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Review of the Effectiveness of Energy Retail Market Competition in South Australia

Phase 3 Report for ESCOSA

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1. Introduction

This Phase 3 report is the third in a series of reports prepared as part of the Essential Services Commission of South Australia's ("the Commission's") Review of the Effectiveness of Energy Retail Market Competition in South Australia.

Full retail contestability was introduced in the South Australian electricity and gas markets in January 2003 and July 2004 respectively. In line with its obligations under section 6 of the Essential Services Commission (ESC) Act, the Commission has developed a framework for monitoring the impact of full retail contestability within these markets. Under this framework, the Commission collects and publishes information from both retailers and customers in order to monitor the development of electricity and gas retail markets by reference to seven indictors of competition.

The current review represents a further development and refinement of the Commission's existing framework and bi-annual monitoring reports. Its purpose is to draw conclusions on the overall effectiveness of electricity and gas retail competition for residential and small business customers in South Australia and to make recommendations as to the means by which the Commission's retail market activities could be amended to enhance retail market competition for these customers.

Our assessment of the state of competition in both the South Australian electricity and gas retail markets suggests that competition is generally effective for most residential and small business customers. Despite this finding, we recommend that the Commission continue to monitor the state of competition in these markets, particularly for those customers for whom competition is less effective due to the existence of barriers to new entry or expansion. This phase 3 report sets out our recommendations for the enhancement of the Commission's current monitoring framework and other measures it has adopted in order to promote the development of competitive retail markets.

The remainder of this report is structured as follows:

- section 2 provides an overview of our findings in relation to the structure of the electricity and gas retail markets in South Australia as well as the conduct and performance of participants within those markets; and
- section 3 sets out our recommendations for the Commission in relation to its retail market activities.

2. Summary of Findings

In the Phase 2 report, we concluded that competition appears to be effective in the electricity retail market for small customers in South Australia and is well on the way to being effective in the gas retail market.

Our assessment considered a range of indicators that reveal information in relation to the structure of the electricity and gas retail markets, as well as the conduct and performance of participants in these markets. Our findings in relation to the market structure, conduct and performance of market participants are summarised in the sections below.

2.1. Market Structure

The electricity retail market for residential and small business customers in South Australia appears to be characterised by low barriers to entry. Nine retailers have entered the market since the introduction of FRC in January 2003, some of whom are vertically integrated with generation interests, while others are not. All new entrants also operate in one or both adjacent States of Victoria and New South Wales.

In the four years to 31 December 2006, new entrant retailers managed to capture a 36 per cent share of all residential and a 25 per cent share of all small business electricity customers. Most of this market share has been captured by the three vertically integrated retailers, being TRUenergy, Origin and EA-IPR Partnership, each of whom has a share of between 10 and 13 per cent. This level of concentration may change over the coming years given the entry of four new retailers within the last 18 months.

In contrast to the electricity retail market, the gas retail market appears to be characterised by relatively significant barriers to entry or expansion in some areas of the state. These barriers are primarily due to capacity constraints on the lateral pipelines that connect to the mainline of the Moomba to Adelaide pipeline system (MAPS) as well as constraints within Envestra's distribution network. These constraints have effectively impeded the ability of new entrant retailers to compete with standing contract retailer Origin in regional areas in the north of the state. To a lesser extent, capacity constraints have also impeded the ability of TRUenergy, which supplies gas from Victoria only via the SEA Gas pipeline, to compete with primarily Origin and AGL in the northern suburbs of Adelaide.

Despite these barriers, the trend in the share of residential gas customers captured by new entrant retailers has been similar to that for electricity, with all three new entrant retailers each having attained a 9 to 12 per cent market share over the two and a half years since the introduction of FRC. By contrast, the proportion of small business gas customers that have taken up contracts with new entrants is considerably lower than that for electricity at around 7 per cent. It is unclear why competition for this particular customer segment appears to have been less vigorous than for residential customers, although we note that in terms of both customer numbers and consumption levels, these customers comprise only a small proportion of the small customer market.

2.2. Market Conduct

Our assessment of retailer and customer behaviour suggests that customer switching to market contracts is primarily driven by the marketing efforts of retailers as opposed to the active participation of customers. Over half of all residential and small business customers had received an offer of a contract from an electricity retailer over the course of 2005. A third of residential gas customers had also received market offers directly from gas retailers, although a much smaller percentage of small business customers had received such offers.

While a number of retailers were not in compliance with the Commission's price disclosure code, it appears that few customers either pro-actively look for information on market contracts or contact retailers directly about market contracts available. This may reflect the fact that customers do not consider energy to be an important component of their household expenditure (and hence do not consider the time and effort required to look for information about alternative offers to be worth the potential cost savings). Alternatively, it may reflect that a large proportion of customers already receive information directly from retailers and do not feel the need to look for more. Although only around half of all customers that look for information on market contracts find that information easy to understand and compare, a much higher proportion consider the information they do obtain to be sufficient to make an informed choice.

The rate of customer switching to market contracts has been significant suggesting that customers are responding to the marketing efforts of retailers. Only 41 per cent of all residential electricity and 53 per cent of all residential gas customers were still under standing contracts as at 31 December 2006. A much higher percentage of small business customers, 66 per cent for electricity and 90 per cent for gas, remained on standing contracts at this time.

The rate of customer switching to electricity market contracts was initially quite slow but gained momentum from around the second quarter of 2004, over a year after FRC was introduced. By contrast, switching by gas customers, primarily residential gas customers, occurred relatively quickly after the introduction of FRC in mid 2004. Given that almost all gas customers also have an electricity connection this suggests that retailers were perhaps better prepared and consumers more aware of their ability to switch retailer upon the opening of this market to competition.

Most customers that have switched to both electricity and gas market contracts have switched to new entrant retailers, although incumbent retailers AGL and Origin have maintained a substantial share of customers on market contracts.

2.3. Market Performance

Our review of market contracts available to residential customers shows that all retailers offer at least one contract at a discount to the standing contract. The discounts available range from 2 to 12 per cent for electricity and 2 to 6 per cent for gas, with most discounted gas offers arising in the context of a dual fuel contract. Retailers also offer a range of other price and non-price benefits which are attached to one or more of their offers.

Retailers also appear to have improved their performance in relation to a range of customer service measures since the implementation of FRC. With the exception of AGL, the number of complaints made in relation to electricity and gas supplies has generally fallen over time and retailer response to telephone enquiries has improved, at least in relation to electricity supply.

Market outcomes for low-income customers also appear to be improving. Low-income customers appear to be taking advantage of market offers. They are just as likely to have switched to market contracts as other customers and are no more likely to have switched to a market contract with the incumbent retailer. In fact, low-income gas customers are more likely than other customers to have switched to AGL as opposed to a market contract with Origin. Concession recipients are now spread between retailers and comprise a higher proportion of the customer base of new entrant retailers Country Energy and Powerdirect than incumbents AGL and Origin.

3. Recommendations

Our recommendations in relation to the Commission's activities in the retail electricity and gas markets are set out in the sections below.

3.1. Enhancements to Performance Monitoring Framework

The Commission developed its framework for monitoring the development of FRC in South Australia in 2004. Under its current framework the Commission monitors and reports on seven main indicators of competition on a bi-annual basis, being:

- Indicator 1 – Number of Electricity Retailers
- Indicator 2 – Customer Switching;
- Indicator 3 – Barriers to Entry;
- Indicator 4 – Information Asymmetries;
- Indicator 5 – Price/Service Mix;
- Indicator 6 – Impacts on Low-Income Groups;
- Indicator 7 – Innovation.

We recommend that the Commission continue to monitor and report on the above indicators, with a view to placing greater emphasis on indicators 2 and 3 above.

3.1.1. Customer Switching and Market Shares

Customer switching is one of the most important indicators of the effectiveness of competition since it indicates how responsive customers are to the marketing efforts of retailers. To date the Commission has reported the number of completed transfers to market contracts and the number of transfers in progress on the basis of NEMMCO and REMCo data, and AGL and Origin Energy data. While this provides some indication of the extent to which customers consider the benefit of switching to outweigh the cost of doing so, it provides little indication of the degree of rivalry between retailers for those customers that are willing to switch.

Going forward, the Commission may find it beneficial to monitor the number of customers switching from standing to market contracts, where the share of market contract customers is identified for each retailer. By assessing the market share of each retailer over time, the Commission may be better able to identify any potential concerns. For example, a growing share of customers moving to market contracts may look encouraging. However if this movement also involved an increased degree of market concentration, this may be less encouraging.

We note that the Commission need not publish information on the market share of individual retailers, particularly if this is considered commercially sensitive or potentially damaging to the reputation of retailers and their ability to attract customers going forward. By way of alternative, the Commission may wish to consider publishing the number of customers on standing contracts, on market contracts with the incumbent retailer and market contracts with new entrant retailers as a whole.

In addition to net switching, the Commission might also want to consider monitoring the number of customers switching from the incumbent (tier one) retailer to new entrant retailers, from new entrant (tier two) retailers to the incumbent retailer and from new entrant retailers to other new entrant retailers. Such statistics, which are available from NEMMCO, provide greater clarification of how customer switching behaviour is affecting the market shares of all retailers.

3.1.2. Barriers to Entry or Expansion

Barriers to entry or expansion appear to have been given little attention in the Commission's monitoring reports to date, yet their potential existence is often critical for the development of effective competition. In the course of this review we have identified a number of barriers to entry that are of primary concern to retailers. While there was considerable variation in the responses provided, the most significant point raised appeared to be the lack of access to adequate gas transmission and distribution services.

The gas market is a contract carriage market and retailers are required to contract separately with gas producers and transmission and distribution pipeline owners for the sale and transport of gas supplies. While not in itself a barrier to entry, we understand that firm transmission capacity is currently fully contracted on the SEA Gas pipeline, is unavailable along the lateral pipelines connected to the MAPS mainline and that constraints in Envestra's distribution network do not allow for the flow of gas from the SEA Gas pipeline to the northern suburbs of Adelaide or the north of the state. We also understand that contractual arrangements in relation to the three city gates that connect the MAPS to Envestra's distribution network conferred the control of capacity through these gates to Origin, at least to 2005. These factors have together impeded competition for gas customers in some areas of the state, namely regional South Australia and to a lesser extent the northern suburbs of Adelaide.

While there is little that the Commission can actively do to alleviate any of these barriers, it is instructive for it to be aware of their existence for the purpose of identifying customer segments for which there may be more or less competition. For example, in the South Australian gas retail market there appears to be no competition for regional customers in the north of the state and less competition in the north compared to the south of Adelaide.

3.2. Compliance with the Commission's Energy Price Disclosure Code

Under the Commission's Energy Price Disclosure Code (the "Code'), which has been in force since January 2005, retailers that make energy market offers available to South Australian residential customers are required to publish on their website a price fact sheet for each of their market offers. The fact sheet is designed to show the estimated annual energy bill payable by those residential customers that consume:

§ 2MWh, 5MWh or 8MWh of electricity per annum at peak rates and 1.5MWh of electricity per annum at off peak rates; and/or

- 6GJ, 24GJ or 24 GJ of gas per annum.

Retailers are also required to specify any additional charges and rebates attached to their market offers including, but not limited to, any applicable loyalty rebates, entry rebates, account establishment fees, exit fees or direct debit rebates. The price disclosure guidelines are intended to enhance the transparency of pricing so as to assist customers to compare available offers.

Our review of the price fact sheets published on retailers' websites revealed that a number are not currently complying with their obligations under the Code. In particular:

- two retailers did not have fact sheets published on their websites;
- three had fact sheets which were out of date, specifying the terms of offers that are no longer available and excluding the terms of their most current offers;
- one had a number of fact sheets for each of its current offers although, for some of these, the estimated annual charge was not based on current rates such that a customer would not be able to compare the offer made with that other retailers; and
- one did not specify the additional fees and charges associated with each offer on its fact sheets, although these were published under a separate 'tab' on the retailer's website.

The results of the Commission's latest customer survey, which was conducted in January 2006, also suggests that the publication of fact sheets has not improved customer understanding of the information provided to them or their ability to compare the offers made by competing retailers. Of the 13 per cent of residential electricity customers that looked for information on market contracts, 55 per cent found the offers easy to understand and compare, up by only 1 percentage point from the prior year. Of the 7 per cent that had looked for information regarding market contracts for gas, only 60 per cent found the information easy to understand and compare, down from 66 per cent in 2004.

While very few customers actively look for information on market contracts, suggesting that price fact sheets are not accessed by a large number of customers, an increasing proportion of those customers that do seek out information are turning to the internet as their primary information source. The price fact sheets published by retailers are likely to be of growing importance to customers in assisting them in their decision to switch retailers.

We therefore recommend that the Commission take measures to monitor and remedy non-compliance with the Code. More specifically, the Commission should ensure that:

- all retailers publish a separate fact sheet for each of their market offers, or alternatively a single price fact sheet containing relevant information on all of their market offers;
- all retailers amend their price fact sheets to take account of new offers or updated rates applicable under their current market contracts within a reasonable period of time – we note that the Code currently requires retailers to provide the Commission with any updated information within 24 hours after any changes have taken effect, but does not require retailers to amend the price fact sheets published on their websites within a particular time frame;

- retailers that offer market contracts of more than one year duration disclose the price that would be payable under the first year of the contract on the basis of current rates; and
- that retailers clearly specify whether discounts or rebates such as direct debit or pay by the due date rebates (which should be specified separately within the fact sheet) are included in the calculation of the estimated annual energy bill.

In addition to the market contract attributes already required to be published by retailers we also suggest that retailers be required to specify the term of all market contracts. The term of contracts is not clear from some of the price fact sheets that are currently available yet is likely to be a significant consideration for customers when deciding whether to switch retailers. It may also be useful for retailers to identify any specific exclusions to the availability of each contract, such as locations that the retailer does not serve or customer classes to whom the contract may not be made available. While none of the retailers that provided information over the course of this review indicated that particular customer classes were not eligible for their market offers, one retailer in particular notes on its fact sheets that offers may be subject to consumption, geographic and credit criteria.

Going forward the Commission could potentially report on compliance with the Code as part of its bi-annual monitoring reports. The Commission may also wish to consider publishing each retailer's fact sheets on its website in addition to its Estimator service.

3.3. Enhancements to the Commission's Estimator Service

The Commission's Estimator service, which was established in April 2003, is an online application that allows users to compare the estimated annual bill payable under market contracts available from licensed energy retailers in their geographic location. The Estimator provides the following details for each market contract available in specific regions of South Australia:

- Cost before incentives;
- Direct debit rebates;
- Other rebates;
- Estimated annual cost;
- Estimated annual saving compared to the standing contract; and
- One-off joining bonuses

While the Estimator focuses primarily on the amount payable under each contract, inclusive of rebates, these are not the only factors that influence customer choice. Many of the contracts currently on offer are subject to account establishment and exit fees, and many also include non-price or non-energy related benefits. These factors are not insubstantial and are likely to be of importance to customers in their decision to switch. We therefore recommend that the Commission include details of these in the Estimator, along with the term of each contract.

Given the increasing prevalence of "green" contracts involving premiums for renewable energy sources, the Commission may wish to consider grouping these contracts separately when displaying the results of the Estimator in order to enable easier comparison between the type of market offers available. It is reasonable to suggest that most customers that opt for green energy contracts are willing to pay a premium for electricity supplies and are therefore likely to make comparisons between those contracts that do involve some use of renewable energy sources. Such customers are also likely want to compare the proportion of consumption that is derived from renewable energy sources under each contract. The Commission may therefore wish to consider either incorporating these details in the Estimator service or indicating to customers where they can look for additional relevant information. We note that the Estimator does not incorporate all "green" contracts that are available from retailers and so does not currently provide a comprehensive comparison service for those customers who value this contract feature.

In addition to the above, we also recommend that the Estimator be extended to cover small business customers, a development that we understand the Commission has previously considered. As is the case for electricity only a small percentage of small business customers actively look for information in regard to market contracts (15 per cent for electricity and 5 per cent for gas). However, the proportion of small business customers that look for information does appear to be higher than the proportion of customers that have switched to market contracts each year from 2003 to 2006. An increasing proportion of these customers look to the internet as their primary information source (38 per cent for electricity). Further clarification of the price and non-price terms of the market offers available to these customers may therefore in their decision to switch.

3.4. Commission's Approach to Retail Price Regulation

On the Commission's approach to the regulation of retail prices, our findings suggest that the Commission should continue to adopt a relatively light handed approach, and allow plenty of flexibility for tariffs to adjust towards cost reflective levels.

In preparing for its upcoming review of AGL standing contracts, we recommend the Commission further relax existing side constraints which limit the extent of any price increase applicable to residential and small business customers. Under the Commission's March 2005 determination, AGL was subject to an average price cap applying to the combined total of its standing contract tariffs but was restricted from raising prices to residential customers by more than CPI plus 4 per cent and for small business customers by more than CPI plus 4 per cent or $40. The Commission noted that the advantage to AGL SA from the proposed price control system was that it could undertake some re-balancing of tariffs to move towards greater cost reflectivity, thereby gradually removing any remaining cross subsidies. Nevertheless, the Commission did note that such cross subsidies would not be removed in the period to December 2007.[1]

We recommend that the Commission review the extent to which cross subsidies were reduced over the last regulatory period and consider whether the current constraints on the rebalancing of tariffs should be relaxed even further.

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[1] ESCOSA, *"Inquiry into Retail Electricity Price Path, Final Report"*, March 2005, p.68.

We also note that, in the period since our assessment of the competitiveness of the retail electricity market began, there has been a substantial increase in wholesale electricity prices across the national electricity market, primarily induced by the drought. To the extent current wholesale electricity market conditions are likely to be sustained for a material period, we recognise that this poses a significant challenge for electricity retailers and their customers. These circumstances, in combination with our findings on the effectiveness of retail competition, argue for yet greater emphasis being placed on ensuring price flexibility for standing contracts.

In the case of gas, the principal source of competitive concern appears to be the difficulty in ensuring access to adequate transmission and distribution services, primarily in the north of the state and to a lesser extent in the north of Adelaide. While there is little that the Commission can do to alleviate these physical impediments to competition, it can ensure that customers in these areas are protected from the potential exercise of market power by Origin through the maintenance of adequate price controls and rebalancing constraints.

We understand that the Commission currently applies two average revenue controls for gas standing tariffs, one for residential and another for small to medium enterprises. The average revenue control for each type of customer is aggregated over all five pricing zones. While the Commission did consider applying a separate control to each pricing zone in its last determination, it concluded that such an approach would make the control more cumbersome and questioned the value of such added complexity, particularly when over 90 per cent of gas consumption by small customers was in the Adelaide region.[2] Rather than adopt a separate price control for each pricing zone, the Commission applied a rebalancing control of CPI plus 7 per cent for residential and CPI plus 5 per cent for small business customers.

We note that under the current price control Origin may potentially have the ability to raise the price of gas above competitive levels for those customers that are not effectively contestable through its control of firm transport capacity. If the level of capacity held by Origin is greater than that which it reasonably requires to service all of its customers, including larger industrial customers, then it may have the ability to maintain artificially high prices - providing the cost of maintaining this excess capacity is able to be passed through to small customers.

The Commission identified and discussed a number of issues associated with the maintenance of excess capacity in its last price determination. In its review of standing contract prices the Commission did consider the allowance to be provided for prudent and efficient transmission costs in the building block, including:

§ the prudence of Origin Energy's transmission contracting strategy and the efficiency of the contract prices;

§ the allocation of gas transmission costs to gas standing contract customers (which involved allocating costs between standing contract customers and other customers, and then allocating costs within the standing contract customer class); and

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2 ESCOSA, "*Gas Standing Contract Price Path: Final Inquiry Report and Final Price Determination*", p. A-100.

- whether it would be prudent for Origin to sell any excess pipeline capacity on secondary markets, and if so, whether to pass through any reduction in transmission costs as a result.

While the Commission expressed concern at Origin's approach to reserving capacity on the basis of a 1 in 25 year event, under which it holds excess capacity almost all of the time, it was not able to justify a move away from this standard. Similarly, the Commission was not able to develop a reasonable approach for the valuation of trading in secondary markets.

For the purpose of its forthcoming review of Origin's standing contract prices, we recommend that the Commission give further attention to the issue of excess capacity and the prudence of Origin's gas transmission costs. While we appreciate the difficulty the Commission faces in assessing the optimal transmission capacity reservation strategy for a standing contract provider, we suggest that the Commission take the approach of seeking further supporting information from Origin on this issue. We also recommend that the Commission investigate, the extent to which other retailers in South Australia, or incumbent retailers in other states, adopt similar strategies.

Finally, in addition to the an investigation of the transmission capacity reservation arrangements for the incumbent retailer, we also recommend that the Commission maintain side constraints which would prevent any sudden price increases for those small gas customers which are not yet effectively contestable.

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