

# **Submission to Australian Energy Markets Commission Second Draft Report on Effectiveness of Competition (Victoria)**

## **Victoria Electricity**

**1 February 2008**

### **Introduction**

Victoria Electricity Pty Ltd thanks the Australian Energy Market Commission for this opportunity to make submissions on the draft Review of the Effectiveness of Competition in the Electricity and Gas Retail Markets in Australia.

Victoria Electricity is supportive of the removal of price regulation effective 1 January 2009, subject to remedying significant problems in the wholesale gas market.

We offer comment on two specific matters:

- The effect of wholesale market rules in gas on competition
- Obligation to supply

## Effectiveness of Competition in Gas

### Background

Victoria Electricity, along with other “second tier” and new entrant retailers, strongly contends that the new rule requiring the procurement of physical gas for injection at Longford is a major barrier to entry and growth. Continuing with this new rule will only support incumbency domination and risk the collapse of new entrant competition.

We do not intend providing details of the reasoning in this submission, having discussed this previously in earlier submissions. However, we are available to revisit the core issue if required. Suffice to say that little has changed since those earlier submissions, except that, in order to protect itself, Victoria Electricity (and possibly others) has already had to take steps that will have the effect of reducing our ability to compete for Victorian energy customers.

### AEMC has been misinformed

Victoria Electricity is disturbed that the “understands that steps are being taken to address” the “amendments to the rules governing the operation of the wholesale gas market which...have unintended consequences for the future competitiveness of gas retailing in Victoria”.

This is simply not the case. A great many parties, including AEMC, have expressed concern about the serious threat to retail competition. However, no arm of the Victorian Government with the authority to remedy the situation has commenced changes to market rules regarding injection dependency of AMDQ. To date, actions have been limited to:

- A review of VoLL for Gas – a report has been finalised by MMA for consideration, and we hope this will be implemented before Winter 2008. This is helpful but is not a solution.
- A general “Top End Review” – this was always on the agenda and CRA have been commissioned to conduct the review. We are pleased to participate in this review but have always made the point that this is a longer term exercise with uncertain outcomes and will not be completed before Winter 2008. As a result, new entrants and second tier retailers face extensive risks going into this year.

The most important item remains unaddressed – an interim solution that will allow smaller retailers to compete for customers over 2008 and the following 2-3 years.

### An Interim Solution Prior to Winter 2008?

AEMC would be aware that Victoria Electricity, and other second tier retailers, sought an interim solution in order to ensure that risks faced in winter 2008 do not undermine competition in the longer term. We proposed that the market rules on AMDQ and injection dependency revert to the pre-February 2007 arrangements until more permanent arrangements can be determined and transition arrangements put in place. This would permit second tier retailers to continue to compete for customers in Victoria and for new entrants to enter the market.

Unfortunately, despite extensive discussions, the management of VENCORP is not prepared to recommend any interim amendments be made to the gas market rules with respect to injection dependent AMDQ. The paper provided by VENCORP management to the Gas Market Consultative Committee is attached for your reference. In our view, that paper is emotive and flawed. It betrays a closed mind and shows a lack of regard for retail competition. The main arguments put forward by VENCORP managers for not implementing an interim solution are summarised below, with some brief commentary from VE:

- *There is disagreement between market participants* – It is hardly surprising that dominant retailers that have benefited from a market rule change would disagree with smaller

competitors who are severely disadvantaged by it. If VENCORP is waiting for consensus, it will never be in a position to act. We had previously been advised by VENCORP that consensus at GMCC is not required and that VENCORP considers not only the arguments and “votes” but the motivations and market structures behind those positions. This approach has not been demonstrated by VENCORP executives. During the course of discussions, VENCORP executives pointed out that those opposed to an interim solution account for 80% of the market. This betrays an alarming attitude to competition issues. In effect, VENCORP management has decided to take a position that favours those dominant retailers.

- *A change would shift some risks and liabilities to those who currently have gas contracts –* This is a recognition that risk was shifted away from dominant incumbents and to second tier retailers in February last year. This is the nub of the problem. In fact, those vertically integrated incumbents with gas injection contracts face far less risk from an interim solution than smaller retailers faced by the introduction of new market rules on injection dependency, and there would be no negative consequences for competition by removing injection dependency on an interim basis.
- *Injection dependency is required for a market in transmission capacity –* This is one of the weakest arguments, but one that has been raised again and again as a mantra, despite the reality. VENCORP and all market participants accept that there is no prospect of such a market in the foreseeable future, and all recent investments have been through the net benefit test/regulated pricing method.
- *IT changes may not be able to implemented in time –* This is a very weak excuse, particularly when the interim solution involves going back to a method that applied for many years up until February 2007 and the consequences of injection dependency can be so severe for competition.

## Lack of Regard for Competition

One overwhelming feature of all discussions with VENCORP management and their documentation is the complete absence of regard for competition. There is no indication that retail competition was considered in introducing the new market rules and latest discussions with VENCORP suggest that this will continue. You will see in the attached paper that there is no reference whatsoever made by VENCORP to the competition effects of the rule, confirming our contention that such bodies and groups cannot be relied upon to consider competition issues when recommending amendments to the rules.

## Recommendations

1. We urge AEMC to meet with the VENCORP Board of Directors to advocate urgency and consideration of competition. The VENCORP Board is meeting on 18 February and a paper will be submitted by VENCORP management. If the recent paper to the Gas Market Consultative Committee is any guide, it will not be favourable to taking steps to protect retail competition. Victoria Electricity will be making a submission to the Board and will provide that to the AEMC. Victoria Electricity strongly recommends that the AEMC review its understanding that the issue is being addressed.
2. Before concluding that competition is effective, the AEMC must satisfy itself that the rules have been amended to facilitate competition as it cannot rely on any understanding that steps might be taken.

## Obligation to Supply

### Where should the Obligation to Supply rest?

#### *Relevance of Incumbency*

AMEC has addressed the issue of obligation to supply in part on the basis that the importance of retail incumbency is diminishing. Victoria Electricity believes that the shift away from incumbency has not been as significant as represented by some parties. There are a number of incumbency benefits that Origin, AGL and TRUenergy continue to enjoy in Victoria, and will for some time:

- *Customer “Stickiness”* – while there has been a great deal of churn in Victoria, there are many, many households that have never churned and are unlikely to do so, regardless of the offers made to them by new entrants. These customers are high value and a direct result of incumbency. For better or worse, those customers assist in offsetting some of the costs experienced in other areas (a benefit that new entrants do not have).
- *Brand awareness* – it remains the fact that as a result of incumbency, AGL, Origin and TRU have much higher levels of brand awareness than new entrants and second tier players (regardless of levels of marketing). This allows them to attract customers at lower cost when those customers are making a choice. While incumbents may complain about an obligation to supply, they also attract a large number of high value customers through their incumbent brand awareness.
- *Long standing wholesale contracts & vertical integration* – Incumbents benefit from wholesale long standing supply contracts including arrangements that pre-dated current market structures.
- *Standing with Suppliers and Counterparties* – Incumbents by their nature have scale and as a result find it far easier to secure credit positions with counterparties at a lower cost than new entrants.

That is, while incumbents bear an obligation that other retailers do not, they also continue to enjoy benefits not enjoyed by new entrants. Victoria Electricity proposes that any change to status quo not be introduced until 2012, after an assessment of the benefits of incumbency.

#### *Obligation to Supply dependent on access to wholesale markets*

New entrants enter markets incrementally depending on ability to secure wholesale hedges, and the cash/credit arrangements required to support those arrangements. A broad obligation to supply is onerous and would severely limit competition.

An obligation to supply gas is particularly problematic when smaller retailers and new entrants face highly illiquid wholesale markets effectively controlled by their retail competitors. Under these circumstances, new entrants and smaller retailers cannot supply customers without bearing potentially catastrophic financial risks. This is currently the case in Victoria in gas and there are no evidence that this situation will be resolved by 2009 (see earlier in this submission and our submission on the first draft report). There is also evidence that this situation is emerging in the South Australian electricity market.

This problem is most acute if there were a universal obligation to supply, or an obligation to supply in a dedicated area.

#### *FRMP Model*

AEMC has recommended that the obligation to offer to supply and sell energy to a residential customer at premises where there is an existing connection should rest with the FRMP for the

relevant premises. Victoria Electricity agrees that, when the time is right to move from the status quo, the FRMP model is the most balanced approach.

## Standard Offers

It would be highly onerous on second tier and new entrant retailers if, in addition to having an obligation to supply, the terms of that supply were imposed or limited by Government or regulators. That would certainly impose a dead weight on customer sales programmes in Victoria and substantially reduce competition.

If at some time in the future a FRMP model is introduced for obligation to supply of existing premises, Victoria Electricity strongly recommends that it be introduced only on the following basis:

- Each retailer should have control over its own standard supply arrangements with the ability to determine rates/pricing, contract terms and bond/credit requirements, as long as those terms comply with the energy retail code.
- Retailers will have the right to make alternative offers to customers that may be different to the standard offer, or waive some conditions of the standard offer. To do otherwise would put an end to sales based competition.
- The retailer's own standard offer would be the default or deemed supply arrangement for any person moving into a house or building, rather than any arrangements that were in place with the previous occupant. This appears consistent with the approach recommended by AEMC.

Under those circumstances, Victoria Electricity has no objection to publishing the standing offer price and other terms and conditions. Publication of the standard offer rates will assist customer's awareness of the costs they will incur when consuming energy.

## Obligation to Supply New Connections

AEMC has canvassed four models for Obligation to Supply for new premises:

- Host retailer
- Universal
- Defined Area
- Distributor Tender

The Universal model would impose barriers to entry to new entrants and small retailers who require careful management of wholesale hedging and cash liquidity. The defined area model is a barrier to growth and competition for smaller retailers, who would be incentivised to avoid sales activity in areas prone to higher rates of new connections, to the detriment of competition and to existing customers in those areas.

In addition, an obligation to supply new connections with gas is particularly onerous:

- New entrants and smaller retailers face the same problems for new connections as existing connections when it comes to highly illiquid wholesale markets controlled by retailer competitors (see comments above).
- In other states, there simply is no viable wholesale market for gas that will support new retailers.
- In Victoria, supply of gas to new connections involves far higher standards of certification and capability with Energy Safe Victoria. As an example, Victoria Electricity does not currently have the certifications and resources required to supply new gas connections (and does not do so). We would be surprised if that is not the case with other smaller retailers/new entrants.

Victoria Electricity supports the approach proposed by the AEMC and would be satisfied by either the host retailer approach or the distributor tender.

## Education and Mutual Obligation

Victoria Electricity would request stronger controls and an education program around a customer's obligation to advise the retailer of their occupation of a premise to avoid prolonged and costly administrative work that can result in unnecessary retailer and customer dispute.

The Commission has recommended that a Consumer awareness and education campaign will be forthcoming and Victoria Electricity would support a program that not only highlights the rights of the customers and therefore a retailer's accountability but also supports the role of the retailer and the customer's responsibility to the retailer and their energy consumption. The greater the customer's awareness the more rapidly financial difficulties will be avoided or dealt with by the retailer.

## Price Monitoring

Victoria Electricity does not support price monitoring as such, but recommends instead ongoing monitoring of competitiveness. In our experience, formal price monitoring (in the form generally undertaken by ACCC) results in unnecessarily contentious reporting and politicisation of pricing. It often requires Ministers and government officials to endorse or criticise commercial prices, regardless of the basis of those prices. Price monitoring raises expectations that Governments will make a judgement and take some action on prices, which they should not do if there is competition in the market. Monitoring raises the questions:

- What criteria will be used to make a judgement about standard offers?
- What will Government/regulators do if they make a judgement that they do not like standard offers (but those offers are compliant with codes and there is competition in the market)?

It would be far more productive for the ESC and AEMC to monitor competition itself to ensure that consumers have choice and that there is the genuine possibility of customers being acquired by other retailers. Compliance with the relevant codes will naturally continue. Victoria Electricity recommends that this approach be adopted.

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**GAS MARKET CONSULTATIVE COMMITTEE**

SUBMISSION FOR MEETING No 135, 22 Jan 2008

**SUMMARY SHEET****ITEM FOR DISCUSSION**

<b>SUBJECT</b>	<b>REMOVAL OF AMDQ INJECTION HEDGE DEPENDENCY</b>		
<b>REPORT</b>	<p>At the GMCC meeting on 18 December 2007, there was considerable discussion about the removal of injection dependency. The discussion was based on the paper GMCC 07-084-07 Paper on the Top 5 Issues for Winter 2008. The option that was discussed was the removal of all injection dependency for AMDQ and AMDQ credits.</p> <p>It was pointed out that this would not change the total amount of uplift but it would shift it from congestion to surprise. VENCorp is doing some analysis to estimate the percentage reduction of congestion uplift that would have occurred on a peak day in winter 2007 had there been no injection dependency – this should be available by the time of the GMCC meeting. It is clear however that there would be a systematic shift of risk and cost from those without gas contracts injecting into the Longford to Melbourne pipeline to all other market participants.</p> <p>The opinions at the meeting were very mixed with the 2<sup>nd</sup> tier retailers being for the removal of injection dependency and at least 2 host retailers being adamantly opposed to the removal. The other participants were somewhere in the middle to these extremes either wanting more information or being open to the suggestion.</p> <p>As stated in the paper GMCC 07-084-07 this issue is one of the main issues being picked up in the CRA review of the market. The present arrangement has come about through a number of years of consultation and the market evolution was heading towards stronger market carriage signals and not weaker (or complete removal). Some participants have prepared themselves for this market with appropriate contracts to match their portfolios of customers and suppliers while others believe that a spot market should not almost mandate participants in having to enter into bilateral contracts with others that may be, in some cases, their competitors. The Victorian gas market has never been just a spot market and there was much opposition to moving as far as we did from contract carriage.</p> <p>All this being considered, VENCorp management consider that it would be foolhardy and inequitable to suddenly remove AMDQ injection dependency for some time. The market rules have been known for some 12 months prior to the start of this market in February 2007 and participants should have been aware. The CRA review may bring about changes in an orderly and considered manner. The IT work required to remove the injection dependency would not be without risk and would require significant cost and time to retest the settlements system.</p> <p>VENCorp management will explain the process that has been undertaken to the VENCorp Board and that we recommend that no change to injection dependency be made at this stage. If anyone wishes to make a submission to the Board in writing explaining their view on the decision and outcome then that would be included in the Board submission.</p>		
<b>RECOMMENDATION/S</b>	That the GMCC note the recommendation of VENCorp management and discuss any issues.		
<b>SUBMITTED BY</b>	<b>Name</b>	John Howarth	15 Jan 2008
	<b>Organisation</b>	VENCorp	