a public forum to be held in Adelaide on Friday, 7 November 2008. The process for providing written submissions and registering for the forum is set out in Chapter 1.

### **Box ES.1: Commission's draft recommendations**

#### Recommendation 1

The regulation of standing contract prices should cease by no later than the expiration of the current price determinations made under section 36AA of the Electricity Act and section 34A of the Gas Act.

#### Recommendation 2

A price monitoring framework to monitor standing contract and default contract prices should be introduced for a period of at least three years following the removal of retail price regulation.

#### Recommendation 3

A conditional statutory power that can be exercised by the South Australian Government to re-introduce retail price regulation should be included in each of the Electricity Act and the Gas Act. In accordance with the terms of the AEMA, the exercise of the power would be conditional upon a review of competition by the Australian Energy Market Commission concluding that competition is no longer effective and recommending the re-introduction of retail price regulation as the appropriate policy response.

#### Recommendation 4

The obligation to agree to supply electricity, and the obligation to agree to sell and supply gas, to small customers pursuant to the standing contract price and subject to the standing contract terms and conditions remain in place. In respect of new connections, the obligations should bind the relevant standing contract retailer and, in the case of existing connections, the financially responsible market participant for that connection.

#### Recommendation 5

The framework for entering into default contracts should remain in place. Each retailer should determine its own default contract price. The provisions allowing ESCOSA to fix the default contract price and for the price to be fixed by reference to the Electricity Pricing Order or Schedule 2 of the Gas Act should be removed.

#### Recommendation 6

Each retailer should determine its own standing contract and default contract prices for energy and publish its prices on its website. Notification that the standing contract price or the default contract price is to change should be published in a newspaper with an appropriate circulation in accordance with any requirements specified by ESCOSA.

#### Recommendation 7

The application of the Energy Price Disclosure Code be extended to standing contracts and default contracts.

#### Recommendation 8

ESCOSA should be tasked to monitor and report every six months on observed standing contract and default contract prices for a minimum of three years. ESCOSA should also maintain and update a central data base on its website of the current standing contract and default contract prices of all South Australian retailers.

#### Recommendation 9

ESCOSA should also maintain and update a central data base on its website of the current standing contract and default contract prices of all South Australian retailers.

#### Recommendation 10

The AEMC should undertake a review of the price monitoring framework within three years of its implementation.

#### Recommendation 11

The South Australian Government undertake a consumer awareness and education campaign as part of the transition to phasing out retail price regulation.

#### Recommendation 12

ESCOSA should consider whether the reference in the RoLR Guideline to linking the variable element of the price should continue to be referenced to the variable element of the standing contract price.

#### Recommendation 13

A RoLR scheme for gas should be introduced at the earliest opportunity.

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# 1 Purpose of the Second Draft Report

The Australian Energy Market Agreement (AEMA) requires the Australian Energy Market Commission (Commission) to review and publicly report on the effectiveness of retail competition for small customers in the energy markets of each jurisdiction participating in the National Electricity Market (NEM). Where competition is found to be effective, the Commission is to advise on ways to phase out retail price regulation. Where competition is found not to be effective, the Commission's advice must suggest ways to improve competition.

In September 2008, the Commission published *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – First Final Report* (First Final Report), which sets out the Commission's conclusions about the effectiveness of energy retail competition in South Australia. The Commission's finding, which is summarised in Chapter 2 below, was that competition is effective for small electricity and small natural gas customers in South Australia, although relatively more intense in electricity than in gas.

In accordance with the terms of the AEMA, the Commission must now provide advice about ways to phase out retail price regulation and an appropriate timeframe for doing so. In preparing its draft advice, the Commission has had regard to the terms of the AEMA, the commitments made by South Australia as a signatory to it, the findings of the First Final Report, and submissions made by parties to date concerning the future of price regulation.

## 1.1 Provide draft advice on the future of retail price regulation

The primary purpose of this report, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – Second Draft Report* (Second Draft Report) is to provide the Commission's draft advice to the South Australian Government and the Ministerial Council on Energy (MCE) about ways to remove regulation of electricity and gas retail prices for small customers in South Australia.

In summary, the Second Draft Report sets out the Commission's:

- assessment of the impact of the existing retail price regulation framework on the efficiency and effectiveness of retail energy competition in South Australia (Chapter 3)
- draft advice on ways to remove retail price regulation and the timetable for its removal (Chapter 4);
- given the removal of retail price regulation draft advice for the obligation to supply, default contracts and retailer of last resort arrangements (Chapter 5);
- assessment of South Australia's compliance with the AEMA (Chapter 6).

## **1.2 Invite stakeholders to comment on the draft advice**

The advice contained in the Second Draft Report is an important contribution to policy discussions about the future direction of energy retailing in South Australia. Given the significance of the Commission's final recommendations, it is vital that the Commission test its advice through a process of open and informed public consultation that invites, and carefully considers, the views of stakeholders.

To this end, the Commission invites all interested parties to participate in two forms of public consultation: a process of making formal written submissions to the Commission, and attending a public forum.

### **1.2.1 Providing written submissions**

#### **1.2.1.1 Matters to address in submissions**

The Commission encourages all stakeholders to make a formal written submission commenting on the draft advice contained in the Second Draft Report, and on any other matter that stakeholders consider pertinent to the Commission's consideration of the removal of retail price regulation in South Australia.

To assist parties interested in preparing submissions, the Commission has identified several matters that it specifically invites stakeholders to comment on:

- whether default contract prices should be subject to the proposed price monitoring regime;
- whether the application of the Energy Price Disclosure Code should be extended to standing contracts and default contracts;
- the appropriateness of monitoring trends in regional variations of market contract prices for gas customers in South Australia;
- the appropriateness of establishing and maintaining a register of approaches to Origin for access to the South East South Australian Pipeline and the outcomes of those request for access;
- the impact of the Country Equalisation Scheme on the development of retail electricity competition in South Australia.

#### **1.2.1.2 Lodging submissions**

Submissions are required to be lodged by 4 pm on **Monday, 17 November 2008** in accordance with the following requirements.

##### Lodging a submission electronically

- The submission must be sent by email to [submissions@aemc.gov.au](mailto:submissions@aemc.gov.au);

- The email must contain the reference “EMO 0004/3” in the subject line;
- The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated;
- The submission must be in PDF format; and
- The submission must also be forwarded to the Commission via ordinary mail.

Upon receipt of the electronic version of the submission, the Commission will issue a confirmation email. If this confirmation email is not received within three business days, it is the responsibility of the person who made the submission to ensure it has been successfully delivered.

#### Lodging a submission by mail

- The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated by the submitter;
- The letter must contain the reference “EMO 0004/3”;
- The submission should be sent by ordinary mail to:

Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Except in circumstances where the submission has been submitted electronically, upon receipt of the hardcopy submission the Commission will issue a confirmation letter. If this confirmation letter is not received within three business days, it is the responsibility of the person who made the submission to ensure it has been successfully delivered.

The Commission will have full regard to all submissions lodged within the specified time period but regrets that it may not be able to afford late submissions the same level of consideration. To ensure it is able to give full consideration to each submission, interested parties are encouraged to provide their submissions by Monday, 17 November 2008.

### **1.2.2 Attending the public forum**

To assist stakeholders in familiarising themselves with the draft advice presented in the Second Draft Report, the Commission is holding a public forum.

The purpose of the public forum is:

- for the Commission to present its draft advice as contained in the Second Draft Report; and

- to give stakeholders and interested parties the opportunity to ask questions of the Commission and discuss issues of concern prior to finalising their written submissions.

It is intended that the public forum will assist parties to prepare their written submissions. The forum will be held in Adelaide on Friday, 7 November 2008. Further details about the forum will shortly be published on the Commission's website.

Parties interested in attending the public forum are asked to register by completing a registration form, which is available from the Commission's website at [www.aemc.gov.au](http://www.aemc.gov.au).

## 2 Framework for Developing Advice

This Chapter explains the policy and analytical frameworks that underpin the development of the Commission's draft advice for phasing out retail price regulation. The Chapter is structured as follows:

- a summary of the Commission's finding in its First Final Report on the effectiveness of competition in the supply of electricity and gas to small customers in South Australia;
- a discussion of the efficiency benefits of competitive markets;
- an outline of the criteria used by the Commission to develop its draft advice for the phasing out of retail price regulation; and
- key design features considered by the Commission.

### 2.1 Findings from the Commission's First Final Report

In September 2008, the Commission publicly reported its assessment of retail competition in South Australia, publishing Review of the First Final Report. The Commission's finding in its First Final Report was that retail competition is effective for the supply of electricity and natural gas to small customers in South Australia, although competition is relatively more intense in electricity than in gas. In making its findings, the Commission identified some structural limitations that are affecting the ability of small gas customers in regional areas to access the full benefits of competition. The Commission has outlined options for the South Australian Government to consider to address these structural limitations in Chapter 4 of this report.

The First Final Report indicates that competition is effective in keeping market contract prices in line with real costs of supply, and margins at or below competitive levels. In these circumstances price regulation is unnecessary and costly.

The Commission's assessment of the effectiveness of competition was supported by evidence of strong rivalry between energy retailers, as they seek to gain customer share by offering customers alternative price, product and service combinations. Up-front discounts of up to 7 per cent from the standing contract price are available under electricity market contracts, with lower up-front discounts available to gas market customers. Large numbers of electricity and metropolitan gas customers have been willing and able to respond to competitive offers when approached by retailers and given sufficient incentive. Approximately 66 per cent of electricity customers and 59 per cent of gas customers are now supplied under a market contract. Brand loyalty and switching costs do not appear to be significant deterrents to customers' willingness to switch retailers.

The Commission's findings were also supported by a history of conditions that are conducive to entry into and expansion within the retail energy sector. However, there are emerging indications of competitive risks and pressures in the small

customer electricity sector that were not evident in the last few years, which have made entry and expansion more difficult for smaller retailers. In particular, recent changes in wholesale electricity costs have undermined retailers' profit margins and have prompted a number of retailers to temporarily cease actively marketing to prospective new customers until such time as margins improve.

New retailers have also entered gas retailing and have competed effectively with the standing contract retailer, generally through dual fuel marketing strategies. However, unattractive profit margins in the gas market have limited the opportunities for new retailers to compete for South Australian gas customers on a stand alone basis. Since competitive entry into, and the marketing of, retail gas to small customers has generally occurred through dual fuel strategies, the squeeze on electricity margins has also affected retail gas competition. New retailers also appear to have been discouraged from offering to sell and supply small customers in regional South Australia, due to structural constraints on access to transmission haulage capacity on gas pipelines servicing regional areas.

Effective retail competition can be expected to accommodate changes in the real cost of inputs as long as prices are able to adjust to provide competitive retail margins. If standing contract prices are not permitted such flexibility, retailer viability and effective competition could be placed at risk.

## **2.2 The benefits of competitive markets**

Where competition is effective in promoting economic efficiency, there is generally no need for price regulation. Regulated prices will almost always be an imperfect substitute for prices determined by competitive processes and are likely to impose costs and distortions not present in a competitive market. Because regulators have imperfect information, regulated prices will generally either be set too low, deterring investment and innovation, or too high, to the detriment of consumers. Regulated pricing arrangements also lack the flexibility of market prices. The distortions price regulation cause and the administrative and compliance costs it imposes are likely to be higher, and the benefits lower, where price regulation is imposed on a competitive market compared to a situation where the market is not competitive.<sup>1</sup>

The difficulty that is involved in attempting to estimate future efficient costs and competitive prices is one of the key reasons for preferring competition over regulation, where the former is feasible and effective. In competitive markets, no single entity is required to estimate efficient costs. Rather, efficient costs and efficient price levels are revealed over time by the process of offer and counter offer and entry and exit from the market.

In simple terms, this means businesses will produce goods and services at least cost while directing resources toward the production of goods and services that are valued most highly by consumers. Over time, businesses will respond in a timely

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<sup>1</sup> Professor George Yarrow, *Report on the impact of maintaining price regulation*, Regulatory Policy Institute, Oxford, January 2008.

manner to changes in consumer tastes and to changes in production techniques and technology.<sup>2</sup> As the ultimate beneficiaries of economic efficiencies include consumers and the broader community, the principal objective of competition policy is to maximise economic efficiency.

It is also important to distinguish between competition issues and non-competition issues. Where concerns arise regarding issues going beyond the operation and performance of the competitive energy market, such as the affordability of energy for low income households, these issues need to be addressed through appropriately targeted policies rather than by intervening to distort the efficient operation of the market. While energy affordability is a genuine concern, particularly if energy prices rise in the future, price regulation is not the answer and indeed could exacerbate the underlying problem of increased prices.

Price regulation affects all market participants, not just those consumers experiencing hardship. A competitive market ensures that energy prices reflect the real resource costs of energy supply and sends appropriate price signals to firms regarding investment decisions and to consumers regarding their energy use. The introduction of price regulation can subvert that process, distorting competitive market outcomes and imposing costs on all consumers, including those experiencing hardship.

### **2.3 Criteria for developing the Commission's advice**

The AEMC reflects the commitment of the Commonwealth, State and Territory governments to adopt market-based rather than regulatory solutions where competition is effective. Informed by its finding in its First Final Report and the AEMA's stated preference the Commission has used various criterion to guide the development of its draft advice for the future of price regulation in South Australia.

In identifying the appropriate criteria, the Commission has been mindful of the need for its draft advice to be:

- appropriate for the current and future market environment for energy retailing; and
- consistent with best practice principles for developing regulation.

#### **2.3.1 Current and future retail energy market environment**

To ensure that current levels of competition in the retail supply of energy in South Australia are sustained and increased into the future, the Commission's advice for phasing out of retail price regulation must be appropriate for the current and future environment for energy retailing. Therefore, in developing its draft advice, the Commission has had regard to those factors that are affecting, or will affect, market participants throughout the NEM and those that are particular to South Australia.

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<sup>2</sup> Economists often refer to these as production (or cost), allocative and dynamic efficiencies: Hilmer Committee, *National Competition Policy: Report by the Independent Committee of Inquiry*, August 1993, p. 4.

### **2.3.1.1 Factors impacting the energy industry across the NEM**

The Commission has considered the impact of the following NEM-wide factors when developing its draft advice:

- **Policy uncertainty due to the expected climate change policy initiatives such as the Carbon Pollution Reduction Scheme (CPRS)**

The implementation of the CPRS is likely to place a “carbon cost” on energy production, as generators will be required to purchase permits to meet their emissions. This will increase the costs of wholesale electricity supply and the price of risk mitigation instruments. Some retailers have indicated to the Commission that the major difficulty in negotiating hedge contracts with generators in the current environment is uncertainty about how to factor in the carbon prices that will be associated with the CPRS. Policy uncertainty regarding the impact of the CPRS has meant that retailers have become more reliant on short term hedge contracts, which are by nature more volatile than longer term hedge contracts.

- **Potential impacts of increasing LNG export prices for the cost of gas for domestic consumption**

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.<sup>3</sup> Continued growth in the global LNG market is likely to impact on the gas prices in other regions across Australia.

It is also likely that, by adding a carbon cost to energy, the use of gas-fired electricity generation will increase. In addition, with increases in renewable generation, which is more intermittent, there may be an increased demand for gas-fired generation to ensure demand is met by an increasingly “peaky” generation profile.

- **Increases in the costs of construction of new infrastructure**

Global resource and infrastructure costs have been increasing and this trend is expected to continue. Combined with resource shortages in the commodities sector and labour shortages, the costs of construction for new infrastructure are likely to increase. This could potentially impact on investment decisions for constructing new infrastructure required for the energy industry.

- **Increases in wholesale energy pricing trends**

The factors outlined above, together with the impact of recent drought conditions, have contributed to an increase in wholesale energy pricing trends across the NEM. Further, the volatility of wholesale energy prices has also increased.

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<sup>3</sup> Electricity Supply Industry Planning Council (ESIPC), 2007 Annual Planning Report, June 2007, p. 88

The Commission notes that high wholesale energy prices and increases in the costs of risk mitigation instruments have led to the suspension of active marketing activities by some retailers in South Australia.<sup>4</sup>

Vertical integration between generation and retail operations has also become increasingly prevalent in Australian energy markets, in part because of the natural hedge that vertical integration provides retailers against price volatility and contract market illiquidity.

- **Development of the National Customer Framework**

The MCE Standing Committee of Officials (SCO) has developed a policy paper (NCF Policy Paper)<sup>5</sup>, which proposed a policy framework that may be used as the basis for the drafting of the Laws and Rules for a single national framework for the regulation of the retail supply of energy (National Customer Framework). The policy paper canvasses a number of issues addressed in this Report, including the obligation to supply, the price regulation of default contracts, and standing contract tariffs. The Commission has had regard to the policy positions outlined by SCO in developing its draft advice. However, the Commission also notes that SCO's policy framework has not been considered by Ministers and as such, may not reflect the positions that are ultimately agreed upon by the MCE.

### **2.3.1.2 Factors specific to the South Australian energy sector**

The Commission has also considered factors which are specific to the South Australian energy sector. The factors considered by the Commission include:

- **Peak and weather dependant load**

Compared to other regions in the NEM, demand in South Australia is highly weather dependant and variations in summer temperatures can result in large swings in demand levels from year to year. Evidence of South Australia's severe and unpredictable weather conditions was observed in March 2008, when Adelaide experienced 15 days of consistently high temperatures above 35 degrees, the longest ever heatwave for any Australian capital city.<sup>6</sup> This characteristic of the South Australian retail market impacts on the ability of retailers to effectively manage their load and risk exposure.

- **More expensive fuel used for generation in South Australia**

Compared to other regions in the NEM, South Australia has a high proportion of gas-fired electricity generation which is more expensive than, for example, coal-fired generation. Although cheaper energy from Victoria is able to be imported, at times

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<sup>4</sup> LECG, *Survey and interviews with South Australian electricity and gas retailers*, 18 June 2008, p. 24.

<sup>5</sup> Ministerial Council on Energy Standing Committee of Officials, *A National Framework for Regulating Electricity and Gas (Energy) Distribution and Retail Services to Customers: Policy Response Paper*, June 2008.

<sup>6</sup> AER, *Spot prices greater than \$5000/MWh: South Australia 5-17 March 2008*, May 2008, p. 2.

when the interconnectors are constrained, higher-cost local generation must be dispatched to meet demand, which may result in higher wholesale electricity costs.

- **Tightening supply - demand balance**

NEMMCO projections have identified an increased risk that by 2010/2011 South Australia could breach its minimum reserve requirements.<sup>7</sup> This tightening supply-demand balance is likely to impact on wholesale energy costs and investment requirements for the region. The Commission notes that a number of generation plants are currently being planned or are under construction, which may alleviate South Australia's tightening supply-demand balance over the medium term.<sup>8</sup>

### **2.3.2 Best practice principles for developing regulation**

In recognition of the positive impact that appropriate, targeted regulation can have – and the costs incurred as a result of unnecessary, imprecise or ill-defined regulation – considerable resources have been expended in recent years on developing principles and processes to ensure the development and implementation of effective and balanced regulation, both in Australia and overseas.

#### **2.3.2.1 Productivity Commission's best practice principles for prices oversight**

In developing its draft advice on the future of retail price regulation of the supply of retail energy in South Australia, the Commission has been guided by best practice principles for prices oversight developed by the Productivity Commission.<sup>9</sup> These principles include:

- **A preference for market-based rather than regulatory solutions**

Where possible, the minimum regulatory response necessary to protect consumers from the potential exercise of market power should be adopted. Regulation imposes distortions on the market and involves costs for regulators, consumers, market participants and governments. In contrast, effectively competitive markets encourage businesses to: produce the goods and services that consumers want and value most at the least cost; and respond to changes in consumer tastes by offering new, different or better goods and services in a timely manner.

- **Transparency**

The development of policy advice and regulatory decisions should involve widespread public input into deliberations. This will ensure that different sources of information are taken into account and decision making is open to public scrutiny and comment. Transparency in the development of policy advice is also likely to

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<sup>7</sup> NEMMCO, *Statement of Opportunities 2007*, pp. 2-12 and 2-20.

<sup>8</sup> ESIPC, *Submission to the First Draft Report*, pp. 2-3.

<sup>9</sup> Productivity Commission, *Review of the Prices Surveillance Act 1983*, Appendix B, August 2001.

ensure that proposed solutions are appropriate for the relevant market failure being addressed.

The intent of policy advice and regulatory decisions should be clearly explained. The roles and responsibilities of regulators and regulated parties and the interactions between these roles, should also be well defined.

- **Accountability**

Regulatory frameworks should ensure that governments and regulators are responsible for their actions, act impartially with due regard for proper process, and within the limits of their authority. Accountability is enhanced where the regulators are required to achieve clearly defined objectives and follow a transparent process.

Regulatory instruments should be implemented for a finite period of time and then reviewed to determine whether they remain appropriate for the current market environment. Where appropriate, mechanisms should also be in place to monitor the responsibilities of regulated parties and their compliance with those responsibilities.

- **Proportionality of the regulatory intervention given the gravity of the market failure**

The extent to which market behaviour is constrained should be proportional to the likely economic or social harm that would flow from the market failure that it seeks to address. Assessing the likely economic or social harm requires an assessment of both the nature and magnitude of the consequences if certain behaviour takes place, and the likelihood that such behaviour will take place.

- **Independence of policy advice and regulation**

The development of regulation is enhanced if the body which advises government on whether regulation is needed is separate from the entity that implements the regulation. Conflicts of interest may exist if the same body undertakes both functions and may lead to a preference for regulatory rather than market-based solutions.

### **2.3.2.2 OECD and Office of Best Practice Regulation principles for best practice regulation**

The Commission has also had regard to principles for best practice regulation developed by the Organisation for Economic Co-operation and Development (OECD)<sup>10</sup> and Australian Government's Taskforce on Reducing Regulatory Burdens on Business<sup>11</sup>.

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<sup>10</sup> OECD, *Guiding Principles for Regulatory Quality and Performance*, Paris, 2005, p. 3.

<sup>11</sup> Regulation Taskforce, *Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business*, Report to the Prime Minister and the Treasurer, Canberra, January 2006, p. 147.

## OECD principles of good regulation

In 2005, the OECD released its updated principles to help countries face the challenges posed by regulatory reform in the 21<sup>st</sup> century, which include eight factors that guide “good regulation”. The OECD’s *Guiding Principles for Regulatory Quality and Performance*<sup>12</sup> observes that good regulation should:

- serve clearly identified policy goals, and be effective in achieving those goals;
- have a sound legal and empirical basis;
- produce benefits that justify costs, considering the distribution of effects across society and taking economic, environmental and social effects into account;
- minimise costs and market distortions;
- promote innovation through market incentives and goal-based approaches;
- be clear, simple and practical for users;
- be consistent with other regulations and policies; and
- be compatible as far as possible with competition, trade and investment-facilitating principles at domestic and international levels.

## Taskforce recommendations on good regulatory process

In October 2006, the Taskforce on Reducing Regulatory Burdens on Business was appointed to identify practical options for alleviating the compliance burden on business arising out of Commonwealth Government regulation. One of the Taskforce’s recommendations was that the Government endorse six principles of good regulatory process. These principles are now embodied in the *Best Practice Regulation Handbook* published by the Office of Best Practice Regulation.<sup>13</sup>

The Taskforce’s six principles of good regulatory process included:

- Governments should not act to address “problems” until a case for action has been established;
- A range of feasible policy options – including self-regulatory and co-regulatory approaches – need to be identified and their benefits and costs, including compliance costs, assessed within an appropriate framework;

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<sup>12</sup> Organisation for Economic Co-operation and Development, *Guiding Principles for Regulatory Quality and Performance*, Paris, 2005.

<sup>13</sup> A copy of the Best Practice Regulation Handbook is available from the Office of Best Practice Regulation’s website at [www.obpr.gov.au](http://www.obpr.gov.au).

- Only the option that generates the greatest net benefit for the community, taking into account all the impacts, should be adopted;
- Effective guidance should be provided to relevant regulators and regulated parties in order to ensure that the policy intent of the regulation is clear, as well as the expected compliance requirements;
- Mechanisms are needed to ensure that regulation remains relevant and effective over time; and
- There needs to be effective consultation with regulated parties at all stages of the regulatory cycle.

## 2.4 Key design features

In considering the appropriate form of regulation for energy retailing in South Australia, the Commission considered the following key design features:

- roles and obligations of ESCOSA;
- rights and obligations of the standing contract retailers and new retailers;
- the need for and if required, form and substance of, a reserve pricing power;
- if provision is made for a reserve pricing power, the pre-conditions for exercising the reserve pricing power and a process for re-introducing retail price controls; and
- periodic reviews to assess the appropriateness of the form of price oversight going forward.

The Commission's draft advice on ways to remove retail price regulation, which canvasses these design features, is set out in Chapter 4.

The Commission has also considered how the removal of retail price regulation may affect the price regulation of default contracts, the obligations to supply electricity and gas to small customers, and Retailer of Last Resort (RoLR) schemes. The Commission's draft advice on the consequential amendments that are necessary for these mechanisms to continue to operate following the removal of price regulation is contained in Chapter 5.

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### 3 Regulating Retail Prices in South Australia

Energy retailers operating in South Australia are required to comply with specific requirements prescribed by legislation and a range of sub-ordinate instruments including regulations, licences, codes and guidelines. The obligations imposed by virtue of these instruments govern many aspects of energy retailing, including the terms and conditions on which energy products and services are offered. Under these arrangements, the retailers responsible for offering standing contracts (i.e. the standing contract retailer) must make these offers at the regulated price.

This Chapter assesses the impact of the existing retail price regulation framework on the efficiency and effectiveness of retail energy competition in South Australia.

To provide the basis for that assessment, this Chapter also describes the process by which standing contract prices are determined. It begins by outlining the legislative framework for retail price regulation in South Australia, and the role of ESCOSA and the standing contract retailers. It also provides an overview of the form of regulation applied by ESCOSA in the current price determinations. A more detailed discussion of each of these issues is contained in Appendix A.

#### 3.1 Legislative framework for retail price regulation

The framework for regulating retail energy prices in South Australia is contained principally in three pieces of legislation:

- *Essential Services Commission Act 2002 (SA)* (ESC Act);
- *Electricity Act 1996 (SA)* (Electricity Act); and
- *Gas Act 1997 (SA)* (Gas Act).

The ESC Act establishes ESCOSA as the jurisdictional regulator and, amongst other things, gives it the power to regulate prices, conditions relating to prices and price-fixing factors for goods and services in a regulated industry.<sup>14</sup> The Electricity Act and the Gas Act (together, the Industry Acts) provide that ESCOSA can exercise its price regulation functions in relation to electricity and gas standing contracts with small customers.<sup>15</sup>

In South Australia, a retailer can supply energy (electricity and/or gas) to a small customer under one of three types of contract: a standing contract (if the retailer is the standing contract retailer), a default contract, or a market contract.

The standing contract is available from the standing contract retailer on request to every small customer who is not on a market contract. The standing contract retailer for electricity in South Australia is AGL Energy (AGL) and, for gas, Origin Energy

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<sup>14</sup> ESC Act, s 25(1).

<sup>15</sup> Electricity Act, s 36AA; Gas Act, s 34A.

(Origin). Under the standing contract, the standing contract retailer agrees to sell electricity or to supply and sell gas (as appropriate) to the customer at the standing contract price and subject to the standing contract terms and conditions. In the Second Draft Report, this obligation is referred to as the Energy Obligation. The price for energy supplied under a standing contract is determined by ESCOSA under the price regulation arrangements described at 3.2 below.

A default contract is a contract formed between a retailer who is financially responsible for a small customer's connection point, and the small customer at that connection point who does not have any existing contract in place with that retailer for that connection point but has begun taking supply.<sup>16</sup> While ESCOSA can determine the price for energy supplied under a default contract, it does not currently do so. Each retailer is able to determine the price it charges under its default contract. A retailer who does not set its own price is deemed to supply energy at the price that applied as at 31 December 2002.<sup>17</sup>

The price of energy under a market contract is unregulated. A market contract is a contract offered by any retailer that is not a standing or default contract.

### **3.2 ESCOSA's price regulation role**

The Industry Acts require ESCOSA to "fix" the standing contract price. To do this, ESCOSA may specify a number that is the standing contract price or, at least, a methodology or formula that can be applied to produce a price. Regardless of the approach ESCOSA uses to fix the price, at the time the price determination is made it must be possible to ascertain the standing contract price at any point in time during which the price determination is in force. If ESCOSA does not fix a price, the Industry Acts provide that the standing contract price will be the price that applied as at 31 December 2002.

The process for making a standing contract price determination commences when the standing contract retailer lodges a submission with ESCOSA stating the price it proposes be fixed as its standing contract price and justifying the proposed price.<sup>18</sup> Unless special circumstances exist, the standing contract retailer is not to lodge its submission more than nine months or less than six months before the existing price determination expires.

Before it makes a price determination, ESCOSA must conduct an inquiry under Part 7 of the ESC Act into the question of the appropriate price to be fixed.<sup>19</sup> This requirement can be waived if special circumstances exist.

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<sup>16</sup> Electricity Act, s 36AB(1); Electricity Regulations, reg 7F(1).

<sup>17</sup> Electricity Act, s 36AB(3); Gas Act, s 34B(3).

<sup>18</sup> Electricity Act, s 36AA(4a)(d)(ii); Gas Act, s 34A(4a)(d)(ii).

<sup>19</sup> Electricity Act, s 36AA(4a)(d)(iii); Gas Act, s 34A(4a)(d)(iii).

The Industry Acts require a price determination to apply for a minimum of three years.<sup>20</sup> Again, unless special circumstances exist, a price determination cannot be made to take effect before the expiry date of the preceding determination.<sup>21</sup>

The Industry Acts do not define what constitutes “special circumstances”. As such, it is a matter for ESCOSA to decide whether special circumstances exist. The guidance ESCOSA has provided to date suggests that special circumstances will arise where unexpected events materially impact the integrity of the determination.<sup>22</sup>

Where ESCOSA finds that special circumstances do exist, ESCOSA also has some discretion as to the process it will follow and may elect to initiate a review of the price determination in force at the time. If ESCOSA concludes that circumstances warrant the making of a new price determination, the new determination must apply for a minimum of three years from the date it takes effect.

### **3.3 Existing price determinations**

Currently, price determinations are in place governing the standing contract prices for electricity from 1 January 2008 to 31 December 2010 (Electricity Price Determination 2007) and, for gas, from 1 July 2008 to 30 June 2011 (Gas Price Determination 2008) (together, the Price Determinations). Based on the timing provisions contained in the Industry Acts, unless special circumstances exist, AGL is not permitted to submit its submission to commence the next price review until April 2010. Similarly, Origin is not permitted to lodge its submission prior to October 2010.

#### **3.3.1 Form of regulation: building blocks**

Subject to its obligation to “fix” the standing contract price and to have regard to certain factors when performing its functions<sup>23</sup>, ESCOSA is able to choose the methodology it uses to determine the standing contract price.

The prices fixed under the existing Price Determinations are calculated using a “building blocks” (or “cost of service”) approach. Under this approach, the regulator reviews the demand estimates for the coming three year regulatory period put forward by the regulated business and the projected efficient future costs provided by the business based on those estimates. The regulator then forms its own view about the projections of future demand and efficient costs as the basis for determining the regulated prices to apply under the price determination. The

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<sup>20</sup> Electricity Act, s 36AA(4a)(b); Gas Act, s 34A(4a)(b).

<sup>21</sup> Electricity Act, s 36AA(4a)(d)(i); Gas Act, s 34A(4a)(d)(i).

<sup>22</sup> See, for example, ESCOSA, Electricity Price Determination 2007, p. A-30-A31; ESCOSA, Gas Price Determination 2008, pp. A-44-A-45, A-46.

<sup>23</sup> The ESC Act, Electricity Act and Gas Act each set out factors that ESCOSA must have regard to when exercising its functions, including making a price determination. These factors are discussed in Appendix A.

regulated tariffs (retail prices) are intended to permit the regulator's projections of efficient costs to be recovered from end use customers.

ESCOSA, in applying the building blocks approach, assesses only the forward-looking costs that are within the control of the retailer. In the case of electricity, these are: wholesale electricity costs, retailer operating costs and the retail margin. For gas, they are: the wholesale cost of gas, transmission costs<sup>24</sup>, retail operating costs and the retail margin. The summation of the controllable costs for electricity and gas form the basis for deriving the retailer tariffs, which comprise one component of the electricity and gas standing contract prices respectively. ESCOSA's application of the building blocks approach is described in greater detail in Appendix A.

ESCOSA fixes the standing contract prices to reflect its best estimate of forward-looking efficient controllable costs, rather than the actual costs incurred by the standing contract retailer during the regulatory period. The actual costs incurred by the retailer may be higher or lower than those projected by the regulator depending on the market conditions that emerge in practice. ESCOSA has noted that prices are set independently of actual costs in order to provide the standing contract retailer with an incentive to outperform the cost benchmarks and retain the financial benefits of more efficient performance.<sup>25</sup> While this incentive regulation approach is appropriate for monopoly network businesses who are not subject to competition and who control large capital and operating cost programs, arguably it is a less appropriate form of regulation for competitive retailers who have limited capacity to control the network and energy costs that make up most of the delivered price.

The other component of the standing contract price is made up of the costs that standing contract retailers face that are outside their control. These costs are the network (transmission and distribution) charges, market charges and GST. In effect, these non-controllable costs are directly passed through to standing contract customers as part of the standing contract price.

### **3.3.2 The initial standing contract price**

As noted above, a price determination must apply for a minimum of three years and must allow the standing contract price to be ascertained at any point in time while it is in force. However, the Price Determinations do permit the standing contract retailer to seek variations to the regulated tariffs to reflect unanticipated changes to controllable costs and forecast demand.

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<sup>24</sup> Gas transmission costs in South Australia are negotiated between the retailer and the pipeline owner/operator, rather than being set by the AER. As such, gas transmission costs are treated as controllable costs.

<sup>25</sup> See, for example, ESCOSA, Gas Price Determination 2008, p. A-37.

Each Price Determination is divided into a number of “regulatory periods”<sup>26</sup>. For the initial regulatory period, a schedule to the Price Determination specifies the supply charge and a volume charge for consumption. For example, the maximum standing contract price that Origin Energy is permitted to charge residential customers in the metropolitan area<sup>27</sup> for gas supplied from 1 July 2008 is a supply charge of \$44.27 per quarter and a consumption charge of 1.9652 cents per megajoule for the first 4,500 megajoules, and 1.2929 cents per megajoule thereafter.

### **3.3.3 Intra-period variations to the standing contract price**

During the period in which the Price Determinations are in place, there are two principal ways that the standing contract price can vary:

- through the annual tariff variation process; and/or
- by passing through a cost increase or decrease in accordance with the pass through mechanism.

#### **3.3.3.1 Annual tariff variation process**

The Price Determinations provide for ESCOSA to approve the annual variations in the standing contract price, with effect from the commencement of each subsequent regulatory period within the three year duration of the price determination. The purpose of this process is to allow the regulated price to be adjusted within the overall price caps allowed by the determination.

Between 35 and 60 days prior to the commencement of the new regulatory period, the standing contract retailer must submit a statement to ESCOSA setting out the proposed price for the next regulatory period, together with information about the forecast number of standing contract customers and total consumption for each standing contract tariff.

ESCOSA considers the statement and approves or rejects the proposed new price. The revenue to be generated by the proposed price, when divided by total consumption, must not exceed the allowed average retail revenue price control specified in the Price Determination. In addition, the charge at any level of annual consumption of each tariff must not be greater than an amount specified in the Price Determination (i.e. the rebalancing control).<sup>28</sup> In the case of electricity, this amount is CPI + 4% above the applicable charge (or CPI + 4% or \$40 for small business customers). For gas, it is CPI +3% for all residential and Small to Medium Enterprise

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<sup>26</sup> Under the Electricity Price Determination 2007, a period is the period from 1 January 2008-30 June 2008 (the initial period), each subsequent 12 month period ending 30 June, and the period 1 July 2010-31 December 2010. Under the Gas Price Determination 2008, a regulatory period is each period of 12 months ending on 30 June until 30 June 2011.

<sup>27</sup> The metropolitan area is all areas of South Australia other than Mt Gambier, Port Pirie, Whyalla, Riverland and Murray Bridge but including Barossa and Peterborough: ESCOSA, Gas Price Determination 2008, Part B, Schedule 1.

<sup>28</sup> ESCOSA, Gas Price Determination 2008, Part B, Schedule 1.

customers. The controls that apply to annual tariff variations are explained in greater detail in Appendix A.

If the standing contract retailer does not submit a statement or, if the statement is rejected, a replacement statement, ESCOSA will vary the standing contract retailer's tariffs for the relevant period. The new price takes effect at the commencement of the next regulatory period.

### **3.3.3.2 Pass through mechanisms**

The Price Determinations also include a process that permits the standing contract price to be varied in order to pass through to standing contract customers an increase or decrease in the cost of providing the service (i.e. the pass through amount). The pass through mechanism operates in addition to the annual tariff variation process.

The circumstances in which a standing contract retailer can pass through a change in costs are limited to changes arising from a specified pass through event, and require ESCOSA's approval. The permitted pass through events are specified in the relevant Price Determination and include, for example, a change in taxes or a regulatory reset event.<sup>29</sup> The process for lodging a pass through application and the circumstances in which an application can be lodged are described further in Appendix A.

In general, ESCOSA has allowed for cost pass throughs on the basis that the following criteria are met:<sup>30</sup>

- the event should be able to be clearly defined (i.e. there should be little ambiguity about whether or not the event has occurred);
- the event should be outside the control of the retailer;
- the event should impact directly on the retailer's costs (e.g. an obligation or additional cost should be placed directly on the business); and
- the impact of the event on the retailer's costs should be capable of being measured accurately.

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<sup>29</sup> A "regulatory reset event" is defined in the Price Determinations as (a) a material change in the standing contract retailer's obligation to offer to supply electricity / offer to supply and sell gas (as appropriate) to small customers; or (b) (i) a decision by ESCOSA, the AEMC, the AER or the South Australian Government after the price determination commences that imposes new minimum standards for providing the standing contract, or (ii) requires the standing contract retailer to purchase financial products in relation to a specified environmental outcome, or (iii) participate in a scheme relating to a specified environmental or energy efficiency outcome; as a result of which the standing contract retailer would incur materially higher or lower costs in providing standing contracts than it would have incurred but for that event. See clause 5 of ESCOSA's Electricity Price Determination 2007 and the Gas Price Determination 2008.

<sup>30</sup> ESCOSA, Gas Price Determination 2008, p. A-43.

### 3.3.3.3 Re-opening a price determination in “special circumstances”

The “special circumstances” provisions contained in the Industry Acts permit price determinations to be re-opened and, if appropriate, a new determination made.

ESCOSA notes that while it is not permitted to decide whether or not a price determination is capable of being re-opened (as the re-opening is already provided for in the Industry Act), it is open to ESCOSA to establish what constitutes “special circumstances”. As noted at 3.2 above, special circumstances are likely to arise when an unexpected event occurs that materially impacts on the integrity of the price determination. The Price Determinations indicate that significant changes in input costs (specifically, the cost of wholesale energy) are appropriately a matter to be considered in a special circumstances review.<sup>31</sup>

Based on the approach set out in the Gas Price Determination 2008, a special circumstances review assesses:

- whether the event giving rise to special circumstances was unable to be predicted, planned for or reasonably insured against; and
- the extent to which the event had a material impact on the standing contract retailer’s prudent costs, such that the price path set in the price determination is no longer credible.<sup>32</sup>

If ESCOSA concludes that circumstances warrant the making of a new price determination, the new determination must apply for a minimum of three years from the date it takes effect. Accordingly, ESCOSA would be required to form a view about the future demand and efficient costs (and therefore the regulated tariffs) for that period of the new price determination that was not covered by the re-opened price determination. It is reasonable to expect that this is likely to affect the volume of information ESCOSA requires to make a price determination, and therefore the time it requires to complete a special circumstances review.

### 3.3.4 Limitations on the current price regulation framework

In the context of more uncertain energy market conditions and policy settings, and with the expectation of increasing and more volatile future energy costs, the current price regulation arrangements in South Australia are subject to a number of limitations. Some of the more significant limitations identified by the Commission include:

- the requirement that price determinations, including determinations made following a special circumstances review, apply for three years;

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<sup>31</sup> ESCOSA, Electricity Price Determination 2007, p. A-30 - A31; ESCOSA, Gas Price Determination 2008, pp. A-45, A-46.

<sup>32</sup> ESCOSA, Gas Price Determination 2008, p. A-45.

- the requirement to project future demand and efficient future costs over a three year period as the basis for setting a three year regulated price path;
- the requirement that ESCOSA must “fix” standing contract prices directly or use a methodology such that the standing contract price can be ascertained at any time within the three year period;
- the application of a building blocks and incentive regulation framework more suited to a monopoly network context than the competitive and dynamic context of energy retailing;
- the process requirements and other limitations on ESCOSA’s capacity to vary the standing contract price to reflect changing market and cost conditions;
- the conservative interpretation that ESCOSA appears to place on the circumstances in which cost pass through should be allowed;
- the time consuming and information intensive processes ESCOSA is required to adopt in reviewing pass through applications or re-opening the price determination where “special circumstances” exist.

### **3.3.5 Introducing greater flexibility for cost pass through**

As discussed at 3.3.3 above, the annual tariff variation and pass through mechanisms contained in the Price Determinations and the “special circumstances” exceptions in the Industry Acts provide some scope for ESCOSA to vary the standing contract price in response to changes in market and cost conditions. However, the prospective changes in energy market conditions identified in the First Final Report highlight the need to consider more flexible alternatives for passing through rising real costs and so reduce some of the adverse consequences of retail price regulation in the current environment.

The Commission’s discussions with stakeholders have identified possible options for introducing greater cost pass through flexibility into the legislative framework. Some of the principal changes that would allow a more flexible approach to passing through rising input costs are described briefly in Box 3.1 below.

### **Box 3.1: A more flexible approach to cost pass through**

- The building blocks approach could be replaced by a form of regulation that is better able to respond to changes in controllable costs. For example, the standing contract price in the final regulatory period could be carried over to the next price determination, subject to an adjustment for any increase/decrease in the cost of providing retail energy services, and set as the standing contract price for the initial regulatory period. This would reduce the information burden and time required to conduct a full cost build up.
- Future price determinations could allow changed input costs to be passed through in circumstances other than those identified in the existing pass through mechanisms. For example, it may be appropriate to allow identifiable increases in wholesale energy costs to be passed through even though they may not be directly attributable to a clearly defined event.
- The requirement that price determinations following a special circumstances review must be made for three years or more could be relaxed to introduce greater flexibility at a time of changing costs and market conditions.
- The requirement to “fix” the standing contract price such that the standing contract price can be ascertained at any time within the three year period could be relaxed, for example, by introducing a more flexible tariff basket price cap for regulated retail prices with greater rebalancing flexibility within the cap.
- ESCOSA could be required to prepare and publish a guideline to provide greater transparency and regulatory certainty about the circumstances in which it is likely to consider that “special circumstances” exist, and around the processes and procedures ESCOSA would follow where it considers such circumstances arise. Guidelines addressing these issues may assist the standing contract retailers to better understand the circumstances in which changes in input costs might be passed through to standing contract customers following a special circumstances review.

While the Commission understands that some of the variations to the current price regulation arrangements proposed in Box 3.1 could be implemented within the current regulatory framework, others would require changes to the existing legislation. While such changes would reduce some of the risks, distortions and delays associated with the existing approach, the amended regime would continue to have many of the disadvantages of price regulation in a rising cost market environment. These are examined further in section 3.4 below.

### **3.4 Evaluating the existing regulatory framework**

In the First Final Report, the Commission identified significant changes that the South Australian retail energy sector is likely to face in the coming years. Retailers are likely to face increased energy costs caused by one or more of: rising input costs; the need for substantial significant new generation and network investment

requirements; and changing costs structures due to the introduction of climate change policies. Changes in the real costs faced by retailers will need to be passed on in the form of higher retail energy prices to avoid unacceptable reductions in retail margins, with detrimental consequences for supply side responses and competition. This would adversely affect the interests of consumers in the longer term.

The Commission believes that more timely and efficient responses to these changes will be achieved by maintaining and promoting the competitiveness of energy retailing in South Australia, to the benefit of energy consumers and retailers alike. In this section, the Commission evaluates the implications of maintaining the existing framework for retail price regulation for the interests of consumers, retailers, the effectiveness of competition, and the reliability of energy supply in the long term.

#### **3.4.1 Price regulation is not necessary in a competitive market**

In Chapter 2, the Commission observed that price regulation is unnecessary in a competitive market because the competitive process constrains sellers to setting cost-reflective prices. Rivalry between sellers provides the incentive to attract and retain customers by providing the price, product and/or service combination that is most attractive to customers at the lowest cost.

The First Final Report found that competition in energy retailing in South Australia is keeping prices in line with costs and margins at competitive levels. Retailers are subject to competitive disciplines in two principal forms: rivalry between actual and potential competitors as they compete for customers; and customer switching, as customers change retailers and/or switch between offers to take up the product that is best suited to their needs. These disciplines have been effective in ensuring that the prices for retail energy services reflect the efficient cost of providing those services. Indeed, the Commission's analysis of the margins earned by energy retailers in South Australia indicates that margins to date appear to have been competitive and sufficient to encourage new entry and competition, although recent cost increases appear to have reduced margins below competitive levels in some cases.

Where competition is delivering cost-reflective pricing and market efficiency, price regulation is unnecessary. Furthermore, retaining retail price regulation in an environment where retailers are facing increasing input costs is likely to adversely affect the ability of retailers to maintain viable businesses.

#### **3.4.2 Markets are better than regulators at processing information and responding to changing cost and market conditions**

Competition continues to be the most effective (and efficient) mechanism for responding to changes in market conditions. Markets are better able to process complex and rapidly changing information, particularly in relation to changes in costs, in a timely manner and coordinate the actions of market participants. When competition is effective, markets maintain prices in line with real costs of supply as they adjust to changing conditions.

Regulation and regulators are necessarily much less effective in achieving efficient price outcomes due to the inflexibility of regulatory processes and the inherent uncertainty of attempting to forecast efficient future costs and prices over an extended period. Regulators are also unable to react quickly and frequently to changes, often unexpected, in underlying supply and demand conditions. In the South Australian context, the ability of the standing contract price to respond to such changes is subject to an inevitable time lag because increased costs can not be recovered in prices until a pass through application or the next annual tariff adjustment is approved<sup>33</sup>, or until after a special circumstances review is concluded.

While regulators (including ESCOSA) have had some success historically in using the building blocks approach to determine the standing contract prices under conditions of relatively stable costs, there remains a material information asymmetry between regulators and regulated businesses in seeking to forecast future costs and prices. This will be magnified in future by the prospective increases in supply costs in the period ahead. The information difficulties facing regulators mean it is unlikely that price-setting will replicate effective competition. Rather, it is likely to impose costs on retailers and consumers, squeeze retail margins, distort signals for entry and investment, and impede competition in the future.

### **3.4.3 Price regulation is inflexible, particularly in times of unpredictable wholesale energy prices**

As noted in 3.3.4 above, the framework for regulating prices in South Australia does not provide the flexibility necessary to allow ESCOSA or retailers to respond to changes in the real cost of inputs in a timely manner. The premise of the framework appears to be that controllable costs can be reasonably accurately estimated at the time the price determination is made, and will not vary significantly during the three years that a determination is in force.

The process for making a new price determination requires the retailer, in effect, to forecast input costs four years into the future. The changing dynamics of the energy sector suggest there will almost certainly be a substantial misalignment between forecast and actual costs. The annual tariff adjustments are subject to the average revenue and rebalancing controls and cost pass throughs are only permitted in prescribed circumstances. Although these restrictions are, at least in part, intended to provide incentives for the standing contract retailer to operate more efficiently, they also suggest an assumption that the cost of providing electricity or gas retail services within the regulatory period will not change markedly and that any changes that do occur will be reasonably predictable.

As noted above, future energy market conditions are likely to involve increasing and more volatile costs that would be difficult to forecast with any certainty.

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<sup>33</sup> In circumstances where the standing contract retailer does not submit a pass through application, ESCOSA may require the retailer to pass through an amount specified by ESCOSA, i.e. a negative pass through.

Relying on a special circumstances review to provide a timely response to significant changes in input costs is also likely to be inadequate for the reasons set out at 3.3.4 above.

Even if a more flexible approach to pass through was considered (for example, the options canvassed in Box 3.1), uncertainties about future cost trends and delays in the assessment decision-making process would result in the cost pass through process having many of the same risks and shortcomings as the initial price determination process.

#### **3.4.4 Price regulation distorts market signals, supply responses and the development of competition**

Regulating prices in a competitive market can distort the signals that are provided to both suppliers and consumers compared to competitive market-determined prices that reflect the efficient costs of producing that good or service. In the context of an effectively competitive energy retailing sector (such as that in South Australia), price regulation which sets standing contract prices that are either too high or too low can distort competitive pricing of market contracts. Pricing distortions can result if prices are prevented from rising above the regulated price, thereby precluding retailers from recovering rising costs. Distortions can also arise if the level at which the standing contract price is set discourages price reductions to reflect lower real costs because of the need to rebuild margins, or because the standing contract price acts as a focal point in facilitating price coordination by retailers.

As discussed in the preceding sections, if the standing contract price is set below the efficient price, the standing contract retailer (and, by implication, other retailers who offer market contracts priced to compete against the standing contract price) may be unable to earn a margin that is sufficient to preserve financial viability. The Commission's sensitivity analysis in the First Final Report suggests that the likely consequence of maintaining the current standing contract price in an environment of rising input costs is that margins available under market contracts are likely to be below the competitive level and, in the case of electricity, could be negative. The Commission observed that if standing contract prices are not able to accommodate in a flexible and timely way the higher input costs that are likely to flow from the tightening supply/demand balance and the introduction of climate change policies, retailer viability and effective competition could be placed at risk.<sup>34</sup>

The distortions to market signals caused by price regulation can also impede the further development of competition. Declining retail margins can cause financial stress and possible market exit by current retailers, and dissuade entry by new retailers. Generator entry and investment may also be discouraged if the viability of retailers is placed at risk by retail price regulation and generators lose confidence in the capacity of their retailer contract counterparties to meet their financial obligations in the future. These outcomes can have important consequences for energy

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<sup>34</sup> AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia – First Final Report*, September 2008, p. 39.

consumers, retailers and governments. If generator entry or expansion is being constrained at a time when demand for energy is placing pressure on the available generation capacity, South Australian energy consumers may face an increasing risk that the reliability of their electricity supply may be compromised.

### **3.4.5 Price regulation discourages price and service innovation**

The First Final Report found that the presence of the standing contract price was limiting product innovation by South Australian retailers.<sup>35</sup> Although some product innovation has been observed, this is principally restricted to the “pay as you go” product offered by Aurora Energy. The Commission noted that retailers in countries where retail price regulation has been removed have responded to customer demand by offering more innovative tariff designs. For example, price guarantee contracts and fixed and capped price contracts are now offered in the UK; in Norway and Sweden, retailers have developed a range of products including contracts that link the retail price to the electricity spot price.

The standing contract prices also act as a focal point for competition. To date, South Australian retailers have tended to use the standing contract price as the benchmark for their own product development, setting their prices and pricing structures by reference to it, rather than by reference to the prices of their competitors or their own efficient costs.<sup>36</sup> This can encourage tacit price collusion between retailers where it would not otherwise occur such that, on average, customers to pay more than in an environment where prices are not regulated.

### **3.4.6 Price regulation discourages consumer search**

Continuing to regulate retail prices in a competitive market can have detrimental consequences for customers. In his report to the Commission, Professor George Yarrow noted that consumers may be misled into thinking that the regulated price is a price that ESCOSA thinks is fair and reasonable, whereas the price may be above what it would be if it was determined by the competitive market. Similarly, consumers may form the view that a discount on the regulated price must therefore be a good deal, whereas this may also not be the case. Professor Yarrow concluded that consumers who make these assumptions will be discouraged from actively engaging in the market, even where this would provide net benefits to them.<sup>37</sup>

In South Australia, consumers play an important role in imposing a competitive discipline on the pricing and output decisions of energy retailers. A reduction in the vigour of demand side participation may reduce the pressure on retailers to provide their most attractive offers to customers. To preserve the existing levels of effective competition as the retail energy sector transitions to a CPRS and new investment is

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<sup>35</sup> *Ibid*, p. 86.

<sup>36</sup> *Ibid*, p. 86-87.

<sup>37</sup> Professor George Yarrow, *Report on the impact of maintaining price regulation*, Oxford, January 2008, prepared for the Australian Energy Market Commission, pp. 26-27.

commissioned to address the supply/demand balance, it is appropriate that the distortions caused by retail price regulation are removed.

### **3.4.7 Commission's observations**

The existing framework for regulating energy retail prices in South Australia has been overtaken by the development of effective competition as well as by prospective changes in the cost of energy supply which are uncertain and difficult to forecast. The Commission's assessment of competition in the First Final Report indicates that competition is effective in keeping market contract prices in line with real costs of supply, and margins at or below competitive levels. In these circumstances, price regulation is unnecessary and costly. The observable rivalry between retailers and the demonstrated willingness of customers to switch to a different retailer or energy offering is evidence of the discipline that competition is placing on retailers' pricing behaviour. This competitive discipline is sufficient to ensure that the prices for retail energy services continue to reflect the efficient cost of providing those services in future.

The First Final Report also indicates that the regulation of standing contract prices has prevented retailers from passing through rising costs and eroded margins, thus impeding competitive activity. The Report also notes that significant changes to energy markets are approaching, which are likely to involve increasing energy costs and retail energy prices in the coming years. These cost increases are expected as a result of rising input costs, significant new generation and network investment requirements, and changing costs structures due to climate change policies.

The Commission does not believe that the existing framework for price regulation is sufficiently flexible to allow retail prices to respond to these changes. The Commission's analysis suggests that the principal limitation of the regulatory framework is ESCOSA's obligation to "fix" the standing contract price for a three year period in circumstances of rising costs of energy supply. The Industry Acts preclude ESCOSA from adopting less intrusive and more flexible forms of regulation that permit direct pricing intervention to be scaled back while still allowing ESCOSA to monitor pricing patterns and behaviour. The Commission has considered whether this objective could be better achieved within the constraints of the existing legislative framework, or by introducing greater flexibility into the framework. However, it has concluded that the current specification of the price regulation framework (or any variation to it) would remain an obstacle to more flexible cost-reflective pricing which will be necessary in future to allow the timely recovery of increasing energy supply costs. In the absence of such pricing flexibility, there will be risks to the continuing effectiveness of retail competition in South Australia.

Retaining price regulation, even if greater cost pass through flexibility were introduced, is likely to impede the future competitiveness of energy retailing, harming the viability of existing retailers if margins continue to fall. While there is currently a process for standing contract prices to be adjusted to reflect changing market circumstances, the capacity for cost pass through appears to be limited and the process is time consuming and information intensive. Competitive markets are

much better than regulators at processing large quantities of dispersed and changing information.

The Commission has concluded that the current pricing oversight arrangements will be unable to respond effectively to prospective changes in future energy market and cost conditions, relying, as they do, on the capacity of the regulator to determine a future price cap for retail prices based on best estimates of likely future cost and market conditions. An alternative price oversight framework is proposed in Chapter 4 which is better suited to the competitive and cost conditions now in prospect in South Australia.

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## 4 Advice on the Removal of Retail Price Regulation

This Chapter sets out the Commission's draft advice for phasing out retail price regulation and an appropriate timetable for doing so. In developing its draft advice, the Commission has had regard to the analytical framework described in Chapter 2. It has also had regard to the limitations in the existing framework for regulating standing contract prices identified in Chapter 3.

The Commission's draft advice is that the current form of regulation for electricity and gas retail prices in South Australia be replaced with a price monitoring framework supported by a conditional reserve price regulation power that could be applied should effective competition deteriorate substantially. The Commission's draft advice is presented in the following way:

- summary of the key features of the proposed price monitoring framework (section 4.1); and
- assessment of the key features of the proposed framework, including the Commission's reasons for incorporating a price monitoring approach to pricing oversight (sections 4.2 to 4.7).

### 4.1 Summary of the Commission's draft advice

The Commission considers that replacing retail price regulation for standing contracts with a price monitoring framework for standing and default contract prices supported by a conditional reserve pricing power, is the most effective form of regulation for the future of the South Australian retail gas and electricity markets. The introduction of a conditional reserve pricing power would enable the South Australian Government to re-introduce price controls, if effective competition deteriorates. Monitoring and reporting prices promotes transparency which, together with the credible threat of re-regulation, fosters competition while ensuring that prices reflect the real costs of supply.

Price monitoring of all standing contracts and default contracts would apply for an initial three year period, with a review by the AEMC within this period to determine whether the price monitoring regime should continue or be removed.

Under the Commission's recommended framework, all retailers (standing contract and new retailers) will have the obligation to agree to sell electricity and sell and supply gas to consumers on standing contracts (collectively, the Energy Obligation). The Energy Obligation will apply to the financially responsible market participant (FRMP) for the relevant premises. In relation to new connections, the Energy Obligation will remain with the standing contract retailer. Following the removal of retail price regulation, all retailers would be responsible for the setting and amending of their own standing contract prices and the publication of these prices, in accordance with specified disclosure requirements. Default contract prices would be subject to the same disclosure requirements as standing contracts.

In developing its draft advice, the Commission considered the option of removing all retail price regulation and oversight. However, the Commission considers that the removal of all price oversight would not be appropriate at this time as the South Australian retail energy market transitions from regulation to market-determined retail prices and the energy market faces significant changes in costs and market conditions. Rather, the Commission proposes a transitional period where the South Australian Government maintains prudent and transparent regulatory oversight of the pricing performance of the competitive retail market with a credible threat of re-regulation should competition deteriorate substantially, and with a review of the regime to be considered within three years.

Removing retail price regulation in South Australia will allow standing contracts to be priced in a flexible and cost reflective manner, while transparent price monitoring with a reserve pricing power allows the South Australian Government to identify and respond if necessary to any future deterioration of competition and the re-emergence of market power. The competitive market also operates in the context of a comprehensive energy consumer protection framework, which the Commission expects will continue to operate following the removal of direct retail price regulation. The Commission considers that together, the competitive market, the price monitoring framework, reserve pricing powers, and the consumer protection framework, provide a sound basis for protecting the interests of consumers while removing direct retail price regulation.

The key features of the Commission's price monitoring framework are:

- the Energy Obligation will apply to the FRMP for the relevant premises;
- the Energy Obligation for new connections will remain with the standing contract retailer;
- each retailer will be responsible for setting and changing its own standing contract price;
- retailers will not be required to seek ESCOSA's approval to change their standing contract prices but will be subject to a range of publication requirements to notify their current standing contract prices and any changes to them;
- default contract prices will be subject to the same disclosure requirements as standing contract prices;
- ESCOSA will be required to monitor trends in standing contract and default contract prices and be responsible for publishing half-yearly price monitoring reports until such time as its retail price regulation functions are transferred to the Australian Energy Regulator (AER);
- the AEMC will undertake a review of the price monitoring framework within three years of its implementation; and
- the South Australian Government would introduce a conditional reserve pricing power to enable it to re-impose direct price regulation. However, this reserve pricing power would only be exercised following a finding by the AEMC that

competition was no longer effective and recommends re-introducing retail price regulation as an appropriate response.

A role for additional oversight of retail competition for gas in regional areas by ESCOSA is also proposed.

The Commission recommends that this pricing oversight framework be implemented as soon as practicable, noting that a number of legislative changes will be required before this regulatory framework can be put into place. The Commission also notes that the current standing contract price determinations for electricity and gas expire in December 2010 and June 2011 respectively.

## **4.2 Obligation to agree to supply and sell to apply to the FRMP**

The purpose of standing contracts is to provide small customers with the universal right to access electricity and gas supply at a reliable quality and on reasonable terms and conditions. In South Australia, the Energy Obligation currently rests with AGL for electricity and with Origin for gas (i.e. the 'standing contract retailers') under the Electricity Act and Gas Act respectively.

The Commission recommends that the obligation to agree to supply and sell energy on reasonable terms and conditions to small customers should continue to apply following the removal of retail price regulation.

However, the Commission recommends that the Energy Obligation should apply to the FRMP for the relevant premises and, for new connections, the Obligation should remain with the standing contract retailer.

The Commission notes that under the Electricity Act and Gas Act<sup>38</sup>, AGL and Origin are required to fulfil their Energy Obligations by offering to sell energy to small customers, when requested, on standing contracts. The Energy Obligation is a condition of each retailers' retail licence.<sup>39</sup> Therefore, under the Commission's proposed framework, all retailers, not just the standing contract retailer, will be required maintain a standing contract in order to fulfil their Energy Obligations. The Commission understands that this could be achieved by the South Australian Governor declaring the new retailers to be bound by section 36AA of the Electricity Act and section 34A of the Gas Act as appropriate.

The FRMP model allows the Energy Obligation to be allocated to new retailers in line with growth in their shares of the market. If a retailer has been successful at obtaining a customer, it allows the retailer to "retain some value from the initial effort invested, even if that customer later vacates the premises".<sup>40</sup> The FRMP will remain the move-in customer's retailer, unless the new customer chooses to switch to

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<sup>38</sup> Electricity Act, s 36AA(2); Gas Act, s 34A(2).

<sup>39</sup> *Id.*

<sup>40</sup> Ministerial Council on Energy Standing Committee of Officials, *A National Framework for Regulating Electricity and Gas (Energy) Distribution and Retail Services to Customers: Policy Response Paper*, June 2008, p. 20

another retailer. Correspondingly, under the FRMP model, the Energy Obligation for the standing contract retailer diminishes in line with the reduction in its market share.

The FRMP model also sits comfortably with the existing default contract arrangements provided for in the Electricity Act and Gas Act. Under the default contract arrangements the existing retailer or FRMP has the obligation to supply energy to the premises for which it is financially responsible. It follows that the FRMP should also have the Energy Obligation for the premises for which it is financially responsible.<sup>41</sup> Further discussion on the existing default contract arrangements is in Chapter 5.

In relation to the Energy Obligation for new connections, requiring new retailers to supply new connections may create a barrier to entry. This may occur as new retailers may not have adequate wholesale and risk management arrangements in place to support supply obligations that the retailer cannot control or predict with any degree of certainty. In contrast, the standing contract retailer has both sufficient customer numbers and consumption load to accommodate customers acquired through new connections.

In the Victorian Review, the Commission canvassed the option of a distributor tender model for new connections.<sup>42</sup> Under this option, the Energy Obligation for new connections in a specific distribution area would be tendered out to retailers by the relevant distributor. However, stakeholders were almost universally opposed to this option.<sup>43</sup> As a result, the Commission considers that the standing contract retailer's Energy Obligation for new connections should be maintained, at least in the initial three year period of this framework.

### **4.3 Retailers set and amend their own standing contract prices**

Standing contract prices for electricity and gas are currently determined by ESCOSA. The terms and conditions of standing contracts are set out in ESCOSA's Energy Retail Code and cannot be varied by the standing contract retailer.

In contrast, each retailer is free to determine the prices for its own market contracts. Retailers are also able to vary some of the minimum terms and conditions in the Energy Retail Code in their market contracts without ESCOSA's approval.

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<sup>41</sup> The FRMP model simplifies the application of default supply arrangements for new retailers in that it will be required to have standing offer terms and conditions and these can be used as the basis for default supply arrangements. In addition it may address concerns about what should happen at the end of the term of a default supply arrangement in that the default supplier will also be the retailer required to supply on standing offer terms.

<sup>42</sup> AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria – Second Draft Report*, 19 December 2007, pp. 33-35.

<sup>43</sup> See submissions to the Commission's Second Draft Report in the Victorian Review from Citipower, p. 2, Origin p. 6, TRUenergy p. 2, United, p. 2 and SP AusNet pp. 3 - 4.

Under the Commission's proposed framework, ESCOSA would no longer be responsible for determining standing contract prices for electricity and gas and retailers would be allowed to set and amend their own standing contract prices. As discussed above, all retailers will be required to maintain a standing contract, as each FRMP will have the Obligation to supply the relevant premises.

Retailers would not be required to obtain approval from ESCOSA to set or amend their standing contract prices. However, retailers would be subject to a range of disclosure requirements prior to and following a change in their standing contract prices. These disclosure requirements are discussed in section 4.3.2 below. The terms and conditions of standing contracts would also remain subject to the Energy Retail Code and could not be varied by retailers.

Under the Commission's recommended framework, retailers will retain the right to determine their own default contract prices. The Commission's recommendations regarding default contract prices are set out in Chapter 5.

### **4.3.1 Rationale for the removal of retail price regulation**

A regulatory framework that allows the competitive retail market to determine cost-reflective prices will deliver more efficient market outcomes and be in the long-term interests of energy consumers.

As explained in Chapter 3, the regulation of prices in an effectively competitive market will distort price signals, impede competition, and undermine the viability of retailers.

If prices determined by a competitive market are accompanied by a transparent price monitoring regime and an ability to reintroduce price regulation if effective competition deteriorates, a more efficient and flexible price oversight arrangement, which is more suited to an environment of rising energy costs and prices can be applied.

### **4.3.2 Price disclosure requirements for retailers prior to and following a change in standing contract and default contract prices**

#### **4.3.2.1 Publication of summary notices in newspapers**

Prior to changing their standing contract and default contract prices, retailers would be required to publish a summary notice in a relevant local newspaper advising consumers that their prices are to change. This notice would indicate that consumers are able to obtain a copy of the new standing contract/default contract prices on the retailer's website or, upon request, in hard copy from the retailer.

The Commission suggests that ESCOSA develop guidelines governing the timing and format of the publication of these summary notices, which could be included in ESCOSA's Energy Price Disclosure Code.

The Electricity Act and the Gas Act<sup>44</sup> currently require each retailer to publish its default contract prices in the South Australian Government Gazette and in a newspaper circulating generally in the State. Under the Commission's proposed framework, the current disclosure requirements for default contracts could be replaced by a requirement to publish a summary notice in a newspaper indicating a forthcoming change in price rather than the actual amended default contract price. This will be more cost efficient for retailers. Removing the requirement to publish default contract prices in the South Australian Government Gazette will have minimal impact, as few consumers will be aware of this publication.

ESCOSA would also be required to maintain and update a central data base on its website of the current standing contract and default contract prices of all South Australian retailers for ease of access by South Australian energy consumers.

#### **4.3.2.2 Extension of the Energy Price Disclosure Code to standing contract and default contract prices**

ESCOSA's current Energy Price Disclosure Code imposes price disclosure requirements in relation to retailers' market contracts to enable customers to compare competing offers for the sale of electricity and gas.

The Commission proposes that, following the removal of retail price regulation, ESCOSA amend the Energy Price Disclosure Code to extend its disclosure requirements to standing contract prices and default contract prices. Amendment of the Code will require a consultation process.

Some of the price disclosure requirements in the current Energy Price Disclosure Code include:

- publishing a price factsheet for each market contract that a retailer offers to residential customers. These factsheets must contain the estimated annual cost of the market contract for various specified consumption levels and details on any rebates and fees associated with the market contract. These factsheets must be published on the retailer's website, included with any written disclosure statements provided to residential customers, and provided to residential customers on request.
- providing information to ESCOSA for each market contract a retailer has, including but not limited to the price and pricing structures, rebates and fees, and non-price incentives. Retailers are required to inform ESCOSA of any changes to this information within 24 hours of the change.

Extending these disclosure requirements to retailer's standing contract prices and default contract prices, following the removal of retail price regulation, would:

- improve the transparency of standing contract and default contract prices;

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<sup>44</sup> Electricity Act, s 36AB(3)(b); Gas Act, s 34B(3)(b).

- increase the accountability of retailers following a change to their standing contract and default contract prices;
- ensure customers are informed and able to readily access information about changes in standing contract and default contract prices;
- promote price comparisons by customers, which will facilitate greater customer switching;
- provide consistency in the regulatory requirements of market, standing, and default contracts, which is in accordance with good regulatory practice; and
- impose practical limitations on how frequently retailers are able to change their standing contract and default contract prices.

While there are a number of benefits associated with the disclosure of energy prices, there are also risks.

Under certain market conditions, the disclosure of energy prices has the potential to facilitate coordinated pricing and to deter customer poaching through price discounting and “specials”.<sup>45</sup> The UK regulator requires all tariff schedules to be published with a view to reducing consumers’ search costs, but some commentators have been critical of this approach because it also provides information to firms about the behaviour of competitors, and may lead to less vigorous competition.<sup>46</sup> These potentially negative effects of price transparency are more likely to occur where all prices are posted and universally available and where other conditions are conducive to coordinated conduct in a market. An obligation to publish every price deal or offer made to a customer, particularly when made to win a sale, and make it generally, or conditionally, available to all customers, may act as a disincentive for retailers to make such offers and compete as vigorously for customers.

Extending the disclosure requirements in the Energy Price Disclosure Code to standing contracts and default contracts will impose an additional regulatory burden on retailers and intervenes in the operation of effectively competitive markets. Public intervention may also lead to the ‘crowding out’ of information provision services on retail energy prices, which may be offered by private companies such as consumer magazines or newspapers.<sup>47</sup>

The Commission has considered the benefits and risks of extending the disclosure requirements in the Energy Price Disclosure Code to standing contracts and default

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<sup>45</sup> See, for example, David Genesove and Wallace P Mullin, “Rules, Communication and Collusion: Narrative Evidence from the Sugar Institute Case”, *The American Economic Review* Vol 91 No 3, June 2001, 379; Svend Albaek, Peter Mollgaard and Per B Overgaard, “Government Assisted Oligopoly Coordination? A Concrete Case”, *The Journal of Industrial Economics*, Vol. XLV, No.4, December 1997, 429; Jill Walker and Luke Woodward, “The Ampol/Caltex Australia Merger: Trade Practices Issues”, *Trade Practices Law Journal*, Vol.4, No.1, March 1996, 21.

<sup>46</sup> Professor Stephen Davies, Prof Catherine Waddams Price and Cheryl Whittaker, “Competition Policy and the UK Energy Markets”, *Consumer Policy Review* Jan/Feb 2007, Vol 17, 1 at p. 5.

<sup>47</sup> Professor George Yarrow, *Report on the impact of maintaining price regulation*, Regulatory Policy Institute, Oxford, January 2008, p. 28.

contracts. On balance, the Commission considers that the benefits to consumers of extending these disclosure requirements, in terms of price transparency and information accessibility, outweigh the potential risks of price coordination by retailers and a reduced incentive to discount. Further, standing contract and default contract customers are generally those who have not actively participated in the market by switching to a market contract for retail energy supply. Therefore, standing contract and default contract customers may have a greater need for transparent and easily accessible pricing information. As the South Australian retail energy sector transitions from regulation to market-determined retail prices, the Commission suggests that it may be prudent to extend these disclosure requirements to standing contract and default contract prices.

The disclosure of pricing information on market contracts is already required by ESCOSA under the Energy Price Disclosure Code. The Commission considers that, in the initial three year period of the price monitoring framework, these disclosure requirements for market contracts should remain in place. The continued need for price disclosure requirements for market contracts could be reviewed by the AEMC as part of its review of the price monitoring framework. Further discussion on the Commission's recommendations for its review of the framework can be found in section 4.7 below.

#### **4.4 Price monitoring role for ESCOSA**

The AEMA recognises that phasing out retail price regulation could involve a period of price monitoring.

Under the regime recommended by the Commission, in addition to the above publication requirements for standing contract and default contract prices, ESCOSA would undertake a clearly specified form of price monitoring, following the removal of direct retail price regulation. Once the national framework for retail regulation is established and transferred to the AER, it is appropriate that this monitoring function be performed by the AER.

The objective of a price monitoring framework would be to monitor and publish trends in the standing contract and default contract prices for gas and electricity products offered to small customers. As discussed above, standing contract and default contract customers are generally those who have not actively participated in the market by switching to a market contract for retail energy supply. They are therefore more likely to assume that standing contract and default contract prices are reasonable without question or market verification, and are therefore more in need of the safeguard of a price monitoring regime for standing contract and default contract prices.

The Commission considers that the monitoring of standing contract and default contract prices will:

- provide price transparency for consumers and the South Australian Government, and accountability of price transparency for retailers;

- allow the identification of any potentially inappropriate pricing; and
- provide an informative basis for any further competition review by the AEMC and subsequent policy action by the South Australian Government.

#### **4.4.1 Proposed features for the price monitoring framework**

ESCOSA's price monitoring framework should have the following features:

- operate for a minimum of three years, with a review within this period of the need for it to continue beyond three years;
- monitoring and reporting to be based on observed standing contract and default contract prices;
- price monitoring and reporting to be conducted and published by ESCOSA and reported to the South Australian Government, at least until the establishment of the National Customer Framework; and
- ESCOSA to be required to publish half-yearly price monitoring reports.

At a minimum, the following information is to be reported on by ESCOSA in its half-yearly price monitoring reports:

- trends for each retailer's standing contract and default contract prices, including the price impacts of each standing contract and default contract on annual customer bills for defined consumption levels; and
- changes in the pricing structures for standing contract and default contract prices.

ESCOSA already reports on a range of pricing information in its Annual Performance Reports on the energy retail market. Under the proposed price monitoring framework, ESCOSA would continue to prepare and publish its Annual Performance Reports. It is likely that ESCOSA's Annual Performance Reports would contain similar information to ESCOSA's price monitoring reports. Therefore, to avoid duplication and reduce the regulatory burden for ESCOSA, ESCOSA could publish one stand alone price monitoring report a year (e.g. in June each year) and include an update of its price monitoring report in its Annual Performance Report in the second half of the year. This would allow ESCOSA to fulfil its half-yearly price monitoring/reporting function with minimal additional compliance costs.

It was suggested above that ESCOSA could consider amending the Energy Price Disclosure Code to require retailers to publish factsheets and certain other information about their standing contract and default contract prices. Such an amendment may assist ESCOSA to perform its proposed price monitoring role using the information obtained from retailers under the Code. Retailers should also be required to provide any additional information to ESCOSA which is necessary for it to fulfil its price monitoring role, following a reasonable request. Such requests are likely to occur infrequently. Therefore, the implementation of this price monitoring framework is likely to impose low compliance costs for retailers.

The Commission does not recommend that ESCOSA's monitoring role be extended to movements in wholesale electricity and gas prices. Retailers employ a wide variety of hedging strategies to manage wholesale price risk on behalf of their customers and there is no simple or necessary correlation between wholesale and retail prices in a effectively competitive market. Energy contract portfolios are traded and varied daily by retailers and their component parts and values cannot be represented in simple averages. Furthermore, retailers' energy contract portfolios provide for supply to all of their customers and are not targeted to different customer classes such as small customers. This suggests that monitoring retailers' wholesale costs is likely to be an arbitrary and uncertain exercise with high compliance and administration costs.

The Commission considers that these proposed disclosure requirements represent a reasonable balance between ensuring information transparency and accessibility for consumers, whilst not imposing excessive additional costs upon retailers or ESCOSA.

#### **4.4.2 Additional oversight of retail competition for gas in regional areas**

The First Final Report found that competition in both the gas and electricity retail markets in South Australia is effective. However, a number of structural features were identified as limiting the opportunities for new retailers to expand into regional areas. These structural features included difficulty experienced by retailers in accessing firm capacity in the case of the laterals on the Moomba to Adelaide Pipeline System (MAPS) and difficulty experienced by retailers in accessing firm capacity at competitive prices in the case of the South East South Australian (SESA) Pipeline.

Access to the MAPS laterals is required to supply gas customers in the Whyalla, Port Pirie, Riverland and Murray Bridge areas, while access to the SESA Pipeline is necessary to supply customers in the Mt Gambier regional network. As discussed in the First Final Report, all firm capacity on the MAPS laterals is fully contracted to the standing contract retailer Origin, under contracts which were in place prior to the start of full retail contestability (i.e. legacy contracts). Firm capacity is also currently fully contracted to Origin on the SESA Pipeline and retailers wishing to supply Mt Gambier gas customers must negotiate for capacity with Origin, their competitor.

While these issues do not impact on 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 gas customers to access the full benefits of competition.

As discussed in the First Final Report, some of these issues may be resolved in the near term. In particular, Origin's legacy contracts for firm transmission haulage capacity on the MAPS laterals are expected to expire in the short to medium term. In addition, market offers from Origin available to regional gas customers currently provide the same level of discounting as market offers available in Adelaide, which are subject to more intense competition.

Nevertheless, the Commission considers there could be value in requiring oversight by ESCOSA of gas pricing offers in regional areas, in order to monitor the impact of these structural features in the regional gas supply over the near term on the access of regional gas customers to competitively priced market offers.

The Commission considers that this additional oversight role for ESCOSA could include:

- reporting on the price difference between market contracts offered by Origin in regional areas and comparable market contracts offered by Origin in metropolitan Adelaide; and/or
- maintaining a register of approaches to Origin for access to the SESA Pipeline and the outcomes of those requests for access.

Such additional oversight role could be undertaken by ESCOSA in addition to the general price monitoring role discussed above. The Commission seeks stakeholder comments on these additional monitoring options which are discussed further below.

#### **4.4.2.1 Reporting on the price difference between comparable market contracts in regional and metropolitan areas**

Under this option, ESCOSA could include a section in its half-yearly price monitoring reports on trends in the price differences between comparable market contracts offered by Origin in regional areas and in metropolitan Adelaide.

As discussed above, Origin is currently the only retailer in regional South Australia offering market contracts. Despite this, Origin's market offers to regional gas customers currently provide the same level of discounting as market offers available in Adelaide.

Monitoring by ESCOSA of trends in the pricing of comparable regional and market contracts from Origin may assist ESCOSA to identify any changes in Origin's pricing behaviour in regional areas following the removal of retail price regulation. This will also allow ESCOSA to monitor the access of regional customers to competitively priced market offers, after taking into account any differences in transportation costs between the metropolitan and regional retail gas supply.

As discussed above, as retailers are already required to report to ESCOSA on their market contract prices under the Energy Price Disclosure Code, Origin would not be required to comply with any other additional reporting obligations. Therefore, the costs of implementing this additional reporting function are likely to be relatively low for Origin and ESCOSA.

The Commission would welcome stakeholder views on the appropriateness of this option.

#### **4.4.2.2 Maintaining a register of approaches to Origin for access to the SESA Pipeline**

Under this option, Origin would be required to notify ESCOSA on a periodic basis of any requests for access to the SESA Pipeline that it had received and the outcome of each request for access. This would allow ESCOSA to monitor the level of competition, and the potential for future competition, in gas retailing to small customers in regional areas and identify any potential for the exercise of market power by Origin. This may be indicated by the register if for instance, an ongoing trend of failures in negotiations for access to the Pipeline are reported by Origin, which could not be justified on verifiable commercial grounds. The Commission suggests that this register may improve the transparency and accountability of Origin's negotiations with its competitors.

A similar obligation has been placed on service providers of light regulation covered pipelines under the National Gas Rules.<sup>48</sup> The National Competition Council has suggested that the disclosure of information about access arrangements for light regulation covered pipelines may address "any information asymmetry between service providers and users and assist in providing a more even platform for negotiations to take place between them".<sup>49</sup>

The scope and content of this register, including the type of information which is reported on by Origin and the frequency of reporting could be developed by ESCOSA through a public consultation process. This would allow stakeholders to comment on the role and content of the register, while also ensuring that the costs of complying are not unduly high for Origin and do not risk exposing commercial in confidence information. The Commission also notes that if this option is developed further, this register would need to be mindful of the impact on the existing contractual rights of Origin.

The Commission seeks stakeholder submissions and comments on this proposal for monitoring Origin's responses to requests for access to gas pipeline capacity or haulage contracts.

### **4.5 Introduction of a conditional reserve pricing power**

Clause 14.14(c) of the AEMA provides for the retention of a reserve price regulation power by jurisdictions following the phasing out of retail price regulation.

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<sup>48</sup> Under s 37 of the National Gas Rules, service providers of light regulation pipelines are required to report to the AER on access negotiations for light regulation services. These reports must be made at least annually at times specified by the AER and state the result of the access negotiations. Under the National Gas Rules, the AER is also able to: require that other additional information be included in these reports; specify the manner and the format of these reports; and publish an assessment of the information reported to it by service providers.

<sup>49</sup> National Competition Council, *The National Gas Law: A guide to the functions and power of the National Competition Council under the National Gas Law: Part C: Light regulation of covered pipeline services*, August 2008, p. 48.

The Commission recommends that a conditional statutory power that can be exercised by the South Australian Government to re-introduce retail price regulation be included in the Electricity Act and the Gas Act. Under this power, the South Australian Government could respond quickly to re-introduce price regulation, where a review of competition by the AEMC concludes that competition is no longer effective and recommends the re-introduction of retail price regulation as the appropriate policy response. As noted in section 4.6 below, such reviews by the AEMC would need to be conducted on an expedited basis to ensure a timely policy response to substantial changes in market conditions and outcomes.

The introduction of a reserve pricing power, together with the capacity for accelerated competition reviews by the AEMC, publication requirements for retailers, and regular price monitoring reports by ESCOSA, will provide appropriate incentives for retailers to charge cost-reflective prices following the removal of price controls. The creation of a reserve pricing power should, however, provide comfort to consumers and the South Australian Government that a mechanism is in place to allow for retail price regulation to be re-introduced in the event that these incentives are not sufficient to ensure that competition remains effective.

#### **4.6 Additional competition reviews by the AEMC**

Under the AEMA, the South Australian Government can request that the AEMC undertake another competition review if there is concern that there has been a substantial deterioration in the effectiveness of competition in either the retail supply of gas or electricity.

A request by the South Australian Government for a further competition review could be triggered by a change in trends in standing contract and/or default contract prices, which can not be satisfactorily explained by observable market conditions or by the retailer(s) concerned following a request for additional information.

Under this framework, changes in the trends of standing contract and/or default contract prices could be identified through:

- ESCOSA's half-yearly price monitoring reports; and/or
- the AEMC's periodic review of the framework.

The South Australian Government may also consider requesting the AEMC to undertake a subsequent competition review as a result of:

- structural changes in the retail sale of gas or electricity, such as the exit of retailers or the suspension of active marketing activities by a number of retailers;
- a rapid increase in the number of retailers pursuing vertical integration with generators;
- an increase in the number of customer complaints to the Energy Industry Ombudsman; or
- a sharp reduction in customer churn.

These events represent just some of the events which may trigger a request for another competition review by the Commission. Ultimately, the South Australian Government has the discretion to determine whether conditions in the retail supply of electricity or gas justify the need to request another competition review.

If the South Australian Government considers that there may have been a deterioration in effective competition, there may be a need for a rapid response by the Commission. Therefore, the South Australian Government should have the ability to request a review by the Commission at short notice and according to an accelerated timeframe. The Commission suggests that there is the potential for an accelerated competition review to be completed within a matter of weeks rather than months.

This will allow the South Australian Government to assure consumers that it is able to respond in a timely manner and take appropriate policy action following a suspected deterioration in effective competition. Further, the ability of the South Australian Government to undertake a swift policy response following the identification of a credible threat to the effectiveness of competition will also provide a strong incentive for retailers to avoid market behaviours which are likely to trigger such a response.

#### **4.7 AEMC review after three years on the effectiveness of the framework and the form of regulation that should apply**

A periodic review of this regulatory framework would be in accordance with good regulatory practice and would be necessary to ensure that the form of regulation is appropriate for the state of development of competition in the market.

The Commission recommends that the AEMC undertake the review of the price monitoring regime to assess the effectiveness of the framework in encouraging competition in the supply of gas and electricity to small customers in South Australia, within three years of the implementation of this framework. This review could also include an assessment of and recommendation on the form of regulation that should apply in the retail supply of gas and electricity in South Australia going forward. The findings of this review would be presented to the South Australian Government for its consideration.

#### **4.8 Commission's observations**

The Commission considers that replacing retail price regulation with a comprehensive price monitoring framework for standing and default contract prices, supported by a conditional reserve pricing power, is the most effective form of regulation for the current and likely future conditions in the South Australian retail gas and electricity markets.

The removal of retail price regulation in markets where there is effective competition will allow energy prices to respond flexibly to changes in the real costs of producing and supplying energy. This will ensure the viability of retailers and the maintenance of effective retail competition in an environment of changing market conditions,

policy settings, and rising energy costs. A comprehensive price monitoring regime for standing and default contract prices will provide price transparency and accountability for consumers. It also allows the South Australian Government to maintain prudent and transparent regulatory oversight of the pricing performance of the competitive retail market, identify any potentially inappropriate pricing by retailers, and inform the need for any subsequent competition review by the AEMC. The introduction of a conditional reserve pricing power enables the South Australian Government to reintroduce price controls, under specific conditions, should effective competition deteriorate.

The Commission considers that its recommended regulatory framework together with the existing consumer protection framework provides an appropriate balance between ensuring that the viability of retailing is maintained into the future and protecting the interests of consumers.

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## 5 Consequential Amendments Following the Removal of Retail Price Regulation

As noted in Chapter 3, the existing framework for regulating energy retailing in South Australia contains a range of mechanisms aimed at protecting customers. These include the price-setting function performed by ESCOSA in relation to standing contract prices, and regulation (again by ESCOSA) of the non-price terms and conditions on which energy is supplied.

The Industry Acts provide a number of other important non-price protections for customers: the obligation on a standing contract retailer to offer to supply and sell energy to any customer who seeks it (the obligation to supply or, in this Report, the Energy Obligation); treating a contract as being in place to ensure the customer is supplied on minimum terms and conditions, including price (default contracts); and providing for energy to continue to be supplied to customers whose retailer defaults on this obligation (retailer of last resort).

The Commission does not propose that these protections be removed. The Commission has considered how the replacement of direct retail price regulation with a price monitoring framework will affect the ways these protections operate and, in some circumstances, makes some suggestions as to how these protections might be improved. This Chapter sets out the Commission's advice about how these protections can continue to operate effectively in an environment without direct retail price regulation. Chapter 5 concludes with a discussion of the need for an awareness and education campaign for small customers.

### 5.1 Pricing the Energy Obligation

Section 36AA of the Electricity Act provides that a licensed retailer declared by the Governor to be an entity to which the section applies is subject to a licence condition that requires the retailer to, at the request of a small customer, agree to sell electricity to the customer at the retailer's standing contract price and subject to its standing contract terms and conditions.<sup>50</sup> Corresponding provisions apply in relation to the sale and supply of gas under the Gas Act.<sup>51</sup> In the Second Draft Report, these obligations are referred to as the "Energy Obligation".

#### 5.1.1 Commission's analysis

Energy, particularly electricity, is an essential service for modern day living. Therefore, the Energy Obligation serves as an important safeguard for those consumers who, by virtue of their personal circumstances or the perception that they

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<sup>50</sup> Electricity Act, s 36AA(1) and (2). On 12 September 2002, AGL South Australia Pty Limited was declared as a retailer to whom s 36AA applies.

<sup>51</sup> Gas Act, s 34A(1) and (2). On 24 September 2004, Origin Energy Retail Pty Limited was declared as a retailer to whom s 34A applies.

are unprofitable to serve, may be at risk of experiencing difficulty in securing a market contract.

In recognition of its essential nature, the Commission considers that regulatory arrangements should remain in place to ensure that residential customers have access to the sale and supply of energy on reasonable terms and conditions. To this end, the Commission is of the view that the non-price terms and conditions on which energy is supplied in satisfaction of this obligation should continue to be regulated by ESCOSA through the Energy Retail Code.

Consistent with the Commission's recommendation in Chapter 4 that direct retail price regulation be replaced with a price monitoring framework, the price at which energy is offered for sale and supply will cease to be regulated. This will not, however, frustrate the continuation of the Energy Obligation. As discussed in Chapter 4, the Commission has recommended that all retailers (standing contract and new retailers) be bound by the Energy Obligation in respect of each premises for which it is the FRMP. In relation to new connections, the Energy Obligation will remain with the standing contract retailer.

Under the Commission's recommended framework, each retailer will be able to set its own standing contract prices, affording it greater flexibility to determine more cost-reflective prices. These prices will be subject to a range of publication and disclosure obligations, which are discussed further in Chapter 4.

The Commission also notes that its recommendations are consistent with the recommendations in the NCF Policy Paper, which was recently published by the MCE SCO on the National Framework for Regulating Electricity and Gas (Energy) Distribution and Retail Services to Customers.<sup>52</sup> The MCE SCO's recommendations have not yet been accepted by the MCE, however the Commission acknowledges that the recommendations have been made following an exhaustive public consultation process.

The Commission has also had regard to whether the Energy Obligation should continue in relation to residential and business customers. This policy issue was also reviewed by the MCE SCO in its Policy Response Paper. The MCE SCO suggested that the obligation apply to all residential customers, and non-residential customers whose consumption is less than 100 MWh of electricity or 1 TJ of gas per annum but that a retailer be able to fulfil its obligation by offering those customers whose consumption is 40-100 MWh per annum a market contract. The Commission is of the view that questions about the breadth of the Energy Obligation should be considered as part of the MCE process.

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<sup>52</sup> Ministerial Council on Energy Standing Committee of Officials, *A National Framework for Regulating Electricity and Gas (Energy) Distribution and Retail Services to Customers: Policy Response Paper*, June 2008, p. 19.

### 5.1.2 Commission's draft recommendations

The Commission recommends that:

- the obligations to sell electricity and supply and to sell gas to small energy customers apply to the FRMP for the relevant premises;
- the obligation to sell electricity and supply and to sell gas to small energy customers for new connections continue to be borne by the electricity standing contract retailer and the gas standing contract retailer; and
- each retailer be able to set and amend its own standing contract price, without ESCOSA's approval.

## 5.2 Default contract pricing

A default contract is a contract formed between a retailer who is financially responsible for a small customer's connection point (i.e. the FRMP), and the small customer at that connection point who does not have any existing contract in place with that retailer for that connection point but has begun taking supply.<sup>53</sup>

Under the current framework, the price for energy supplied under a default contract can be set in one of three ways. In the case of electricity, the default contract price is whichever of the following was last fixed:

- the price fixed for the sale of electricity to non-contestable customers under the Electricity Pricing Order as at 31 December 2002 for the sale of electricity to non-contestable customers;
- the price fixed by the retailer as its default contract price; or
- the price fixed by ESCOSA as the retailer's default contract price.

Similar arrangements apply to setting the energy price under default gas contracts, with the price determined by whichever of the following three prices was last fixed:

- the price fixed under the Gas Act as at 31 December 2002 for the sale and supply of gas to a class of customers to which the customer belongs;
- the price fixed by the retailer as its default contract price; or
- the price fixed by ESCOSA as the retailer's default contract price.

A retailer who sets its own default contract price must publish notice of its prices in the South Australian Government Gazette and include a statement of justification for the price they have set.

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<sup>53</sup> Electricity Act, s 36AB(1); Electricity Regulations, reg 7F(1).

Most South Australian energy retailers have elected to fix their default contract prices in this way, stating that their price is the same as the standing contract price determined by ESCOSA. Those who have not set a price are required to supply energy under a default contract at prices which were in place prior to full retail competition (FRC).

### **5.2.1 Commission's analysis**

Under the Commission's proposed framework, retailers will be able to set and amend their own standing contract prices. Consistent with this recommendation, the Commission considers that retailers should retain their right to set and amend their own default contract prices.

Retailers who currently set their default contract price at the standing contract price could continue to use the standing contract price as a reference. However, under the framework recommended by the Commission, this would be a price determined by each retailer rather than by ESCOSA.

The opportunity for the default contract price to be set either by ESCOSA or by reference to the pre-FRC prices contained in the Electricity Pricing Order or Gas Act amount, in effect, to retail price regulation. Consistent with the objectives of the AEMA, it is appropriate that these price controls be phased out. Accordingly, the ability for ESCOSA to set the price and the opportunity for the price to be determined by the Electricity Pricing Order or Gas Act (as appropriate) should be removed.

As discussed in Chapter 4, the Commission has recommended that the Energy Price Disclosure Code be extended to default contract prices and that prior to changing their default contract prices, retailers should be required to publish a summary notice in a newspaper, indicating that their default contract prices are to change. The Commission also recommended in Chapter 4 that default contract prices should be subject to its proposed price monitoring framework.

### **5.2.2 Commission's draft recommendations**

The Commission's draft recommendations are that:

- the default contract price not be able to be fixed by ESCOSA. Each retailer should determine its own default contract price;
- retailers' default contract prices should be subject to the requirements in ESCOSA's Energy Price Disclosure Code;
- prior to changing their default contract prices, retailers should be required to publish a summary notice in a relevant local newspaper advising consumers that their prices are to change; and
- default contract prices should be subject to the Commission's proposed price monitoring framework, as outlined in Chapter 4.

### 5.3 Pricing energy sold following a RoLR event

The failure of a retailer to meet its obligation to supply electricity or gas to its customers can trigger a RoLR event. The RoLR scheme endeavours to ensure that electricity or gas (as appropriate) is supplied to these customers by another retailer. The kinds of events that can cause a retailer to default on its obligations and the operation of South Australia's electricity RoLR scheme are described in Appendix A. South Australia does not presently have a RoLR scheme for gas.

The price at which electricity is supplied to small electricity customers is determined by the retailer of last resort, ETSA Utilities. This price must be calculated in accordance with principles set out by ESCOSA in *Electricity Industry Guideline No 8: Retailer of Last Resort Pricing Guideline* (RoLR Guideline). In short, the Guideline sets out:

- ETSA Utilities to use its best endeavours to incur the lowest possible costs in meeting its obligations, including making appropriate arrangements with third party service providers.
- Costs incurred by ETSA Utilities are assigned to three categories: establishment costs, energy costs and retail operating costs. Establishment costs are the costs that ETSA Utilities must incur because of its legal obligation to act as the RoLR, notwithstanding a RoLR event may not occur. Establishment costs are recovered by ETSA Utilities under the Electricity Distribution Price Determination (EDPD) through distribution use of system charges. The latter two categories, energy costs and retail operating costs, would be incurred during a RoLR event and are defined as "Retailer of Last Resort Charges" and may be recovered from customers through the charges imposed for the sale of electricity when acting as the RoLR.
- Provisions are in place for ETSA Utilities to apply to ESCOSA for costs to be recovered as a pass through amount under the EDPD if ETSA Utilities does not recover sufficient revenues through its Retailer of Last Resort Charges.
- ETSA Utilities must develop standard terms and conditions for the sale of electricity to customers that are required to be approved by ESCOSA.
- ETSA Utilities must develop prices for the sale of electricity to small customers and the prices must comprise a fixed element (supply charge) and a variable element (usage charge).

Relevantly for present purposes, the RoLR Guideline requires that the variable element of the price for the sale of electricity to small customers (i.e. the usage charge) must be consistent with the variable element of the relevant standing contract prices.<sup>54</sup> This can be achieved by either replicating the relevant element of

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<sup>54</sup> RoLR Guideline, clause 2.5.4.

the relevant standing contract prices, or averaging of the relevant elements of all standing contract prices into one or more classes.<sup>55</sup>

### **5.3.1 Commission's analysis**

The RoLR Guideline provides a well-defined process for the recovery of costs associated with establishing the RoLR requirements and acting as the RoLR in a RoLR event. The pricing of the variable component of the energy charge is linked to elements of the standing contract price, which may provide ETSA Utilities with a defined reference point. Given the Commission's draft recommendation to allow retailers to set their own standing contract prices, the elements considered by retailers in setting their standing contract prices may not be readily available to ETSA Utilities. In this case, it may be more appropriate to establish an alternate reference point or clarify the considerations that must be taken into account by ETSA Utilities when pricing the variable charges to be applied in a RoLR event.

The RoLR scheme minimises the risks faced by both energy consumers and businesses in the event a retailer makes an unplanned exit from the market. For this reason, a RoLR scheme for gas would also be of benefit.

### **5.3.2 Commission's draft recommendations**

The Commission's draft recommendations are that:

- ESCOSA consider whether the reference in the RoLR Guideline to linking the variable element of the price should continue to be referenced to the variable element of the standing contract price; and
- a RoLR scheme be introduced for gas as a matter of priority.

## **5.4 Consumer awareness and education**

### **5.4.1 Commission's analysis**

Removing retail price regulation for small customers represents a substantial reform of the energy regulatory framework. Communicating the changes to all stakeholders and, in particular, residential customers, is necessary to ensure awareness and to maintain confidence in the market.

The effectiveness of the regulatory framework relies on small customers being aware of their rights to request and receive information about energy offers. An effective consumer awareness and education campaign may help to address concerns that some customers are not well informed and do not know where to go to obtain information about retail energy offers.

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<sup>55</sup> RoLR Guideline, clause 2.5.5.

An awareness and education campaign may also present a timely opportunity to ensure that small customers are aware of their rights under the consumer protection framework. This may serve to reassure customers that there are range of energy-specific provisions and provisions of general application that will support customers in the transition to an energy retail sector without retail price regulation.

For these reasons, the Commission considers it is appropriate, prior to the removal of retail price regulation, to implement a consumer awareness and education campaign, as a transitional measure.

#### **5.4.2 Commission's draft recommendation**

The Commission's draft recommendation is that an appropriately targeted and timely consumer awareness and education campaign be undertaken to inform small energy customers of:

- the formal changes that will take place, e.g. the ability for each retailer to set its own standing contract price, and explaining the implications of these changes;
- their rights under the consumer protection framework;
- the benefits of seeking alternative offers and information from retailers and other sources (including the ESCOSA Estimator service) regarding alternate energy options; and
- the avenues available to them for seeking redress or lodging complaints about marketing or sales misconduct.

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## 6 Assessing South Australia's Compliance with the AEMA

As noted previously, the AEMA records the commitment made by each signatory to phase out retail price regulation for electricity and natural gas where effective retail competition can be demonstrated.<sup>56</sup> The specifics of this commitment are reflected in clauses 14.10-14.11 of the Agreement. The AEMA requires that, as part of this Review, the Commission advise South Australia on its compliance with these clauses.<sup>57</sup>

This chapter summarises South Australia's obligations under the relevant clauses of the AEMA, identifies those obligations the Commission is able to assess compliance with at this time, and sets out the its preliminary conclusions.

### 6.1 Obligations against which compliance is to be assessed

Under clauses 14.10-14.11 of the AEMA, South Australia is, in summary, required to:

- reaffirm its commitment to full retail contestability in accordance with the National Competition Policy Agreements<sup>58</sup>;
- meet social welfare and equity objectives through clearly specified and transparently funded community service obligations (CSOs) that do not materially impede competition<sup>59</sup>;
- where competition is not yet effective for a market, group of users or a region and energy retail price controls are imposed, impose controls that do not, to the extent possible, further hinder the development of competition and ensure that the benefits outweigh the costs, and costs are minimised<sup>60</sup>;
- where competition is not yet effective for a market, group of users or a region and energy retail price controls are imposed, retain such price controls under the existing arrangements or transfer them to the AER and the Commission<sup>61</sup>;
- where competition is found to be effective, phase out retail price regulation<sup>62</sup>; and
- where a reserve price regulation power is retained, only exercise that power in accordance with a regulatory methodology promulgated by the Commission and

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<sup>56</sup> AEMA, clause 14.11.

<sup>57</sup> AEMA, clause 14.11(c) and letter dated 25 May 2007 from the Chair of the Ministerial Council on Energy, the Hon Ian McFarlane to the Chairman of the AEMC, Dr John Tamblyn.

<sup>58</sup> AEMA, clause 14.10.

<sup>59</sup> *Ibid*, clause 14.11(b).

<sup>60</sup> *Ibid*, clause 14.12(a).

<sup>61</sup> *Ibid*, clause 14.12(b).

<sup>62</sup> *Ibid*, clause 14.13.

subject to review by the Commission of the effectiveness of competition in accordance with clause 14.11.<sup>63</sup>

As the South Australian Review is the first review to be undertaken in the jurisdiction pursuant to the AEMA, and given the Commission's findings that competition is effective for the whole of the electricity and gas markets, the compliance matters on which the Commission is required to advise are subject to practical limitations. Therefore, at this time, the Commission's advice relates to South Australia's compliance with clauses 14.10 and 14.11(b) of the AEMA.

Compliance with other clauses of the AEMA, such as clause 14.13 (commitment to phasing out retail price regulation) and 14.14(c) (exercise of a reserve price regulation power), will assume greater significance in the event that the Commission undertakes a second or subsequent review under the AEMA.

## **6.2 Assessment of South Australia's compliance with the AEMA**

### **6.2.1 Commitment to full retail contestability**

The South Australian energy sector has experienced a number of significant reforms over the past 15 years. While some of the reforms, such as the corporatisation of South Australia's energy assets, commenced prior to the formulation of Australia's National Competition Policy (NCP), energy sector reform has continued in line with the NCP objective of enhancing competition in Australia. One of the most recent – and notable – examples of competition reform is the introduction of FRC for all electricity and gas customers in South Australia.

In light of South Australia's introduction of contestability for all energy customers, the Commission is of the view that South Australia has demonstrated its commitment to full retail contestability in accordance with the NCP.

### **6.2.2 Community service obligations**

Under clause 14.11(b) of the AEMA, South Australia is to ensure that its social welfare and equity objectives are met through clearly specified and transparently funded CSOs that do not materially impede competition.

There are currently four CSO programs in place in South Australia:

- a customer concession scheme for energy;
- the Emergency Electricity Payment Scheme;
- funding assistance; and

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<sup>63</sup> *Ibid*, clause 14.14(c).

- the Country Equalisation Scheme.

Each of these CSOs, and the Commission's assessment of their compliance with the AEMA, are discussed in turn below.

### **6.2.2.1 Customer concession scheme for energy**

The customer concession scheme is a discount on the cost of energy provided to an eligible customer by way of a reduction in the amount payable under an electricity bill, exclusive of GST.<sup>64</sup> The scheme provides for a maximum daily concession amount, payable per billing period up to \$120 per annum. For administrative simplicity the concession is applied through the electricity bill.

The concession is funded by the South Australian Government and the scheme is administered by the Department of Families and Communities. The customer concession scheme for energy is a scheme established under section 21(1)(h) of the Electricity Act. It is a condition of each retailer's licence that they must comply with the requirements of the scheme, thereby ensuring all eligible customers have access to the scheme.

The Commission considers that the energy concession scheme is clearly specified and transparently funded. Eligible customers receive a concession in the cost of energy and, as all retailers are required to comply with the requirements of the scheme, the application of the scheme does not affect the conditions of retail competition. For these reasons, the Commission's view is that the scheme does not materially impede competition.

### **6.2.2.2 Emergency Electricity Payment Scheme**

Under the Emergency Electricity Payment Scheme (EEPS), customers experiencing the threat of disconnection may be eligible for a one-off payment of up to \$400. The payment is made against the balance of the customer's electricity bill, although it can be used for household electricity or gas consumption. EEPS is administered by the Department of Families and Community and funded by the South Australian Government.

A customer wishing to make an application for payment must contact a Families SA District Centre (District Centre). The applicant must then attend at least one financial counselling session with the District Centre or with an approved non-government financial counsellor. The counsellor will consider the customer's circumstances according to criteria specified by the Department before making a recommendation about the customer's suitability for the payment. As the payment is only available to customers under the threat of disconnection, evidence of the threat of disconnection

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<sup>64</sup> An eligible customer includes a person in receipt of certain pensions or benefits and who meets certain other criteria. Further information about eligibility is available from the Department of Families and Communities website at [www.familiesandcommunities.sa.gov.au](http://www.familiesandcommunities.sa.gov.au).

is usually required. Other criteria used for the assessment include whether the customer:

- is in acute financial distress;
- has experienced a recent decrease in income levels;
- has experienced a large unexpected increase in expenses (e.g. due to a medical condition); and/or
- has experienced a significant increase in the use of electricity.

An eligible customer may also be recommended to enter into a realistic instalment plan under the Hardship program with the energy retailer prior to receiving any payment.<sup>65</sup>

The Commission considers that EEPS is clearly specified and transparently funded and, in the view of the Commission, does not materially impede competition.

### **6.2.2.3 Miscellaneous funding assistance**

The Department of Family and Communities also provides limited funding to Families SA District Centres to assist customers in financial need. Eligibility for funding is determined on a case-by-case basis by community support workers or financial counsellors. The payments made under this scheme are generally to address an immediate crisis and to assist with essential requirements such as food, transport and energy. Payments may be made in addition to any payment under the EEPS.

The Commission considers that the scheme for providing funding assistance is clearly specified and transparently funded and, in the view of the Commission, does not materially impede competition.

### **6.2.2.4 Country Equalisation Scheme (CES)**

One of the South Australian Government's objectives of the electricity reform process in South Australia was to maintain minimal differences in the electricity prices paid by country customers compared to city customers.<sup>66</sup> To this end, the Country Equalisation Scheme (CES) was established under section 21(6) of the *Electricity Corporations (Restructuring and Disposal) Act 1999* (SA) (ECRD Act). This scheme was to be administered in two parts:

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<sup>65</sup> A customer would not be excluded from the scheme if he or she was already enrolled in the Hardship program with the energy retailer prior to applying for the payment.

<sup>66</sup> The Office of the South Australian Independent Industry Regulator (SAIIR), *Country Equalisation Scheme – Discussion Paper*, July 2002, p. 2.

- section 8.2 of the Electricity Pricing Order (EPO) imposed an obligation on retailers that the retail charges for small country customers must not be more than 101.7% of the total amount charged to their counterparts in the city for the same service; and
- section 21(1)(c) of the ECRD Act allowed those retailers with costs greater than they charge small country customers to be compensated under the EPO.

Although most of the provisions contained in the EPO have ceased to have effect, those provisions of the EPO that give effect to the CES remain in force. The EPO has the force of law.

In essence, the CES imposes postage stamp pricing for retail customers. Retailers who incur costs in supplying customers that exceed what they can recover through retail price are compensated using the proceeds of the privatisation process. To date, no applications for compensation have been made.

In principle, the CES entrenches a cross-subsidy. A cross-subsidy may preclude customers from receiving accurate signals about efficient prices of goods and services they purchase. It also has the potential to distort the signals to retailers that are necessary to ensure resources are applied to their highest value uses and to encourage innovation. In the case of electricity retailing, requiring retailers to extend offers to customers throughout the state can deter retailers from responding to local market issues by making competitive offers.

However, the evidence before the Commission suggests that cost drivers for location pricing in South Australia are currently weak or absent. Retailers in South Australia face the same charges for using the transmission and distribution systems regardless of the location of the customers they are supplying. Similarly, a single loss factor applies to each system throughout the state. Further, it does not appear that the continuation of the CES has distorted the efficient costs of retailing in regional areas or otherwise impeded the development of retail competition. For example, a number of independent electricity retailers offer market contracts to customers throughout South Australia.

On balance, it does not appear that the CES is adversely affecting retail competition. However, the Commission invites stakeholders to put provide comments and information on this matter for the Commission's consideration prior to the Second Final Report.

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## A Framework for Retail Price Regulation in South Australia

There are three pieces of legislation that, together, principally regulate how electricity and gas is retailed to small customers in South Australia:

- *Electricity Act 1996* (SA) (Electricity Act);
- *Gas Act 1997* (SA) (Gas Act); and
- *Essential Services Commission Act 2002* (SA) (ESC Act).

This appendix summarises the process that is followed to determine the energy prices charged to small customers in South Australia. This information is relevant to the Commission's draft advice for phasing out retail price regulation in Chapter 4.

This appendix also explains the obligation to supply and how retail services provided pursuant to it are supplied, the formation and pricing of default contracts, and the operation of the RoLR scheme as it applies to small customers in South Australia. This information is relevant to the discussions contained in Chapter 5.

A number of non-energy specific regulatory instruments also provide a number of consumer protections to small energy customers in South Australia. This legislation, which includes the *Trade Practices Act 1974* (Cth) and the *Fair Trading Act 1987* (SA), are not canvassed in this Appendix.

### A.1 Overview

In South Australia, a retailer can sell electricity and/or sell and supply gas to a small customer under one of three types of contract:

- standing contract (if the retailer is a standing contract retailer);
- default contract; or
- market contract.

The price at which energy is supplied under a standing contract is regulated by ESCOSA, the jurisdictional regulator. In the case of a default contract, ESCOSA may choose to determine the price for energy or, if the retailer fails to set a price, the prices in force prior to the start of FRC apply. There is no scope for the price for energy supplied under a market contract to be set other than by the retailer.

The terms and conditions on which energy is supplied to small customers are required to be consistent with the terms and conditions approved by ESCOSA and set out in the Energy Retail Code. The standing and default contracts for the sale of electricity must comply with Part B of the Code, and Part C for the sale and supply of gas standing and default contracts. Market contracts for the sale of electricity or the sale and supply of gas must comply with Part A. All contracts, including market contracts, must also comply with other applicable legislation, e.g. the *Trade Practices Act 1974* (Cth) and the *Fair Trading Act 1987* (SA).

## **A.2 Standing contract prices and price setting**

A small customer can request that a retailer designated retailer (in this case, the standing contract retailer), sell electricity or sell and supply gas to him or her and the retailer must agree. In the Second Draft Report, this obligation is referred to as the Energy Obligation.

The contract governing the supply of energy pursuant to this obligation is called the “standing contract”. It is offered at the retailer’s standing contract price and subject to the retailer’s standing contract terms and conditions. The standing contract price is determined by ESCOSA. The non-price terms and conditions are required to be those set out in the Energy Retail Code.

### **A.2.1 ESCOSA’s price regulation functions**

In accordance with Part 3 of the ESC Act, ESCOSA may perform price regulation functions in respect of regulated industries. The electricity supply industry and the gas supply industry (which include the relevant retail sectors) are each declared to be a “regulated industry”.<sup>67</sup> However, any price regulation functions ESCOSA has in relation to the energy retail sector is subject to any limitations imposed by the Electricity Act or the Gas Act (together, the Industry Acts). The implications of this restriction are discussed in further detail below.

ESCOSA’s general power to regulate prices in regulated industries is contained in section 25 of the ESC Act. This section states:

A price determination may regulate prices, conditions relating to prices, or price-fixing factors in a regulated industry in any manner the Commission considers appropriate.

The section then gives a non-exhaustive list of ways that price regulation could be undertaken, including by:

- fixing a price or the rate of increase or decrease in a price;
- fixing a maximum price or maximum rate of increase or minimum rate of decrease in a maximum price;
- fixing an average price for specified goods or services or an average rate of increase or decrease in an average price;
- specifying pricing policies or principles;
- specifying an amount determined by reference to a general price index, the cost of production, a rate of return on assets employed or any other specified factor;

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<sup>67</sup> Electricity Act, s 14D; Gas Act, s 18B.

- specifying an amount determined by reference to quantity, location, period or other specified factor relevant to the supply of goods or services;
- fixing a maximum average revenue, or maximum rate of increase or minimum rate of decrease in maximum average revenue, in relation to specified goods or services;
- monitoring the price levels of specified goods and services.

While section 25 appears to provide ESCOSA a discretion about the manner in which it will regulate retail prices, as foreshadowed above, ESCOSA's price regulation function in respect of energy retailing is limited by the Industry Acts.

In effect, the provisions of the Industry Acts concerning standing contracts<sup>68</sup> require ESCOSA to make a price determination specifying the standing contract price. In the case of electricity, the Electricity Act provides that if ESCOSA does not fix a price under section 36AA(4a), the standing contract price will be the price fixed by the Electricity Pricing Order at as 31 December 2002.<sup>69</sup> The Gas Act contains a similar provision, which refers to 2002 prices contained in a schedule to that Act.<sup>70</sup> In short, the consequence of ESCOSA not making a determination is that standing contract price is set at pre-FRC levels. Given that the process for making a price determination is initiated when the standing contract retailer lodges its pricing submission (see further A.2.3.1 below), a decision by ESCOSA not to consider the submission and/or not to make a determination setting the standing contract price is inconsistent with good regulatory practice.

The Industry Acts also narrowly prescribe what ESCOSA is permitted to do in determining the standing contract price. The Acts define "standing contract price" as "the price fixed by [ESCOSA]".<sup>71</sup> This language requires that the standing contract price must be decided by ESCOSA rather than by another body, as may be the case under a price monitoring regime or, depending on their nature, the application of pricing policies or principles. Further, the obligation on ESCOSA to "fix" the price indicates that ESCOSA's price determination must specify a number that is the standing contract price or, at least, a methodology that can be applied to produce a price. Accordingly, ESCOSA is restricted to using only those regulatory methodologies that derive a quantifiable, pre-determined price.

## **A.2.2 Making a price determination**

In performing its functions under the ESC Act, ESCOSA must have as its primary objective protection of the long term interests of South Australian consumers with

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<sup>68</sup> Electricity Act, s 36AA; Gas Act, s 34A.

<sup>69</sup> Electricity Act, s 36AA(6)(b).

<sup>70</sup> Gas Act, s 34A(6)(b)(ii).

<sup>71</sup> Electricity Act, s 36AA(6)(a); Gas Act, s 34A(6)(a). These provisions provide that, in the event that there is no price fixed by ESCOSA, the standing contract price is set at pre-FRC levels.

respect to the price, quality and reliability of essential services.<sup>72</sup> It must, at the same time, have regard to a number of specific factors enumerated in section 6(1)(b) of the ESC Act. Section 25(4) of the ESC Act sets out a non-exhaustive list of eight additional factors that ESCOSA must have regard to when it is making a price determination. The factors set out in sections 6(1)(b) and 25(4) are set out in Box A.1 below.

In making a price determination under section 25 of the ESC Act, ESCOSA must ensure that:

- wherever possible the costs of regulation do not exceed the benefits; and
- the decision takes into account and clearly articulates any trade-off between costs and service standards.

The extent to which ESCOSA takes into account all of these factors is subject to the provisions of the Electricity Act or Gas Act (as appropriate).<sup>73</sup> The Electricity Act does require ESCOSA to have regard to the provisions of the National Electricity Rules and to the need to avoid duplication of, or inconsistency within, regulatory requirements under the Rules. As yet, no equivalent provisions have been included in the Gas Act.

While the Industry Acts do not specify any factors that expressly limit the factors set out in the ESC Act, it may be relevant for ESCOSA to consider also the objectives of each Industry Act. In relation to retail energy services, the Electricity Act and the Gas Act each provide that their objectives are to:<sup>74</sup>

- promote efficiency and competition in the electricity / gas supply industries; and
- promote the establishment and maintenance of a safe and efficient system of electricity / gas supply industries; and
- establish and enforce proper standards of safety, reliability and quality in the electricity / gas supply industries; and
- protect the interests of consumers of electricity.

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<sup>72</sup> ESC Act, s 6(1)(a).

<sup>73</sup> ESC Act, s 25(6).

<sup>74</sup> Electricity Act, s 3; Gas Act, s 3.

### **Box A.1: Factors that ESCOSA is to have regard to**

Under section 6(b) of the ESC Act, ESCOSA must have regard to the need to:

- promote competitive and fair market conduct; and
- prevent misuse of monopoly power; and
- facilitate entry into relevant markets; and
- promote economic efficiency; and
- ensure consumers benefit from competition and efficiency; and
- facilitate maintenance of the financial viability of regulated industries and the incentive for long term investment; and
- promote consistency in regulation with other jurisdictions.

Under section 25(4) of the ESC Act, ESCOSA must also have regard to:

- the particular circumstances of the regulated industry and the goods and services for which the determination is being made;
- the costs of making, producing or supplying the goods or services;
- the costs of complying with laws or regulatory requirements;
- the return on assets in the regulated industry;
- any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries;
- the financial implications of the determination;
- any factors specified by a relevant “industry regulation Act” or by regulation under the ESC Act;
- any other factors that the Commission considers relevant.

## **A.2.3 Making a new price determination**

### **A.2.3.1 Commencing the price determination process**

Unless special circumstances exist, the process for setting the standing contract prices for the next three year period can only commence when the standing contract retailer

makes a pricing submission to ESCOSA within the required timeframe. The submission must state the price the standing contract retailer proposes be fixed as its standing contract price<sup>75</sup>, justify the proposed price<sup>76</sup>, and comply with any requirements as to form and content prescribed by ESCOSA.<sup>77</sup> Failure by the standing contract retailer to submit its pricing submission means ESCOSA cannot commence a review. In the absence of “special circumstances”, the standing contract price reverts to the prices at 31 December 2002 upon expiration of the existing determination.

The submission cannot be submitted to ESCOSA more than nine months or less than six months before the existing price determination expires. In effect, this allows ESCOSA at least six but no more than nine months to make a price determination.

### **A.2.3.2 Price inquiry under Part 7 of the ESC Act**

Unless special circumstances exist, ESCOSA must conduct an inquiry under Part 7 of the ESC Act into the question of the appropriate price to be fixed as a standing contract price before it makes a price determination fixing that price.<sup>78</sup> In practice, ESCOSA conducts the inquiry concurrently with the price determination, with the inquiry informing the determination.

### **A.2.3.3 Duration**

A price determination made under section 36AA of the Electricity Act or section 35A of the Gas Act must apply for a minimum of three years.<sup>79</sup> Unless special circumstances exist, a price determination cannot be made to take effect before the expiry date of the preceding determination.<sup>80</sup>

## **A.2.4 Current ESCOSA price determinations**

At present, price determinations are in place that govern the standing contract prices for electricity from 1 January 2008 to 31 December 2010 (Electricity Price Determination 2007), and from 1 July 2008 to 30 June 2011 for gas (Gas Price Determination 2008) (together, the Price Determinations). This section provides a high level summary of approach the ESCOSA uses to fix standing contract prices under its price determinations.

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<sup>75</sup> Electricity Act, s 36AA(4a)(d)(ii); Gas Act, s 34A(4a)(d)(ii).

<sup>76</sup> Electricity Act, s 36AA(4a)(d)(ii); Gas Act, s 34A(4a)(d)(ii).

<sup>77</sup> Electricity Act, s 36AA(4a)(e); Gas Act, s 34A(4a)(e).

<sup>78</sup> Electricity Act, s 36AA(4a)(d)(iii); Gas Act, s 34A(4a)(d)(iii).

<sup>79</sup> Electricity Act, s 36AA(4a)(b); Gas Act, s 34A(4a)(b).

<sup>80</sup> Electricity Act, s 36AA(4a)(d)(i); Gas Act, s 34A(4a)(d)(i).

The Price Determinations use the building blocks (cost of service) methodology to fix standing contract prices. Under this approach, ESCOSA assesses the forward-looking costs that are within the control of the retailer. In the case of electricity, these are: wholesale electricity costs, retailer operating costs and the retail margin (which includes an allowance for both the return on investment and depreciation and amortisation). For gas, they are: the wholesale cost of gas, transmission costs<sup>81</sup>, retail operating costs and the retail margin. For each of electricity and gas, the summation of these respective controllable costs form the basis for deriving the retailer tariffs that comprise one component of the standing contract price.

ESCOSA fixes the standing contract prices to reflect forward-looking efficient costs, rather than the actual costs incurred by the standing contract retailer during the regulatory period. The actual costs incurred by the retailer may be higher or lower than those projected by the regulator depending on the market conditions that emerge in practice. ESCOSA has noted that prices are set independently of actual costs in order to provide the standing contract retailer with an incentive to outperform the cost benchmarks and retain the financial benefits of more efficient performance.<sup>82</sup>

The other component of the standing contract price is made up of the costs that standing contract retailers face that are outside their control. These costs are the network (transmission and/or distribution) charges, GST and, in the case of gas, charges levied by the market operator REMCo. Transmission and distribution charges are regulated separately; by the AER in the case of electricity and gas transmission services, and until recently, ESCOSA for electricity and gas distribution services. Once the national framework for distribution regulation is established, these functions will be transferred to the AER. REMCo's charges are also regulated by ESCOSA. In effect, these non-controllable costs are directly passed through to standing contract customers as part of the standing contract price.

#### **A.2.4.1 Fixing the standing contract price**

Each Price Determination is divided into a number of "regulatory periods"<sup>83</sup>. The price determination must allow the standing contract price to be ascertained at any point in time while it is in force. For the initial regulatory period, a schedule to the Price Determination specifies the supply charge and a volume charge for consumption.

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<sup>81</sup> Gas transmission costs in South Australia are negotiated between the retailer and the pipeline owner/operator, rather than being set by the AER. As such, gas transmission costs are treated as controllable costs.

<sup>82</sup> See, for example, ESCOSA, Gas Price Determination 2008, p. A-37.

<sup>83</sup> Under the Electricity Price Determination 2007, a period is the period from 1 January 2008-30 June 2008 (the initial period), each subsequent 12 month period ending 30 June, and the period 1 July 2010-31 December 2010. Under the Gas Price Determination 2008, a regulatory period is each period of 12 months ending on 30 June until 30 June 2011.

During the Price Determination, there are two principal ways that the standing contract price can vary:

- through the annual tariff variation process; and/or
- by passing through a cost increase or decrease in accordance with the pass through mechanism.

### **Annual tariff variations**

Chapter 3 (at 3.3.3.1) outlined the annual tariff variation process that applies under the Price Determinations. It observed that the amount by which the standing contract price can vary between regulatory periods is controlled by two factors:

- the “average revenue control”, which is maximum average revenue that the standing contract retailer is permitted to earn from residential and Small to Medium Enterprise (SME) standing contract customers; and
- the “rebalancing control”, which limits the extent to which retailer tariffs can be rebalanced from year to year.

The average revenue control caps the amount by which the forecast average revenue that can be recovered from standing contract customers can change from one regulatory period to the next.

While the average revenue form of regulation is intended to allow the standing contract retailer to have flexibility to move prices to cost-reflective levels, the rebalancing control is a secondary price control that limits the extent to which tariffs can be rebalanced in any one year, thereby reducing the risks of price shocks for some customers. In the Gas Price Determination 2008, the rebalancing control constrains the extent to which tariff components (e.g. the supply charge) can increase within any tariff category, and the extent to which there can be any rebalancing between geographic regions.<sup>84</sup>

### **Pass through mechanisms**

Subject to ESCOSA’s approval, the Price Determinations permit the relevant standing contract retailer to pass through to a standing contract customer a cost increase or decrease (i.e. a pass through amount) that results from a pass through event. Under the Electricity Price Determination 2007, the relevant events are:

- a change in taxes event;

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<sup>84</sup> ESCOSA, Gas Price Determination 2008, pp. A-40-41.

- a regulatory reset event (such as a change in the minimum standing contract terms and conditions);
- a reserve trader event (being the amount of a payment to NEMMCO calculated in accordance with the National Electricity Rules which results in the standing contract retailer incurring materially higher or lower costs in providing standing contracts); or
- a NEMMCO directions event (being a direction issued by NEMMCO in accordance with the National Electricity Rules which results in the standing contract retailer incurring materially higher or lower costs in providing standing contracts).

The Gas Price Determination 2008 defines the following as a pass through event:

- a change in taxes event;
- a regulatory reset event (such as a change in the minimum standing contract terms and conditions);
- a Ministerial directions event (being a direction given under section 37 of the Gas Act relating to gas rationing).

In seeking ESCOSA's approval to pass through the cost increase or decrease, the standing contract retailer must give ESCOSA a statement within 60 business days of the event occurring, accompanied by certain minimum information.<sup>85</sup> If ESCOSA decides the relevant pass through event occurred, it will (amongst other things) decide:

- the quantum of the pass through amount;
- the basis on which the pass through amount may be applied to tariffs; and
- the date from, and period over which, the pass through amount may be applied.<sup>86</sup>

The standing contract retailer must apply the pass through amount on the basis, from the date and over the period specified by the Commission.<sup>87</sup> In making a

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<sup>85</sup> ESCOSA, Electricity Price Determination 2007, Part B, clause 4.2.2. The retailer must provide details of the pass through event, the date the event took or takes place, the estimated financial effects of the event on the provision of standing contracts, the pass through amount the retailer proposes, the basis on which the retailer proposes to pass through that amount to retailer tariffs, and the date from and period over which the retailer proposes to apply the pass through amount.

<sup>86</sup> *Ibid*, clause 4.3.1.

<sup>87</sup> *Ibid*, clause 4.6.

decision in relation to a pass through event ESCOSA will seek to ensure that the financial effect on the standing contract retailer is economically neutral.<sup>88</sup>

If a pass through event occurs and, in the absence of a statement being given by the standing contract retailer, ESCOSA may require the standing contract retailer to pass through an amount specified by ESCOSA.<sup>89</sup> This is most likely to occur where ESCOSA identifies a reduction in costs but the standing contract retailer does not submit a statement.

In respect of retrospective losses, the standing contract retailer must comply with the time constraints set out in the price determination when making an application to ESCOSA in relation to a pass through event. Thus, only those losses that qualify as pass through events are able to be recovered (subject to ESCOSA's approval), provided that the standing contract retailer makes its application within the period specified in the price determination.

The standing contract retailer must ensure that its standing contract customers are notified of any positive or negative pass through amount ESCOSA approves, the circumstances giving rise to the pass through amount and the basis on which, and date from and period over which, the pass through amount will be applied to standing contract prices.

#### **A.2.5 Special circumstances**

The Industry Acts each provide that, where "special circumstances" exist, the following pre-conditions to ESCOSA making a price determination do not apply:

- commencement of the new price determination (see A.2.3.3);
- lodgement of a pricing submission by the standing contract retailer (see A.2.3.1); and
- undertaking an inquiry (see A.2.3.2).

The Industry Acts do not define what constitutes "special circumstances" or the process for making a price determination that ESCOSA is to follow. It therefore appears that it is open to ESCOSA to determine when special circumstances exist.

ESCOSA has given some guidance about the circumstances it expects constitute "special circumstances". In the Electricity Price Determination 2007, it noted:<sup>90</sup>

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<sup>88</sup> *Ibid*, clause 4.5.

<sup>89</sup> *Ibid*, clause 4.4.

<sup>90</sup> *Ibid*, p. A-31.

[ESCOSA] considers that “special circumstances” will generally be events of a magnitude such as to disturb the fundamental basis of an existing Price Determination so much as to require a new determination to be made. [ESCOSA] may determine the matter of its own volition or, alternatively, AGL SA or any other interested party may ask [ESCOSA] to consider if special circumstances have arisen such that the existing Price Determination should be reviewed and possibly replaced.

Similarly, in the Gas Price Determination 2008, ESCOSA stated:<sup>91</sup>

The “special circumstances” provision of the Gas Act provides the ability for a gas standing contract price determination to be reopened if considered appropriate. [ESCOSA] expects that, if an unexpected event occurs which can be shown to have a material impact on the credibility of the price path determination, a review would be initiated pursuant to the “special circumstances” provision of the Gas Act, to determine if the event was unable to be predicted, planned for or reasonably insured against. The review would also determine the extent to which the event had a material impact on [Origin’s] prudent costs, such that the price path set in the price determination was no longer credible.

Where ESCOSA finds that “special circumstances” exist, it may initiate a review of the price determination presently in force. If ESCOSA concludes that circumstances warrant that a new price determination be made, that new determination must provide for a minimum three year term from the date it takes effect.

### **A.3 Market contracts**

Retailers may offer a market contract to small customers. Each retailer is free to determine the prices for its own market contracts. The Energy Price Disclosure Code requires retailers to provide ESCOSA with full and accurate information about each of the market contracts it offers to residential customers, including the price and any non-price incentives.<sup>92</sup>

The terms and conditions (other than price) on which market contracts are offered are determined by ESCOSA and set out in Part A of the Energy Retail Code. Most of these 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 the Commission's approval:

- the obligation to bill quarterly (clause 6.1.1);
- methods of payment (clauses 6.3.4(i) and 7.2);

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<sup>91</sup> ESCOSA, Gas Price Determination 2008, p. A-45.

<sup>92</sup> Energy Price Disclosure Code, clause 3.

- 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
- payments in advance (clause 7.11).

#### **A.4 Default contracts**

A default contract is a contract formed between a retailer who is financially responsible for a small customer's connection point, and the small customer at that connection point who does not have any existing contract in place with that retailer for that connection point but has begun taking supply.<sup>93</sup> The terms and conditions (other than price) governing supply under a default contract are set out in Parts A and B of the Energy Retail Code.

The retailer must give a 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 electricity/gas.<sup>94</sup>

A default contract continues until the small customer becomes party to a market contract or standing contract in relation to the connection point or another person becomes party to a retail contract in relation to that connection point.<sup>95</sup>

The process for determining the price for energy supplied under a default contract is set out in the industry legislation as being whichever of three prices was the last to be fixed:

- in the case of electricity, the price fixed:
  - for the sale of electricity to non-contestable customers under the Electricity Pricing Order immediately before 1 January 2003;
  - by the retailer as its default contract price; or
  - by ESCOSA as the retailer's default contract price;

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<sup>93</sup> Electricity Act, s 36AB(1); Electricity Regulations, reg 7F(1).

<sup>94</sup> Electricity Act, s 36AB(2)(a); Electricity Regulations, reg 7F(4) and (5); Energy Industry Retail Code, Part A, clause 1.4.3.

<sup>95</sup> Electricity Regulations, reg 7F(3).

- in the case of gas, the price fixed:
  - under the Gas Act as at 31 December 2002 for the sale and supply of gas to a class of customers to which the customer belongs;
  - by the retailer as its default contract price; or
  - by ESCOSA as the retailer's default contract price.

ESCOSA has not fixed default prices for either electricity or gas retailers. AGL, Simply Energy and TRUenergy have set their electricity and gas default prices by reference to ESCOSA's most recent standing contract price determination, as are Red Energy's default electricity prices. Origin's default contract gas prices are linked to the standing contract price for 2008 but its default electricity prices remain unchanged since 2006.

South Australia Electricity, Jackgreen, Momentum Energy and Country Energy do not appear to have gazetted any default prices. Given that ESCOSA has not fixed default prices, it is assumed that these retailers charge the prices set under the Electricity Pricing Order and the Gas Act to their default contract customers.

There is no legislative requirement that retailers must set their default contract prices to the standing offer contract price. However, retailers are required to provide a statement of justification for their default prices in the Gazette.

## **A.5 Electricity Pricing Order**

The Electricity Pricing Order (EPO) maintains parity between the prices charged to small country and small city electricity customers, which is implemented via the Country Equalisation Scheme. The EPO was made by the Treasurer of South Australia in accordance with section 35B of the Electricity Act. It has the effect of legislation and cannot be varied (except as contemplated by the EPO) or revoked.<sup>96</sup>

The Country Equalisation Scheme, a retailer may not charge a small country customer a price for the sale of electricity that is more than 1.7% 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 prices that it offers to small city customers.

No equivalent scheme operates in relation to gas.

## **A.6 Obligation to supply**

It is a condition of each standing contract retailer's licence that it must, at the request of a small customer who is not on a market contract, agree to sell electricity or agree

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<sup>96</sup> Electricity Act, s 35B(7)(b).

to sell and supply gas (as appropriate) to the customer at its standing contract price and subject to its standing contract terms and conditions.

The process for determining the standing contract price is set out at A.2 above. The minimum terms and conditions applicable to standing contracts are contained in Parts A and B of the Energy Retail Code.

## **A.7 Retailer of Last Resort**

On occasion, events take place that cause a licensed energy retailer to default on its obligations in the energy markets, including its obligations to supply energy to small customers. When such events occur, the RoLR scheme endeavours to ensure that electricity and gas customers continue to receive energy supplies.

In South Australia, each contract that a retailer enters into with a small customer must expressly provide<sup>97</sup> that:

- the contract will terminate in the event that the retailer is no longer entitled to sell electricity or sell and supply gas (appropriate) due to a last resort event in respect of that retailer; and
- when the retailer is no longer entitled to sell electricity or sell and supply gas (as appropriate) 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.

Currently, the National Retail Policy Working Group is considering options to progress the RoLR schemes of each of the NEM jurisdictions in the context of the National Energy Customer Framework.

### **A.7.1 Electricity RoLR**

ETSA Utilities, the incumbent distribution network service provider in South Australia, is the RoLR for electricity in South Australia. The obligation is imposed on ETSA Utilities as a mandatory licence condition in accordance with the requirements of the Electricity Act. If a RoLR event occurs, ETSA Utilities must sell electricity to the customers of the defaulting retailer for up to three months for a price, and on terms and conditions, that are regulated by ESCOSA.<sup>98</sup>

However, section 24(2)(f) of the Electricity Act provides that ESCOSA must make a retail licence subject to a condition that requires the licensee to provide services specified by ESCOSA, on a cost recovery basis approved by ESCOSA, to ETSA

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<sup>97</sup> See the Electricity Act, the Gas Act, the Energy Retail Code and retail licences.

<sup>98</sup> Electricity Act, s 23(1)(n)(viii) and (4).

Utilities in the event that ETSA Utilities becomes bound to sell electricity under a RoLR requirement. ESCOSA has included a condition to this effect in the licence issued to AGL.<sup>99</sup>

Pursuant to clause 8.1(b) of the EPO, ESCOSA has published guidelines for the purpose of determining the amount that ETSA Utilities may charge for the sale of electricity pursuant to a RoLR requirement.<sup>100</sup> In developing these guidelines, ESCOSA must seek to ensure that the financial effect on ETSA Utilities of the RoLR requirement is economically neutral.<sup>101</sup>

The retailer of last resort obligation ceases to apply in relation to a customer 3 months after the RoLR event. At this time, the customer may enter into a standing contract with AGL or a market contract with any retailer. A customer who fails to enter into either form of contract is deemed to have entered into a default contract with AGL, as the financially responsible market participant for that supply point.<sup>102</sup>

### **A.7.2 Gas RoLR**

Regulations made under the Gas Act may prescribe a retailer or supplier as the RoLR, however no regulations have been made for that purpose.

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<sup>99</sup> AGL South Australia Pty Limited Electricity Retail Licence, clause 20.1.

<sup>100</sup>ESCOSA, *Electricity Guideline No 8 – Retailer of Last Resort Pricing Guideline*, July 2007.

<sup>101</sup>Electricity Pricing Order, clause 8.1.

<sup>102</sup>As AGL is the retailer who supplied electricity to any customer whose retailer experiences of RoLR event (in accordance with the terms of the Electricity Default Contract for Retailer of Last Resort), AGL is the financially responsible market participant for that supply point. Accordingly, any customer who becomes party to a default contract is contracting for energy supply with AGL.

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