15 February 2013

Attention: The Project Leader
Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales, Issues Paper
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

email: aemc@aemc.gov.au

Dear Sir/Madam

RE: Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales, Issues Paper

Thank you for your invitation to make a submission to this important review. Momentum Energy is a second tier retailer with current retail electricity licenses in Victoria, New South Wales, South Australia and the Australian Capital Territory. Momentum Energy is fully owned by Hydro Tasmania, which produces more clean energy than any other company in Australia.

In considering the issues in this paper Momentum Energy believes that 2013 represents a key turning point in the lifecycle of the NSW energy markets. Whilst IPART will focus on ensuring that the long term interests of consumers are served by a competitive market, and the 2013-2016 determination should provide the basis for the market to progress to full deregulation, the AEMC assessment of retail competition is an important step towards the phasing out retail price regulation.

Market definition

Q1. To what extent can other fuels or products be substituted for the supply of electricity or natural gas to small customers in NSW's electricity and natural gas retail markets (including the extent to which they are substitutes for each other)?

One of the requirements for what might be called perfect competition is that other fuels or products could be perfectly substituted to supply electricity or natural gas. For the small retail customer this is unrealistic as LPG is not a perfect substitute for natural gas and nor are diesel generators a perfect substitute for mains supply electricity. While there is potential for gas and electricity to be substituted in certain circumstance, ie cooking, heating, water heating, the actual ability of customers to substitute their usage of one fuel for the other in NSW is much lower than what occurs in Victoria and South Australia, due to the lower level of gas penetration.

Q2. (a) Are there barriers to single-fuel energy retailers (i.e. suppliers of either electricity or natural gas only) supplying both electricity and natural gas to small customers in NSW's electricity and natural gas retail markets?

Q6. (a) Have the structural conditions for small customer electricity and natural gas retailing in different geographical areas or distribution networks of NSW supported or hindered the development of effective competition?

Second tier retailers have a strong and growing presence in the electricity retail market in NSW, and yet are barely visible in the retail gas market. While there may be rivalry between the big three retailers, the NSW retail gas market is in practice largely limited to just them. This absence of actively competing gas retailers is due to the barriers to entry being high. There are three principal reasons for this are:

- Procuring wholesale gas is more difficult in NSW than Victoria;
- There are less supply and transportation options in NSW, and;
- Gas retailers rely heavily on bi-lateral contracts rather than purchasing from the market.

Gas is now transacted through the STTM at the Sydney Hub, but this gas is primarily used for balancing purposes. When smaller retailers are seeking reliable longer term contracts, gas producers generally demand a higher price for gas from such a lower volume purchaser, combined with more onerous take or pay arrangements and less flexibility in daily cash flow arrangements[1]. Consequently, for second tier retailers, price and volume are unlikely to be sufficiently certain to back the provision of gas to their retail customers.

Q2. (b) Do energy retailers of both fuels (i.e. suppliers of both electricity and natural gas) enjoy cost or other advantages over single-fuel energy retailers?

The majority of retailing costs to serve are fixed, so any advantages in costs from dual fuel will be limited to that small proportion of variable retailing costs to serve. More importantly, dual fuel customers contribute to overcoming the difficulties of low margins by creating an additional margin for each customer who purchases gas as well as electricity, for only an incremental increase in the cost of acquisition. The advantages to suppliers of both electricity and gas over single fuel energy retailers are also apparent when acquiring customers in that these retailers can offer a more compelling sales proposition of a discount on both gas and electricity in return for a contract period is a more compelling customer proposition than a single fuel offer.

[1] Report: Gas wholesale markets and retail competition in NSW and Victoria, July 2012, Hughson and Mauseth Johnson

Q3. (a) Are there different costs to serve electricity small customers, and/or natural gas small customers, at different energy consumption levels in NSW's electricity and natural gas retail markets?

Retailers generally segment their cost to serve into four categories: metering, billing, collections and the contact centre, and these are then further segmented into key business requirements, such as, staff, other opex costs and capital costs. The majority of these costs are fixed with staffing levels being the biggest variable in the remaining retailer costs to serve, followed by levels of customer enquiries. Retailer costs to serve are not a singular function of consumption levels.

Q3. (b) Are there barriers to energy retailers supplying electricity, and/or natural gas, to small customers at different energy consumption levels in NSW's electricity and natural gas retail markets?

Increasing gross margins are broadly a function of increased consumption levels. Marketers may try to segment the market to find classes of customers with higher consumption, but there are no barriers to entry created by a small customer's consumption level. All customer consumption levels have the potential contribute to a retailer recovering fixed costs.

Q4. (a) Are there different costs of supplying electricity, and/or natural gas, to small customers located in different geographical areas or distribution networks of NSW? For example, the cost(s) of supplying energy to small customers residing in rural or remote areas of NSW compared to the cost(s) of supplying energy to small customers residing in urban areas.

The additional costs of supplying electricity or gas to more remote communities in the form of line losses or unaccounted for gas are well documented, as are the higher distribution charges that generally apply in these networks. In addition, the smaller scale of new entrant retailers may mean they are not able to procure as competitive wholesale supply arrangements as the larger retailers. These three factors will not generally impact competition, except where there is insufficient allowance for them in any benchmark retail price (ie insufficient headroom or margin to compete within). Momentum Energy nevertheless is of the view that competition in the electricity market is generally effective.

In the breakdown of costs to serve between customer classes, including those of urban, regional and rural there can be wide margins of error. However, there are three issues that may lead to reduced competitive activity in the Essential Energy network area. Firstly, competitive acquisition of small customers in the Essential Energy network (rural or remote areas) is impacted by the comparatively low number of customers on a simple domestic tariff combined with the great number of other individual regulated tariffs (many of which are still not at cost reflective levels, in spite of recent progress in this regard). Secondly, there is an additional cost for the retailer in not only having to develop specific rates for such customers, but equally having to implement the necessary systems and processes to service them. Finally, the cost of sales acquisition using the customary direct selling channel of door to door is made more expensive due to the lower customer density.

These three features may combine to make competition somewhat less rigorous within rural and remote parts of NSW, however the initiatives to overcome tariff complexity, combined with the removal of retail side constraints, should address these issues over time.

Q5. (a) What other characteristics of NSW's small customer electricity and natural gas retail markets should the AEMC take into consideration when defining the market for the NSW Review?

Many electricity retailers are now vertically integrated with generation assets. Vertical integration is a tool to manage wholesale price volatility that results in retailers requiring both smaller volume and fewer contracts to manage price volatility in the wholesale market. It has been argued that over time this leads to a reduction in the number of contracts available in the market and ultimately this reduces liquidity and that this in turn makes it more difficult for a new entrant without generation to manage volatility, and consequently more difficult to enter the market

Q6. (b) Are the structural conditions referred to in (a) likely to support or impede improvements in competition in the future?

Without addressing the matters referred to in Questions 2 & 6 above, in an environment where barriers to entry are high, and new entrants are unable to enter the market, the existing retailers are able to operate free from some of the competitive discipline normally imposed by the market. Therefore these conditions are likely to persist.

It should be noted that the structural matters referred to will persist with or without regulated pricing.

Q8. (a) Are there barriers to expansion, or exit, that impact on the development of effective competition in small customer electricity and natural gas retailing in different geographical areas or distribution networks of NSW?

The difficulty that new entrant retailers have in entering the NSW gas retail market is evidenced by their market share of NSW residential natural gas small customers. In 2011, AGL held a market share of around 66 per cent, EnergyAustralia held a market share of around 24 per cent, and Origin Energy (including acquired Essential Energy / Country Energy customers) held a market share of around 8 per cent, meaning these three companies hold 98 per cent of the market.[2] Closer examination reveals that Actew/AGL market share could be appropriately included as one of the incumbents, concluding a three firm market share closer to 100%.

The AEMC review could compare these outcomes to those seen in Victorian and South Australian retail gas markets. Whilst in NSW there is a three-firm concentration of 98 per cent, in Victoria the same three companies now hold only 80 per cent. Since 2005 second tier retailers have won 20 per cent of the retail gas market for small customers away from the original incumbents; in addition to the churn between those

[2] AEMC, Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales, Issues Paper, Dec 2012

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incumbent retailers[3]. Similarly in South Australia nearly 50 per cent of small retail gas customers have been won away from Origin Energy since competition was introduced into the retail gas market there[4].

NSW has the lowest percentage of any state of customer switching of retailers[5]. Momentum acknowledges that there may be other reasons for this low rate of switching apart from an absence of competition, such as customers are happy with the service they receive from their existing retailer, or that second tier retailers have deliberately chosen not to market gas in NSW. However, concurrent outcomes for these very same retailers in natural gas other States do not support these hypotheses.

Q8. (b) Have the barriers to expansion, or exit, referred to in (a) dissuaded prospective energy retailers from entering NSW's small customer electricity and natural gas retail markets, or can they be overcome?

The number of licences is not always a good guide to retailers' enthusiasm for the NSW small customer market. There are around 26 licenced electricity retailers in NSW but only 11 active in the market. Similarly there are 18 authorised gas retailers, but only five brands actively offering gas, or less than half the active electricity retailers in the market. Of these five, Australian Power and Gas is the only second tier retailer. Whilst there may be churn between AGL, Origin and Energy Australia, clearly second tier retailers are dissuaded from the NSW natural gas market.

Q8. (c) Are the barriers to expansion, or exit, referred to in (a) likely to persist or abate in the future?

Without addressing the matters referred to in (a) above, in an environment where barriers to entry are high, and new entrants are unable to enter the market, the existing retailers are able to operate free from some of the competitive discipline normally imposed by the market. Therefore these conditions are likely to persist.

Q9. (a) Are there unique or specific features of the small customer electricity and natural gas retailing environment in different geographical areas or distribution networks of NSW that support, or impede, the development of competition? For example, energy retailers offering small customers "multi utility" products and services (e.g. across energy, water and telecommunications industries) or "dual fuel" products and services (i.e. in electricity and natural gas).

The dominant position of ActewAGL is an important guide when assessing the ability to bundle water in addition to electricity and gas. Actew AGL's strong level of brand loyalty is not anti-competitive in itself, but the low level of competition in the ACT is an indicator of bundling advantage, especially with a non-contestable utility such as water.

[3] AER Power of Choice Review, Chapter 4, p. 107
[4] AER Power of Choice Review, Chapter 4, p. 107
[5] AER Power of Choice Review, Chapter 4, p. 109

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Barriers to entry to retailing natural gas are also impeding new entrant activity in dual fuel, as dual fuel customers contribute to overcoming the difficulties of low margins by creating an additional margin for each customer who purchases gas as well as electricity, for an incremental increase in the cost of acquisition. The advantages to suppliers of both electricity and gas over single fuel energy retailers are also apparent in customer acquisition, where a discount on both gas and electricity in return for a contract period is a more compelling customer proposition than a single fuel offer.

Thank you for the opportunity to contribute to this important consultation. Should you or your staff wish to discuss this matter further please feel free to give me a call on (03) 8612-6471.

Yours sincerely

Alastair Phillips
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