

Australian Energy Market Commission

DRAFT REPORT

Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales

23 May 2013

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About the AEMC

The Council of Australian Governments (COAG), through its then Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. In June 2011, COAG established the Standing Council on Energy and Resources (SCER) to replace the MCE. The AEMC has two main functions. We make and amend the national electricity, gas and energy retail rules, and we conduct independent reviews of the energy markets for the SCER.

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Executive Summary

This draft report sets out our assessment of the effectiveness of competition in retail markets for small electricity and gas customers in New South Wales (NSW). It also sets out our recommendations to the NSW government on whether, and if so how, price caps should be removed.

We have found that competition in the electricity and natural gas markets for small customers in NSW is delivering benefits to customers. Customers can choose from a range of products from a range of retailers and are increasingly taking advantage of these choices.

An increased drive towards customer choice will encourage greater innovation by retailers and lead to more tailored energy products and services being available.

A number of measures should be put in place to support this increased choice. The most important of these are measures to make it easier for customers to engage in the market. This could include better customer information, and the tools to better understand and compare prices. The recommendations in this draft report build on our conclusions on this topic in our Power of choice report.

Other measures we recommend include ongoing monitoring of the market, and the power to reintroduce price caps if competition is found to be no longer effective. In addition, the National Energy Customer Framework (NECF), which the NSW government is aiming to adopt on 1 July 2013, will extend and improve protections for customers in NSW.

Competition is benefiting customers in NSW

We have based our conclusion that competition is benefiting customers on five key factors:

- How active are customers in the market?
- Are there any barriers to retailers entering, expanding or exiting the market?
- Is there independent rivalry amongst retailers?
- Are customers satisfied with outcomes in the market?
- Are retailer profit margins consistent with those in a competitive market?

Customers are active in the market. Our surveys indicate that 90 per cent of electricity customers and 86 per cent of natural gas customers are aware that they can switch energy retailer. Not only are customers aware that they can switch retailer, 21 per cent of electricity and 14 per cent of natural gas customers switched retailer in the last year.

The rate of switching in electricity is among the highest in the world¹ and it is increasing. There is nothing to suggest that the increasing trend of switching rates will not continue.

We did not find significant barriers to entry, exit and expansion. There are currently twelve active electricity and five active gas retailers operating in the market. However, this is changing as more retailers enter the market, such as the launch of Click Energy in NSW in March this year. Retailers are able to source electricity and natural gas supply to their customers. This is easier in electricity, where retailers can source electricity and manage spot price risk through hedges. In gas, we found that it is harder to access gas and pipeline capacity with a small customer base. However, since Australian Power & Gas and Lumo have recently entered the gas market and are winning customers, these issues are not insurmountable.

There is also independent rivalry amongst retailers. Between late 2010 and 2012 there were at least 102 unique electricity, 22 dual fuel and nine gas offers available across NSW, many with different discounts and benefits in the form of points, subscriptions and rebates from which customers can choose. This competition has resulted in small retailers winning market share from the big retailers. Standard retailers have all lost market share in their region and are having to compete to retain customers.

Results from our surveys indicate that the majority of customers appear satisfied with the choices available and their decisions. However, we also found that customers want more from their retailers and are demanding more transparent information, particularly regarding prices. Some surveyed customers reported having had negative experiences in the market and approximately six in 1,000 electricity and three in 1,000 gas customers have made complaints to the ombudsman. These complaint rates are not out of step with results in other states and industries.

Retailer profit margins are consistent with a workably competitive market. We estimated the margins available in regulated price caps and considered the discounts being observed by retailers in the market. The margins available have supported retailers offering average bill reductions of between four and six per cent from the regulated price caps.

While we assessed the retail electricity and gas markets separately, our observations of the way these markets operate indicate that there is significant overlap between the two. Among other things, additional competitive pressure arises in gas where customers have the potential to change from gas to electricity, such as in heating and cooking.

Some stakeholders commented that competition is not yet sufficient in rural areas for price caps to be removed. While competition is less effective in rural areas than urban areas, we consider competition to be sufficient to enable these customers to benefit from the removal of price caps. Retailers in NSW have customers across the state and

¹ The current switching rate for electricity in NSW would place NSW fourth in the latest VassaETT rankings. The rankings list is based on switching rates in 2011 with Victoria at the top of the list and South Australia in third place. See VassaETT, *World Energy Retailer Market Rankings*, 2012, p. 14.

the majority of retailers have market offers in rural areas. Amongst customers, the awareness of the ability to switch and switching rates are similar between urban and rural areas.

Pathways to removing price caps

We have considered a number of different pathways for removing price caps. Our recommendation is that price caps be removed for all customers at the same time so that all customers have an equal opportunity to benefit from increased competition and product choice.

We also recommend additional consumer protections be put in place. In particular, ongoing market monitoring should be implemented. This could consider both price and non-price indicators to assess the state of competition. Such indicators might include market shares, switching rates and retailer margins. This market monitoring should be accompanied by a power to reintroduce price caps if competition is found to be no longer effective.

This support framework would also include the NECF, which will include controls on some terms and conditions of retailers' offers such as late fees and early termination fees. The NSW government is aiming to adopt the NECF on 1 July 2013.

Measures to improve customer engagement will further enhance competition

We also recommend that measures to make it easier for customers to engage with the market be implemented. Although competition is already effective, customers seek information that would allow them to better understand the market, and better compare the offers that they receive. Moreover, as competition becomes more intense, customers need the tools and knowledge to make effective choices. Information should be easy to understand and up to date. Targeted and effective communication channels should evolve with the market. These measures will result in greater customer participation in the market which will enhance the competition that is already present in electricity and gas for small customers.

Leading up to our final report in September, we will work with stakeholders to develop a blueprint that sets out measures to make it easier for customers to engage with the market. This will build on our work in the Power of choice review. Our final report will not set out the detail of how these measures are to be implemented, but rather describe an overall approach.

Our approach to this review

We are conducting this review in response to a request from the Standing Council on Energy and Resources (SCER)² dated 10 October 2012. It is based on a process set out in the Australian Energy Market Agreement (AEMA) for the Australian Energy Market Commission (AEMC or Commission) to assess the effectiveness of competition in retail electricity and natural gas markets in the jurisdictions. Previously, we have conducted reviews in Victoria (2008), South Australia (2009) and the Australian Capital Territory (2011).

We are required to provide our final report to SCER by 30 September 2013. Our final report will make recommendations to the NSW government on the effectiveness of competition and whether price caps should be removed for such customers.

The NSW utilities regulator, the Independent Pricing and Regulatory Tribunal (IPART), is in the process of setting price caps for the period 1 July 2013 to 30 June 2016. It will issue its final report by 30 June 2013. That process is independent of our review of retail competition; however, we have engaged with IPART in the course of preparing this draft report and acknowledge the assistance IPART has provided. We note that IPART has also found competition to be effective in electricity and gas markets.

We encourage stakeholders to consider the issues raised in this draft report in preparing submissions. Submissions close on 5 July 2013.

² Formerly the Ministerial Council on Energy (MCE).

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1 Introduction

The Australian Energy Market Commission (AEMC or Commission) has been tasked with reviewing the effectiveness of competition in the New South Wales (NSW) small customer retail markets for electricity and natural gas (the NSW review).³

The purpose of the NSW review is threefold:

- assess whether competition in NSW energy retail markets is promoting effective choices for customers at a price and with the quality of service that is consistent with competitive market outcomes;
- consider the availability, take-up and impact on competition of time of use tariffs; and
- provide recommendations on removing price regulations and what mechanisms may be required to improve the effectiveness of competition, if competition is found not to be effective.

The NSW energy retail market has undergone a number of changes recently that have affected both customers and retailers, and further changes are forecast. The introduction of state and federal climate change policies and significant increases in network costs have contributed to rising electricity prices; regulated electricity prices rose by approximately 20 per cent in the 2012-2013 financial year in NSW, primarily due to increased network costs.⁴ Price regulation has not protected customers from such price rises because they relate to increases in the underlying costs of retailing electricity.

Price rises have increased community and media interest in the energy industry, as well as garnered focus from all levels of government. Increasing prices have also led to innovations such as the One Big Switch campaign, which sought to negotiate power discounts for households. While future increases in electricity prices are expected to be lower, retailers, as the interface between customers and networks, have had to address customer concerns about their electricity bills.

The nature of the retail operating environment has also been affected by the privatisation of government-owned retail businesses and the partial sell-off of generation trading rights. The NSW Government has announced the sell-off of the majority of its remaining generation assets. Ongoing uncertainty in wholesale gas prices has also brought challenges for gas retailers. Finally, the introduction of the National Electricity Customer Framework (NECF) represents another change that will affect the way that retailers discharge their obligations to their customers once implemented in NSW, scheduled for 1 July 2013.

³ Small customers are defined as electricity users that use less than 160Megawatt hours (MWh) per annum and gas users which consume less than 1 terajoule (TJ) per annum.

⁴ AEMC, *Electricity price trends final report. Possible future retail electricity price movements: 1 July 2012 to 30 June 2015*, 22 March 2013, p. 41.

Furthermore, the IPART is currently reviewing the regulated retail prices for both electricity and gas for the period 1 July 2013 to 30 June 2016.⁵ Regulated prices represent a cap on the prices that retailers can charge. Consequently, the outcome of these reviews will impact retailers' profitability. IPART published its draft reports for these reviews on 23 April 2013. We note that while these tariffs are intended to remain in place until 30 June 2016 the NSW Government is able or has the option to remove price regulation at any time.

1.1 Request for advice

The Commission received the request for advice from SCER on 10 October 2012.⁶ The request for advice also included a statement of approach⁷ that laid out the methodology for assessing retail competition and the scope that the review must follow. The review is to be completed and the final report submitted to the NSW Government and SCER by 30 September 2013.

The Commission was requested to provide advice on:

- the state of competition and the extent to which it is deemed effective for small electricity (ie customers that consume less than 160 MWh hours per annum) and small natural gas customers (ie customers that consume less than one terajoule per annum);
- the availability and take up of time of use tariffs and the impact of time of use tariffs on competition; and
- based on that assessment, provide advice on ways in which the effectiveness of competition can be improved (where competition is found not to be effective) as well as possible implementation strategies for the removal of retail price regulation ("paths to deregulation") for small electricity customers and small natural gas customers in NSW, regardless of the state of competition. This is to include advice for an option to gradually roll back retail price regulation through a reducing eligible consumption threshold.

This review focuses on whether *price* regulation is still required for gas and electricity supply to small customers in NSW. Any recommendation to remove price regulation would not necessarily mean all terms and conditions of energy retail contracts or other aspects of retailer behaviour should be deregulated. For example, terms and conditions

⁵ These prices will apply to electricity customers consuming less than 100 Megawatt hours (MWh) per annum and gas customers that consume less than one terajoule per annum. Note that while this is consistent with our review for gas, our terms of reference defines a small electricity customer as consuming less than 160 MWh per annum. The NECF defines a small customer as consuming less than 100 MWh per annum.

⁶ This notification was issued in a letter from the Chair of the SCER, the Hon. Martin Ferguson AM MP, to the Chairman of the AEMC, John Pierce, 10 October 2012. Available on our website at www.aemc.gov.au.

⁷ Available on our website at www.aemc.gov.au.

regarding late fees or termination fees and regulations around disconnections and retailer misconduct should remain.

1.2 Differences from previous review

This review is the fourth competition review conducted by the AEMC. The statement of approach for this review is similar to that followed by the AEMC in the previous reviews. However, there are two key differences:

1. In the previous reviews the AEMC undertook a two stage process. The first stage was to determine the state of competition in the relevant markets. The second stage of these reviews was focussed on the options for removing price regulation and improving the effectiveness of competition. Draft and final reports were produced for each stage. For this review, the AEMC was requested to provide a single draft and final report on both the effectiveness of competition and recommendations on removing price caps.
2. The request for advice also requires that the AEMC examine the availability and take up of time of use tariffs and their potential impact on competition. This consideration of time of use tariffs is unique to this review.

1.3 Purpose of the draft report and next steps

This report sets out the Commission's draft findings on the state of competition in the NSW energy markets, including the impact of time of use tariffs on competition, and our draft advice on the appropriate path towards removing price regulation. It also includes proposed advice on time of use tariffs.

The Commission welcomes stakeholder comments on these draft findings and recommendations. Stakeholder feedback the Commission seeks includes:

- any additional evidence on the state of competition in the electricity and gas/dual fuel markets and whether, based on that evidence, price regulation should be removed;
- if price caps are removed, comments on the appropriate paths to deregulation, including the time frame over which this should occur, what measures should be monitored and what form the power to reintroduce price caps should take; and
- specific suggestions for improving customer engagement and measures to provide customers with the tools they need to participate effectively in the market.

Stakeholders are invited to provide written submissions by no later than 5pm, **Friday 5 July 2013**. Section 1.6 sets out how submissions may be lodged.

The next steps of the review process are to:

- consider submissions to this draft report;
- consider any further evidence on the state of competition;
- evaluate and identify a preferred option for transitioning to price deregulation, if required;
- evaluate and identify preferred methods for increasing the effectiveness of competition, if required; and
- work with stakeholders to develop a framework that sets out the steps that will need to be taken to enhance customer engagement.

Our final assessment and advice must be provided to the SCER by 30 September 2013.

1.4 Sources of information the Commission has drawn upon

1.4.1 Submissions to the Issues Paper

The commission initiated this review on 13 December 2012 by releasing an Issues Paper for stakeholder comment. The purpose of the Issues Paper was to invite observations from stakeholders concerning their experience of competition in NSW's small customer electricity and natural gas retail markets since the introduction of full retail contestability in January 2002.

In response, the Commission received 17 submissions from consumer groups, retailers, industry associations, a gas distribution business and an energy consultancy. The Commission has drawn from these submissions in developing its draft findings and recommendations. A summary of stakeholder submissions is provided in appendix F.

1.4.2 Consultants

To inform our considerations and to provide additional analysis for this review the AEMC engaged three consultants:

- Roy Morgan carried out research with small customers of gas and electricity. The purpose of this work was to better understand the participation and perception of customers in the NSW retail energy markets. These results were presented in three reports:
 - Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013;
 - Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013; and
 - Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Consumers*, 28 February 2013.
- Sapere Research Group (Sapere) interviewed retailers to better understand retailer views of the NSW retail energy market, including whether there are barriers to entering the market. Sixteen retailers were interviewed as well as the Energy Retailers Association and the Energy Supply Association of Australia:
 - Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013.
- NERA Economic Consulting (NERA) estimated the profit margin for small electricity and natural gas customers for the period between 2002 and 2012. The purpose of NERA's assessment was to examine whether the estimated margin since the introduction of full retail competition was sufficient to support effective competition:
 - NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013.

These consultant reports are available on the AEMC website.

In addition, Professor George Yarrow of the Regulatory Policy Institute peer reviewed this draft report.

1.5 Structure of the report

The report is structured as follows:

- Chapter 2 sets out the assessment framework used by the AEMC for this review;
- Chapter 3 describes the market definition used for this review;
- Chapter 4 presents our assessment of competition in the electricity market;
- Chapter 5 provides our assessment of competition in the dual fuel market;
- Chapter 6 evaluates the impact of community service obligations on competition;
- Chapter 7 presents the options that we have identified for transitioning to deregulation and ways to promote competition; and
- Chapter 8 sets out how we intend to develop a blueprint for designing information and education programs to enhance customers' knowledge of the energy industry and empower customers to participate in the market.

Additionally, the report includes six appendices laying out additional detail to support the draft advice in the main body. These appendices are as follows:

- Appendix A analyses market structure;
- Appendix B assesses market conduct;
- Appendix C evaluates market performance;
- Appendix D examines the impact of time of use pricing;
- Appendix E provides an international survey of how other countries have removed price regulation; and
- Appendix F presents a summary of submissions.

1.6 Lodging submissions

Written submissions from stakeholders and interested parties in response to this draft review must be lodged with the AEMC **by no later than 5pm, 5 July 2013**.

Submissions should refer to AEMC project number "RPR0001" and be sent electronically through the AEMC's online lodgement facility at www.aemc.gov.au.

All submissions received during the course of the NSW Review will be published on the AEMC's website, subject to any claims for confidentiality.

In order for the NSW Review to be completed by no later than 30 September 2013, the AEMC must adhere to strict deadlines. While the AEMC will have full regard to all submissions lodged within the specified time period, late submissions may not be afforded the same level of consideration. To ensure the AEMC is able to fully consider all submissions, we request that stakeholders lodge their submissions by no later than the due date.

2 Assessment framework

This chapter summarises the analytical framework that underpins the Commission's assessment of the effectiveness of competition in the retail energy markets. This chapter sets out the indicators used in the assessment and their relevance to the criteria determined by the Ministerial Council on Energy (MCE) in the Statement of Approach.

2.1 What does effective competition mean for customers?

Currently in NSW standard retailers⁸ are required to offer customers a regulated price in addition to their market offers. Regulated prices, which cap the price that retailers can charge, are necessary when a market is in transition from monopoly to effective competition. Setting price caps for the standard retailer in each area ensures that, regardless of the level of competition, all customers in that area can obtain a price for electricity and gas which is considered reasonable by the regulator. In the absence of effective competition, this prevents the standard retailer from taking advantage of its position by raising prices. However, once competition is effective, price caps are unnecessary and can be harmful. The risks associated with price caps are discussed in section 7.2.

Effective competition is characterised by how well the process of markets promote the long term interest of customers. This may be summarised as:

- prices which trend to efficient costs over time;
- quality of service which matches customers' expectations; and
- a choice of products and services consistent with customers' preferences.

These characteristics reflect the nature of competition as a discovery process. As customer preferences and technology are dynamic, so too are markets, and markets are mechanisms for retailers to discover what customers want and for customers to discover the price they are willing to pay for their wants.

For example, customers signal their preferences through choosing how much and which products they will consume at particular prices. Retailers respond by constantly refining and introducing new products and technologies for customers. Where a retailer introduces a successful new product or reduces its costs, it is able to make higher profits for a period until its competitors and new entrants can match the cost reduction or new product, when profit levels will fall again. These short periods of higher profit are important to provide a reward for innovation and spur firms to reduce costs. This is a continuous, iterative process. Consequently, it is difficult to establish precise metrics for determining the effectiveness of competition at a point in time.

⁸ Standard retailers are required to offer small customers in their respective supply areas a regulated retail price that is approved by the NSW IPART. Supply areas are based on distribution network areas, as discussed further in appendix A.

2.2 How do we measure effective competition?

Effective competition requires effective participation of both the demand and supply side of the market - that is, customers and retailers. Our assessment has considered whether customers are aware, informed and engaged, and whether retailers are motivated to provide the products customers want at prices reflecting the costs of providing them.

There is no single measure of effective competition. Rather, we have examined a number of different indicators that together have informed our conclusions. Accordingly, the Commission has been guided by the market characteristics that are most likely to provide outcomes consistent with those in effectively competitive markets.

As discussed above, markets are also dynamic. Conditions change as, for example, the cost of inputs change, demand levels vary and firms enter and exit the market. It is therefore important for any assessment of competition to look over a period of time, rather than just a snapshot of competition at a point in time. It is also important to consider whether current conditions are likely to prevail in the future. As part of this assessment, we have asked whether there are likely to be any major changes in market conditions that could impact the level of competition.

The purpose of the assessment is to determine whether competition is sufficiently effective such that price regulation is no longer required. In other words, do competitive forces from the demand and/or supply sides constrain retailers from raising prices above competitive levels or reducing service quality? We have also considered what the effect of removing price regulation would be.

2.2.1 Factors we are required to consider and our approach

Under the terms of the Australian Energy Market Agreement (AEMA), the AEMC is to base its assessment of the effectiveness of competition on criteria that were developed by the MCE through public consultation.⁹ The six MCE criteria are:

1. customer switching behaviour;
2. ability of suppliers to enter the market;
3. independent rivalry within the market;
4. differentiated products and services;
5. price and profit margins; and
6. the exercise of market choice by customers.

⁹ Notice of amendment to the Australian Energy Market Agreement, 2 October 2011.

For this review we have drawn on these criteria and refined them to focus our assessment on whether the NSW retail market is providing outcomes that are consistent with effective competition as discussed in the previous section. In summary, we have considered whether:

- *customers are active in the market* - this incorporates the first and sixth MCE criteria. The desirable outcome of a competitive market is that customers are aware of the choices available to them, are able to exercise choice and switching behaviour is consistent with a competitive market. This requires assessing whether customers can switch and understanding what is motivating them to do so;
- *there are any barriers to retailers entering, expanding or existing the market* - this expands upon the second MCE criterion to consider whether existing retailers can expand or exit in addition to a consideration of whether new retailers can enter the market;
- *there is independent rivalry, such that retailers are competing strongly with each other to attract and retain customers* - this combines the third and fourth MCE criteria since differentiated products and services are a way in which retailers compete when there is independent rivalry;
- *customers are satisfied with outcomes in the market* - this has been added as it is not explicitly included in the MCE criteria. However it is an important consideration on its own merits as well as to understand the nature of switching behaviour; and
- *retailers are making profit margins that are consistent with a competitive market* - this is the fifth MCE criterion.

Together, these are referred to as the "competitive market indicators" (or "indicators"). We have used these indicators to structure our assessment of competition in chapters 4 and 5. We have considered these indicators in the framework of the four dimensions of a standard competition assessment. That is, in order to determine whether the market is consistent with the above indicators we have examined:

- market definition - setting out the bounds for the assessment;
- market structure - the nature of existing players and conditions in the market;
- market conduct - how players in the market are behaving; and
- market performance - the outcomes of the market.

Market definition is discussed in the next chapter. The remaining dimensions reflect the first three appendices. Below is an overview of how the indicators have been considered within each of the four dimensions.

2.2.2 Market definition

Any competition assessment first requires a definition of the relevant market. This sets the boundaries of the products that will be the focus of the review. The AEMC has defined the relevant market having regard to the product and geographic dimensions of the market.

The relevant market for this review is bounded to a certain extent by the request for advice, that is, the supply of electricity and gas to small customers in NSW. However, we have also assessed whether the relevant market may be wider than this, or whether it is appropriate to identify any sub-markets.

To a certain extent the definition of a market is informed by analysis of the structure, conduct and performance of the market and participants. Therefore, we have used the information gathered in the analysis of these dimensions to assist in defining the market.

2.2.3 Market structure

The market structure component of this review has covered both demand and supply aspects of the NSW market. This has included a consideration of:

- customer demand;
- aspects of independent rivalry related to the structure of the market; and
- the ability of suppliers to enter the market.

In assessing the nature of the market, we have considered the relative attractiveness of the NSW market for retailers. This involved considering the characteristics of small electricity and natural gas customers in NSW, such as the number of households and demand.

We have examined whether there is independent rivalry in the market by looking at the number of electricity suppliers that are active in the NSW market. In so doing, the following has been considered:

- the number, type and size of electricity and natural gas suppliers, and changes in the number and size of suppliers over time;
- market concentration indices; and
- the market shares of electricity and natural gas suppliers, and changes to those shares over time.

The ability of suppliers to enter the market is determined by the extent of "barriers to entry". We have assessed the extent to which electricity and natural gas retailers can enter into and expand within the market and whether there are regulatory or other

barriers to either. In this assessment, the Commission has considered the following aspects:

- Non-regulatory barriers:
 - evidence of new entry;
 - access to wholesale markets and risk management vehicles;
 - the extent and effect of economies of scale and scope;
 - exit costs;
- Regulatory barriers:
 - retail price regulation;
 - prudential and credit requirements; and
 - state-based regulations.

2.2.4 Market conduct

Market conduct focuses on the behaviour of individuals and entities participating in the market. As with market structure, both supply and demand-side aspects have been considered. In doing so, we assessed whether:

- there is independent rivalry, such that retailers are competing strongly with each other to attract and retain customers; and
- customers are active in the market.

The behaviour of electricity and natural gas retailers is an important measurement of rival conduct - that is, whether or not retailers are competing with each other for customers. The behaviour has been assessed based on evidence of product differentiation and innovation, marketing activities and other evidence that retailers are actively competing to obtain new, and retain existing, customers.

The demand-side aspect of market conduct evaluates how well customers are placed to be active participants in the market. This has required customer research to assess customer awareness of competition and choice and the ease of obtaining, understanding and comparing information. Information includes the extent and type of marketing activity undertaken by each electricity supplier and the extent of offers being sought and made by customers.

In addition to market research, customer behaviour has also been assessed by analysing switching behaviour - the extent to which customers act on the information available in the market. This has included the number of customers accepting market offers and/or switching retailers, reasons for switching and whether switches are by first tier (standard) or second tier (other) retailers.

2.2.5 Market performance

The performance of a market is a reflection of both its structure and the collective conduct of the participants acting in the market. This is being evaluated by assessing whether:

- retailers are making profit margins that are consistent with a competitive market; and
- customers are satisfied with outcomes in the market.

Profit margins that are consistent with a competitive market allow retailers to earn the efficient cost of supply, including a return on invested capital. Competitive markets also require profit margins to encourage and reward innovation in order to respond to customer demands. In markets in transition from price regulation, we are looking at whether the regulated margin can support price-based competition. A margin that supports price-based competition can provide the evidence necessary to provide confidence that if price regulation is removed, incumbents will be unable to raise prices and earn supranormal profits without a corresponding innovation or change in service offering.

Customers that are satisfied with the market will have low complaint levels. We have assessed the extent of customer satisfaction by examining the nature and frequency of customer complaints and satisfaction ratings.

3 Market definition

Box 3.1: Summary of chapter

The Commission considers that the relevant markets for assessment in this review are:

- the market for the retail of electricity to small customers in NSW; and
- the market for the retail of dual fuel to small customers in NSW.

The main reasons for finding a market for electricity retail and a market for dual fuel retail are:

- customers who are only connected to the electricity network (and not the gas network) cannot easily switch between gas and electricity. These customers form part of the electricity market;
- for customers with a connection to both fuels, there is a choice between gas and electricity for the provision of all services that gas can provide (mainly heating and cooking). Further, these customers can choose to purchase their electricity and gas from the same retailer or from separate retailers. These customers form part of the dual fuel market;
- the majority of dual fuel customers have their gas and electricity accounts with the same provider;
- there are no gas-only retailers; and
- there are low barriers to entry into electricity retailing.

The main reasons for finding the geographic scope of the relevant markets to be NSW are:

- competitive conditions in NSW are sufficiently different from conditions in other states, that the markets should not be defined any more broadly than NSW; and
- the costs and conditions of operating a retail business are sufficiently similar across the three distribution areas that they do not constitute separate markets for the purposes of assessing the effectiveness of competition.

This market definition guides the structure of, and analysis in, this report.

3.1 Introduction

Determining whether competition is effective requires assessing whether customers are able to switch away from one service to another service if prices increase above an efficient level or if quality of service deteriorates. Where competition is not effective, retailers are able to increase their profitability by raising prices and/or reducing product or service quality without losing customers. In contrast, where competition is effective, retailers must strive to lower prices and improve services in order to acquire and retain customers.

The terms of reference for the review require the Commission to assess whether competition is effective for small electricity and natural gas customers in NSW. In order to carry out that assessment, we need to know whether the supply of electricity and gas to small customers in NSW is a single market, is part of a larger market or consists of a number of markets.

As set out in the Statement of Approach, the assessment draws on the framework used by the Australian Competition and Consumer Commission (ACCC). The key to market definition is product or service substitution; that is, the extent to which "goods or services are substitutable for, or otherwise competitive with, the goods or services under analysis."¹⁰ In broad terms, this requires answering the following questions:

- What alternatives are available to customers when making decisions about gas and electricity consumption?
- Are there retailers that are not currently supplying customers who could quickly enter the market to supply dissatisfied customers, for example in response to price rises?
- Are there any groups of customers, such as regional customers, for whom the answers to these questions differ?

This chapter focuses on two key dimensions of substitution: the product dimension and the geographic dimension.¹¹

Establishing the relevant market is informed by the assessment of market structure, conduct and performance, since this can provide information on the way customers and retailers react to changes in prices of the products in question. Consequently, we draw on the same assessment factors in this analysis. While the majority of the discussion on the assessment is set out in chapters 4, 5 and the appendices, this section

¹⁰ ACCC, *Merger guidelines*, November 2008, p. 15.

¹¹ We do not consider it necessary to consider the temporal dimension of the markets in any detail, since this is only relevant in markets where there are material differences in the provision of the relevant product or service at different times of day or year. The Commission does not consider such differences apply to residential or small business consumption of electricity or gas. Appendix D considers the availability and take up of time of use tariffs by small electricity customers in NSW and the effect such tariffs may have on competition.

refers to analysis in those sections of the report in order to come to a view on the relevant market for assessment.

Market definition is not an end in itself but a step in identifying the competitive constraints acting on a retailer of a given product or service. It is not always necessary to formally and precisely define the relevant markets for the purposes of assessing competition, since the policy response may not in the end depend on the precise definition. However, market definition provides a framework for competition analysis. It is therefore important as a minimum to consider broadly where the competitive constraints and interactions lie.

The following sections summarise our views on the bounds of the relevant markets.

3.2 Product dimension

The Commission considers there are two product markets for retailing electricity and natural gas in NSW: an electricity market and a dual fuel market. Further, the activity of retailing constitutes a relevant market which is distinct from other activities in the supply chain such as generation and transport. This section explains how this draft conclusion was reached.¹²

The product dimension considers the product(s) or service(s) that should be considered as being within the same market. It considers the products to which customers could easily switch if prices of the product in question rose. It also looks at whether retailers of alternative products can easily start supplying the product in question.

There do not appear to be any other close substitutes for natural gas or electricity which might constitute the same market. Therefore we do not consider the relevant market (or markets) for this review contains any products other than natural gas or electricity.

3.2.1 Electricity

Electricity is generally accepted to be an essential service for modern living. Electricity is required for the services it provides (such as lighting, cooling, refrigeration etc), rather than for direct consumption. Many of these services cannot be obtained without electricity, at least at a comparable cost or quality.

Natural gas can be used to provide some of the services provided by electricity, in particular heating and cooking. Therefore customers could switch to gas for some services. However, other services, such as lighting and most appliances, still require electricity. Further, some households may not have access to natural gas because:

¹² In its review of regulated electricity retail prices 2013 to 2016, published on 23 April 2013, IPART defines the relevant markets for the purposes of its review as electricity and gas. Market definition provides a framework for assessment, but should not impact final policy conclusions. IPART's review has different objectives to this review, and it is appropriate that the market definition adopted may vary depending on the question being addressed and the approach to the analysis.

- in NSW there is a limit on how many customers are able to access natural gas due to limited penetration of gas infrastructure; and
- even where natural gas infrastructure is available, the take-up of gas is discretionary.

A number of retailers note that natural gas is not available to all customers in NSW.¹³ Jemena Gas Networks (Jemena) states that only 62 per cent of households in NSW have access to gas infrastructure.¹⁴ Consequently, although a customer may wish to access natural gas, it may not be possible at a reasonable cost if the infrastructure is not already available.

Related to this, Alinta also mentions the discretionary nature of the take up of gas: almost all households need to connect to electricity, but there is less need to connect to gas.¹⁵ Jemena notes that of the 62 per cent of residential customers that have access to gas infrastructure, only 70 per cent of these are connected - ie about 43 per cent of all residential customers.¹⁶ Jemena suggests that there are relatively high barriers to converting electricity only households to gas and electricity households due to a number of factors including the warm climate in NSW (which means demand is generally lower than in Victoria, for example) and a number of costs involved in connecting to gas.

Approximately 57 per cent of residential customers currently are not connected to mains gas infrastructure. For these customers, using gas instead of electricity for services such as heating or cooking is either costly or not feasible. Gas does not act as a substitute for electricity for these customers, and therefore we consider there is a separate market for electricity for those customers.

3.2.2 Dual fuel

This section considers whether customers that have access to both electricity and gas make decisions on the supply of the two fuels independently or together. It also considers whether these customers are able to substitute between the two fuels. For the purposes of this discussion, “dual fuel” refers to customers that are able to access both gas and electricity, although they may choose to have the same or separate suppliers.

Once a customer has decided to have both electricity and gas supply, the choices and products available to that customer are quite different from if a customer only has an electricity supply. These customers can now decide whether to have a dual fuel retail product or source their supply of electricity and gas separately. This changes the nature of the market and the behaviour of retailers towards the customer.

¹³ Alinta, Issues Paper Submission, 8 February 2013, p.3, AGL, Issues Paper Submission, 13 February 2013, p.3, Origin, Issues Paper Submission, 8 February 2013, p.4.

¹⁴ Jemena, Issues Paper submission, 8 February 2013, p.2.

¹⁵ Alinta, Issues Paper Submission, 8 February 2013, p.3.

¹⁶ Jemena, Issues Paper submission, 8 February 2013, p. 2.

In NSW, gas bills are relatively small compared to electricity bills so gas is often considered an “add-on” to electricity. Approximately 67 per cent of NSW small gas customers have a single retailer for both their gas and electricity.¹⁷ The proportion of customers on dual fuel contracts is much higher for new entrant gas retailers. This suggests that customers are increasingly choosing to purchase their energy from a single retailer.

All services provided by gas (primarily heating and cooking) can also be provided by electricity. Although the quality of the service may not always be identical (eg some people may prefer cooking with gas ovens to electric ovens, or vice versa), customers do have a choice for those services. Conversely, it is not a realistic proposition to use gas for a large number of the services provided by electricity: televisions, fridges and light bulbs, for example, all require electricity. That is, customers can switch from gas to electricity for all services provided by gas, whereas switching from electricity to gas is only possible for a subset of the services provided by electricity.

This is consistent with retailer submissions. For example, Origin suggests that gas provides limited substitutability for electricity whereas electricity can be considered a more effective substitute for gas.¹⁸ EnergyAustralia considers that gas and electricity are substitutes for each other for a number of small customer applications such as heating, cooling and cooking.¹⁹

In the context of a comparison of Sydney and Melbourne energy bills, Ausgrid has observed that, although gas use is higher in Melbourne, total energy bills faced by equivalent customers in the two jurisdictions are similar.²⁰ This is because higher gas usage generally results in lower electricity demand. This suggests a degree of substitutability between the two fuels.

A potential alternative to using gas supplied through the reticulated gas network is using liquid petroleum gas (LPG). This can be supplied in bottles and connected to any individual appliances which are designed or modified for that purpose. It is most commonly used by customers who do not have access to natural gas through the reticulated network. Whilst it is feasible that customers with a natural gas connection could use LPG as an alternative, the cost difference is such that it is unlikely to be seen as a substitute by the majority of customers. Consequently, we do not consider it forms part of the dual fuel market.

On the supply side, observation of the operations of retailers in NSW suggests there are synergies between gas and electricity retailing. All retailers who offer gas in NSW also offer electricity - ie there are no gas-only retailers. Furthermore, the Public Interest Advocacy Centre (PIAC) notes in its submission that some retailers apparently only offer gas products as part of a dual fuel offer.²¹ The Commission's understanding is

17 Calculated using information provided by gas retailers.

18 Origin, Issues Paper Submission, 8 February 2013, p.4.

19 EnergyAustralia, Issues Paper Submission, 8 February 2013, p.3.

20 Ausgrid, *Residential electricity prices and energy bills 2011/12 – Sydney vs Melbourne*, April 2012.

21 PIAC, Issues Paper submission, 8 February 2013, p. 16.

that while retailers do not usually actively market gas-only contracts, many retailers display their energy product offers separately on their websites.

Consistent with those observations, this review identifies low barriers to entry into electricity retail. Retailers can enter the electricity market relatively easily, and so substitution from gas to electricity is possible, and does occur, on the supply side.

3.2.3 Functional dimension: the retail of electricity and dual fuel is in a separate market to other stages of the supply chain

A market typically involves multiple stages of production. Examples of such stages could be production, transport and retail. These are referred to as functional levels. This section considers whether customers can easily obtain the service they require from a different functional level of the supply chain (eg a retail customer can purchase at the wholesale level). On the supply side, it looks at whether firms at different stages of the supply chain are able to easily switch (some of) their operations to the function in question.

The electricity and gas supply chains can be divided into three main functional levels: production, transport and retail. This separation is recognised and reflected in the national and NSW legislative frameworks for energy. Separate licences are required for retailing and distributing electricity, issued by the Minister for Resources and Energy. There is a single electricity transmission company (TransGrid) operating in NSW. Similarly, separate licences are required for natural gas transmission (reticulation), distribution and retail.

Transport of electricity and gas are natural monopoly activities, which involve a different set of resources and expertise from either retail or production. Transport is not a substitute for the retailing of gas or electricity, since both are required to deliver the respective service to customers.

The larger electricity retail businesses in NSW also own some electricity generation interests. Whilst there are likely to be some benefits to vertical integration, the two activities are neither sufficiently substitutable nor sufficiently similar as to constitute the same market. On the demand side, the costs involved in operating in the wholesale market are significant, and only the very largest customers are likely to consider participation as a substitute for purchasing electricity through a retailer.

Similarly in gas, there is a degree of vertical integration within the larger retailers, but the requirements of the different activities (production and retail) are quite different. It is also only the very largest customers who would consider directly participating in the wholesale market.

The Commission considers the evidence points to separate markets for the retail of electricity and the retail of dual fuel, distinct from the other stages of the supply chain.

3.2.4 Why small business and residential markets are not separate

There is less information available at a sufficiently granular level to assess any differences between small business and residential customers. Consequently, the evidence is less conclusive on whether small business and residential customers are in the same or separate markets.

The legislative requirements for retailing to residential and small business customers are the same: a single licence is required to retail electricity or natural gas to both residential and small business customers in NSW, and the regulated electricity tariff is to be available for all small customers in NSW (including residential and small business customers below a certain consumption threshold).

While some electricity retailers only offer to one of these sets of customers, the majority of retailers market to both: six retailers market electricity to both residential and small business customers; another three retailers are focussed only on residential customers; and another two are focussed on small business.²² In gas all active gas retailers compete for both residential and small business customers.²³

According to surveys undertaken by Roy Morgan, customer awareness of the ability to choose a retailer is similar for both small business and residential customers. Small business customers overall had a slightly higher awareness in gas (91 per cent compared to 86 per cent for residential customers).²⁴ Actual switching rates were not available by customer type. However, according to the Roy Morgan survey, slightly more residential customers than small business customers had switched at least once in both electricity and gas.²⁵

There are some differences in the range and level of offers between the two customer groups. There are fewer offers for small business customers than for residential customers. A sample of electricity offers in the Ausgrid area revealed 27 market offers for residential customers compared to 16 offers for small business customers.²⁶ Residential customers had 18 gas or dual fuel offers, compared to 10 gas or dual fuel offers for small business customers. However, the types of products and services available are similar.

²² Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, 28 February 2013, p. 5.

²³ Note that Australian Power & Gas has only very recently entered the small business market for gas.

²⁴ Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 9.

²⁵ Fifty-three per cent of residential customers and 45 per cent of small business customers surveyed had switched their electricity provider at least once. Thirty three per cent of residential customers and 25 per cent of small business customers reported switching their gas provider at least once. See Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 21; and Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 22.

²⁶ Research conducted on IPART's My Energy Offers website on 7 April 2013. Postcode was 2042 (Enmore).

A similar proportion of residential and small business customers reported being approached by retailers with an offer in both gas and electricity.²⁷ The method of approach differed, with more small business customers being approached by telephone, whereas residential customers were more commonly approached by door to door sales consultants.²⁸ This does not necessarily provide evidence of a separate market, since a retailer is likely to require a number of sales channels for marketing to any single group of customers; the costs of switching to marketing to the other group would therefore be small.

On balance, the Commission considers that the evidence points to residential and small business customers being in the same market. However, we would welcome further evidence from stakeholders on this issue.

3.2.5 Summary: relevant product market

The Commission considers that an assessment of competition for small customers in NSW should be carried out on the basis of two separate product markets:

- a market for the retail of electricity for small customers who are not connected to the natural gas network, and
- a market for the retail of dual fuel (gas and electricity) for small customers connected to both mains gas and mains electricity.²⁹

In summary, the reasons for this are:

- Customers face different choices depending on whether they are connected to gas and electricity or only electricity:
 - customers who have a gas connection have choices on whether to use gas or electricity for some services. They also face a broader range of offers from retailers; and
 - for customers who are not connected to gas, gas is not a realistic substitute for electricity in the face of a small increase in the price of electricity.
- There is significant substitutability from gas to electricity for retailers:

²⁷ See Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 12; and Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 13.

²⁸ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 14-15.

²⁹ Note that dual fuel in this context means customers with access to both electricity and gas, not necessarily with the same retailer for both.

- Customers who are connected to gas have options in whether they use gas or electricity for the provision of some services such as heating and cooking.
- There are no significant differences between the retailing of electricity or dual fuel to residential customers and to small business customers.

3.3 Geographic dimension: There is a single electricity market across NSW

The geographic dimension of market definition refers to the physical area or areas over which the relevant product or products are supplied and over which customers can practically access the product. This considers whether customers can easily switch their consumption to an alternative geographic area. On the supply side it looks at whether suppliers in other areas could easily switch to supplying in the area in question.

While the request for advice requires us to consider small customers in NSW, the economic assessment needs to consider whether the relevant geographic market(s) may be larger or smaller.

3.3.1 Why the market is not NEM-wide

AGL has suggested that retailing electricity in NSW should be considered as wide as retailing in the National Electricity Market (NEM).³⁰ Similarly, AGL argues that the relevant gas market should comprise the sale of retail gas on the east coast, including South East Queensland, NSW, the Australian Capital Territory, Victoria and South Australia. Broadly, AGL considers these market definitions appropriate because of the overlap of retailers in each of these areas and the general move towards increasingly national frameworks and regimes.

The Commission considers the markets are highly related and notes that a greater emphasis in nationally consistent approaches to retailing in both gas and electricity may eventually lead to a single market. However, these processes are not sufficiently progressed for the NEM or east coast gas markets to be considered single markets for retailing at this stage.

Geographic substitution is limited for customers:

- Customers in NSW are not able to obtain supply from retailers that operate in other states but not NSW, such as Alinta Energy.
- Retail offers, unlike in some industries, are specific to customers in a particular state.

³⁰ AGL, Issues Paper submission, 13 February 2013, p. 4.

- It is unlikely customers would move their consumption (ie move house or relocate their business) from NSW to another state (or vice versa) in response to a small change in the electricity or gas price.

We can therefore rule out demand side substitution as a reason to adopt a market definition wider than NSW.

On the supply side, currently each state has its own approach to licensing requirements and regulations. While these should become more aligned as the states adopt NECF, most states are not yet operating under this framework. Even after adoption, deviations will remain. For example, even once NECF is adopted in NSW, retailers will still be required to include messaging about the carbon price on bills.³¹

Differences in licensing and regulations create different conditions between states. For example, one retailer noted that when applying for its NSW electricity licence it was required to align its billing system to the concession rebates in NSW, even though it was not intending to retail to residential customers. These different requirements for entering different states suggest that substitution from other states into NSW involves material cost and complexity.

Similarly, price regulation in some states but not others affects operating conditions and ease of entry. Among the states which currently maintain price regulation, different approaches are taken to the calculation of allowances. Understanding the various approaches and assessing the costs, risks and potential returns takes time and resources. Again, this creates a difference between jurisdictions, making it hard for retailers to enter states in response to a profit opportunity.

There is also a greater level of risk in purchasing electricity on the wholesale market from generators in other states, as the risk of network constraints affecting the ability to transport electricity is greater when that electricity has to be transmitted between states than if it is purchased and consumed within the same state.

As a consequence of these differences, not all retailers are operating in every state. Differences in operating conditions and licensing requirements mean that a retailer cannot easily enter another state in response to a profit opportunity. For these reasons, the Commission considers that the relevant market for electricity is no wider than NSW.

Apart from the unique communications system between retailers and gas networks employed in NSW/Australian Capital Territory (ACT), which is discussed in section 5.3.2, there appear to be fewer differences between states for the retail of gas. However, the Commission considers that the relevant market for the retail of dual fuel is not as broad as the east coast, because the dual fuel market is substantially influenced by the electricity market. There are also material costs and legislative requirements for gas retailers seeking to switch operations to NSW from other states.

³¹ See <http://www.energy.nsw.gov.au/customers/necf>

3.3.2 Why there are no regional sub-markets

Prior to March 2011, the NSW electricity market was divided into three areas, each with a state owned distribution business which was also the standard retailer, required to offer a regulated tariff to small customers in that area. In March 2011, the standard electricity retailers were split from the associated distribution companies and privatised. The distribution companies were retained in government ownership and rebranded as Ausgrid, Endeavour Energy and Essential Energy. The split between the three areas remains for the purposes of distribution network operation and defining supply areas for standard retailers.³² In brief, the three areas can be described as:

- **Ausgrid:** Inner, northern and eastern metropolitan Sydney and surrounds. Approximately 1.6m customers over 22 275 km²;
- **Endeavour:** Southern and western metropolitan Sydney and surrounds. Approximately 0.9m customers over 24 500 km²; and
- **Essential:** Country and regional NSW. Approximately 0.8m customers over 582 000 km².

The Commission has considered the evidence available and considers that the competitive conditions across the three areas are sufficiently similar that they should not be treated as separate geographic markets for the purposes of assessing competition.³³ The evidence suggests that there are no significant differences between the three distribution areas that are likely to persist. We note that there are some specific areas where competition may be less effective for historic reasons, however the Commission considers that any regulation for these areas should be in the form of more targeted mechanisms rather than price regulation.³⁴

The PIAC considers that the three distribution areas should be considered three separate sub-markets.³⁵ They consider that:

- customer acquisition costs are higher in rural areas and so rural customers are less likely to benefit from competition;
- evidence from a survey³⁶ conducted in five regional centres suggest these customers are approached less often than residents of Sydney, the Illawarra and the Hunter; and

³² Standard retailers are required to offer small customers in their respective supply areas a regulated retail price that is approved by the NSW IPART.

³³ For the purposes of its review of regulated electricity retail prices 2013 to 2016, published on 23 April 2013, IPART defines separate relevant markets for each of the distribution areas. As noted in a previous footnote, it is appropriate that the market definition adopted may vary depending on the question being addressed and the approach to the analysis.

³⁴ Competition in a pocket of far west NSW (around Broken Hill) is less effective than the rest of the state because of the presence of obsolete tariffs which are priced below the cost of provision, meaning retailers are not able to offer competitive offers.

³⁵ PIAC, Issues Paper submission, 8 February 2013, pp. 7-8.

- the survey also found a lower level of awareness of retail competition amongst regional customers.

Results from Roy Morgan's surveys differ from those found in PIAC's survey. However, PIAC's survey was undertaken in August 2010, prior to the government owned retailers being privatised. As discussed further in chapter 4, switching rates have increased significantly since privatisation in March 2011. This may explain why we have found improvements in many of the indicators since PIAC's survey was conducted.

We have found that non-metro customers are benefiting from competition through product choice. There are now multiple market offers in every network area from multiple retailers. Between late 2010 and December 2012 there were 31 offers in the Ausgrid area, 41 in the Endeavour area, and 30 in the Essential area.³⁷

Most retailers who operate in NSW operate in all three areas, providing strong evidence of substitution between the areas. For example, a snapshot of offers across the three networks³⁸ revealed offers from 10 different retailers in the Ausgrid and Endeavour Energy network areas, and 8 different retailers in the Essential Energy area.³⁹ In responses to the Sapere survey, retailers said that they do not necessarily discriminate on the basis of geography.⁴⁰

Surveys conducted for the Commission found that awareness of the ability to choose an energy retailer is lower in non-metro areas, but not significantly different from metro areas. Ninety-two per cent of customers in metro areas, including the Hunter and Illawara, were aware they could choose their retailer. In contrast, 83 per cent of non-metro customers were aware of this choice.⁴¹

We note, however, the one exception is that EnergyAustralia currently does not market in the far west (the area around Broken Hill) due to the presence of obsolete tariffs, which it is not able to compete against.⁴²

Non-metro customers do receive fewer approaches by retailers than customers in the Sydney area and Hunter and Illawarra areas (54 per cent and 71 per cent,

³⁶ PIAC, *Choice? What Choice?*, June 2011.

³⁷ NERA, *Prices and profit margin analysis for the NSW retail competition review*, 25 February 2013, p. 35.

³⁸ Research conducted on IPART's My Energy Offers website on 7 April 2013. Postcodes were: 2042 (Enmore, Ausgrid); 2170 (Liverpool, Endeavour Energy); and 2630 (Cooma, Essential Energy).

³⁹ ActewAGL or AGL; Australian Power & Gas; Dodo; EnergyAustralia; Lumo; Momentum Energy; Origin Energy; Powerdirect; QEnergy; and Red Energy had offers in the Ausgrid and Endeavour Energy network areas. In contrast, QEnergy and Momentum Energy did not appear to have offers in the Essential Energy network area.

⁴⁰ Sapere Research Group, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, 28 February 2013, p. 20.

⁴¹ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 136.

⁴² Obsolete tariffs are tariffs that are no longer available for new customers.

respectively).⁴³ However, two big retailers are no longer engaging in door-knocking, which has been the most common form of approach to residential customers and the primary cost differential between acquiring customers in metro versus non-metro areas.

Retailers appear to be increasingly utilising web-based marketing. One advantage of online marketing is that it does not discriminate based on geography.⁴⁴ As a result, the differences between metro and non-metro areas in terms of approaches by retailers should become less significant. We also note that of those customers that searched for information on arrangements for changing retailers, most used internet searches or internet price comparators.⁴⁵ Further, Click Energy operates exclusively online.

As Figure 3.1 below shows, the rates at which customers are switching are high and similar in each network area.⁴⁶ The standard retailers have maintained a large proportion of customers in their respective areas, but their market shares are declining as new entrants win customers. Consequently, many of the switches are away from standard retailers, reducing market concentration. Section 4.4.1 provides further evidence that standard retailers are losing market share in their supply areas.

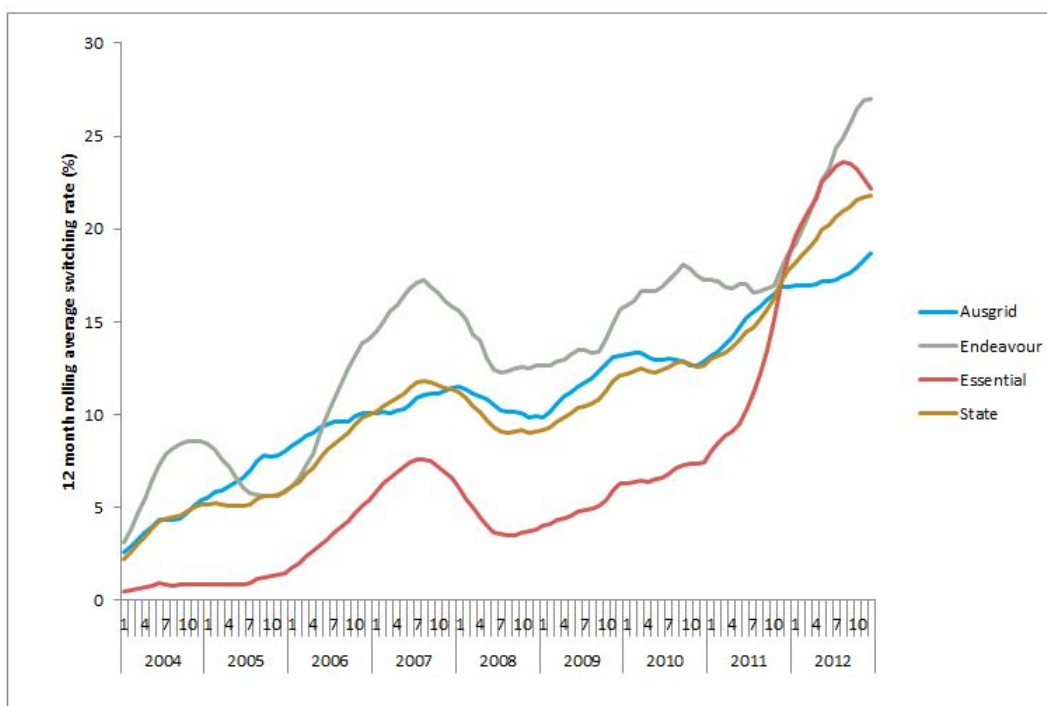
⁴³ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 136.

⁴⁴ We note, however, that there are customers who do not have access to the internet. As discussed in chapter 7, the Commission considers that specific mechanisms are required to assist customers without access to the internet to compare and choose offers and so access the benefits of competition.

⁴⁵ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 41.

⁴⁶ We note that the switching rates in the Essential Energy distribution area are slightly overstated as some switches between two different Origin meters have been counted as a switch. This has also occurred in the other network areas although to a lesser extent.

Figure 3.1 **Switching rates by distribution network**



Source: Data provided by AEMO.

Finally, discounts on market offers relative to the regulated price are similar across the three distribution areas. As mentioned in section 4.4.3 and discussed in more detail in appendix C, average discounts over the last two years have been six per cent in the Ausgrid and Endeavour Energy network areas and five per cent in the Essential Energy network area.

There is therefore substantial evidence that the competitive conditions across the three distribution areas within NSW are similar and therefore they should not be treated as separate markets for the purposes of assessing competition.

It may be possible to define a separate market for a small group of customers in far-west NSW due to the presence of obsolete tariffs which are prohibiting retailers making competitive offers. However, these tariffs are a legacy matter and are currently being phased out. As a result we do not consider that there is a separate small market for these customers.

The Commission has seen no evidence to suggest there may be sub-markets for gas or dual fuel retail within NSW. Furthermore, conduct within the dual fuel market is largely influenced by the structure of and conduct in the electricity market. Except where further evidence suggests otherwise, we consider the geographic scope of the dual fuel market is likely to be the same or similar to that of the electricity market.

3.3.3 Summary: relevant geographic market

The Commission considers the geographic scope of the relevant market is NSW, for both electricity and dual fuel.

There are sufficient differences between states, and costs of entering the NSW retail markets, that they should not be defined any more broadly than NSW.

The costs and conditions of operating a retail business are sufficiently similar across the three distribution areas that they do not constitute separate markets for the purposes of our assessment of competition.

3.4 Conclusion

The Commission considers that the relevant markets for assessment in this review are:

- the market for the retail of electricity to small customers in NSW; and
- the market for the retail of dual fuel to small customers in NSW.

Customers who have connected to the gas and electricity networks form part of the dual fuel market. Customers only connected to the electricity network form part of the electricity market.

This market definition guides the structure of, and analysis in, this report. We look at each relevant market in turn in the following chapters.

While we do not consider there to be a separate market for gas retail to small customers in NSW, analysis of the gas sector and the firms who retail gas is an important part of the analysis of the dual fuel market.

4 Assessment of competition in the electricity market

Box 4.1: Summary of chapter

The Commission's draft conclusion is that competition in the retail electricity market is providing benefits to small customers through effective choice of their retailer and electricity product. The market will continue to grow and evolve if price caps are removed. This draft conclusion is based on the following findings:

1. Customers are active in the market: 21 per cent of customers switched their electricity retailer last year, primarily to obtain a better price. The One Big Switch campaign highlighted the ability of customers to effectively participate in the market. There is no evidence to suggest that this trend of increasing participation will not continue. However, improvements can be made to the clarity and accessibility of information to increase engagement and enhance the tools customers use to choose the best tariff.
2. There are no barriers to retailers entering, expanding and exiting the market: retailers are able to source electricity, manage spot price risk through hedges and access economies of scale through outsourcing their billing systems. However, most new entrants are using Victoria as a springboard into the NSW market and many have backing from a strong parent company. Since this review has commenced, a new electricity company has entered the market.
3. There are signs of independent rivalry: while market concentration is high, smaller retailers are winning market share and competition appears to be intense between the three biggest retailers. There is some choice available to customers in both price and non-price terms and conditions (eg discounts for paying on time) and this is likely to increase if price caps are removed.

Further, outcomes in the market are consistent with effective competition:

4. Customers are generally satisfied with their experience in the market: the majority of customers appear satisfied with their retailers and with the switching process, but are demanding more transparent information, particularly in relation to prices. A minority of customers have had negative experiences, particularly in relation to marketing practices.
5. Profit margins are consistent with a competitive market: the regulated tariff has sufficient headroom to support competitive activity. New entrant retailers are offering discounts from the regulated price and incumbents are responding to this price-based competition by also offering discounts.

Finally, all retailers are offering time of use tariffs; however more work is required to clarify customer choice and improve customer understanding of time of use tariffs to allow them to participate effectively in this segment of the

market.

There are some groups of customers that are not currently participating in the market because comparing tariffs is too complex or because electricity is a low involvement product and customers have limited interest in considering their options. Chapter 8 considers how such customers may be provided with the tools to make effective choices and increase their engagement in the market.

4.1 Introduction

This chapter assesses whether the electricity market is effectively delivering efficient outcomes for small customers. As discussed in chapter 2, in assessing whether the electricity market delivers efficient outcomes for small customers, the Commission has considered whether:

- customers are active in the market;
- there are any barriers to retailers entering, expanding or exiting the market;
- there is independent rivalry, such that retailers are competing strongly with each other to attract and retain customers;
- customers are satisfied with outcomes in the market; and
- retailers are making profit margins that are consistent with a competitive market.

The Commission has also considered the availability and take-up of time of use tariffs and the implications for competition, as required by our Request for Advice.

The remainder of this chapter provides a summary of our findings in each of these areas and the evidence that supports our draft conclusions. Greater detail is provided in appendices A to D, including greater discussion of points raised by stakeholders in their submissions to our Issues Paper. The evidence that we have drawn from includes:

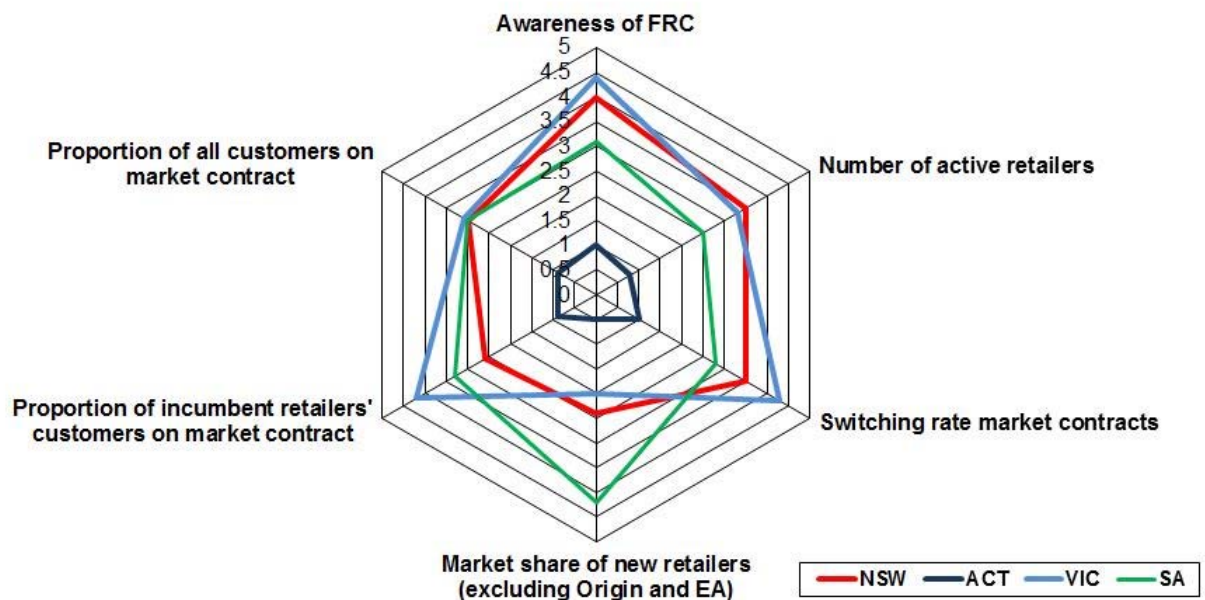
- three reports by Roy Morgan, who we engaged to conduct a quantitative survey of residential and small business customers⁴⁷ as well as hold four focus groups to understand customer experiences in the market;
- a report by Sapere Research Group, who we engaged to interview retailers and associations to understand retailers' views of the market;
- a report by NERA Economic Consulting (NERA) analysing historical regulated and market prices and profit margins;
- submissions to our Issues Paper;

⁴⁷ Where the results of these surveys are presented in the remainder of this chapter they reflect the results for residential customers. The small business customer results are presented and discussed if they differ from the residential results by more than five per cent.

- data supplied by the Australian Energy Market Operator (AEMO), including market shares and switching behaviour;
- data provided by retailers and distribution businesses; and
- other information as relevant.

The following diagram provides a snapshot of the relative competitiveness of the NSW electricity retail market compared to the Victorian, South Australian and Australian Capital Territory markets at the time of the AEMC's review of competition in those states (conducted in 2008, 2009 and 2011, respectively). The NSW market is performing better than the ACT on all criteria, and is also performing reasonably well compared to Victoria and South Australia at the time of those reviews.

Figure 4.1 **Snapshot of the relative effectiveness of competition compared to other states**



Source: AEMC 2007, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria*, First Final Report, 19 December 2007, Sydney; and AEMC 2008, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia*, First Final Report, 19 September 2008, Sydney.

Indicator	0	5	NSW	ACT	Vic	SA
Awareness of full retail contestability (FRC)	50%	100%	90%	60%	94%	82%
Number of active retailers	0	20+	14	2	13	10
Switching rate market contracts	0%	30%+	21%	6%	26%	17%
Market share of new retailers	0%	50%+	27%	5%	20%	42%
Proportion of incumbent retailers customers on market contracts	0%	60%+	45%	11%	50%	40%
Proportion of all customers on market contracts	0%	100%	60%	18%	62%	60%

4.2 Customers are active in the market

Customer participation in the market is an important measure of whether competition is effective. Without customers actively searching for better offers, retailers could raise prices and lower service quality without losing customers in response. By searching for better deals and switching to retailers that have lower prices or better service, customers play an important role in maintaining downward pressure on prices and driving retailers to provide the quality of service that customers want. Further, active customer participation is required to signal what products and initiatives retailers should offer their customers.

It is not sufficient for customers simply to be aware of their ability to choose their retailer: they also need to see value in switching retailer; have the right information and tools to make the best choice for them; and be confident that the switch will provide positive outcomes.

4.2.1 Awareness is high

The Roy Morgan survey results show that awareness of the ability to switch is high: around 90 per cent of small customers are aware they can choose their electricity retailer.⁴⁸ A number of recent events have contributed to the high level of awareness:

- *Privatisation of the government-owned retailers.* Privatisation has had two positive effects on customer awareness and so competition. First, many customers had a high degree of loyalty to the standard retailer⁴⁹ in their region, either because of legacy reasons (when customers had to purchase their electricity from their local retailer) or because a customer identified with the local brand ("The reason I went with Country Energy was when you see the country word you know you think this will be good"⁵⁰). Second, some customers believed that the government-owned retailers' links to the distribution businesses implied that if they shifted retailer their supply may not be as reliable. This link was broken when the retailers were divested from their associated distribution companies and sold to TRUenergy (now EnergyAustralia) and Origin Energy in March 2011.
- *Price rises.* Electricity price rises have attracted significant attention from media and all levels of government in recent times. Analysis undertaken by St Vincent de Paul suggests that the average annual electricity bill in NSW increased by between \$200 and \$500 from July 2011 to July 2012.⁵¹ As electricity bills increase

⁴⁸ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 9.

⁴⁹ Standard retailers are required to offer small customers in their respective supply areas a regulated retail price that is approved by the NSW IPART. Supply areas are based on distribution network areas, as discussed further in appendix A.

⁵⁰ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Consumers*, 28 February 2013, p. 11.

⁵¹ St Vincent de Paul Society, *NSW Energy Prices July 2011 - July 2012*, p. 5.

and become a higher proportion of household expenditure, customers have a greater incentive to shop around and look for better deals.

- *The One Big Switch campaign.* In response to higher electricity prices, the One Big Switch campaign was conducted in July and August 2012 across Australia. The organisers invited customers to sign up to the campaign then approached a number of electricity retailers to negotiate bulk power discounts for those customers that had registered their interest. The campaign was broadly advertised and supported by a number of media companies. One Big Switch claim to have "...helped more than 60,000 people save money on their energy bills through the Big Electricity Switch."⁵²

The degree of awareness of customers of their ability to choose their electricity retailer is a first step in considering whether there is sufficient customer participation in the market to maintain downward pressure on prices and ensure retailers provide the products that are demanded. The second step is that customers are acting on this awareness.

4.2.2 Customers are switching

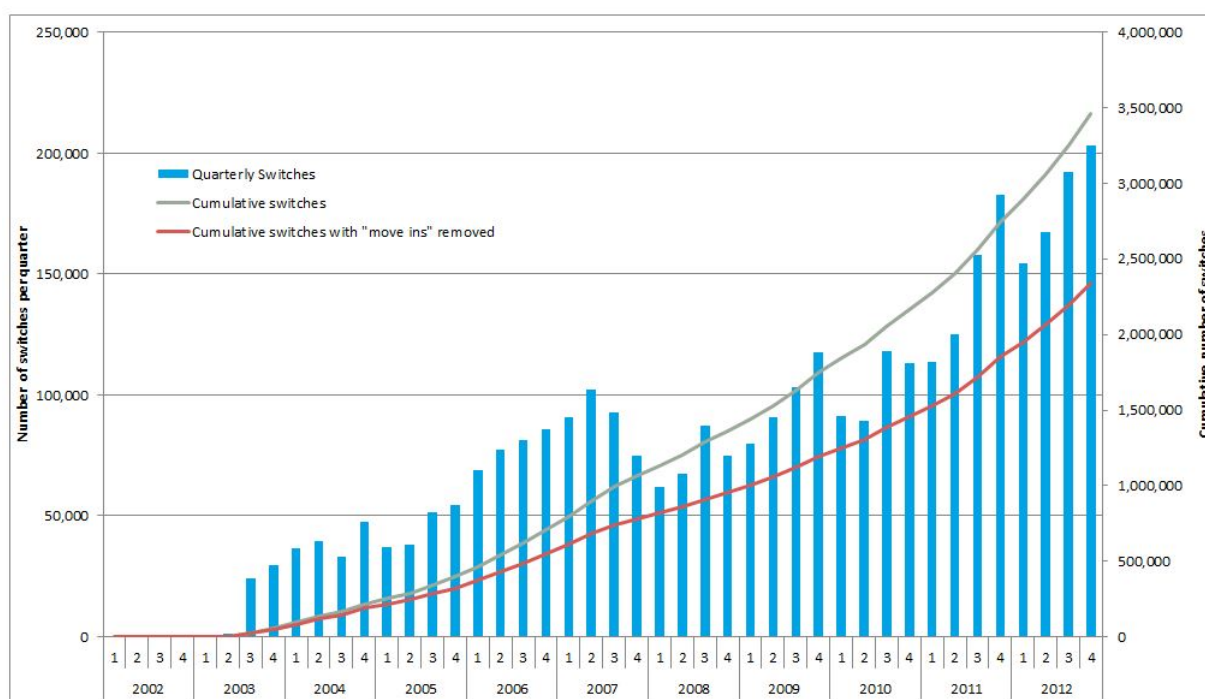
Evidence shows that customers are increasingly exercising their ability to choose their retailer, particularly since the government-owned retailers were privatised in 2011. This is demonstrated in the chart below, which shows quarterly switches since retail competition was introduced in 2002. The chart also shows cumulative switches since full retail contestability began, and cumulative switches net of move-ins.⁵³ The upward trend in switching rates is broadly consistent across all three network areas, as shown in the previous chapter.

In 2012, 21 per cent of customers switched their electricity retailer. This compares to 26 per cent in Victoria and 23 per cent in South Australia over the same period.

⁵² See www.onebigswitch.com.au/energy.

⁵³ A "move-in" occurs when a customer, who has a contract with retailer A, moves into a new residence where the former tenant or owner had a contract with retailer B. When the customer carries their old contract with retailer A to their new residence, the National Meter Identifier (NMI) at the new residence is then transferred to retailer A. For the purpose of switching data, this transfer will show up as a "switch" from retailer B to retailer A, even though there has been no actual active switch between retailers by the customer.

Figure 4.2 Quarterly switching from 2002 to 2012



Source: Data provided by AEMO.

The Roy Morgan survey suggests that customers are switching primarily to obtain a lower rate. Sixty-nine per cent of residential customers⁵⁴ and 82 per cent of small business customers⁵⁵ surveyed switched either to obtain a better price or for some other financial reason such as a monetary rebate. As discussed further below, very few of the customers surveyed switched because they were dissatisfied with their existing retailer. This suggests that behaviour on the demand side is consistent with a competitive market and that customers are placing pressure on retailers to keep their prices down by switching retailers where they find a better price. Customer switching behaviour is resulting in retailers offering better prices to customers, often from incumbents once a customer has signalled their intention to switch.⁵⁶

Further, of those customers surveyed that switched, the majority were satisfied with their new retailer. Only 13 per cent were somewhat or very dissatisfied. A further 27 per cent were neither satisfied nor dissatisfied.⁵⁷

⁵⁴ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 24.

⁵⁵ Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 25.

⁵⁶ Sapere Research Group, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 10; Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Customers*, 28 February 2013, p. 18.

⁵⁷ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 28.

The One Big Switch campaign provides a good example of demand side bargaining power and demonstrates that electricity customers do not have to be passive participants in the market. Approximately 240,000 people registered their interest with One Big Switch. The campaign organisers noted that "Tens of thousands have switched using the One Big Switch campaign or used it to ask for a better offer from their existing provider",⁵⁸ suggesting that many customers may have been motivated to seek out a better deal as a result of the campaign. A survey conducted by One Big Switch following the campaign found that almost one in four survey respondents got a better deal from their current provider by asking.⁵⁹

Switching rates, while a useful indicator of customer participation, are not a perfect measure of the number of customers that are active in the market. Switching rates only tell us the number of switches that occur, not the number of customers that switch. Consequently we cannot differentiate between a single customer that switches three times and three customers that each switch once. Further, switching rates would be expected to stabilise and lower as the market matures.

Switching rates may also underestimate the number of customers that are actually participating in the market. As switching is defined as a customer changing their electricity provider, these figures do not capture those customers that may move off a regulated tariff onto a market contract with the same retailer. Roy Morgan found that of the customers they surveyed, an additional one in five had changed their arrangements with their existing retailer.⁶⁰

Similarly, even the 40 per cent⁶¹ of customers that remain on regulated tariffs may have considered changing but decided not to for one of a number of reasons. This does not necessarily imply such customers are not making an active decision, as discussed further below.

Switching in electricity appears high compared to other industries. Switching rates are likely to differ between industries for a number of reasons, including customer awareness of cost, level of potential financial benefits resulting from switching, ease of searching for new products, and the cost of switching. However, switching rates in other industries can provide a broad basis for comparison. The box below provides a summary of switching rates, number of active firms and market concentration of a number of other industries.

⁵⁸ One Big Switch, *Switch: a definition of success*, 20 August 2012. Available at www.onebigswitch.com.au.

⁵⁹ One Big Switch, *Survey Shines Light on Electricity Myths*, 10 September 2012.

⁶⁰ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 31.

⁶¹ IPART, *Review of regulated retail prices for electricity - draft report, 2013 to 2016*, 22 April 2013, p. 12.

Box 4.2: Industry analysis of switching rates

While switching rates alone are not a good measure of an industry's competitiveness, they are commonly used as a guide for assessing how active customers are in a market. To provide context to the Commission's findings in the electricity and gas industries, we have analysed the switching rates in a number of other industries. The table below also sets out the number of active firms, market share and market concentration as measured by the Herfindahl-Hirschman Index (HHI) and market share of the largest three retailers (CR₃). Note that different industries can be expected to have different switching rates depending on a number of factors including industry structure and the nature of the product.

Product	Annual switching rate	Number of active firms	Market concentration
NSW electricity retail small customers	21%	11	CR ₃ :94%, HHI:3,200
NSW gas retail small customers	14%	5	CR ₃ :97%, HHI:4,500
Retail banking - transaction accounts	24%	61	CR ₃ :46%, HHI:1,009-1,109
Owner-occupier residential mortgages	7.5%	28	CR ₃ :46%, HHI:908-933
Investor mortgages	8%	27	CR ₃ :45%, HHI:950
Credit cards	9.2%	16	CR ₃ :53%, HHI:1,118-1,218
Internet Service Providers	15%	332	CR ₃ :57%, HHI:1,938-2,038
Health insurance	2.1%	35	CR ₃ :64%, HHI:1,725

Sources: Banking information from RFintelligence; Internet Service Provider market share from IBISWorld, *Internet Service Providers in Australia*, IBISWorld Industry Report J7124, October 2012. Switching rates from Tindal, S. 2008, "Young churners the scourge of Aussie telcos", <http://www.zdnet.com/young-churners-the-scourge-of-aussie-telcos-1339288193/> Accessed 1 February 2013; Health insurance figures estimated from Private Health Insurance Administration Council data.

While the majority of switching is between the "big three" retailers (Origin Energy, AGL and EnergyAustralia), more customers are switching to smaller retailers than are switching back from smaller retailers towards the big three. This is discussed further in section 4.4.1 below. Although bigger retailers may have had an advantage in the past

as some customers may have had concerns about being supplied by a smaller retailer⁶² or the link to a distribution business, many customers are willing to try smaller retailers that may be able to offer lower prices or differentiate themselves in other ways.

Concerns have been raised about awareness of retail competition and switching rates in Essential Energy's network area. While there is some evidence to suggest customers have previously been less active in this area, recent increases in switching rates in the Essential Energy network area suggests these customers are becoming as active as their urban counterparts.⁶³ This is shown in Figure 3.1 in the previous chapter.

4.2.3 Some customers are still on regulated tariffs

This section explores in greater detail why some customers currently do not appear to be making an active choice on their electricity tariff, and consequently may not be capturing the benefits of competition. This provides further insight into what switching rates indicate about the effectiveness of competition.

The IPART notes that around 40 per cent of customers are on regulated tariffs.⁶⁴ It is important to distinguish between those customers that cannot switch, for example due to limited choice or lack of tools and knowledge, and those that choose not to participate because they are not willing to invest the time required to understand, compare and choose a tariff. In practice it is difficult to distinguish between these two groups of customers and to identify what proportion of customers is in each group.

We consider that all customers should have the means to participate effectively in the market, whether or not they choose to engage. By "effective" participation, we mean that customers should have the necessary tools and knowledge to make the best choice for them. All customers are different and what defines the "best choice" for one customer may differ for another. For example, while some customers' priority is to obtain the lowest possible bill, others may want to support investment in renewable energy or Australian businesses. Others may be satisfied with a better price than they are currently on but are not willing to invest the time required to find the best price. While these customers may ultimately choose different tariffs, none of them are making "right" or "wrong" decisions. They are making the best decision to suit their individual circumstances.

⁶² Roy Morgan notes that "bigger is better" was mentioned as a reason for customers deciding to use one retailer over another. See Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Customers*, 28 February 2013, p. 11.

⁶³ See chapter 3 for further discussion on why we consider the electricity market to be NSW-wide and not defined by smaller, regional sub-markets.

⁶⁴ IPART, *Review of regulated retail prices for electricity - draft report, 2013 to 2016*, p. 12.

To enable effective participation, consideration needs to be given to why such customers are currently not moving off regulated tariffs and, where possible, address the reasons for their lack of participation. For example:

- Some may believe that the information required to make an informed decision is too complex or they may not have access to the right information in a form that they can easily understand. In this instance, improving the transparency, quality and accessibility of information may be sufficient to encourage them to participate.
- Other customers may perceive that the regulated price is reasonable since it is determined by an independent organisation. Informing such customers of the alternative offers available may encourage them to become more active. Such information campaigns should also reach any remaining customers who may be unaware that they can choose their retailer.
- Some customers may not have access to a choice of retailer due to barriers to retailers entering their area. The presence of obsolete tariffs, as discussed in section 4.3.1, may be an example of this. Such barriers need to be identified and action taken to remove any impediments to other retailers entering the market to provide all customers with access to the benefits of competition.
- Ultimately, some customers may never switch; however, this does not mean they are not making a considered choice or need additional protection. For example, some customers may assess the time and effort involved in researching alternative retailers as too high, perhaps compared to the value of their bill. If electricity bills increase as a proportion of their income, such customers may eventually have an incentive to switch.

4.2.4 Information provision needs to be improved

In order to participate effectively in the market, customers need to have the right information and tools to make the best choice for them. Unless they are provided with information that is easy to obtain and understand, relevant, up to date and allows competing energy offers to be compared, customers may not be able to capture the full benefits of competition.

While many customers are switching, surveys commissioned by the AEMC reveal that many customers find the information provided by retailers to be difficult to understand and unhelpful for choosing an offer. Some customers surveyed felt inundated by information and offers,⁶⁵ yet only a third of customers felt they were given sufficient information to make an informed choice on their electricity retailer.⁶⁶ A

⁶⁵ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Customers*, 28 February 2013, p. 16.

⁶⁶ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 15.

number of residential customers that had not switched cited reasons related to information quality and concerns about the switching process.⁶⁷

- 25 per cent could not be bothered switching or thought it was too much effort;
- 16 per cent thought the information was too complex, there was too much to sort through or figure out, or the information was too technical;
- 13 per cent found there was insufficient information;
- 11 per cent were concerned about the switching process; and
- 9 per cent could not understand the information, found it vague or ambiguous, poorly written or poorly organised.

Small businesses' results were approximately five per cent higher in most of these categories, and 21 per cent of small business customers were concerned about the switching process. This suggests that small business customers in particular may need improved information and encouragement to participate in the market, as discussed in chapter 8.

On the other hand, those customers surveyed that had pro-actively searched for information found it easier to understand and more useful for comparing offers.⁶⁸ These customers predominantly looked for information using internet searches and internet price comparators.

There are mixed views on the benefits of price comparator websites. While some consumer groups praised IPART's website,⁶⁹ others raised concerns that it appeared out of date.⁷⁰ Customers that participated in Roy Morgan's focus groups were generally favourable about price comparison services, such as iSelect, but there was some scepticism about their impartiality.⁷¹ These customers were also sceptical about information provided on retailers' websites. We note that once the National Energy Customer Framework (NECF) is implemented, customers will also have access to the Australian Energy Regulator's "Energy Made Easy" comparator website.

Further, not all customers have access to the internet. In 2010, 79 per cent of households in NSW had an internet connection at home. However, only 60 per cent of households

⁶⁷ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 22. Note that respondents could provide multiple reasons for not switching.

⁶⁸ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 43. We note, however, that small business gas customers that searched for information on switching were less positive about the quality and usefulness of the information provided. This may be a customer group to target with the information programs.

⁶⁹ Energy and Water Ombudsman NSW, Issues Paper submission, p. 7.

⁷⁰ PIAC, Issues Paper submission, 8 February 2013, p. 9

⁷¹ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Customers*, 28 February 2013, p. 16.

with incomes under \$40,000 per annum did so.⁷² As discussed further in chapter 8, additional support may be required to reach customers that may not have the required tools to allow them to access the best offers, including those customers that do not have access to the internet.

Some consumer groups have raised concerns that a lack of useful information and a proliferation of tariffs with multiple variables is either preventing customers from participating in the market or resulting in poor choices by customers.⁷³ Box 4.3 provides a summary of the factors that NSW customers need to take into account in comparing electricity offers. Consumer groups are also concerned that information is not appropriately targeted towards or available to certain sections of the community that have difficulty participating in the market.⁷⁴

Drawing from the focus groups, Roy Morgan noted:⁷⁵

“Issues such as contracts, smart metering, and retail vs. infrastructure led most respondents, business or residential, to say they did not feel particularly well informed about energy companies and energy policies. Yet, they were not resigned to a position of ignorance as if the issues were all too complex. They were hungry for clear information provided by energy companies that would help them to stay informed and help them to make informed choices in the current competitive NSW retail environment.”

⁷² Australian Bureau of Statistics (ABS) data set 81460.

⁷³ Choice, Issues Paper submission, 8 February 2013, p. 6. Also see Consumer Utilities Advocacy Centre, *Improving energy market competition through consumer participation*, December 2011.

⁷⁴ Ethnic Communities Council, Issues Paper submission, 8 February 2013, p. 6.

⁷⁵ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Customers*, 28 February 2013, p. 25.

Box 4.3: Snapshot of variances in offers

The AEMC tested the various offers available by taking a snapshot of tariffs offered in the Ausgrid area on IPART's comparison website (excluding time of use tariffs, which are considered in section 4.7). The analysis reveals the following factors that a customer would need to take into consideration in choosing an electricity offer:

- the quantum of the tariffs: the majority of tariffs offer discounts off the regulated rate; however, some simply offer a higher or lower tariff with no usage discount;
- the consumption blocks to which the tariff applies and over what time period: the majority of tariffs follow the three tier inclining block structure of the regulated tariff (1,000 kWh blocks per quarter); however EnergyAustralia has two tariffs with a two-tier structure which is applied daily⁷⁶ and a third tariff that has three tiers that are applied daily;⁷⁷
- the contract term for which the offer applies: the offers have different contract terms, ranging from no fixed term to a three year term;
- the quantum of the termination fee, if any;
- the quantum of late payment fees, if any;
- discounts for paying on time;
- discounts for paying by direct debit;
- discounts for dual fuel; and
- signing on bonuses, rebates or other offers such as memberships to sports clubs.

The majority of retailers also note that they may vary the charges at any time, usually accompanied by some form of notification. For example, Origin Energy note "We may vary the Charges (including the amount, nature and structure of any of the charges) by notice to you at any time during or after your Energy Plan Period (if any). The notice could take the form of a message contained in your next bill, and will specify the effective date of the variation".⁷⁸ Others only change their rates when the regulated tariffs change each year due to changes in network costs.

⁷⁶ Flexi Saver - Home and Everyday Saver - Home.

⁷⁷ Basic - Home.

⁷⁸ Obtained from IPART's "My Energy Offers" website.

The Commission considers that the effectiveness of competition could be further improved by better equipping customers with the tools they need to participate effectively in the market. There is a risk that the type and format of information currently being provided is not helping some customers make the choices that best suit them. For this reason the Commission supports introducing measures to help engage customers and empower them to make effective decisions. The Commission's proposals for improving customer engagement are discussed in chapter 8.

As discussed further in chapter 8, we also note that electricity is an inherently complex product and the market is likely to become more complex as new technology is introduced that allows customers to better monitor their consumption and potentially choose from tariffs that better match their demand profiles. While these developments will bring benefits to customers and allow them to better respond to price changes, they will inevitably further increase the complexity of participating in the electricity retail market. It is therefore desirable that targeted and effective information provision evolve with the market to continue to empower customers.

4.3 Retailers can enter, expand and exit the market

Barriers to entry, expansion and exit are an important element of an assessment of competition. Where retailers can freely enter and exit the market there will be competitive pressures on incumbent firms to charge prices that are commensurate with their costs. Incumbents will also have an incentive to innovate and provide customers with the products and service that they demand or face the threat of new entrants competing customers away.

When seeking to enter the market, retailers must have confidence that they will be able to earn a competitive return on their investment within a reasonable time period and that they will be on an equal footing with other retailers. Consequently, they require investment certainty, which is driven in part by a stable regulatory environment. Potential new entrants will consider factors such as:

- the time period over which a positive return could be made;
- access to and cost of financing, which may be influenced by the financial strength of a parent company;
- the cost structure of the company;
- price and cost volatility;
- the presence and level of price caps;
- cost and complexity of complying with licence conditions; and
- the risk of regulatory change, or new objectives for regulation.

The less certain these factors are, the more difficult it is for a retailer to enter the market. It is also easier to bear initial losses and access financing if a retailer is backed

by a strong parent company. The majority of new entrants currently competing in NSW are backed by generation companies (which provide the additional benefit of providing a physical hedge) or other large infrastructure companies.

We note that many new entrant retailers began retailing first in Victoria before expanding into other markets. For example, Australian Power & Gas (APG) and Lumo entered Victoria first. While some of these retailers entered prior to price caps being removed in that state, arguably the conditions in the Victorian market made it easier for retailers to enter and acquire a customer base there first. Since this review commenced Click Energy has entered the NSW market. There are still several retailers active in that state that are yet to enter the small customer market in NSW, including Alinta Energy and Simply Energy. These retailers are licensed to participate in the NSW market, but may be delaying the decision to enter due to a number of different reasons, such as the outcome of the current retail price determination.

4.3.1 Historical barriers to entry

Historically there have been a number of impediments to competition flourishing in the NSW electricity retail market. However, these impediments have been, or are currently being, phased out. As discussed above, there was a degree of customer loyalty and misunderstanding about the link between retailers and distributors. Another impediment cited by retailers has been the historically low level of headroom factored into the regulated price, as discussed in section 4.6 below. This section considers two further barriers have been the Electricity Tariff and Equalisation Fund (ETEF) and numerous, non-cost reflective obsolete tariffs.⁷⁹

The ETEF provided government-owned retailers with an additional means to smooth wholesale electricity risk by requiring them to pay into a fund when wholesale prices were low and allowing them to draw from the fund when wholesale prices were high. Other retailers did not have access to this fund, and consequently had relatively higher hedging costs. This scheme closed in mid-2011.

For legacy reasons, there are a number of regulated tariffs in the Essential Energy network area that are no longer available to new customers but still exist for customers who have not moved off those tariffs. While the number of these obsolete tariffs has reduced significantly since 2002, there are still 68 such tariffs that are priced differently to the common tariffs. Obsolete tariffs make it difficult for other retailers to compete for two reasons. First, all of these tariffs are under-recovering, so new retailers cannot match the regulated price. Second, the sheer number of these tariffs makes it difficult for competing retailers to know what tariffs some customers are on and therefore design competing offers. Further, EnergyAustralia notes that the high number of tariffs "increases the likelihood that quoting or billing errors will be made with pricing and is costly to support".⁸⁰

⁷⁹ Additional information on these barriers is available in appendix A.

⁸⁰ EnergyAustralia, Issues Paper submission, 8 February 2013, p. 3.

Origin considers that these obsolete tariffs do not represent a barrier to entry in practice because switching rates are similar across current and obsolete residential tariffs.⁸¹ Origin noted in its submission that it is "progressively rationalising and rebalancing the remaining tariffs which have historically been at a lower price".⁸² In its recent draft report, IPART states it will:⁸³

" remove the additional constraint that limited Origin Energy's ability to increase individual prices by more than a specified amount (in the Essential Energy supply area) and to remove the requirement for Origin Energy to obtain IPART's approval to transfer customers between prices. Instead, we will invite Origin Energy to set out how it will rationalise obsolete prices in the Essential Energy area over the determination period."

There are also a number of obsolete network tariffs that Origin does not control. Consequently, these customers may continue to be offered fewer choices until both the network and retail tariffs are addressed. If price caps are removed, Origin Energy's progress in rationalising obsolete tariffs should be assessed and consideration given to whether additional measures are required to support competition in this area.

The impact of the ETEF and obsolete tariffs can be seen in the relatively low switching rates seen in the early years of full retail contestability, demonstrated in Figure 4.2 above. However, these barriers have been, or are currently being, phased out. Since privatisation switching rates have increased significantly, suggesting that removing these barriers has had a positive impact on competition.

4.3.2 Current potential barriers to entry

There are a number of regulatory and non-regulatory costs and impediments that could still impose a barrier to entry and so inhibit new retailers from entering the market and providing competitive pressure on incumbents. The Commission has considered each of these in turn, in addition to whether there is evidence of new entry, and concluded that there are no barriers to entry, expansion or exit.

The wholesale market

The Commission has found that new entrant retailers are able to source electricity and manage wholesale spot price risk through a number of financial hedging products.⁸⁴ A number of new entrants are backed by generation companies and so also have access to

⁸¹ Origin Energy, Issues Paper submission, 8 February 2013, p. 9.

⁸² Ibid.

⁸³ IPART, *Review of regulated retail prices for electricity - Draft report*, 2013 to 2016, April 2013 p. 39.

⁸⁴ Retailers are able to source electricity from the electricity wholesale market, which operates as a "gross pool": all electricity that is generated and consumed is traded through this market. However, electricity spot market prices are very volatile, so to enter the market retailers must have access to products that allow them to hedge the risks associated with purchasing from the wholesale market.

physical hedges.⁸⁵ For those companies without any physical hedges, the contracting market is liquid and 55 per cent of generation capacity in NSW is controlled by state-owned corporations (not other retailers), suggesting there are no barriers to obtaining hedges at reasonable prices.⁸⁶ However, we note that the sale of the NSW generation assets may change the market structure and could potentially make it more difficult for smaller retailers to obtain hedges in the future.

Economies of scale and scope

Economies of scale exist in electricity retailing where the average cost of serving a customer declines as the size of the customer base increases, since a larger customer base allows a retailer to spread its fixed costs across a greater number of customers. Consequently incumbent retailers with large legacy customer bases may have an advantage over small new entrants, whose costs per customer may be much higher.

Economies of scope may exist where a retailer can spread its fixed costs over more than one product (eg electricity and gas) has an advantage over retailers that only offer one product. Such retailers can leverage off a single marketing channel. This reduces their costs, for example because they can market two or more products to a single customer at the same cost. Further, customers that have more than one product with a single retailer may be "stickier" and less likely to switch.

The Commission has found that economies of scale and scope are not barriers to entry in the electricity retail market. Small retailers did not raise economies of scale or scope as an issue that was preventing them from competing. Small retailers are able to access economies of scale by outsourcing their billing to third party providers. Consequently, they do not need to invest in expensive information technology (IT) systems before reaching a critical size, at which point it may be more cost effective to invest in capital infrastructure. Further, NEM-wide entry allows retailers to achieve economies of scale across states. Finally, depending on the cost structure of the business, retailers may be able to achieve profitability with a relatively small customer base.

Economies of scope are not a barrier because not all customers in NSW are connected to gas and so there are opportunities to compete only in the electricity market. Further, economies of scope are not limited to energy products. For example, Dodo leveraged off its existing internet, mobile, home phone and insurance services to enter the energy market. Similarly, APG is now offering insurance and phone and internet services.

Exit costs

Exit costs may arise where substantial upfront investment is required to enter the market and this investment cannot be recouped on exit. Exit barriers may also exist where contractual arrangements, for example, with suppliers or customers, may

⁸⁵ For example, Momentum is backed by Hydro Tasmania, Simply Energy is backed by International Power-GDF SUEZ and Red Energy is backed by Snowy Hydro.

⁸⁶ See section A.3.2 for further discussion.

impede exit. The Commission has found that there are no substantial exit costs in electricity retailing. Submissions to the Issues Paper and the retailer interviews did not emphasise exit costs as a barrier to entry in electricity. The two exit barriers that were identified - selling retail contracts and reputational damage - were not seen to be significant.

Prudential and network credit requirements

The market operator and network businesses place prudential and network credit requirements on retailers to support electricity purchases and the cost of transport across networks to small customers.⁸⁷ The cost of these prudentials can be high and cash-intensive for a retail business that requires consistent cashflow.

The Commission has found that these costs are not a barrier to entry or expansion because they are scalable and so smaller retailers will face lower costs. In fact, prudential requirements can improve competition by providing customers with confidence that their retailer is a viable business and so support customers' willingness to switch to new retailers. However, we also note that cost and ease of securing prudentials and credit ratings will hinge upon the financial backing of a parent company. While this is not essential for entering the market, being backed by a financially secure parent company would reduce costs and smooth the way for a new entrant.

State regulations

There are a number of state-based regulatory requirements that retailers cited as increasing the cost and complexity of operating in the electricity retail market. These costs include a multitude of environmental and green schemes that differ across jurisdictions and, specific to NSW, a requirement to print a message about the carbon price on customer bills. The Commission agrees that state-based regulations can be costly, particularly where they diverge across jurisdictions. However, these costs do not appear to be preventing retailers from entering or expanding in the market. Further, the NECF may reduce some of these differences.

Price regulation and regulatory uncertainty

Finally, we note that many retailers suggested that the biggest barrier to entering the NSW electricity market was the continuation of price regulation.⁸⁸ One retailer reported that in terms of barriers to entry, price regulation was "[n]umber one, two and three on the list".⁸⁹

⁸⁷ We note that the network credit arrangements for retailers will eventually be governed by the NECF, which adopts a different approach to the existing arrangements.

⁸⁸ See Sapere Research Group, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, pp. 35-38.

⁸⁹ Sapere Research Group, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, pp. 36.

Price regulation can create regulatory uncertainty, which can reduce a retailer's capacity to both enter and expand in the market, partly because it makes it more difficult to access finance. This is an issue that has been at the forefront of retailer concerns following regulatory decisions in Queensland and South Australia (prior to deregulation in that state). Regulatory uncertainty can also reduce retailers' capacity to innovate, particularly since innovation typically comes at some cost. Sapere states:⁹⁰

“While the regulatory processes in NSW are, for the most part, viewed as sensible and transparent, the market has been alarmed by the recent events in Queensland and South Australia. These events seem to be having a negative effect on the sentiments of retailers towards jurisdictions that are not yet deregulated such as NSW. This view is particularly prevalent amongst new entrant retailers and inactive retailers.”

Price regulation can also impede competition where regulated prices are set too low. As discussed in section 4.6 below, retailers will not enter the market if they cannot recover their efficient costs, including a return on their investment.

The apparent use of Victoria as a springboard into energy retailing in NSW suggests that there are some barriers to entry in the NSW market compared to the Victorian market. However, they do not appear to be insurmountable. On the contrary, as discussed in the next section, a number of new retailers have entered the market in the last few years.

4.4 There is independent rivalry

The extent to which retailers are competing to attract or maintain customers is another indicator of the state of competition in the market. Rivalrous behaviour can be measured by a number of indicators, including: the number of retailers participating in the market; their market share and the concentration of the market; innovation in service and product offerings; and the aggressiveness or defensiveness of marketing strategies.

In summary, while market concentration is high and product differentiation is not as great as in Victoria, there are other factors, such as switching between retailers and marketing expenditure, that suggest there is a sufficient level of independent rivalry to support competition.

4.4.1 Market structure

There are currently 12 retailers competing across NSW.⁹¹ Six of these market electricity to both residential and small business. Four retailers are focussed on residential

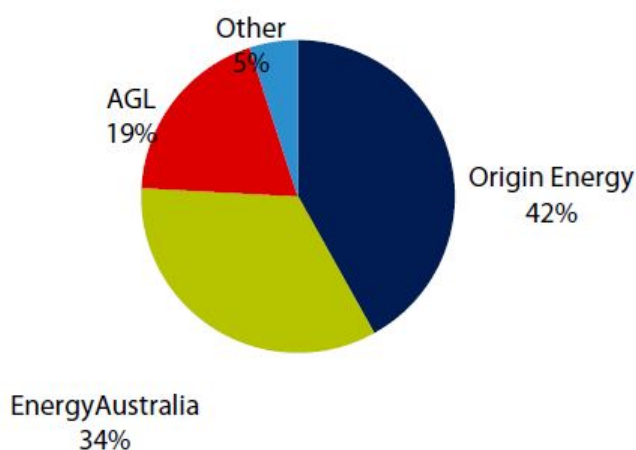
⁹⁰ Sapere Research Group, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, pp. 36.

⁹¹ Note that ActewAGL and AGL both retail electricity but do not compete in the same area.

customers, while the remaining two are focussed on small business.⁹² EnergyAustralia is the standard retailer for the Ausgrid distribution network area. Origin is the standard retailer for the Endeavour and Essential Energy distribution network areas.

Market concentration is high: the big three retailers, AGL, EnergyAustralia and Origin Energy, together have a 95 per cent market share. This represents an increase in market concentration since privatisation. Market concentration as measured by the Herfindahl-Hirschman Index (HHI) is even higher when assessed by network area, because the standard retailer controls a larger proportion of the market.

Figure 4.3 Electricity market share (June 2012)



Source: IPART, *Review of regulated retail prices and charges for electricity 2013 to 2016: Issues Paper*, November 2012, p. 25.

However, this high concentration is not necessarily a sign of a lack of competition. Customers are switching between retailers, as demonstrated in Figure 4.2 above. Incumbent retailers are losing market share in their regions⁹³ and are also offering discounts in their own regions, evidence that they are having actively to work to keep their customers.⁹⁴

While the majority of switching does occur between the big three retailers, smaller retailers are capturing market share. The chart below shows that since privatisation

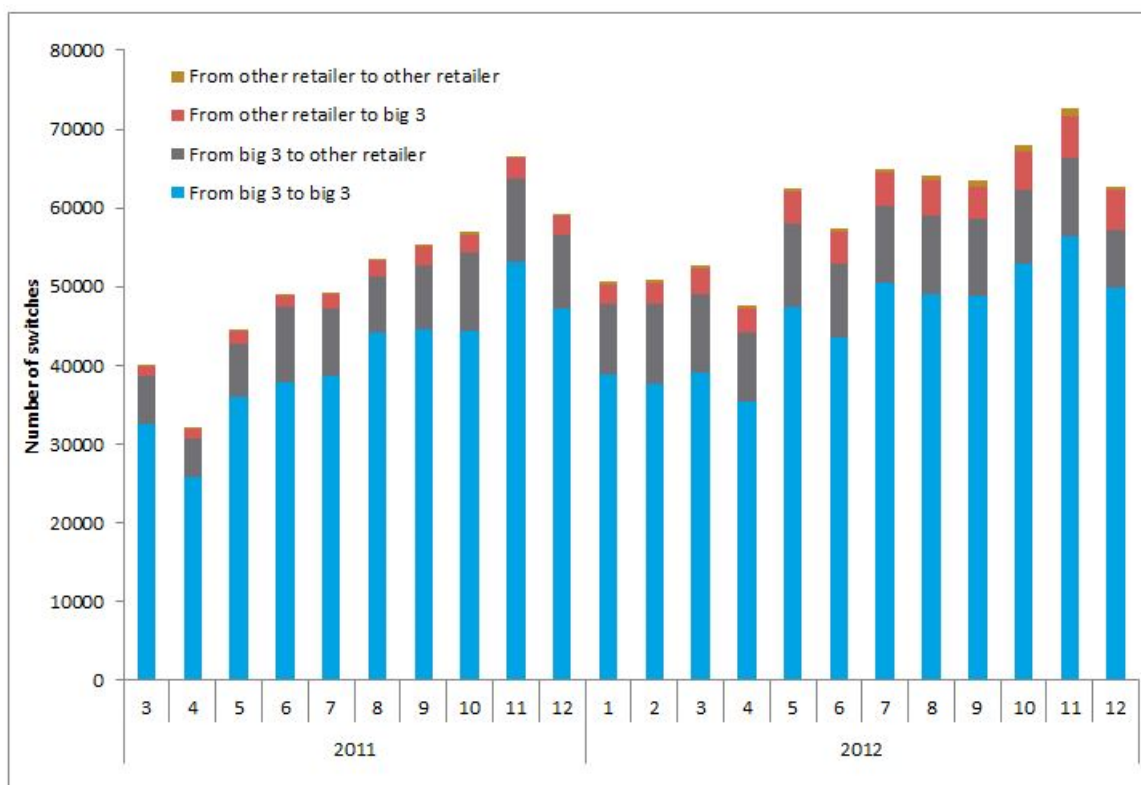
⁹² Sapere Research Group, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 5. Note that Click Energy entered the NSW market after these interviews were conducted.

⁹³ See section A.1.2

⁹⁴ For example, in its supply area EnergyAustralia offers a number of products in addition to the regulated tariff, including: a two year contract with a seven per cent discount off the regulated electricity rates and seven per cent discount off green energy rates; and a three year contract with a three per cent discount on the total bill charges and a further three per cent discount for paying bills on time. Origin is the Standard Retailer in Dubbo, where it offers: a one year contract with a 14 per cent discount on electricity usage charges, a two per cent discount for paying on time and a one per cent discount for paying by direct debit; and a contract with no fixed term with a one per cent discount off usage rates where paying by direct debit. These offers were available according to IPART's *myenergyoffers* website on 16 March 2013.

more customers are switching to small retailers from the big three than away from them. For example, APG gained over 10,000 electricity customers in the six months to 31 December 2012.⁹⁵ On the other hand, Origin lost approximately 43,000 electricity customers over the same period.⁹⁶

Figure 4.4 Switching between the big three and other retailers



Source: Data provided by AEMO.

4.4.2 Product differentiation

There is some evidence of product differentiation in the NSW market, however it appears less innovative than the Victorian market. Most product differentiation in NSW for both residential and small business customers occurs in the form of discounts and/or cash rebates that may be linked to conditions such as paying on time or by direct debit. Other offerings directed at residential customers include links to customer loyalty programs such as Velocity and membership of sports teams, which customers may value or understand better than a discount off a usage rate.

Between late 2010 and 2012 there were at least 102 unique offers to small customers for electricity across NSW.⁹⁷ These market offers have, on average, provided discounts of

⁹⁵ APG, *Investor Update*, March 2013, p. 8.

⁹⁶ Origin, *2013 Half Year Results Announcement*, 21 February 2013, p. 33.

⁹⁷ NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 25 February 2013, p. 31.

five to six per cent off a representative customer's regulated bill in all areas.⁹⁸ Retailers noted that there has been an increase in the level of price discounts being offered and that retailers are more aggressive about making counter offers to retain existing customers.⁹⁹ IPART notes that there are currently discounts of up to 15 per cent off regulated usage rates.¹⁰⁰

Unanimously, retailers told Sapere that products which offer a discount or rebate are the most popular.¹⁰¹ This view is consistent with the market research conducted by Roy Morgan. Approximately 76 per cent of residential and small business customers surveyed switched as a result of discounted offers.¹⁰²

As set out in Box 4.3, other differences in product offerings include:

- the contract term;
- conditions under which the retailer could change the price; and
- various fees, including for connection, late payment and contract termination.

EnergyAustralia also offers an inclining block tariff based on daily consumption rather than quarterly consumption and over two consumption blocks instead of three.

The prevalence of late fees or, alternatively, discounts for prompt payment, suggest that most product offerings are aimed at those customers that are able to pay their bills on time, which is a lower cost to serve group.

Despite these product variances, the Victorian market is still viewed by some retailers as having more innovative products than the NSW market.¹⁰³ A recent report by St Vincent de Paul argues that for product innovation to be "meaningful" it requires that "households with certain consumption profiles (eg low consumption, high consumption, high off-peak consumption etc.) are better off with some retailers than others".¹⁰⁴ They go on to state that Victoria is the only state that has seen such innovation.

⁹⁸ Ibid p. 34.

⁹⁹ Sapere Research Group, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 10.

¹⁰⁰ IPART, *Review of regulated retail prices for electricity, 2013 to 2016*, Draft report, April 2013, p. 30.

¹⁰¹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 53.

¹⁰² Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 38; and Roy Morgan, *Survey of business Customers of Electricity and natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 39.

¹⁰³ Sapere Research Group, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 57.

¹⁰⁴ St Vincent de Paul, Victoria and Alvis Consulting Pty Ltd, *The National Energy Market - In a bit of a state?*, November 2012, p. 8.

Three reasons why NSW may have seen fewer innovative products outside of discounts and incentives such as reward schemes include:

- the regulated tariff serves as a "focal point" for retailers;
- customers may prefer, or have a better understanding of, discounts off a common tariff; and
- the technology required to offer some products is not widely available in NSW.

There has been limited innovation in terms of tariff structure in NSW, with almost all market tariffs simply discounting the regulated offer set by the standard retailer. Standard retailers tend to structure the regulated offer based on the structure of the underlying network tariff because network costs are treated as a pass-through for the purposes of regulation. This tariff structure then serves as a "focal point" for retailers around which they base their own offers.¹⁰⁵

Further, retailers may not deviate from this structure because they are not prepared to take on the risk of offering tariff structures that do not align with their underlying costs and negotiating with distribution businesses to change the underlying network tariff is difficult.¹⁰⁶ However, this problem arises due to the underlying network tariffs; removing price caps would not resolve the issue.

Although having a focal point may limit product differentiation, it also provides a point of reference for customers to compare offers. Requiring customers to take into account differences in the tariff to which discounts are applied would add another layer of complexity. Similarly, creating tariffs with different fixed versus variable proportions would make it more difficult for customers to compare offers. Further, retailers may be reluctant to introduce such tariffs as they are difficult to explain to customers.

Finally, we note that the limited number of interval meters and smart meters currently available in NSW also constrains innovation. In Victoria, where smart meters have been rolled out, retailers have responded to customers' demands for additional information by creating online platforms from which customers can access their consumption data. Such developments require access to appropriate technology, which is currently not widespread in NSW. Consequently, while similar products may be offered in NSW, such as AGL's "My AGL IQ", their functionality may be limited.

4.4.3 Marketing

While product differentiation may be somewhat limited, the level of marketing, particularly in recent years, suggests that competition is increasing. Since electricity has historically been a low involvement service, customers typically do not pro-actively

¹⁰⁵ See Yarrow for further discussion on this concept. Submissions to the Issues Paper from AGL (p. 5) and EnergyAustralia (pp. 4 and 6) also noted that price regulation acts as a barrier to innovation.

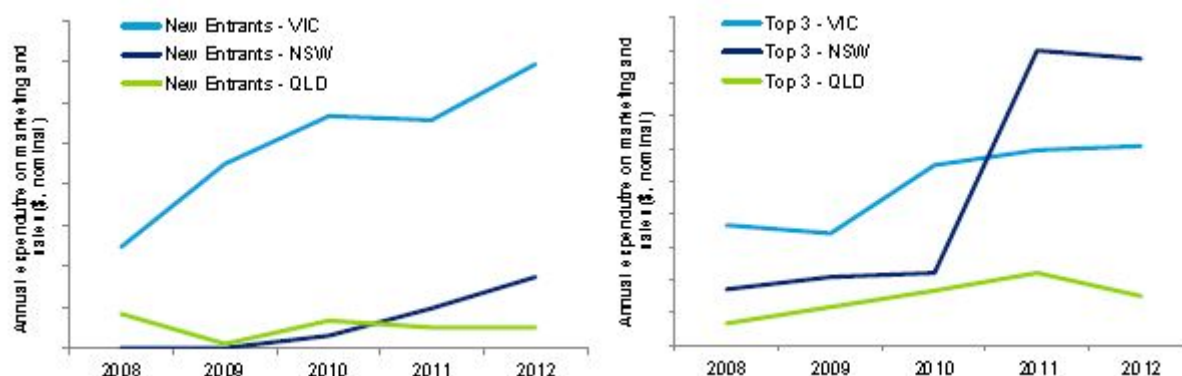
¹⁰⁶ This is partly because distribution businesses have no incentive to engage in discussions with retailers or offer a suite of different network tariff options.

search for alternative retailers. Rather, it is the retailers that inform customers of an alternative choice, typically through marketing approaches such as door to door knocking. As Sapere noted:¹⁰⁷

“Door knocking was viewed as an important form of marketing because it involves direct contact for a product that is traditionally considered to be low involvement and low engagement by customers.”

Retailers, particularly the big three, appear to be focussing their resources on both acquiring and retaining their customers. The chart below shows that marketing expenditure by both small and large retailers has increased following privatisation, although this increase is more marked for the big three retailers.

Figure 4.5 Total marketing and sales expenditure



Source: Research undertaken by Deloitte Access Economics in 2012, supplied by the Energy Retailers Association of Australia.

This significant increase in marketing expenditure may partly reflect the fact that AGL did not purchase an incumbent retail business. Consequently it is now marketing heavily to attract new customers. AGL acquired 64,220 electricity customers in the six months to 31 December 2012.¹⁰⁸ In contrast, EnergyAustralia and Origin are working to retain their newly acquired customer base. This demonstrates that competition can be fierce even between three retailers.

Sixty-eight per cent of residential customers surveyed had been approached by a retailer through a variety of sales channels.¹⁰⁹ Retailers have traditionally relied predominantly on door knocking to attract new residential customers. However, both EnergyAustralia and AGL have announced that they will no longer engage in this marketing practice because of customer complaints. EnergyAustralia noted that it

¹⁰⁷ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 59.

¹⁰⁸ AGL, FY13 Interim Results, 27 February 2013, p. 8.

¹⁰⁹ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 12.

would "continue to use other sales avenues, including our online site",¹¹⁰ suggesting there may be a new focus on online marketing.

4.5 Customers are generally satisfied with their market experiences

High levels of customer awareness and high switching rates by themselves do not provide a full picture of whether there is competition in a market from a demand-side perspective. Importantly, customers must be satisfied both with the range of products available to them and the choices that they make. A high switching rate could indicate a lack of satisfaction with the performance of the market if customers are driven to switch because of poor service by their retailer. Similarly, a low switching rate could be a sign that the market has reached an equilibrium where most customers are satisfied with the offer they are on and the quality of customers service. This section therefore considers market outcomes from a customer perspective.

In summary, the evidence available suggests that on the whole customers are satisfied with their market experience. While there are clearly areas where customers consider retailers could improve, particularly with respect to information provision, the majority of customers appear satisfied with the choices available and their decisions. This is supported by a survey by CHOICE which found that 91 per cent of customers rated their current electricity retailer as excellent, very good, good or fair.¹¹¹

However, we note that there were some differences between Roy Morgan's quantitative survey results, which suggested that customers were generally satisfied with outcomes, and the qualitative focus groups, which raised a number of areas where customers were concerned about retailer practices. This section discusses each of these studies in turn, before considering other available evidence on customer views of market performance.

4.5.1 Quantitative survey results

Roy Morgan's survey results show that of those customers that have switched, the majority were satisfied with their new retailer.¹¹² Generally this was because they felt they had secured a better deal, although 24 per cent noted that their new retailer was easy to deal with or had good customer service.¹¹³ Only 13 per cent were dissatisfied with their new retailer.¹¹⁴ Of these customers, the most common source of their

¹¹⁰ EnergyAustralia news announcement, Knock Knock...Who's there? Not EnergyAustralia, 25 February 2013. Available at www.energyaustralia.com.au.

¹¹¹ CHOICE, Issues Paper submission, p. 19. Note that the CHOICE survey was Australia wide.

¹¹² Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 28.

¹¹³ Ibid, p. 30.

¹¹⁴ Ibid, p. 28.

dissatisfaction was that the price was too high.¹¹⁵ A majority of customers found the switching process easy, smooth and that it took as long or less time than expected.¹¹⁶

The most common reason for switching was to obtain a better price or a monetary rebate.¹¹⁷ Only five per cent of customers surveyed switched because they were unhappy with their existing electricity retailer. This is similar to the results from the PIAC survey of five regional centres in NSW, where they found that two to five per cent of customers switched because they were unhappy with their former retailer or because their new retailer gave them better service.¹¹⁸ This suggests that most customers are motivated to switch for financial reasons, not because of poor service quality.

Of those that had not switched, 36 per cent of customers had not done so because they were satisfied with their existing arrangements.¹¹⁹ Again, this was not dissimilar to PIAC's findings that 35 to 49 per cent of surveyed customers did not switch because of positive experiences with their existing retailer.¹²⁰

Customers were asked whether they had experienced a variety of negative situations with retailers. The results are shown in the table below. While the majority of surveyed customers had not experienced such situations, the fact that 7 per cent of residential customers surveyed claimed to have been transferred without their consent is concerning, although price regulation does not protect customers from such behaviour.

115 Ibid, p. 28.

116 Ibid, p.25

117 Ibid, p. 24.

118 PIAC, *Choice? What Choice?*, June 2011, p. 60.

119 Ibid, p. 22.

120 PIAC's survey included a number of positive reasons in a single category, including "I like the company/happy with current supplier/familiar with them/local company". See PIAC, *Choice? What Choice?*, June 2011, p. 61.

Table 4.1 **Percentage of surveyed customers who have experienced specifically identified negative situations with their electricity retailer¹²¹**

	Residential	Small business
Actual price charged did not match prices quoted	8%	8%
Entered into contract in order to get more information	4%	3%
Felt pressured into signing contract with energy company	15%	8%
Told things about terms and conditions of contract that did not prove to be true	11%	7%
Transferred to another energy company without explicit consent	7%	6%
Unable to terminate its energy contract during cooling off period	2%	1%
Entered into contract simply to get person to leave house/business and/or hang up phone	5%	3%

Source: Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, p. 44; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, p. 45.

4.5.2 Focus group results

Information gleaned from the focus groups suggested there are a number of areas where customers are feeling frustrated by retailer behaviour, which lowers their trust in retailers and, in turn, lowers their willingness to engage in the market. One of the key retailer practices that frustrated customers was when a customer attempted to switch retailers, only to be offered a better deal by their original retailer.¹²² While the customer may ultimately have ended up on a better deal with their original retailer, customers were perplexed as to why the retailer would only offer their customers a better deal when a customer accepts an offer from another company.

¹²¹ Note that customers that have experienced none of the identified negative situations could have had no negative experiences at all or could have experienced negative situations that were not identified in the survey.

¹²² Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Customers*, 28 February 2013, p. 18.

Other practices that customers raised in the focus groups as displeasing included:¹²³

- “ • Price savings that were mentioned in a sales call or sales visit that never materialized. An example of this was a promised percentage discount on gas pricing for bundling the service with electricity that did not show up on the bill.
- Promised savings from switching that were apparent on bills received early in a contract that were rapidly offset by a price increase.
- Being switched or renewed without being informed adequately.”

There was a clear message from the focus groups that retailers would have to work hard to earn customers' trust. At a minimum, customers considered that retailers needed to be more "transparent, straight-forward and consistent on pricing messages and practices".¹²⁴

4.5.3 Customer complaints about electricity retailers

While complaints about NSW electricity retailers have increased over time, the level of complaints does not appear disproportionately high compared to other states. The Electricity and Water Ombudsman of NSW (EWON) appear to receive fewer complaints than its Victorian and South Australian counterparts. The table below shows the number of complaints received by the Ombudsman in each state for the 2011/12 financial year.

Table 4.2 Complaints to the ombudsman about electricity retailers

	NSW	Victoria	South Australia
Number of complaints per 1,000 customers	5.5	18.7	9.5

Source: Calculated using data from: EWON, *Annual report 2011-2012*; EWOV, *Annual report 2011-2012*; ESCOSA, *Performance of the South Australian retail energy market - customers service - 2011/12*; and electricity customer numbers.

However, the number of complaints received about electricity retailers appears to be comparatively higher than complaints in other industries such as telecommunications and finance.¹²⁵

¹²³ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Customers*, 28 February 2013, p. 19.

¹²⁴ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Customers*, 28 February 2013, pp. 20-21.

¹²⁵ See section C.2.3 for further discussion.

The number of complaints received by EWON has increased by approximately 50 per cent from the previous year. The top three complaints to EWON were about high or disputed accounts, poor service and arrears or utility debt. The rate of complaints about issues such as being pressured into signing or agreeing to a contract or being transferred without consent was much lower than the Roy Morgan survey found, suggesting more people are experiencing such incidences than reporting them.

The high level of complaints largely relate to solar feed in tariffs. As the Premium Feed in Tariff ended, the Victorian Ombudsman received a surge of calls from solar customers concerned that their new solar installation may not qualify for it.¹²⁶ Another 5,234 electricity complaints related to concerns about the roll-out of smart meters.¹²⁷ There were also a number of complaints related to technical issues in the billing system of a large retailer.

In their interviews, retailers noted that:¹²⁸

- complaints about higher bills have increased since the carbon price was introduced in July 2012;
- complaints correlate to the levels of marketing activity; and
- door knocking is a key source of complaints.

As discussed above, EnergyAustralia and AGL have announced that, in response to customer complaints, they will cease doorknocking. In their interviews retailers discussed other responses to "negative perceptions of doorknocking activities."¹²⁹ These included establishing Energy Assurance Limited (EAL) and a code of practice to monitor the behaviour of door to door sales agents.

It is too early to assess whether these developments will lower the number of complaints about electricity retailers. While the majority of customers may appear satisfied, instances of misleading marketing and being transferred without consent are concerning and should be addressed. However, as discussed further in section 7.2.4, we note that if price caps are removed there is no reason why this should lead to higher bills or greater retailer misconduct and so an increase in complaints to the Ombudsman.

4.6 Profit margins are consistent with a competitive market

Profit margins can provide an indication of the level of competition in a market. If profit margins are persistently very high, retailers may be earning profits in excess of

¹²⁶ Energy and Water Ombudsman of Victoria (EWOV), *Annual report 2011-2012*. p. 21.

¹²⁷ EWON, *Annual report 2011-2012*. p. 25.

¹²⁸ Sapere Research Group, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 64.

¹²⁹ Sapere Research Group, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 63.

the efficient cost of supply and so the market may not effectively be maintaining downward pressure on prices (for example, due to barriers to entry). On the other hand, if profit margins are persistently very low (for example because the regulated price is set too low) then new retailers may be deterred from entering the market if they cannot earn a reasonable return on their investment.

It is difficult to identify an appropriate benchmark with which to compare profit margins in the retail market. We have therefore focused on whether the regulated profit margin has been sufficient to support competitive activity. That is, if price regulation is removed, is there sufficient competitive activity to prevent incumbents from raising prices?

To calculate historical profit margins requires a comparison between retailers' costs and retail prices. It is difficult to obtain accurate information on the cost of supply. While estimates can be made using publicly available information, different businesses may have different cost structures and so may require different rates of return on their investments.

Analysis must rely on assumptions about the load profile of an average customer (although sensitivity analysis can be conducted to test conclusions). Again, this implies that actual profit margins will differ depending on the various load profiles of a retailer's customer base.

In summary, we have found that profit margins are generally consistent with outcomes that might be expected in an effectively competitive market because they are supporting price-based competition across NSW.

4.6.1 Analysis of retailer profit margins

The AEMC engaged NERA to undertake analysis of retailer profit margins since 2002 and comment on the implications for competition. NERA found that profit margins in electricity under the regulated tariff “were adequate to support effective competition in NSW between 2002 and 2012”.¹³⁰ Their results are set out in the table below for each network area and under three different assumptions about wholesale costs. The analysis was conducted over two time periods: 2002 to 2007 and 2008 to 2013.¹³¹

This analysis is for the regulated tariff and once discounts are applied the profit margins on market offers would be much lower. Recall that discounts have averaged five to six per cent off a regulated bill.

¹³⁰ NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 25 February 2013, p. 46.

¹³¹ See appendix D for further discussion on NERA's results.

Table 4.3 Implied retail margins to supply a representative electricity customer (7,500 kWh) by distribution area

Distribution area	Low wholesale cost	Medium wholesale cost	High wholesale cost
FY2002 - FY2007			
Ausgrid	10%	6%	2%
Endeavour Energy	10%	6%	2%
Essential Energy	13%	10%	6%
FY2008 - FY2013			
Ausgrid	9%	5%	2%
Endeavour Energy	13%	10%	7%
Essential Energy	11%	9%	6%

Source: NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 25 February 2013, p.37.

In general, headroom in recent years appears to have been sufficient to allow new entrants to offer prices below the regulated price while still maintaining a small profit margin. We also found that incumbents are responding and also offering discounts off the regulated price.

4.6.2 The impact of price regulation on profit margins

A number of retailers consider there has historically been insufficient headroom to allow retailers to offer discounts off the regulated rate, limiting the scope for entry.¹³² IPART noted in its 2010 review: "...the regulated tariffs will be set at cost reflective levels in each year of the 2013 determination. This is distinct from the 2007 determination, where regulated tariffs were targeted to reach fully cost reflective levels in 2009/10."¹³³

AGL and Origin consider that regulated prices are now set at levels that allow retailers to earn a cost reflective margin.¹³⁴ However, smaller retailers are less certain. Alinta, currently active in Victoria and South Australia, stated that it is:¹³⁵

¹³² For example AGL, Issues Paper submission, p.5; Origin Energy, Issues Paper submission, p.8

¹³³ IPART, *Review of regulated retail tariffs and charges for electricity 2010-2013*, p. 32.

¹³⁴ AGL, Issues Paper submission, p. 11; Origin Energy, Issues Paper submission, p. 8

¹³⁵ Alinta, Issues Paper submission, 8 February 2013, p. 1.

“...yet to enter the NSW energy market at the mass market (small consumer) level as the current regulated retail price for both gas and electricity is not, in our view, set at levels that allow for the recovery of the efficient costs of operating in the market.”

Two retailers that are currently operating in NSW have ceased marketing activity in the Ausgrid network area.¹³⁶ One of these retailers directly linked this decision to IPART's July 2012 electricity price determination, where it considered that the operating margin was no longer high enough to continue marketing in that area. Instead these retailers are focussing on the Endeavour and Essential Energy network areas.

These views are consistent with the NERA results which found that profit margins for electricity were generally lower in the Ausgrid distribution area, particularly for small customers.¹³⁷ The difference appears to be driven by the structure of the retail and network tariffs to recover fixed costs. As a result, revenues and profits are more dependent on volumes in the Ausgrid distribution area compared to the other areas.

Nevertheless, the level and availability of discounts in the Ausgrid distribution area appear consistent with that available in the other distribution areas. For this reason, we do not consider competition in the Ausgrid area to be adversely affected. Indeed, the above statements may reflect the competitive process whereby retailers enter and exit the market, affecting the level of marketing activity and in turn, margins.

4.7 Time of use tariffs

SCER has also asked the AEMC to undertake a review of, and provide advice on, the availability and take-up of time of use tariffs by small electricity customers in NSW and the effect such tariffs may have on competition. This section provides a summary of our findings on this issue. Our key findings are summarised below. Appendix D contains a more detailed assessment of these issues.

4.7.1 Availability, prevalence and take-up of time of use tariffs

To be offered a time of use retail tariff, a customer must have an interval or smart meter installed at its premises that is being read on an interval basis for settlement purposes. Currently there are approximately:

- 446,000 of the meters installed in small customers' premises in NSW are being read on an interval basis for settlement purposes, which equates to around 13.5 per cent of the small customer metering installations in NSW. Of these meters, 99 per cent are located in Ausgrid's network;¹³⁸ and

¹³⁶ Sapere Research Group, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 37.

¹³⁷ NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, p. 40.

¹³⁸ AEMO, NMI data.

- 343,500 meters that are being read on an accumulation basis for settlement purposes, but which could be read on an interval basis in the future if some incremental capital expenditure was undertaken to ensure they comply with the relevant metrology procedures.¹³⁹

Data on the prevalence and take up¹⁴⁰ of different retail tariff structures is not publicly available. However, data provided by AGL, APG, EnergyAustralia, Lumo and Origin Energy¹⁴¹ indicates that:

- 97 per cent of customers with an interval read meter are currently subject to a time of use tariff, the majority of which were required to move to a time of use tariff; and
- 13 per cent of small customers overall are currently subject to a time of use tariff (residential: 12 per cent and small commercial: 25 per cent) .

In relation to the first of these metrics, the prevalence of time of use tariffs in Ausgrid's network has depended more on the network charging policy employed by Ausgrid than customer preferences. This is because, with the exception of EnergyAustralia, retailers have been unwilling to take on the risk of customers having different network and retail tariff structures.¹⁴² Ausgrid's former policy of moving all small customers with an interval read meter onto a network time of use charge appears to have had a significant effect on the take up of time of use tariffs in this network.

Following a change to Ausgrid's network charging policy, which came into effect on 28 August 2012, residential customers that have an interval read meter installed will only move onto a time of use network charge if they select a time of use retail tariff. Consequently the influence of network charges policy on the take up of time of use tariffs by residential customers in this network should start to diminish.¹⁴³ Our understanding is that Ausgrid's new policy applies both to new meters and residential customers that wish to revert back to an inclining block tariff, however it does not apply to small business customers. Further, it is not clear how residential customers are informed of their ability to choose a time of use tariff.

¹³⁹ Responses to AEMC questionnaire provided by Ausgrid, Endeavour Energy and Essential Energy.

¹⁴⁰ The prevalence of time of use tariffs has been measured by dividing the number of customers currently subject to a time of use tariff by the total number of small customers supplied. The take up of time of use tariffs has been measured by dividing the number of customers subject to a time of use tariff by the number of interval read meters currently installed in NSW.

¹⁴¹ Responses to AEMC questionnaire provided by AGL, APG, EnergyAustralia, Lumo and Origin Energy.

¹⁴² Ibid.

¹⁴³ For small commercial customers in Ausgrid's network, the network charging policy is still expected to have a significant influence on the take up rate because they are still subject to the old policy.

4.7.2 Competition issues associated with time of use tariffs

While the number of small customers on a time of use tariff is currently quite low, time of use tariffs are expected to become more prevalent in the future as more interval read meters are rolled out and as customers' understanding of these products improve. It is timely therefore to consider whether there are any competition issues associated with time of use tariffs and, if so, whether any additional measures may need to be put in place to address these issues.

Based on the assessment we have undertaken of a number of structure, conduct and performance indicators, it would appear that while there is a reasonable degree of competition to supply this segment of the retail electricity market, there are still a number of significant competition related issues affecting participants in this segment of the market.

Customer choice and understanding

To date, the range of tariff structures offered to small customers with an interval read meter appears to have depended more on network charging policies employed by network businesses than customer preferences. As a consequence, some small customers that have wanted to switch from a time of use tariff back to a flat or inclining block retail tariff have found it difficult to do so.

This may in part be due to price regulation, which may limit the ability of retailers to offer customers on a time of use network charge a flat or inclining block retail tariff (and vice versa) because they place a cap on the margin that retailers can earn for taking on the risks associated with customers having different network and retail tariff structures. Consequently competition does not appear to support customer choice between flat or inclining block and time of use retail tariffs at this time.

In the AEMC's Power of choice review we suggested a policy framework is required to clarify whether small customers should have a choice between time of use and flat or inclining block retail tariffs. Our specific recommendations are contained in our final report for that review.¹⁴⁴ We also note that SCER is currently developing its policy on this issue.

Linked to this issue, we have found that small customers are not currently in a position to participate effectively in this segment of the market (ie, they are not in a position to make informed choices about the tariff structure and retail offer that best suits their needs). This is because their level of understanding of time of use tariffs is quite low¹⁴⁵ and they are not sufficiently equipped to make informed decisions. Time of use tariffs could be a particular area of focus for the customer engagement programs proposed in chapter 8.

¹⁴⁴ See AEMC 2012, *Power of choice review - giving consumers options in the way they use their electricity*, Final Report, 30 November 2012, Sydney, Chapter 6 for a full discussion of our recommendations.

¹⁴⁵ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Consumers*, 28 February 2013, pp. 2 and 10.

Independent rivalry amongst retailers

While customers have a choice of retailers offering time of use tariffs in the Ausgrid network area, retailers appear to be making higher margins on time of use tariffs than an equivalent customer on an inclining block retail tariff in this area. The reason for this appears to be that while Ausgrid is discounting its network time of use tariffs, these discounts are not being passed on to customers.

Analysis undertaken by NERA suggests that margins on a representative residential customer on a regulated time of use retail tariff over 2008-2013 were approximately 12 per cent compared to a five per cent margin on an equivalent customer on a regulated inclining block retail tariff.¹⁴⁶ We note that the retail margin analysis conducted by NERA is predicated on a number of significant assumptions and may not necessarily reflect the margins actually earned by retailers. However, while the margin analysis carried out by NERA has its limitations, discussions with stakeholders suggest that its observations on the presence and source of the higher time of use retail margin may have some merit.

These higher margins may have persisted because:

- customers are not currently in a position to participate effectively in this segment of the market, as discussed above; and
- retailers are not competing on the basis of the conditions prevailing in this segment of the market. Rather, they are using the regulated retail tariff as the reference point for their market offers and then offering the same discounts on time of use tariffs as the discounts offered on inclining block tariffs.

We would expect that as time of use tariffs become more prevalent and as customers' understanding of time of use tariffs improves, retailers will start competing more actively in this segment of the market by offering discounts that reflect the conditions prevailing in the market and, in so doing, erode any inefficiently high margins.

4.8 Draft conclusions and recommendations

Based on the available evidence, the Commission considers that the NSW retail electricity market for small customers is competitive. However, the effectiveness of competition could be further enhanced by implementing measures to assist customers to better understand their electricity consumption and options for changing tariffs. Our recommendations in relation to information provision and customer engagement are outlined in chapter 8.

The Commission considers there is a high degree of engagement in the electricity retail market by small customers and that this engagement has been increasing in recent years. Privatisation of the government-owned retailers and the accompanying brand changes have served to increase awareness of retail competition, as have innovations

¹⁴⁶ NERA, *Prices and Profit Margin Analysis for NSW Retail Competition Review*, February 2013, p. 40.

such as the One Big Switch campaign which showed the possibility of collective bargaining for encouraging participation in the market. Customers may also be more active as a result of recent increases in electricity prices, which have added \$200 to \$500 onto the average residential bill in the last year.¹⁴⁷

Customers are also acting on their ability to choose their electricity retailer. Switching rates have increased markedly in the last two years across all network areas. Switching has primarily been driven by a desire to obtain better prices or rebates, suggesting that customers are helping to keep downward pressure on prices consistent with a competitive market.

However, the Commission considers there is a lack of clear and accessible information to engage customers and assist them to choose the best tariffs. Effective information provision and customer education to provide customers with the right tools to participate effectively in the market is a key area for improvement by retailers.

The Commission sees no evidence of barriers inhibiting new entry. On the contrary, a number of new retailers have entered the market in the last few years. However, the Commission does have some concerns about the ongoing ability for small retailers to be able to obtain hedges, depending on the outcome of the sale of the NSW Government's generation assets.

There are mixed signs of independent rivalry in the NSW retail electricity market. Market concentration is high and there is more limited product differentiation than in Victoria, but small retailers are gradually winning market share. Further, there are signs that competition is intense between the big three retailers. Incumbent retailers are losing market share in their regions and are having to compete to keep their customer base. On balance the Commission considers that there is sufficient rivalry in the electricity market to keep competitive pressures on prices and provide retailers with incentives to offer new products.

There is mixed evidence on the level of customer satisfaction in the electricity retail market. While the quantitative survey results suggest that customers are broadly satisfied with their electricity retailer, there are a number of areas where customers are frustrated with retailer behaviour. These mainly relate to marketing activity and a lack of transparent information, particularly in respect of prices. This has led to a level of distrust of electricity retailers. In response retailers are putting in place measures to reduce complaints, particularly in respect of door knocking, although it is too early to tell whether these measures will be effective.

On balance, the Commission considers that customers are generally satisfied with market outcomes. While there are examples where customers have had negative experiences, this is not widespread across the electricity customer base. However, there are a number of areas where retailers could improve their service, particularly when approaching customers with an offer. Clearer information from retailers should assist in improving customer experiences.

¹⁴⁷ St Vincent de Paul Society, *NSW Energy Prices July 2011 - July 2012*, p. 5.

The Commission considers that historical profit margins have supported competitive activity. Retailers have responded to customer switching behaviour by offering tariffs that are below the regulated price. This effective price-based competition provides confidence that price regulation is not required to constrain prices.

In relation to time of use tariffs, it appears that while there is a reasonable degree of competition to supply this segment of the market, there are still a number of competition related issues affecting small customers and retailers operating in this segment of the market. In particular, there is a lack of clarity of choice between a flat or inclining block and time of use tariffs and customers appear unable to participate effectively in this segment of the market. While margins on time of use tariffs in the Ausgrid network area appear high, it is likely that removing price regulation would allow retailers greater flexibility in their pricing options and so these margins should be competed away.

5 Assessment of competition in the dual fuel market

Box 5.1: Summary of chapter

The Commission's draft conclusion is that competition in the dual fuel market is providing benefits to small customers through effective choice of their retailer and electricity product. The market will continue to grow and evolve if price caps are removed.

For competition in the dual fuel market to be effective, competition in both the electricity and gas sectors must be sufficiently effective, but not necessarily to the same degree. As outlined in the previous chapter, the Commission's draft conclusion is that competition is effective in the electricity market. In respect of gas, the Commission has found:

1. Customers are active in the market: 14 per cent of customers switched their electricity retailer last year, primarily to obtain a better price. There is no evidence to suggest that this trend will not continue. However, as with electricity, improvements need to be made to the clarity and accessibility of information to assist customers in making appropriate decisions.
2. There are some barriers to retailers entering the market: accessing gas supply and pipeline capacity with a small customer base is difficult and the NSW gas distribution networks have a bespoke interface system which means retailers may incur additional costs to enter and expand in the NSW market. However, new retailers have entered the market recently and are winning some market share.
3. There are limited signs of independent rivalry: Market concentration is high and there is limited product differentiation. There are fewer dual fuel and gas only offers than in electricity, although this may reflect the fact that fewer customers are connected to gas.

Outcomes in the market appear consistent with effective competition:

4. Customers are generally satisfied with their experience in the market: the majority of customers appear satisfied with their retailers and with the switching process, but are demanding more transparent information. A minority of customers have had negative experiences, particularly in relation to marketing practices.
5. Profit margins are consistent with a competitive market: the regulated tariff has sufficient headroom to support competitive activity. New entrant retailers are offering discounts from the regulated price and incumbents are responding to this price-based competition by also offering discounts.

There are some groups of customers that are not currently participating in the market because comparing tariffs is too complex or because gas is a low

involvement product and customers have limited interest in considering their options. Chapter 8 considers how such customers may be provided with the tools that they require to make effective choices and increase their engagement.

5.1 Introduction

As discussed in chapter 3, the Commission's draft finding is that there is a dual fuel retail market and not a separate market for the retail supply of gas. The dual fuel retail market is made up of the retail supply of electricity and the retail supply of gas to all customers who are connected to both networks. This finding has been based on our observations of how the electricity and gas markets have been operating in practice. Considering the gas market in isolation of electricity would not reflect the realities of the market.

The finding that there is a dual fuel retail market and not a separate market for the retail supply of gas affects how we assess the effectiveness of competition. For the dual fuel market to be functioning in customers' interests, both the electricity and gas retail sectors must effectively deliver customers with a range of choices at an efficient cost and with the quality of service they demand. If competition in the supply of one of the fuels is not effective, there is a risk that dual fuel customers may suffer from higher prices and fewer product choices for that fuel. For example, if there was insufficient levels of competition to prevent gas prices rising to excessive levels, prices for dual fuel products would also be affected.

On the other hand, competition in one market may increase the competitiveness of the other market through dual fuel marketing. Dual fuel effectively provides a retailer with two new customers at the cost of acquiring one, decreasing cost to acquire. It may also decrease the cost to serve through economies of scope. Further, the more products a customer has with a retailer, the less likely they may be to switch. These factors make dual fuel customers an attractive proposition for retailers, who may compete harder across both electricity and gas markets to secure them. Therefore, strong competition in one market may have positive effects on competition in the other.

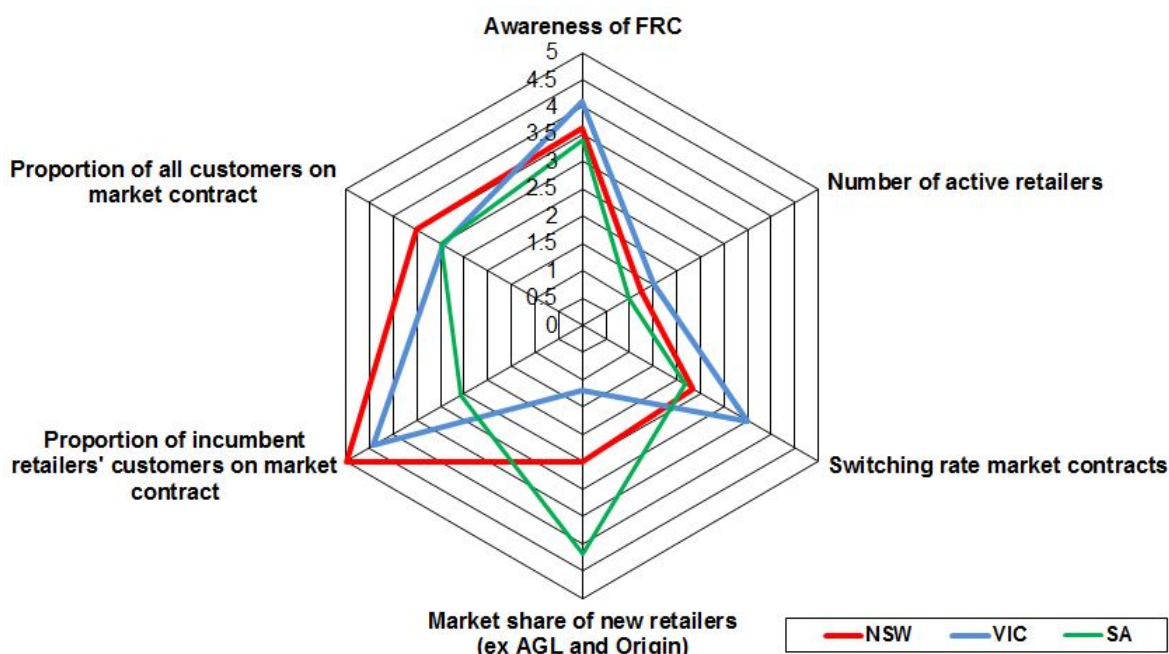
In the previous chapter we found that competition in the electricity market is effective. In order to determine whether competition in the dual fuel market is effective we also need to assess competition in gas. This chapter sets out our findings in respect of gas. The Commission has considered the same factors as in the assessment for the electricity market. Before concluding, this chapter discusses the evidence available on the competitiveness of the dual fuel market itself.

This chapter provides a summary of our findings and the evidence that supports our draft conclusions. Greater detail is provided in appendices A to C.

The following diagram provides a snapshot of the relative competitiveness of the NSW gas retail market compared to the Victorian and South Australian markets at the time of the AEMC's review of competition in those states, which were conducted in 2008

and 2009, respectively.¹⁴⁸ The diagram suggests that the NSW market is performing better than Victoria on half the criteria and better than South Australia on five of the six criteria.

Figure 5.1 **Snapshot of the relative effectiveness of competition compared to other states**



Source: AEMC 2007, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria*, First Final Report, 19 December 2007, Sydney; and AEMC 2008, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia*, First Final Report, 19 September 2008, Sydney.

Indicator	0	5	NSW	Vic	SA
Awareness of full retail contestability (FRC)	50%	100%	86%	91%	84%
Number of active retailers	0	20+	5	6	4
Switching rate market contract	0%	30%+	14%	21%	13%
Market share of new retailers	0%	50%+	25%	12%	42%
Proportion of incumbent retailers customers on market contracts	0%	60%+	60%	53%	31%
Proportion of all customers on market contracts	0%	100%	70%	59%	60%

¹⁴⁸ Note that the AEMC's competition assessment in the Australian Capital Territory was limited to electricity.

5.1.1 Differences between gas and electricity

There are a number of important differences between electricity and gas retail markets that may partially explain some of the differences in our findings. First, fewer people are connected to gas than electricity. There are only 1.2 million gas customers compared to 3.3 million electricity customers in NSW. Second, gas is typically only used in households for a minority of energy needs, such as for hot water and cooking. Consequently, average expenditure on gas is fairly low compared to the average electricity bill, and also compared to expenditure on gas in Victoria.¹⁴⁹

These factors have two important implications. First, the NSW gas market may not be as attractive to retailers as the Victorian market due to low gas penetration and volumes. Therefore we might expect to see fewer retailers entering the gas market in NSW than in Victoria. Second, customers may be less willing to invest the time and effort of researching the best market offer for gas since the gas bill represents a proportionally smaller expense than electricity. Consequently we might expect less engagement from customers compared to electricity, where recent price rises have brought electricity costs into the spotlight.

We also note there have traditionally been fewer controls in the gas retail market than in electricity. This is evidenced by the different approaches adopted by IPART in regulating each market:

- Electricity prices are subject to a weighted average price cap that is developed using a building blocks approach. IPART determines a wholesale cost allowance, a retail operating cost allowance; and a retail margin allowance which are used to derive the price cap. Standard retailers then set individual regulated tariffs to comply with the weighted average price cap and with a number of side constraints.¹⁵⁰
- While gas prices are also subject to a weighted average price cap, this is determined using a "propose/respond" model and set out in a Voluntary Transitional Pricing Agreement rather than through a pricing order. The standard retailers submit a proposal for an agreement which IPART then considers against its terms of reference. IPART can either agree to the proposal or require a standard retailer to submit a revised proposal. Where a mutually satisfactory agreement is not reached, IPART may resort to making a pricing order. However, this has not happened to date.

One reason for less regulatory intervention in gas is that it is feasible to substitute away from gas to electricity. While it is difficult to completely replace electricity with gas (for example electricity is required for lighting and the majority of appliances), it is possible

¹⁴⁹ One retailer noted that the average gas bill in Victoria is about \$600-\$700 while in NSW it is closer to \$200. See Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 22.

¹⁵⁰ For example, individual tariffs cannot increase by more than a specified percentage.

to replace gas with electricity (although we note that this may be at some expense, for example if appliances needed to be replaced). This ability for customers to use an alternative fuel to gas has been viewed as a market mechanism for keeping some control on prices and hence to justify a lighter-handed form of regulation. We also note that NSW is the only state in the east coast gas market to regulate gas retail tariffs.

5.2 Customers are active in the market

5.2.1 Awareness is high and customers are switching

The available evidence suggests that gas customers are active in the market, although slightly less so than in electricity. The Roy Morgan survey found that 86 per cent of residential gas customers were aware they could choose their gas retailer. This compares to 91 per cent in Victoria and 84 per cent in South Australia at the time competition reviews were undertaken in those states.¹⁵¹ However, small business gas customers in non-metro areas were significantly less aware of their ability to choose their retailer than other customer groups.¹⁵² This may be a particular group of customers to focus on in developing appropriate information and education programs to increase customer engagement, discussed in chapter 8.

The upward trend of electricity switching rates is mirrored for gas, with switching rates increasing considerably since privatisation. This could suggest that switching in gas is driven by switching in electricity, which is one of the reasons we consider there is a dual fuel market rather than a gas only market. Quarterly switches by gas customers since full retail contestability began are shown in Figure 5.2 below.

In 2012, 14 per cent of customers switched their gas retailer.¹⁵³ This is lower than current rates of 23 per cent in Victoria and 16 per cent in South Australia.¹⁵⁴ It is also less than for electricity; however this is consistent with Victoria and South Australia, who also had higher switching rates for electricity. A lower switching rate in gas could be explained by gas bills typically being much lower than electricity, and so customers have less incentive to search for a lower cost tariff.

In addition, some customers may be switching their electricity account to their gas retailer and moving onto a dual fuel contract, which would be identified as an electricity switch but not a gas switch.¹⁵⁵ Roy Morgan's survey found that four per cent

¹⁵¹ AEMC 2007, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria*, First Final Report, 19 December 2007, Sydney, p. 7; and AEMC 2008, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia*, First Final Report, 19 September 2008, Sydney, p. 22.

¹⁵² Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 9.

¹⁵³ Data provided by AEMO.

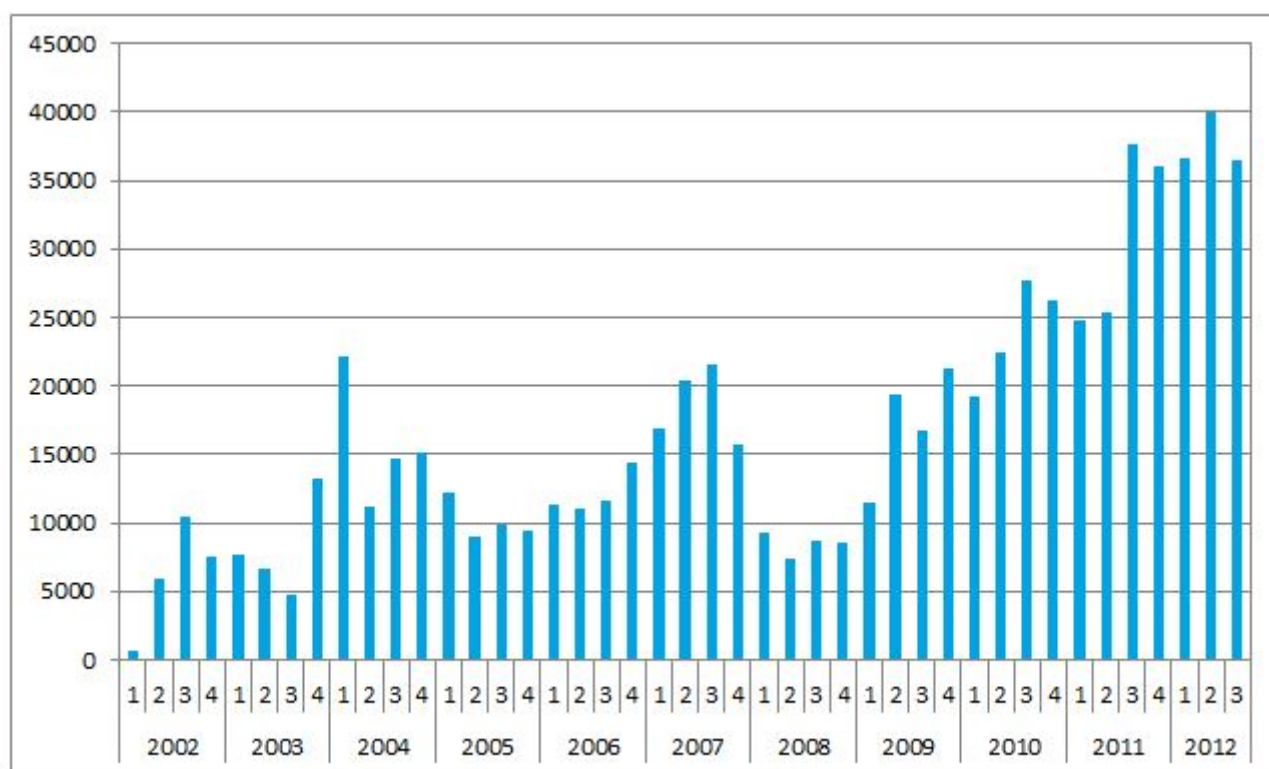
¹⁵⁴ Data provided by AEMO.

¹⁵⁵ Recall that switching is defined as changing a retailer. Changing a tariff with the same retailer is not categorised as a switch.

of electricity customers had switched to be with the same retailer as for gas.¹⁵⁶ We note that 17 per cent of gas customers surveyed stated that they switched so that they could be with the same company for gas and electricity.¹⁵⁷

As discussed further in section 5.7.1, evidence suggests that many of AGL's gas customers are switching their electricity account to AGL. Such customers would appear as a switch for electricity but not for gas, suggesting that the switching rate underestimates the number of customers that are active in the gas market. This is also supported by the fact that more gas customers have moved onto market contracts than electricity customers, with only one third of customers remain on regulated gas tariffs.¹⁵⁸ Also note that these customers should be better off by switching onto a market contract for gas, as well as for electricity.

Figure 5.2 Quarterly switches by gas customers



Source: Data provided by AEMO.

The Roy Morgan survey suggests that customers are switching primarily to obtain a lower rate. Of those customers surveyed that had switched, 60 per cent had done so either to obtain a better price or for some other financial reason such as a monetary

¹⁵⁶ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 24. Note also that a customer could switch to a new retailer, which would show up as both a gas and an electricity switch

¹⁵⁷ Ibid.

¹⁵⁸ IPART, *Review of regulated retail prices and charges for gas, 2013 to 2016*, April 2013 Draft Report, p. 5.

rebate.¹⁵⁹ As discussed further below, very few customers surveyed switched primarily because they are dissatisfied with their existing retailer. As discussed previously, this suggests that behaviour on the demand side is consistent with a competitive market and that customers are placing pressure on retailers to keep their prices down.

PIAC is concerned that customers assume that a retailer offering a competitive deal for electricity will also offer a competitive deal for gas, which may not be the case. Alternatively, customers may switch because they place value on having a single retailer, rather than seeking the lowest possible offer. For this reason PIAC considers that the AEMC should examine whether gas customers are able to make effective choices on their gas retailer and identify the number of customers that switch gas independently from electricity.¹⁶⁰

Available evidence suggests that customers with both electricity and gas are not worse off on a dual fuel contract than a gas only contract, and in fact they may be better off. While retailers do not usually market gas-only contracts, many retailers display their energy product offers separately on their websites. Their "dual fuel" offerings are a combination of an electricity product and a gas product which may also be sold separately. As discussed further below, retailers may also offer a discount where a customer accepts a dual fuel offer since the acquisition costs of obtaining a dual fuel customer are lower. For example, Origin Energy offers an additional one per cent discount if a customer has a dual fuel contract. Therefore customers may in fact be responding to added financial incentives to choose a single energy retailer.

The Commission does not consider that switching for the purpose of having a single energy retailer is necessarily a sign that competition is not effective. As discussed in the previous chapter, all customers are different. Some customers may make a valid decision that the transaction costs associated with searching for the lowest gas price are greater than the potential savings. While such customers may not be on the lowest price, they are still making the best choice for them. While gas remains a relatively low cost fuel, engagement in the gas market can be expected to be lower than in electricity. On the other hand, if gas becomes a higher proportion of household expenditure, customers may become more motivated to seek out better deals on their gas bills independently from electricity.

5.2.2 Information provision needs to be improved

Results from the Roy Morgan survey regarding information provision for gas were similar to the findings in electricity. Gas customers who were surveyed generally found information on gas offers difficult to understand and unhelpful for making an informed choice, although the results were slightly more positive than for electricity. Only 23 per cent of customers surveyed found that the information provided during a

¹⁵⁹ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 24.

¹⁶⁰ PIAC, Issues Paper submission, 8 February 2013, p. 18.

sales encounter made it easy to compare offers.¹⁶¹ In contrast, gas customers that proactively searched for information found it easier to understand and 47 per cent thought the information they found made it easy to compare offers.¹⁶²

Gas offers have a similar number of variables to electricity offers that must be taken into account in assessing offers. In addition to those set out in Box 4.3, gas customers must consider moving home fees and account establishment fees. Customers must also consider their gas consumption across six different daily consumption bands, compared to three quarterly consumption bands in electricity. Further, the gas tariffs decline with consumption, whereas electricity tariffs increase with consumption. This provides an added dimension which energy customers must be aware of and may cause some confusion when evaluating electricity and gas tariffs.

The Commission considers that, as for electricity, the effectiveness of competition could be further improved by better equipping customers with the tools they need to participate effectively in the market. We note, however, that some customers may continue to be less engaged in the gas market while gas remains a relatively low priced commodity.¹⁶³

5.3 Retailers have entered but there are some barriers

While the Commission found that there are no substantial barriers to entering the electricity retail market, we have some concerns about retailers' ability to offer gas to small customers and so enter the dual fuel market. This section focuses on those areas where concerns have been raised, specifically the supply and transport of gas, interface systems with distribution networks, exit costs and obsolete tariffs. A full analysis and discussion is set out in appendix B.

In addition to the potential barriers discussed below, we note that some retailers that are not currently active in the gas retail market have raised its complexity as a reason for not entering.

Sapere found that:¹⁶⁴

“For inactive retailers, the lower margin together with the complexity of the gas market arrangements makes entering the gas market a more difficult proposition.”

¹⁶¹ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 16.

¹⁶² Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 43.

¹⁶³ We note that there is some uncertainty about the future price of gas and the likely impact on competition from the development of liquefied natural gas (LNG) export facilities. See section A.1.3 for a discussion of future market developments in gas.

¹⁶⁴ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 67.

However, despite the complexity and the barriers discussed below, EnergyAustralia (formerly TRUenergy), Australia Power & Gas and Lumo have all entered the NSW gas market and won customers. Therefore although there may be higher barriers than in electricity, it appears that they are manageable. Further, as discussed in section 5.6, analysis undertaken by NERA suggests that margins to supply a representative gas customer on a regulated tariff are higher than in electricity.

5.3.1 The supply and transportation of gas

Obtaining supply and shipping contracts

The gas market operates very differently from electricity, where trading takes place on the national electricity market and risk can be managed through derivatives. Wholesale gas is primarily traded on a confidential basis between gas producers and retailers through long term contracts. Retailers must also source pipeline capacity to ship the gas from the source of supply to the customer. Again, this requires negotiating relatively long-term contracts with pipeline owners.

Prospective retailers need to negotiate such contracts before they can offer gas to small customers. However, for retailers to negotiate supply and shipping contracts requires them to predict what their customers' demand is going to be. It is very difficult to predict gas demand for a very small customer base. In contrast, retailers with large customers bases have a more stable demand. Further, larger retailers can typically negotiate better terms and conditions than those retailers that only require a relatively small amount of gas and pipeline capacity.

In addition, gas producers and shippers generally require retailers to adopt a "take or pay" contract. This means that a retailer is required to pay for the full contracted amount of gas and pipeline capacity, even if it is not utilised. Therefore a retailer needs to build up a customer base and gas portfolio before it can be competitive in the gas market. We note that both APG and Lumo entered the Victorian market first, which has a larger customer base and different gas market model.¹⁶⁵ These companies have been able to leverage off their Victorian gas customer base to negotiate gas supply contracts and so enter the NSW market.

We note that there are a number of changes currently occurring in the gas market in Australia that may impact conditions for obtaining gas. A number of LNG export facilities are currently being constructed in Gladstone, which together represent over triple the existing gas consumption in Australia. This is creating significant uncertainty for retailers and gas suppliers alike, particularly in respect of the price of wholesale gas going forward. However, in the short run it may make it easier for retailers to strike shorter term contracts until the LNG facilities are operational and longer term gas prices become more predictable. We also note that any upward pressure on wholesale

¹⁶⁵ The Victorian gas market operates a "market carriage" model. This means that a new entrant retailer does not have to individually negotiate access to pipeline capacity and pricing with the owner.

gas prices is unlikely to disadvantage new entrants and competition in the medium term, as contract prices are likely to be renegotiated through review mechanisms or on contract expiry.

The short term trading market

The gas short term trading market (STTM) has been raised by some retailers as an alternative source of gas supply.¹⁶⁶ The STTM allows market participants to buy or sell wholesale gas where their contracted supply of gas does not meet their demand on any given day. However, the STTM is primarily a balancing mechanism that was not designed to operate as a wholesale supply market. Consequently it is not very liquid. Further, there is no secondary market to allow participants to hedge STTM price volatility. Finally, pipeline access agreements still need to be negotiated with distribution networks. For these reasons, the Commission does not consider the STTM to provide a feasible gas supply alternative for prospective new entrants at present, other than for daily balancing purposes.¹⁶⁷

5.3.2 Interface with distribution pipeline systems

Concerns were raised in interviews with retailers about how retailers interface with gas distribution networks in NSW. The issue appears to stem from the type of information system employed in NSW for retailers to communicate with distribution networks, which is different from that used in Queensland, Victoria and South Australia. We understand that these systems support Business to Business processes between retailers and distribution networks, such as service order requests, customer transfer notification, network billing and other services.

Jemena noted in a submission to this review that its systems are beneficial to new retailers as they can enter the NSW market "with only a rudimentary market interfacing capability."¹⁶⁸ However, the AEMO has recently published a consultant's paper that found that harmonising the NSW system with other jurisdictions would "offer benefits to all stakeholders and ultimately to customers."¹⁶⁹

As discussed above, one potential strategy employed by gas retailers looking to enter the NSW market is to leverage their existing position from the larger Victorian market. This allows retailers to seek economies of scale by increasing the utilisation of back office infrastructure and staff expertise, while potentially negotiating lower gas prices from higher volumes. Consequently it may be more expensive for retailers if they are required to learn and implement different systems to those used in other markets.

¹⁶⁶ AGL, Issues Paper submission, 13 February 2013, p. 6.

¹⁶⁷ We note that SCER is currently progressing some reforms in this area.

¹⁶⁸ Jemena Gas Networks, Issues Paper submission, 8 February 2013, pp. 1-2.

¹⁶⁹ Nous Group, NSW/ ACT Gas Market Reform - Cost Benefit Analysis, 15 March 2013, p. 3.

During consultation on this draft report, the AEMC would welcome further comments from existing or potential new entrants, or other stakeholders, on the extent to which this issue is a barrier to entry or expansion for the NSW gas retail market.

5.3.3 Exit costs

Exit costs could also be viewed as a barrier to entry due to the long term nature of gas supply and shipping contracts. One retailer noted in interviews that a gas retailer could only exit the market when its gas and pipeline network contracts expired. Since these contracts could expire at different times, exiting the market could be a complicated process.

The Commission considers that there is a potential for exit costs to arise if a retailer sought to exit the market prior to its contracts expiring. These costs are likely to be higher for retailers with larger customer bases since the value of the contracts would be higher. However, the Commission also considers that these risks could be managed, either through seeking reduced contract penalties in negotiating with gas producers and pipeline owners, or through on-selling contracts to third parties.

5.3.4 Obsolete tariffs

As in electricity, there remain a number of customers on regulated gas tariffs that are not cost reflective. Origin Energy notes that:¹⁷⁰

“...in FY13, the tariffs in the former Country Energy area are expected to deliver negative net retail margins and tariffs in the Murray Valley/ Albury area are expected to deliver margins well below a sustainable level.”

This makes it difficult for other retailers to offer tariffs in these areas. Consequently, product and retailer choice in these areas is currently limited. We note that removing price regulation may resolve this barrier, however it could also cause price shocks for customers that are currently on under-recovering tariffs. Further, where the underlying network tariffs are also obsolete, these issues may persist.

These customers may therefore be worse off if price caps are removed. However, the Commission considers that continued price regulation is not the most appropriate mechanism for assisting these customers. Rather, these customers should be supported through more tailored mechanisms that remove structural barriers to competition and support customer participation in the market.

5.4 There is limited independent rivalry

There appears to be less independent rivalry in gas than in electricity. Market concentration is higher than in electricity, and product differentiation is more limited. As discussed in section 5.1.1, part of the reason for this finding may be that the NSW

¹⁷⁰ Origin Energy, Issues Paper submission, 8 February 2013, p. 8.

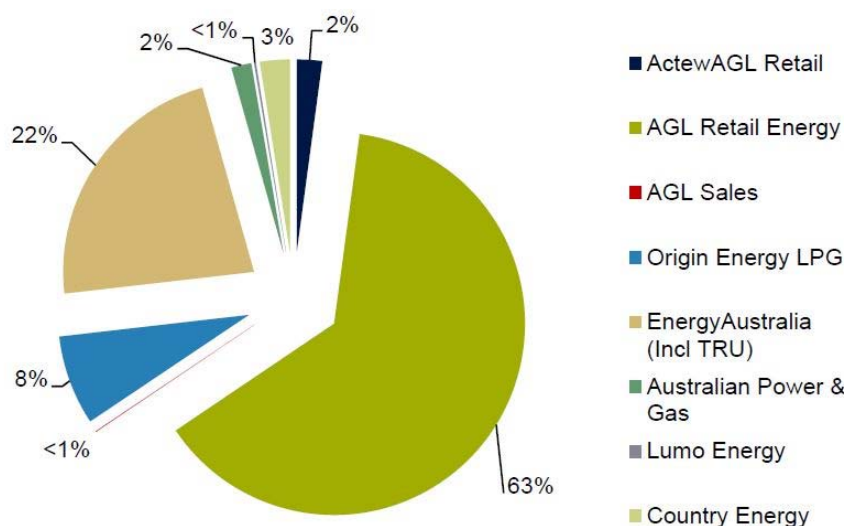
gas market is relatively less attractive than the electricity market or the Victorian gas market due to a smaller customer base and lower consumption. However, the Commission is concerned that it could also stem from the barriers to entry discussed above.

5.4.1 Market structure

There are currently six gas retailers in NSW. AGL, Origin Energy and ActewAGL are standard retailers. However, AGL and ActewAGL do not compete within each other's supply areas. Consequently there are, in effect, five active retailers in the market. All retailers offer gas to both small business and residential customers.

Market concentration is high. The three biggest retailers together have a 97 per cent share of the gas market.

Figure 5.3 Market share of NSW gas market



Source: IPART, *Customer service performance of gas retail suppliers: 1 July 2007 - 30 June 2012*, December 2012, p. 6.

As discussed in the previous chapter, high concentration is not necessarily a sign of a lack of competition. Customers are switching between retailers, as demonstrated in Figure 5.3 above. AGL has been losing market share from 66 per cent of the residential market as at 30 June 2011¹⁷¹ to 63 per cent as at 30 June 2012.¹⁷² In the last 18 months AGL has lost 2.5 per cent of its gas customer base, from 716,386 to 692,809

¹⁷¹ IPART, *Customer service performance of gas retail suppliers*, Information Paper, December 2012, p. 5.

¹⁷² IPART, *Gas retail businesses' performance against customer service indicators in NSW*, Information Paper, January 2012, p. 6.

customers.¹⁷³ AGL is also offering discounts in its own region, evidence that it is having to actively work to keep its customers.¹⁷⁴

We note that while APG gained market share in electricity, it lost approximately 35 per cent of its NSW gas customers in the six months to 31 December 2012.¹⁷⁵ On the other hand, Origin Energy's gas customer base has grown by 22 per cent over the same period.¹⁷⁶

5.4.2 Product differentiation

Similar to electricity, most product differentiation is in the form of discounts and/or cash rebates off the regulated tariff. Discounts are sometimes linked to meeting certain criteria such as paying bills on time or paying by direct debit. Since late 2010 there have been 22 unique dual fuel offers and nine unique gas offers to residential customers.¹⁷⁷ Fewer offers were available for small business customers. The lower number of gas and dual fuel offers compared to electricity could be explained by customer preferences. Customers generally appear less engaged in the gas market and therefore are less likely to demand innovative product offerings.

Again, EnergyAustralia was the only retailer to offer an alternative tariff structure to the underlying network tariff structure.¹⁷⁸ Jemena, the gas distribution pipeline owner, charges a declining block tariff based on six daily consumption bands. This is mirrored by most retailers. In contrast, EnergyAustralia offers a tariff that is based on only two daily consumption bands.

Unlike electricity, gas charges may also include an account establishment fee.

NERA found the mean discount available for gas was four per cent for a residential customer and five per cent for a commercial customer.¹⁷⁹ However, the limited number of offers means that it is difficult to draw firm conclusions about the level of discounting.

¹⁷³ AGL, FY Interim Results, 27 February 2013, p. 40.

¹⁷⁴ For example, AGL offers four gas market tariffs in addition to the regulated offer.

¹⁷⁵ Australian Power & Gas Investor Update, March 2013, p. 8.

¹⁷⁶ Origin Energy, 2013 Half Year results announcement, 21 February 2013, p. 33.

¹⁷⁷ NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 25 February 2013, p. 31.

¹⁷⁸ According to IPART's *myenergyoffers* website on 23 March 2013.

¹⁷⁹ NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 25 February 2013, p. 35.

5.5 Customers are generally satisfied with their experience in the market

The evidence available suggests that on the whole customers are satisfied with their gas market experience, if not more so than in electricity. Gas performed better than electricity on most indicators of satisfaction. This may reflect the relative size of gas bills compared to electricity bills and lower price increases in gas, and consequently lower interest.

5.5.1 Survey results

Roy Morgan's survey results show that of those customers that have switched, 65 per cent were satisfied with their new retailer.¹⁸⁰ The most common reason for customers' satisfaction with their new retailer was because they felt they had secured a better deal, but 11 per cent noted they were satisfied because they had secured a discount for bundling their gas with their electricity.¹⁸¹ Only five per cent of gas customers said they were dissatisfied with their new retailer. As with electricity, gas customers generally found the switching process to be easy and smooth.

Only three per cent of customers responded that the most important reason for switching was dissatisfaction with their existing retailer.¹⁸² Of those that had not switched, 40 per cent of residential customers¹⁸³ and 54 per cent of small business customers¹⁸⁴ had not done so because they were happy with their existing retailer.

These results suggest that the majority of customers are broadly satisfied with their gas retailer.

Further, fewer gas customers than electricity customers had experienced a range of negative situations with retailers. The results are shown in the table below.

¹⁸⁰ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 28.

¹⁸¹ Ibid, p. 30.

¹⁸² Ibid, p. 24.

¹⁸³ Ibid, p. 22

¹⁸⁴ Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 23.

Table 5.1 **Percentage of surveyed customers who have experienced specifically identified negative situations with their gas retailer¹⁸⁵**

	Residential	Small business
Actual price business charged did not match prices it was quoted by energy company	4%	5%
Entered into contract in order to get more information	2%	3%
Felt pressured into signing contract with energy company	7%	4%
Told things about terms and conditions of contract that did not prove to be true	7%	7%
Transferred to another energy company without explicit consent	2%	4%
Unable to terminate its energy contract during cooling off period	1%	3%
Entered into contract simply to get person to leave business/house and/or hang up phone	4%	4%

Source: Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, p. 44; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, p. 45.

Participants in the focus groups were more concerned about electricity than gas, so discussions revealed little about customer views on gas retailers. However, one concern raised was that a retailer promised a discount for bundling electricity and gas, but the promised discount never materialised.¹⁸⁶

Another concern raised was that people with dual fuel accounts expected to be able to address questions on both electricity and gas in the same phone call, which was not always found to be the case.¹⁸⁷

¹⁸⁵ Note that customers that have experienced none of the identified negative situations could have had no negative experiences at all or could have experienced negative situations that were not identified in the survey.

¹⁸⁶ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Customers*, 28 February 2013, p. 19.

¹⁸⁷ Ibid, p. 23.

These complaints appear to be the exception rather than the norm.

5.5.2 Customer complaints about gas retailers

The table below sets out the number of complaints per 1,000 gas customers to the Energy Ombudsmen in NSW, Victoria and South Australia. It shows that there were marginally fewer complaints per customer to the NSW Ombudsman than in South Australia, and less than half as many as in Victoria. Note that there are fewer complaints about gas retailers than electricity retailers.

Table 5.2 Complaints to the Ombudsman about gas retailers

	NSW	Victoria	South Australia
Number of complaints per 1,000 customers	3.4	8.3	3.6

Source: Compiled using information from EWON, *Annual Report*, 2011-2012, p. 16; Energy and Water Ombudsman Victoria, *Annual Report*, 2012, pp. 34, 35, 39, 40; ESCOSA, *Performance of the South Australian retail energy market - customer service - 2011/12*, pp. 3-4.

The number of complaints received by EWON has increased by approximately 20 per cent from the previous year, a lower increase than for electricity. The top three complaints to EWON were about billing, customer service and credit, consistent with electricity. This is consistent with Victoria where the largest category of complaints was billing, which relates to high and erroneous bills. Similar to electricity, the Victorian Ombudsman received a number of complaints relating to technical issues in the billing system of a large retailer.

These results suggest that gas customers are generally more satisfied than electricity retailers.

5.6 Profit margins are generally consistent with competition

The Commission found that profit margins on regulated tariffs in the gas market are generally consistent with outcomes that might be expected in an effectively competitive market.

NERA undertook analysis of retailer profit margins since 2002 and found that margins on a regulated customer were adequate to support effective competition in gas between 2002 and 2012. NERA's results are set out in the table below, which shows the implied retail margins under three different wholesale cost scenarios.

Table 5.3 Implied retail margins to supply a representative natural gas customer

	Low wholesale cost	Medium wholesale cost	High wholesale cost
FY2002 - FY2007	12%	7%	1%
FY2008 - FY2013	14%	10%	6%

Source: NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 25 February 2013, p. 44

Note that these margins reduce as discounts off the regulated tariff are applied.

Margins for gas were found to be slightly higher than those for electricity, however there is very little publicly available information on which to base wholesale gas price assumptions. Therefore, care needs to be taken in interpreting these results. In particular, we note that these findings are inconsistent with the general view put forward by retailers that gas is less profitable than electricity. For example, in the retailer interviews Sapere found:¹⁸⁸

“The main view is that the margins in gas are lower and this is the main reason why gas is not offered on a stand-alone basis but instead is bundled together with electricity.”

5.7 Evidence of competition in the dual fuel market

The previous sections of this chapter set out our findings in relation to the effectiveness of the gas component of the dual fuel market. This section considers the available evidence on the performance of the dual fuel market itself.

5.7.1 Market activity

It is difficult to determine precisely how active customers are in the dual fuel market because switching rates cannot identify those customers that switched onto a dual fuel contract. However, we note that approximately 67 per cent of customers who have gas are on a dual fuel contract.¹⁸⁹ Those retailers that are not offering regulated gas tariffs - EnergyAustralia, APG and Lumo, have a higher proportion of gas customers on dual fuel contracts.

AGL appears to be capturing electricity customers by offering its existing gas customers a dual fuel contract. Across NSW, Victoria, South Australia and Queensland AGL's overall gas customer base has reduced by 3,884 customers, yet the number of dual fuel accounts has increased by 50,948. It appears that the majority of these dual

¹⁸⁸ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 67.

¹⁸⁹ Calculated using information provided by AGL, Origin Energy, EnergyAustralia, APG and Lumo.

fuel accounts have been acquired in NSW.¹⁹⁰ This suggests that there are a large number of customers, particularly in NSW, that have an existing gas account with AGL are shifting their electricity account over. Consequently, while AGL is losing some market share in gas, it is gaining market share in dual fuel by building on its existing gas customer base.

The Roy Morgan survey suggested that around half as many gas customers had been approached by retailers than in electricity. Thirty-two per cent of customers surveyed had been approached by a retailer offering to sell them gas.¹⁹¹ This is consistent with retailers' views that they do not typically market gas only, but seek to bundle it with electricity (although retailers will provide gas only contracts if requested). Since the survey did not ask customers whether they were approached with a dual fuel offer it is difficult to know whether customers would have counted a dual fuel offer as an electricity offer, a gas offer, or neither.

While marketed together, innovation in dual fuel products is currently very limited, with a single retailer offering a discount where customers hold both accounts with them. Removing price caps in both electricity and gas could allow retailers to offer innovative new products not just in each of the separate markets, but also as a combined dual fuel offer.

NERA calculated the implied dual fuel discounts based on available market offers and assumptions about retail costs. NERA found that it appeared that retailers were willing to provide additional discounts for customers that move to dual fuel contracts, but noted that the small number of offers made it difficult to draw firm conclusions.¹⁹²

5.7.2 Market outcomes

EWON received 919 complaints about dual fuel accounts in the 2011/12 financial year. This is approximately¹⁹³ 1.2 complaints per 1,000 dual fuel customers compared to 5.5 complaints per 1,000 electricity customers and 3.4 complaints per 1,000 gas customers. It also represents a 54 per cent increase in complaints about dual fuel retailers since the previous financial year, which may be influenced by increasing numbers of customers shifting to dual fuel contracts.

NERA undertook a sensitivity analysis for a residential dual fuel customer in each of the electricity distribution network areas. As shown in the table below, the results suggest that the implied retail margins for a dual fuel customer are similar to those for

¹⁹⁰ AGL acquired 64,220 new electricity customers in NSW alone. AGL, FY Interim Results, 27 February 2013, p. 40.

¹⁹¹ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 12.

¹⁹² NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 25 February 2013, pp. 35-36.

¹⁹³ This is an estimate for the number of complaints received from residential customers based on information provided by gas retailers, the total number of gas customers and the proportion of residential customers who are connected to the gas network.

an electricity customer (see Table 4.3). As concluded in the previous chapter, the margins (prior to discounts) appear to support price-based competition. Note that the margins were calculated using a medium wholesale cost assumption.

Table 5.4 **Implied retail margins to supply a representative dual fuel customer**

	Ausgrid	Endeavour Energy	Essential Energy
FY2002 - FY2007	4%	4%	6%
FY2008 - FY2013	5%	9%	9%

Source: NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 25 February 2013, p. 45.

5.8 **Draft conclusions and recommendations**

For the dual fuel market to be operating effectively requires that both the electricity and gas retail sectors are delivering customers with a range of choices at an efficient cost and with the quality of service they demand. The previous chapter sets out why the Commission considers that the electricity market was delivering these outcomes for electricity customers. The findings in this chapter suggest that while the gas market is providing less choice for gas customers, both in terms of gas retailer and product choice, the market is still providing efficient outcomes.

While the Commission considers that competition is effective in the gas market there are two areas where it is performing less well than in electricity:

- There appear to be some barriers to entry in the gas market. These include access to wholesale gas and pipeline capacity, and the type of interface system with gas distributions pipelines, which differs from the systems used in other states. Despite these barriers, EnergyAustralia, APG and Lumo have all entered the NSW gas market in recent years. Consequently while the Commission has some concerns about these potential barriers, they do not appear to be impeding entry.
- There are limited signs of independent rivalry for gas. There are only five active retailers across NSW. Market concentration is high. There is limited product differentiation. However, customers are switching between retailers and AGL, the largest standard retailer, has consistently been losing market share in gas since full retail contestability began.

However, these factors are balanced by customers' greater ability to switch away from gas to electricity, which provides pressure to keep gas retailers' prices and service quality similar to outcomes expected in a competitive market.

On the other measures of competition that we have considered, the gas market appears to be operating as effectively as the electricity market in providing customers with efficient outcomes.

There is a high degree of engagement by small customers and this engagement has been increasing in recent years. Customers are aware of their ability to choose their gas retailer, and customers are acting on their ability to choose. Many of those gas customers that are switching retailer appear to be consolidating their gas and electricity accounts with a single retailer. Switching rates in gas have mirrored switching rates in electricity, increasing significantly in the last two years. Switching has primarily been driven by a desire to obtain better prices or rebates, although a significant proportion have switched their gas retailer so as to be with the same retailer for both gas and electricity.

Customers surveyed by Roy Morgan appear slightly more satisfied with their gas retailer compared to their electricity retailer. This could be influenced by the fact that there have been lower price rises in gas over the last few years and the relatively smaller proportion of a gas bill compared to electricity in NSW. There are instances where retailers could improve their service, particularly in regards to their marketing practices and how information is conveyed, however the Roy Morgan survey indicates that instances of behaviour such as switching customers without consent appears to occur relatively less frequently in gas.

Finally, evidence suggests that historical profit margins are consistent with competitive market outcomes. We note that NERA's results suggest that margins in the gas sector have been higher than in electricity. This is not consistent with retailer perspectives, that suggest gas margins are very low. However, NERA's analysis of margins in dual fuel is more consistent with margins in the electricity market.

Based on the available evidence, the Commission considers that the NSW retail dual fuel market for small customers is competitive. However, the effectiveness of competition could be further enhanced by implementing measures to support customers and provide them with the tools they need to participate in the market. Our specific recommendations in relation to information provision and customer engagement are outlined in chapter 8.

6 Impact of community service obligations on competition

6.1 Introduction

The AEMA requires the AEMC to consider a jurisdiction's community service obligations as part of a review into the effectiveness of competition. In particular, the AEMC must assess and report on whether a jurisdiction's social welfare and equity objectives are met through "clearly specified and transparently funded State or Territory community service obligations that do not materially impede competition."¹⁹⁴ The AEMC does not have a role to assess the effectiveness of the schemes or the level of rebate.

There are four such obligations in NSW, along with an additional assistance program:

- low income household rebate;
- family energy rebate;
- medical energy rebate;
- life support energy rebate; and
- energy accounts payment assistance.

These are discussed in turn below.

6.2 Rebates

Retailers are required to comply with the low income household rebate, the family energy rebate, the medical energy rebate and the life support energy rebate as a condition of their licences. The details of the obligation, including the level of the rebate, are set out in a Ministerial Direction and Retailer Guidelines.¹⁹⁵ The obligations are funded by the NSW Government, by way of compensation for the rebate, plus administrative costs. The retailers are responsible for factoring the rebate into the relevant customer's bill.

The retailer must inform customers of the existence of the rebates. In each case the retailer is permitted to promote the rebate along with its own products as part of its overall marketing strategy. It must be clear, however, that the rebate is funded by the NSW government.

¹⁹⁴ AEMA, clauses 14.11(b) and (c).

¹⁹⁵ See Ministerial Direction for Social Programs issued to NSW Electricity Retailers, 1 July 2011; Retailer Guidelines: Medical Energy Rebate, 1 July 2011; Retailer Guidelines: Low Income Household Rebate, 1 July 2011; and Retailer Guidelines: Life Support Electricity Rebate, 1 July 2011.

6.2.1 Low income household rebate

The low income household rebate is available to holders of:

- Pensioner Concession Cards;
- Centrelink Health Care Cards; and
- Department of Veteran Affairs Gold Cards.

The rebate applies only to electricity bills. It amounts to a flat rate of \$215, rising by \$10 per year until 30 June 2015.

6.2.2 Family energy rebate

The Family Energy Rebate was introduced in 2012. This is a rebate of \$75 that is paid to any household who receive Family Tax Benefit A and/or Family Tax Benefit B. The customer must reapply every year with evidence from the Australian Tax Office that they receive at least one of the tax credits. The family energy rebate commenced from 1 July 2012 at \$75. It will rise to \$125 on 1 July 2013 and again to \$150 on 1 July 2014. However, if the customer is also eligible for the low income household rebate then the total amount is capped at \$250. It applies to electricity only.

6.2.3 Medical energy rebate

The medical energy rebate is to ensure energy affordability for customers who have a high energy demand due to medical conditions that stop their body effectively regulating temperature. To be eligible the customer must hold a Pensioner Concession Card, a Health Care Card or a Department of Veterans' Affairs (DVA) Gold Card. Eligibility for this rebate would not disqualify a customer from other rebates.

The rebate applies only to electricity bills. It amounts to a flat rate of \$215, rising by \$10 per year until 30 June 2015.

6.2.4 Life support energy rebate

The life support energy rebate is for customers who require life support equipment. Any customer who requires such equipment is able to apply in writing with a pro forma form. This form must be signed by a medical practitioner. The retailer must inform the local distributor of the location of customers receiving this rebate. The amount paid differs depending on the equipment in use. This rebate applies only to electricity.

6.3 Energy accounts payment assistance

The energy accounts payment assistance operates slightly differently from the rebates. It is administered through community groups, rather than retailers. Customers may

request energy accounts payment assistance vouchers from community groups (such as St Vincent de Paul or Salvation Army). These groups assess which customers receive vouchers. Each voucher is worth \$30 and up to eight vouchers can be issued to one customer at one time.¹⁹⁶ A customer can apply twice a year for vouchers, meaning the limit is 16 vouchers, or \$480, per customer per year. These vouchers can then be submitted to an energy retailer as payment. This is funded by the NSW government.

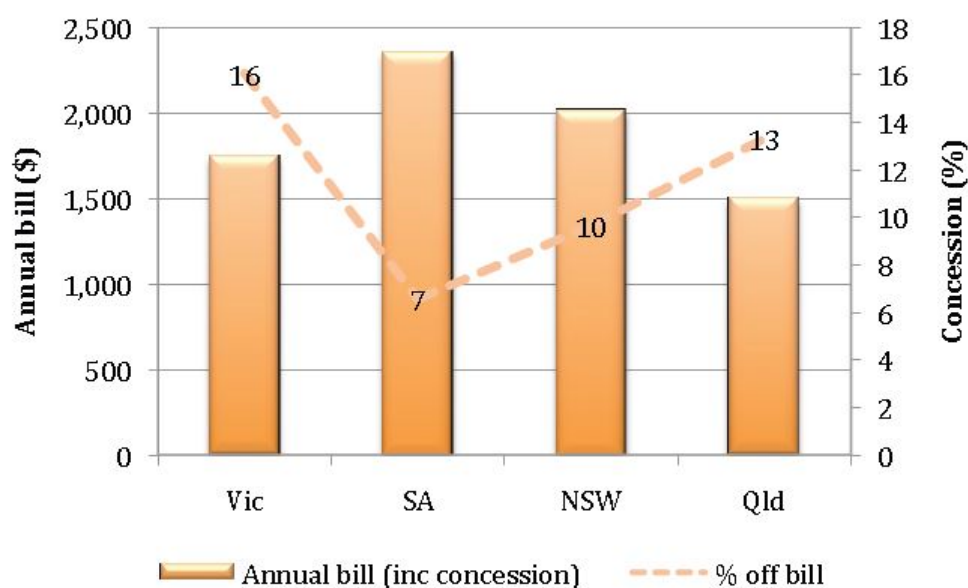
The energy accounts payment assistance is to help people struggling to pay a specific energy bill due to a crisis or emergency situation. Unlike the rebates it is not designed to operate on an ongoing basis. The vouchers can be used for either electricity or gas bills.

6.4 Reports and submissions

6.4.1 St Vincent de Paul Society Report

In January 2013, St Vincent de Paul Society published a report "*The relative value of energy concessions*."¹⁹⁷ This report compared the level of energy concessions available in NSW, South Australia, Victoria and Queensland. It did this by making certain assumptions as to tariffs and consumption, eg that a typical customer consumes 6,400 kilowatt hours (kWh) of electricity and 24,000 megajoules (MJ) of gas annually. In NSW only the low income household rebate was taken into account. The annual electricity and gas bills and level of concession for such a customer in the four different states is shown in the following charts.

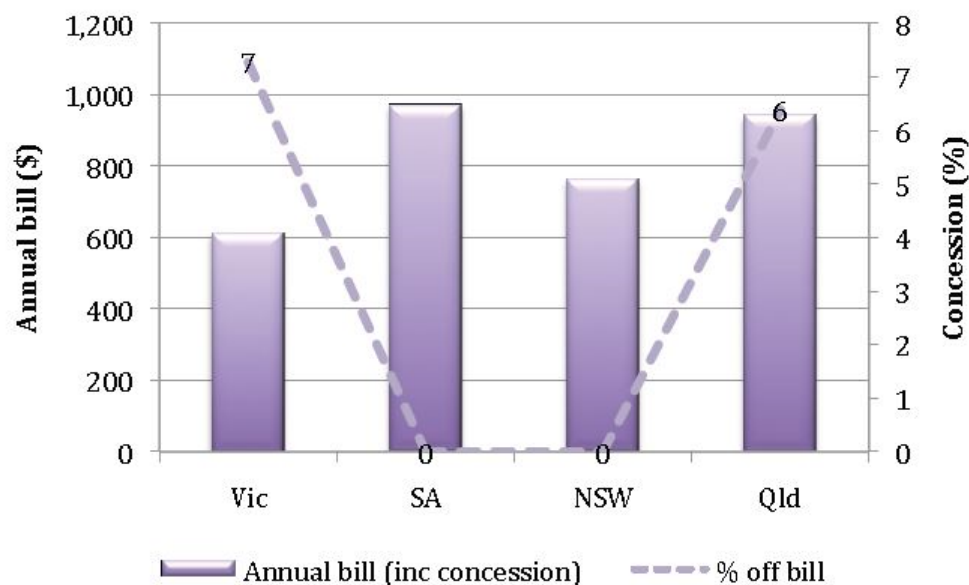
Figure 6.1 Estimated annual electricity bill and discount (%)



¹⁹⁶ The NSW Government has indicated that it will increase the value of a voucher to \$50 on 1 July 2013.

¹⁹⁷ St Vincent de Paul Society, *The value of energy concessions*, Part 1 of the Vinnies' Concessions project, January 2013.

Figure 6.2 Estimated annual gas bill and discount



Source: St Vincent de Paul Society, *The value of energy concessions*, Part 1 of the Vinnes' Concessions project, January 2013, pp. 26-27.

6.4.2 Submissions

The NSW Council of Social Services (NCOSS) raised a number of concerns in its submission in response to the Issues Paper, including customer protections and concerns about the energy accounts payment assistance. In addition, NCOSS claims that there is a lack of customer information about the scheme.¹⁹⁸ The Commission notes NCOSS' concerns. Ultimately, however, energy concessions are matters for consideration by the NSW government and do not impact on the effectiveness of competition, as discussed below.

6.5 Analysis and Conclusion

The Commission considers that the five schemes described above are clearly specified and transparently funded. In particular, for the four rebates there are Ministerial Directions and also Retailer Guidelines. It is clear that the funding is by the NSW government. Although the rebates are able to be promoted by a retailer, it is clear that the retailer has an obligation to clarify that the rebate is funded by the government.

This government funding is very important. If retailers had to fund a rebate by recovering additional revenue from other customers, those other customers would be subsidising the customer receiving the rebate. Retailers may then have an incentive to avoid acquiring low income customers.

As the requirement to offer the rebate applies to all retailers and is transparently funded, the rebates should not distort or impede competition.

¹⁹⁸ NCOSS, Issues Paper submission, 8 February 2013.

While other states offer higher concessions than NSW, the St Vincent de Paul Society report suggests that the NSW concessions are comparable with those in Victoria, South Australia and Queensland. We note that no assistance to gas customers is offered other than the energy accounts payment assistance; however since gas customers typically also have electricity bills the individual customer will have a concession available regardless.

We consider the social welfare and equity objectives in New South Wales are met through clearly specified and transparently funded community service obligations that do not materially impede competition.

If price regulation is removed, we recommend that the concessions schemes are reviewed. This is discussed further in section 7.6.2.

7 A path to removing retail price caps

Box 7.1: Summary of chapter

As discussed in the preceding chapters, the Commission's draft finding is that competition is effective in the electricity and dual fuel markets. This chapter considers what these findings mean for removing retail price caps.

The Commission considers that where competition is providing customers with a choice of energy products and efficient prices, price caps are more likely to inhibit competition than promote it. Consequently, based on our findings in the previous chapters, the Commission recommends that price caps be removed.

There will be consequences for s of removing price caps. Customers who are active in the market are likely to benefit from increased product choice and innovation. However, it is less clear how customers that do not engage in the market will be affected. Effective measures to improve customer engagement will assist these customers. Removing price caps should not create any greater risk of rising prices, disconnection of hardship customers, or retailer misconduct.

There are different options for transitioning away from price caps. The advantages and disadvantages of five such options are considered, noting they are not all necessarily mutually exclusive:

1. remove price regulation for all customers at the same time;
2. remove price caps gradually by reducing thresholds;
3. remove price caps for different groups of customers at different times;
4. remove price regulation for all customers at the same time but retain some form of partial regulation for a sub-group of customers; and
5. allow customers to opt-in to a regulated price (the proposal set out in IPART's issues paper).

The Commission's draft recommendation is that price caps should be removed for all customers at the same time so that all customers are able to benefit from increased produce choice. This approach is consistent with our finding that there are few differences between the way that small business customers and residential customers participate in the market.

Whichever option is chosen, a mechanism should be set up to monitor price and market outcomes as price caps are removed. This should be combined with the option to reintroduce price caps if competition becomes ineffective. For reasons of certainty, there should be set criteria to guide when re-regulation may be considered.

If price caps are removed, consideration should be given to the other forms of protection for customers. Non-price protections are provided by the NECF. Contract terms are also a key mechanism by which retailers engage with customers. The Commission does not object in principle to the imposition of early termination fees and late fees on customers. Where customers engage actively in the market, they should be able to switch to offers where such fees are not imposed.

The path for removing price caps, price monitoring arrangements, non-price terms and conditions and measures to increase customer engagement (discussed in chapter 8) should be developed together as a coherent package of measures.

7.1 Introduction

Previous chapters in this report have set out our draft conclusions on the effectiveness of competition. This chapter focuses on price regulation itself. It considers the advantages and disadvantages of price regulation in general, including who benefits from such regulation. It also considers, as required by the terms of reference, possible options for removing price regulation, including the roll back of price regulation on a reducing consumption basis, and what additional protections for customers might be required if price regulation were to be removed.

As discussed below, we consider that providing customers with further tools and skills to participate in the market is desirable if price regulation is removed. We have addressed this in chapter 8.

The remainder of this chapter is structured as follows:

- section 7.2 considers the general arguments for and against price regulation;
- section 7.3 assesses possible paths to removing price caps;
- section 7.4 sets out how customers could transition from a regulated tariff to an unregulated standing offer;
- section 7.5 considers market monitoring and the reintroduction of regulation;
- section 7.6 reviews complementary measures to promote competition and protect customers; and
- section 7.7 sets out our draft conclusions.

Options for removing price regulation, market and price monitoring arrangements, non-price terms and conditions and measures to enhance customer engagement are discussed separately. However, each of these elements is required and should together be developed to form a consistent package of measures for removing price caps.

7.2 Impact of retail price regulation

This section sets out the rationale for price regulation, before considering whether the benefits of price regulation justify the risks and costs.

7.2.1 Rationale for price regulation

Price regulation is usually undertaken to protect customers against excessive pricing arising from the exploitation of market power.

The two main rationales for price regulation are:

- To act as a proxy for competition – the regulator aims to set an efficient price in the absence of sufficient competition in the market; and
- To prevent abuse of market power through excessive pricing – where there is insufficient competition, customers may not be able to switch away from an unfavourable offer.

7.2.2 Retail price regulation: risks and costs

Clearly, in the case of monopolies such as electricity distribution and transmission, price regulation has a vital role to play in protecting customers. However, in sectors where competition is feasible and has been introduced, price regulation is considered to be temporary rather than permanent. As competition develops, price regulation may become unnecessary because competition should protect customers more effectively. Indeed, continuing with price regulation in markets that are considered competitive carries some risks.

Some of the main risks of retaining price regulation are:¹⁹⁹

- Setting prices too high – above market clearing levels. It can be difficult to determine competitive price levels. As a result, regulators of essential services like gas and electricity will often tend towards setting prices too high rather than too low to avoid risks to security and quality of supply. This can then reduce efficiency incentives to reduce costs and may lead to excessive profits.
- Setting prices too low – below market clearing levels. Conversely, if regulators set prices too low this may lead to reduced incentives to invest, along with possible over incentivisation to reduce costs and hence the risk of reductions in quality of service.
- Creation of a focal point - If retailers tend to base their market offers only in relation to the regulated price, this can also limit innovation in the market.

¹⁹⁹ Yarrow, G., *Report on the impact of maintaining price regulation*, January 2008 p. 72.

- Risk of tacit collusion - While active collusion (agreeing prices) is against competition law, a regulated price may enable retailers to come to a very similar market price without the need to talk to each other.
- Misleading for customers – Customers may mistakenly form the view that the regulated price is at an optimal level, when it may not be.
- Regulatory costs and potential burden - These are the direct costs inside the regulatory body and also the costs of all the regulated companies associated with one regulatory process. There is also the question of how frequently to review regulated prices.
- Self-perpetuating - There is therefore a risk that price regulation could become a self-perpetuating system: price regulation leading to a lack of competition, which in turn leads to an increasing need for price regulation.

The desired effect of price regulation is that it will not constrain or impede competition, but it will constrain the exploitation of (residual) market power. In practice, achieving the benefits without the downsides can be very difficult. It is important not to assume that regulation will be designed or implemented without any errors or distortions. In comparing regulation against deregulation it is necessary to weigh up the risks of regulatory failure where prices are regulated against the risk of market failure where prices are deregulated.²⁰⁰

7.2.3 Who does price regulation protect?

As discussed above, maintaining price regulation in a competitive market has a number of risks and costs, particularly for customers that are actively participating in the market. For example, these customers may not have the range of different products that might be available if price regulation did not create a “focal point” for retailers to base their products on.

However, price regulation may provide some protection for customers that are not currently participating, or not participating effectively, in the market. This is because price regulation puts a limit on the prices to which they can be exposed. As discussed further below, regulation does not protect customers that are under financial distress.

There may be a number of reasons why customers do not participate effectively in the market. Some customers lack the ability or resources to properly engage in the energy retail market. This may be due to financial stress, low income, age, disability or education, language or comprehension issues. For example, someone who does not speak English may not be able to work out from their bill what tariffs they are paying, nor research what other offers exist in the market.

²⁰⁰ Moselle, B. *An assessment of the effects of tariff regulation on the Dutch residential retail markets for energy*, June 2009.

For other customers the reason they do not participate in the market is because of a choice rather than a lack of ability or resources. This choice can be active or passive. A customer may not participate because they have assessed the search and transaction costs to shop around and switch retailer as too high, or they consider clear impartial information is too difficult to access. They may decide that the possible benefits from switching do not outweigh the difficulty of finding an offer. Alternatively, customers who do not participate may not have turned their mind to the decision at all, but have ignored the other offers available even though they are aware they have a choice.

Without price regulation, retailers may be able to charge high prices to those customers that do not participate in the market. This can occur if retailers can relatively easily segment the market so that the best prices are only offered to certain customers (for example those who sign up to internet deals or pay by direct debit). Vigorous competition may therefore exist in one part of the market without exerting price pressure on other parts of the market. Further, the gap between the tariffs paid in the competitive and non-competitive parts of the market could widen. Consequently, these customers may be less likely to capture the benefits of competition if price regulation is removed.

There are, however, a number of reasons why price regulation may not be the best way to tackle this problem of customers who do not participate in the market.

First, as mentioned above, a regulated price could actually make customers engage less as they perceive that the regulator is setting a “fair” (efficient) price and therefore they do not need to look for a better offer. Thus price regulation can reduce incentives on customers to shop around. They may believe they are protected from making poor choices by the existence of regulation. As a result, price regulation may even lead to higher rather than lower prices.²⁰¹

Second, there may be other less intrusive ways of protecting those customers. These other ways may include through non-price regulation of the terms and conditions of gas and electricity retail contracts. Some of these non-price mechanisms for protecting hardship customers are discussed below.

Third, rather than regulate prices a better solution may be to make it easier for those customers who do not participate in the market to do so. The measures for increasing customer engagement discussed in the next chapter should assist and encourage customers to engage in the market. If effective, this would benefit not just those who lack the ability or resources to engage in the market. By making information easier to access it should reduce the search and transaction costs for those customers who may have made a conscious decision not to participate.

We note, however, that increasing information and awareness will not assist customers where their difficulty in participating is caused not by a lack of information but by a

²⁰¹ Ibid. See also: Armstrong, Vickers and Zhou, *Consumer Protection and the Incentive to Become Informed*, August 2008.

lack of competing offers available. This issue has been discussed further in the context of barriers to entry for retailers in chapter 4.

It is important to distinguish customers who do not participate in the market from hardship customers. Hardship customers are those who have difficulty paying their bills due to financial stress. They may or may not currently participate in the market, and therefore may or may not benefit from price regulation. Consequently, price regulation does not operate to protect hardship customers because of the hardship they are facing. This is discussed further in the next section.

7.2.4 Effects on the market of removing price caps

In this section we identify and address four key concerns that are often raised about removing price regulation. The four issues are:

- rising prices;
- customer engagement;
- hardship customers and disconnections; and
- misconduct by retailers.

Rising Prices

Concerns are often raised that if price regulation is removed prices will go up. However, it is important to distinguish between efficient cost increases and increased profit margins.

Price regulation serves to keep a check on prices and ensure that prices do not rise above broadly cost-reflective levels. Retail prices faced by customers are made up of a number of different cost components, including wholesale energy costs, network charges and retailer operating costs (as well as a return on investment or profit margin). These costs fluctuate over time and are passed through by retailers to customers.

Whether retail price regulation remains in place or not will have limited bearing on these costs. If the underlying costs increase, retail prices will also increase. Therefore retail price regulation does not protect customers from increases in these costs.

As discussed above, price regulation is typically intended to set an efficient price in the absence of sufficient competition in the market.²⁰² However, where competition is effective and price caps are removed, market forces should prevent retailers from charging inefficiently high prices and profit margins should approach an efficient level.

²⁰² IPART is also required by their terms of reference to consider the effect of its pricing determination on competition in the retail market.

Consequently, price deregulation should not expose customers to any greater likelihood of rising prices than would otherwise occur.

Customers who do not engage in the market

As discussed above, customers that do not currently participate in the market may benefit from price caps. There is therefore a concern that these customers may be worse off if price regulation is removed.

The previous section considered why price regulation may not be the best option for protecting these customers, and what other measures might be considered. All customers should have the means and knowledge of participating in the market and should be encouraged to do so.

Further, price deregulation should increase competition and lead to greater product differentiation. As a result customers who may not have participated while price regulation was in place may be encouraged to do so by the additional offers that are available.

Finally, customers that do not actively participate in the market may not necessarily be worse off than if price regulation continued. They could also benefit from lower prices, although not by as much as others that actively seek out better offers.

Hardship customers and disconnections

Another concern raised with removing price regulation is the effect on hardship customers and the related issues of disconnections.

As discussed above, whether a hardship customer benefits from price regulation is linked to whether or not they participate in the market, not the fact that they are a hardship customer per se.

Hardship customers who do participate in the market may not benefit from price regulation, because price regulation only protects those who are not able to choose to move to a better offer. We note that some customers could end up paying bills that are higher than the regulated tariff where they cannot meet the terms and conditions of the contract, for example if late fees are charged. This issue could affect all customers, but it may disproportionately affect hardship customers. However, price regulation does not protect customers from this outcome.

Conversely, hardship customers that are not participating in the market will benefit from price regulation. Hardship customers may have difficulty participating in the market for reasons discussed above and also due to the types of offers available. For example, many discounts are linked to payment terms such as direct debit and paying on time, which hardship customers may not be able to meet. However, it is important to note that price regulation does not operate to protect hardship customers because of the hardship they are facing.

Disconnections are linked to the hardship that customers face in paying their bills. However, having a regulated price in place does not assist a hardship customer to pay its bill. Consequently price regulation cannot protect these customers from being disconnected. Instead, there are specific hardship programs in place, as discussed in chapter 6. As discussed further in section 7.6.2 below, these programs are an important feature of the market that will remain in place irrespective of whether price caps are removed.

As a result, the impact of electricity prices on hardship customers, and therefore the number of disconnections observed, should not be affected by price deregulation.

Further, deregulation should lead to increased innovation. Innovative new products are not limited to certain groups of customers. Retailers may develop products that are more appropriate for customers with a limited ability to pay. Markets that do not have price regulation have been found to offer a variety of tariff shapes which can benefit customers with different levels of consumption. For example, a low consumption household can choose a lower fixed charge and higher usage charge.²⁰³ While not all hardship customers are necessarily characterised by low consumption, this provides an example of how offers may be developed to target different types of customers.

Retailer misconduct

Retailer misconduct is equally possible under price regulation or price deregulation. Price regulation requires the standard retailer to offer tariffs at the regulated level. It does not affect how the retailer markets its products, or the majority of the terms it enters into with customers (though IPART does also currently regulate security deposits, late payment fees and dishonoured bank cheque fees).

At the same time, if price regulation is removed, there should be no reason why there should be any greater risk of retailer misconduct.

7.2.5 Conclusions on price regulation

Price regulation currently does offer some benefits. For example, it offers some protection for those customers who are unable to engage in the retail market. At the same time, however, there are a number of risks of continuing with price regulation where a market is competitive. Among other things, the existence of a regulated price may discourage innovation, and the difficulty in setting the regulated price at an appropriate level may lead to undesirable consequences.

The Commission's view is that where sufficient competition is present, the risks of price caps outweigh the benefits, and price caps should be removed. Chapters 4 and 5 set out why we consider competition to be effective in electricity and gas markets. Consequently the Commission considers that price caps should be removed.

²⁰³ See, for example, Nelson, T. and Cameron R., "Reconciling energy prices and social policy", *AGL Applied Economic and Policy Research*, April 2013, p. 15.

Most customers will be no worse off, and indeed may be better off, if prices caps are removed. In particular, there should be no greater risk of disconnections of hardship customers, retailer misconduct, or rising prices. Customers who do not currently engage in the market would no longer have the protection of regulated prices, but effective information and awareness programs will assist these customers to switch to better offers if they are being charged high prices.

In general we consider that there would be benefits from customers being better informed and educated about the choices available to them in electricity and gas. Customers would then be in a position to make decisions which better reflect their usage and needs. The complexity of switching decisions should be reduced, and customers who do not engage in the market may be more encouraged to switch. Chapter 8 considers in further detail what mechanisms could be put in place to better inform, educate and engage customers.

7.3 Options for removing price caps

This section explores the options for removing price caps and their advantages and disadvantages. The five options that we assess are:

1. remove price caps for all customers at the same time;
2. remove price caps gradually by reducing thresholds (as required by the Request for Advice);
3. remove price caps for different groups of customers at different times;
4. remove price caps for all customers at the same time but retain some form of partial regulation for a sub-group of customers; and
5. allow customers to opt-in to a regulated price (the proposal set out in IPART's draft report).

These options do not include the option of retaining price regulation. The advantages and disadvantages of price regulation have been discussed in the previous section.

Note that these options are not necessarily mutually exclusive. For example, the opt-in model could be a first step in transitioning to removing price regulation using one of the other options. Similarly, maintaining partial regulation for a sub-group of customers could be combined with removing price caps by one of the first three options.

Different options could also apply to electricity and gas, or price deregulation could progress along different time frames for these two sectors. However, the Commission has found that both sectors have effective competition. Further, this could create confusion amongst customers. Consequently the Commission considers that the same options and time frames for removing price caps should apply to both electricity and gas.

In assessing these options, a key question we have considered is whether and how to remove price caps in a way that sufficiently protects customers and provides clarity and certainty for retailers. Some of the specific factors that we considered in assessing these options include:

- whether and how effectiveness of competition varies between different customer groups;
- customer outcomes;
- robust and consistent regulatory practice;
- administrative costs of regulation; and
- clarity and certainty for retail businesses.

7.3.1 Option 1 - Remove price caps for all customers at the same time

Removing price caps for all customers at the same time would mean that all the prices currently regulated by IPART would become unregulated and that no customers would have access to a regulated tariff. Customers currently on a regulated tariff could move initially to the retailer's default ("standing offer") tariff,²⁰⁴ but there would be no restriction on retailer changes to this tariff. The customer would have the option (as they have at present) to move to a different market offer from that retailer or from another retailer. This is how price caps were removed in South Australia.

Customers would lose the protection of the regulated tariffs. However, any non-price protection currently available to customers in NSW would not be affected by the removal of price regulation. We note that once the NECF becomes effective, these non-price protections will change. Customer protections are discussed further below at section 7.6.

IPART currently regulates a number of charges that are specified under the *Electricity Supply Act 1995*, specifically security deposits, late payment fees and dishonoured bank cheque fees. These charges will in future be governed by the NECF (subject to any derogations which the NSW government might apply).

Advantages of Option 1

Removing price regulation for all customers at the same time is the simplest and "cleanest" option. Since no price regulation would remain, there would be no chance of distortions between those sections of the market still subject to price regulation and those that had been deregulated. All customers would benefit from greater product choice at the same time. This option is also consistent with our finding that there is no significant difference in the way small business and residential customers participate in the market.

²⁰⁴ See section 7.4 for discussion on how this could occur.

Prior to price caps being removed an information campaign would be desirable to communicate the benefits to customers of the changes. This task would be easier where all segments of the market are deregulated at the same time. That is, the messaging will be simpler, and there will be more chance customers will comprehend why and when the changes will occur.

In terms of retailers, it would provide consistency and clarity for retailers and would reduce regulatory costs. It would also allow retailers to develop new offers for customers in all market segments.

Disadvantages of Option 1

If price deregulation occurs for all customers at the same time there may be less opportunity to develop targeted messages for different customer segments within the timeframe for removing price caps. However, this will depend on the timeframe over which deregulation occurs and does not appear a significant disadvantage.

7.3.2 Option 2 - Remove price caps in stages by reducing thresholds

The Request for Advice requires us to consider removing price caps in stages by reducing consumption thresholds. This would involve setting consumption thresholds (MWh or gigajoules (GJ)) and setting dates for the removal of price regulation from each group.

One way this option could work would be for deregulation to be removed for customers defined as large on one date, those who are medium at a second date, and then those who are small on a third date. For example, large electricity customers might be defined as those who consume above 40 MWh per annum; medium customers consume between 10 and 40 MWh per annum; and small customers consume below 10 MWh per annum.

PIAC does not support a gradual deregulation process based on consumption thresholds because retailers cannot know with certainty what the consumption of prospective customers will be (although this might change with smart meter technology) and it would thus be difficult to set the boundaries for customers based on consumption level. PIAC also expressed concern that:²⁰⁵

“[an] unintended consequence could be that retailers offered their best rates to the higher consumption users and made less-generous offers to the ‘last group standing’ in the price deregulation process. PIAC believes a gradual deregulation process based on consumption levels can erode the benefits of competition for average consumption households in NSW.”

²⁰⁵ PIAC, Issues Paper submission, 8 February 2013, p. 7.

Where energy retailers comment on this issue, they tend not to support a gradual deregulation process based on consumption thresholds. Simply Energy note that:²⁰⁶

“Consumption thresholds are arbitrary in the way that they are applied and result in the same customer types being treated differently around the threshold.”

Advantages of Option 2

This option would provide a gradual process for price deregulation in which lower consumption users would benefit from price regulation for longer than the higher consumption users. This may be appropriate if low consumption customers were less likely to receive competitive offers from retailers or if they required more time to adjust to price deregulation than larger customers.

Disadvantages of Option 2

We note the comments made in submissions about this option, and considered above. No stakeholders who commented on this option indicated support for it. The most significant disadvantage appears to be the difficulties of defining appropriate thresholds and setting the boundaries. In particular, a customer whose consumption was close to a boundary may fall outside price regulation in one period and then within it in the next. This would be an undesirable outcome for the customer.

Further, while thresholds were being reduced there would still be a need for significant regulatory effort to set the regulated prices for smaller numbers of customers.

In addition, most retailers' tariffs are defined by customer type, such as residential and business rather than by consumption level. This would make such an option difficult to implement effectively.

Finally, there is no evidence that the effectiveness of competition varies according to consumption threshold. That is, there is no evidence that lower consumption users benefit from price regulation more than higher consumption users. In practice it is difficult for retailers to identify a customer's consumption level.

7.3.3 Option 3 – Remove price caps in stages by customer group

This option would involve defining specific customer groups and setting different dates for the removal of price regulation for each of those groups. While the market could be segmented in a number of different ways, the most likely groups would be residential customers and business customers. Simply Energy suggested using:²⁰⁷

²⁰⁶ Simply Energy, Issues Paper submission, 11 February 2013, p.3.

²⁰⁷ Simply Energy, Issues Paper submission, 11 February 2013, pp. 2-3.

“customer types as defined in the National Energy Consumer Law. For example, price regulation could apply to ‘residential customers’ or to ‘small market offer customers’ as defined in the Law.”

These groups appear the easiest to use since most retailers have different tariffs for residential and business customers and therefore already have systems in place for distinguishing between these two different types of customer.

In a number of other markets in Australia and overseas, price regulation was removed first for business customers and then for residential customers. This option was used when Victoria deregulated prices in 2008 and 2009. See the box below for further details on how Victoria removed price regulation.

Note that electricity and gas could also be phased in at different times. However, as discussed earlier, the Commission considers this would be a confusing message for customers.

Box 7.2: Case study: how Victoria removed price regulation

- Victorian energy industry privatised in 1994/95 and progressively opened to competition.
- In 2001, all customers were able to choose electricity retailers.
- Choice was extended to all gas customers in late 2002.
- Retailers provided standing and market offers.
- The Victorian Government decided to remove retail price regulation for small business customers, effective 1 January 2008.
- The Victorian energy market was found by the AEMC in 2008 to be highly competitive.
- Until 31 December 2008, standing offer prices for household customers were subject to price oversight under the Safety Net Price Path negotiated between the Victorian Government and the local retailers – AGL, Origin Energy and TRUenergy. This ended following the AEMC review and thus all prices were deregulated from January 2009.
- From 1 January 2009, all retailers with over 500 customers required to publish standing offers and at least one market offer generally available to the majority of customers within the distribution zones and for specified meter types.
- Offers must be provided to the Essential Services Commission for publication on its YourChoice website.

Advantages of Option 3

Removing price regulation for one group but not another would allow for a staged transition to full price deregulation and the use of targeted information programs to the business and residential customer segments at the time of price deregulation for each segment. It would be particularly useful where there is a clearly identified group who would benefit from continuing protection.

Although our draft finding is that small business and residential customers are part of the same market, there may be an advantage in phasing in price regulation. For example, retaining price regulation for the residential sector for a longer period would allow for a number of measures to be implemented in the residential sector to tackle some of the areas of concern about information provision and market complexity. However, we also note that small businesses appear to find the existing information provided by retailers equally difficult to understand and use in order to compare offers.

Disadvantages of Option 3

As with rolling back consumption thresholds, there would still be costs involved in continuing to regulate prices for a smaller number of customers. However, retaining all households as the regulated group makes this less of a concern than if the household sector was being segmented by consumption level.

If price regulation was retained for one group but not another it may cause confusion as to whether deregulation has actually occurred, and make information and awareness programs more challenging. In addition, it may in some cases be difficult to work out which group a customer belongs in: for example, for those who work from home.

Finally, the primary reason for using this phased approach would be if there were significant differences in the level of competition in the small business versus the residential sectors of the market, with the presumption that the residential sector is less competitive. However, as discussed in previous chapters, it does not appear that this is the case in NSW.

7.3.4 Option 4 - Partial (relative) regulation for a sub-group

Partial or relative regulation is an option for continuing with price regulation for one part of the market, whilst removing it from the rest of the market. It involves linking the price in one part to that in another. The main reason for pursuing this option would be if there is a sub-group where competition is considered to be less effective. Such a sub-group could be defined by geographic location (for example, customers located on a particular distribution network) or by some other distinguishing feature, such as payment method. Box 7.3 contains two examples of this form of price regulation.

Box 7.3: Examples of relative price caps

Example 1 - Great Britain. Price caps on the retail prices of the gas incumbent (British Gas/Centrica) were removed in April 2001, except for a relative price cap that was retained for two sub-groups (defined by their usage of certain payment methods) where competition was assessed to be less effective. The groups were households who paid their bills using prepayment meters or on the Late Pay tariff (the latter being those who pay bills within 28 days). Low income households are over-represented in both these groups and the tariffs paid tended to be significantly higher than those offered to households on direct debit and PromptPay (those who pay within seven days of receipt of the bill). The form of relative price regulation used was a cap on the differential between the Direct Debit and LatePay/ PrePayment tariff, and between the PromptPay and LatePay/PrePayment tariff. The relative price cap was retained for one year and ended in April 2002.

Example 2 - South Australia. Retailers who offer a tariff to city customers must offer the same tariffs to country customers at no more than 1.7% above the price for city customers.

Advantages of Option 4

The advantages and disadvantages of this option reflect those of Option 3. In particular, this option would allow price regulation to be directed to a particular group for whom price regulation is less effective.

This is an option that could be considered if sub-group(s) can be identified and targeted who are less likely to benefit from full price deregulation because there are fewer competitive offers available for them in the market. Relative price regulation would offer the scope to link the prices for this group to developments in the rest of the market and so could enable some of the benefits of competition to pass through to this group as well.

Disadvantages of Option 4

It would be very difficult to set accurately the price differential between groups. This would depend on both the likely costs and prices for the base group, and then similar estimates for the second group. This information would have to be forecast. If the differential was not set correctly it would involve a cross subsidy from one group to another which could distort competition. Careful thought would be needed as to how to reduce any potential impacts on efficiency and competition if there was such a cross subsidy.

There would be the continuing costs of regulation for a smaller group of customers, but if their prices are indexed to market prices then the degree of regulatory effort might not be too large. Continued price regulation may inhibit the development of market

offers for this group. There could also be possible unintended consequences, such as different impacts on different retailers. For example, if some retailers have more of the customers types who are the subject of the retail price regulation, it may impose different costs on different retailers and could distort competition.

7.3.5 Option 5 - Opt-in to regulated prices

IPART has recommended that if regulation continues, the NSW Government should consider an option that would allow customers to choose to opt into a regulated price.²⁰⁸ IPART considers this option could be used to transition to full deregulation, where it was not considered appropriate to move to full deregulation directly. Under this option, IPART would set a limited number of cost-reflective regulated prices. Customers on an existing regulated price would then have three options:

- do nothing and remain on their current price which would become unregulated in terms of price (but non-price protections would remain);
- "opt in" to regulated prices by electing to move onto a new regulated price offered by their Standard Retailer; or
- sign a market contract with either their Standard Retailer or one of the "2nd tier retailers" operating in their area.

Customers who already have a market contract may also be able to opt-in to a regulated price if they chose to do so.

A number of details would need to be determined in respect of this option. For example, for those customers moving to market prices by default, could the retailer change the price immediately or would there be an initial period of fixed prices?

PIAC does not support this approach. PIAC is concerned that customers themselves should choose to change tariffs, and that the NSW Government should not choose for them.²⁰⁹ Origin Energy and AGL conditionally support the opt-in model but would prefer deregulation to occur more expeditiously.²¹⁰

Advantages of Option 5

Continued provision of a regulated price will provide some protection for those customers who are not able to benefit from competition and choose to switch back to the regulated price. It may also encourage customers that are currently not participating in the market to engage. This could be a useful transitional approach to full deregulation as it would allow customers to test market contracts but would allow them to switch back to a regulated contract.

²⁰⁸ IPART, *Review of regulated retail for electricity, 2013-2016*: Draft report, April 2013, p. 40.

²⁰⁹ PIAC, Issues Paper submission, 8 February 2013, p. 28.

²¹⁰ Origin Energy, Issues Paper submission, 8 February 2013, p. 21; AGL, Issues Paper submission, 13 February 2013, p. 12.

Disadvantages of Option 5

A key disadvantage of this option is that the customers who would be likely to get the most benefit from a regulated price are those who are not active in the market and instead rely on the regulated tariff. These customers are less likely to make a conscious decision on their energy tariff, and so are less likely to opt-in to regulated prices.

There would also need to be an effective system for notifying all customers of their options and this could involve potentially confusing messages about the availability of a regulated offer and the value of shopping around the various market offers. Adopting an opt-in approach is likely to involve as much regulatory effort to set the regulated prices as at present, but would likely benefit a much small group of customers. Therefore the costs of regulation could be disproportionate to the benefits. There are also the costs for retailers of continuing to offer a regulated price.

On balance it does not appear that the opt-in option would protect the customers who are most likely to benefit from a regulated price. Customer inertia means it is likely that many who could benefit from this protection would fail to opt-in. A minority of customers may choose to opt-in to a regulated tariff; however the costs of maintaining this tariffs for what may be a very small group could outweigh the benefits of maintaining price regulation.

7.3.6 Draft recommendations

Based on the advantages and disadvantages discussed above, the Commission's draft recommendation is that removing price caps for all customers at the same time is the most appropriate approach. This will allow all customers to take advantage of the benefits of competition, including greater product diversity and innovation, at the same time. Further, the Commission has not found a great difference between the effectiveness of competition for small business customers compared to residential customers.

7.4 Transitioning off the regulated price

If price caps are removed, it is likely that there would be a proportion of customers who were still on regulated tariffs at the time deregulation occurs. This section considers how these customers could be transitioned off the regulated tariffs onto a retailer's default (standing offer) tariff if they did not themselves move off the regulated price onto a market contract prior to price caps being removed. This transition process could apply irrespective of which option discussed above is chosen for removing price regulation.

Currently, standard retailers are required to offer a regulated tariff. If price caps are removed, all retailers will be required to publish a "standing offer" tariff that is effectively the default tariff that the retailer will charge if a customer does not choose a market offer. This standing offer is unregulated. Consequently the regulated tariff will effectively be replaced by a standing offer that is not subject to price caps.

The Commission considers that in the transition from regulated tariffs to standing offers an intermediate step is required. The purpose of this step is to commence the process of price deregulation and signal to customers that changes are occurring while continuing to provide them with protection for a period of time, particularly for those customers that are less likely to engage in the market.

Similar to Victoria and South Australia, the Commission therefore considers that customers on the regulated tariff should first be transitioned onto a “fixed standing offer” tariff. The terms and conditions for this transitional standing offer tariff, including price, would be fixed for a period of time, such as six months or a year. The price set under the IPART determination could become the fixed standing offer in this transition process.²¹¹ The table below describes the different tariffs and offers in this transitional process.

Table 7.1 Explanation of tariffs for the transitional process

Regulated tariff (current arrangement)	Fixed standing offer (transitional tariff)	Standing offer (no price caps)
<ul style="list-style-type: none"> Standard retailers are required to offer this tariff Prices regulated by IPART 	<ul style="list-style-type: none"> Standard retailers are required to offer this tariff Price carried over from IPART determination and fixed for a period of time 	<ul style="list-style-type: none"> All retailers are required to make a standing offer available as their default tariff Price determined by retailers

Once the defined period of time elapsed, retailers would be able to alter the terms and conditions of the standing offer, including price, subject to any legal or regulatory constraints. For example, as discussed below, NECF requires retailers to publish notice of their standing offer prices one month in advance and places a limitation on a retailer’s ability to change the price of its standing offer contract more frequently than six monthly.

It would be desirable for information and awareness programs to begin prior to the regulated tariff changing to a fixed standing offer tariff to allow customers time to understand how they can benefit from changing retailers and to provide them with the information and tools to do so. The next chapter discusses how the AEMC will develop a blueprint for designing these programs.

While it is important to identify how the transition from regulated prices should occur, one of the goals of the information and education programs should be to encourage customers to engage in the market and shift onto market contracts. Ideally most customers would be on a market contract prior to price caps being removed. This is because the standing offer is typically higher than other available offers.

²¹¹ Note that the next IPART determination is for the period 1 July 2013 to 30 June 2016. If price caps were removed after this time period additional thought would need to be given to how to set the fixed standing offer.

The figure below sets out the steps for this process.

Figure 7.1 Steps to removing price caps



7.5 Price monitoring and re-regulation

As discussed above, removing price caps where competition is effective should deliver benefits to customers. However it is not possible to predict with certainty what specific outcomes will be in the context of a particular market. Therefore whatever path to removing price caps is adopted, the Commission also recommends that establishing a system of market and price monitoring, and the power to reintroduce regulation prices in certain circumstances, accompany the removal of price caps.

7.5.1 Market and price monitoring

If price caps are removed, we consider that a mechanism should be put in place for monitoring the market, including prices that customers pay. The purpose of this monitoring is to assess trends in the development of the market and to provide information on the market to relevant stakeholders. Such monitoring should help to inform the NSW Government on whether there is a need to further investigate the effectiveness of competition in the market.

Other jurisdictions offer examples of market and price monitoring.

Since price deregulation, the Essential Services Commission (ESC) in Victoria has produced an annual energy retail performance report, with details of switching rates, market shares, prices of standing and market offers and some customer service issues (disconnections, hardship policies, call centre performance). In the first two years after deregulation the report also contained information on market conduct issues (notably marketing and whether retailers provided customers with written offer summaries).

The Commission for Energy Regulation (CER) in Ireland issues a market monitoring report every six months. Where the report shows that the market is at risk of anti-competitive behaviour the CER will consider appropriate remedies, including reimposition of price caps if appropriate. Market monitoring reports review:

- number of suppliers;
- market share for all suppliers;
- switching – total level of switches and switching between independents;
- revenue – revenue earned for all suppliers; and
- range of tariffs on offer and average prices paid by tariff.

We consider that many of the measures that have been considered elsewhere in this report to determine the effectiveness of competition should continue to be monitored. These measures include:

- number and market shares of suppliers and year on year changes;
- gross and net (to assess gains and losses) switching for the whole market and between retailers;
- range of tariffs on offer - standing offers and market offers (including time of use tariffs), terms and conditions by relevant characteristics (eg type of meter, payment method) and average prices by tariff;
- numbers and/or percentages of customers on standing offers and market offers; and
- retailer revenues (as in Ireland) or retailer margins (as in Great Britain).

In addition it would also be useful to undertake periodic customer surveys to ascertain the ease with which customers can compare prices and switch suppliers, the reasons for switching and satisfaction with the new retailer.

A key question will be which entity should undertake the market and price monitoring. Possibilities would be the Australian Energy Regulator (AER) and IPART.

We note the National Energy Retail Law provides for some market monitoring. The National Electricity Retail Law is intended to come into effect on 1 July 2013. This legislation will require the AER to publish a retail market performance report each year.²¹² The National Energy Retail Rules at Part 10 state that such reports must include, among other things:

- a statement of the number of retailers and the number of retailers actively selling energy to customers;

²¹² National Electricity Retail Law, sections 284-285.

- an indication of the number of customers of each retailer;
- an indication of the total number of customers with standard retail contracts and market retail contracts, respectively, and the numbers by reference to each retailer;
- an indication of the numbers of customers who have transferred from one retailer to another retailer;
- information on customer service and customer complaints; and
- a report on energy affordability for small customers.

This legislation would appear to go part of the way towards the type of market monitoring considered here. Additional monitoring of price and retailer revenues/margins would also be required. If the AER performed the market monitoring role, an option may be for IPART to monitor price and retailer margins. This would leverage the capabilities IPART has developed in its current price setting role.

Whichever entity is selected for market and price monitoring, further consideration would need to be given to whether it would need additional information gathering powers to enable it to perform these roles.

7.5.2 Framework for considering reintroducing price regulation

The power to reintroduce price regulation could be retained where prices caps have been removed. Since it is uncertain how the market would develop following price deregulation, retaining this power would provide protection if competition became less effective. In addition, since retailers generally prefer deregulated prices, it would create an incentive for good market conduct by retailers.

The main concern with maintaining a reserve power to reintroduce price regulation is that it could create some uncertainty for retailers and therefore undermine investment or retail entry. However, this risk could be reduced if there are clear criteria that would need to be satisfied before the power is exercised.

Victoria and South Australia have retained the power to reintroduce price regulation, as has the CER in Ireland. It is too early to say what impact this will have. The government in the United Kingdom (UK) did not retain a power to reintroduce regulation in Great Britain, but Ofgem can make changes by proposing licence amendments that are agreed by a majority of retailers. If sufficient retailers do not agree Ofgem can refer the matter to the Competition Commission.²¹³

We note that the AEMA contains provision for price caps to be reintroduced following price deregulation. Clause 14.14 provides:

²¹³ Ofgem commenced a statutory consultation in late March 2013 on some proposed changes. See *Ofgem starts countdown to a simpler, clearer and fairer energy market*, Press release, 21 February 2013.

“The Parties agree that the phase out of the exercise of retail price regulation under clause 14.13:

...

- (c) does not prevent the exercise of a reserve price regulation power by the State or Territory where effective competition for categories of users ceases, provided that the power is only exercised in accordance with a regulatory methodology promulgated by the AEMC, and is subject to review by the AEMC of the effectiveness of competition in accordance with clause 14.11.”

We consider that a reserve power to reregulate prices should be retained if price caps were removed in NSW. This would allow the Government to respond quickly to reintroduce price regulation if competition becomes less effective.

To provide certainty for retailers and investors, it would be preferable that certain criteria or triggers be set in advance for when the power to re-regulate could occur. These should be linked to the indicators of competition that are considered as part of market monitoring. For example, if the AER’s retail market performance report indicated that the number of customers that had switched from one retailer to another over a twelve month period had dropped to less than 10 per cent, this could trigger the re-regulation of competition. Alternatively, if further analysis was required, it could trigger a more detailed report on the effectiveness of competition in NSW.

7.6 Other measures to promote competition and protect customers

This section sets out other measures that would work alongside price deregulation to protect customers and promote competition.

These are:

- the NECF;
- protections for hardship customers;
- regulation of contract terms; and
- price benchmarks.

7.6.1 National Energy Customer Framework

The NECF is the harmonisation of state-based regulatory frameworks (excluding retail price regulation and community service obligations) for energy distribution and retail

into a single set of national rules.²¹⁴ The NECF was designed to provide a suitable consumer protection framework whether or not prices are regulated.

The NECF contains a range of energy-specific consumer protections including:

- rules relating to retailers collecting security deposits from new customers, including their level and application;
- rules relating to retailers imposing late payment fees on small customers' bills, which must be waived for hardship customers;
- each authorised (or licensed) energy retailer must develop, maintain and implement a customer hardship policy for their residential customers;
- an obligation on the Financially Responsible Market Participant to offer a standing offer contract to customers if requested;
- retailers must publish notice of their standing offer prices one month in advance and provide customers with detailed information on prices, terms and conditions at the point of sale;
- a limitation on a retailer's ability to change the price of its standing offer contract more frequently than six monthly; and
- an obligation on retailers to provide details of their generally available offers to the independent price comparator website(s) (operated by the AER).

The NSW Government is intending to commence the NECF on 1 July 2013. Once the National Energy Retail Law and Rules come into force, the AER will be responsible for the retail compliance and enforcement activities. These are currently undertaken by IPART.

The provisions of the NECF will extend and improve the range of protections available to customers in NSW (subject to any derogations which the NSW government might apply). Its adoption should enable retailers to operate more efficiently in multiple jurisdictions and hence to reduce their costs. This in turn may have a positive impact on competition in the market. There have been some concerns that lack of customer understanding of the protections available under market contract may inhibit some customers from switching to such contracts. It will therefore be important that the protections available under the NECF for those on market and standard contracts are communicated effectively to customers.

²¹⁴ The Framework includes National Energy Retail Law and National Energy Retail Rules, which passed in the South Australian Parliament on 9 March 2011 and received Royal Assent on 17 March 2011.

7.6.2 Protections for customers in hardship

As discussed in section 7.2.3, hardship customers are those who have difficulty paying their bills due to financial stress.

The NECF requires each authorised (or licensed) energy retailer to develop, maintain and implement a customer hardship policy for their residential customers. The AER approves hardship policies for each retailer that are required to contain a number of minimum provisions including:

- processes to identify customers experiencing payment difficulties due to hardship;
- processes for the early response by the retailer to residential customers experiencing payment difficulties due to hardship;
- flexible payment options (including a payment plan and Centrepay) for the payment of energy bills by hardship customers;
- processes to identify appropriate government concession programs and financial counselling services and to notify hardship customers of those programs and services;
- processes to review the appropriateness of a hardship customer's market retail contract in accordance with the purpose of the customer hardship policy; and
- processes or programs to assist customers to improve their energy efficiency.

The protection that NECF offers exists independently of whether prices are regulated or not. Thus this protection for hardship customers will continue even if price caps are removed.

The NSW Government currently provides rebates for customers in hardship. These also exist independently of price regulation and are discussed further in chapter 6.

In our Power of choice review we recommended that state governments should review their energy concession schemes and other government assistance programs to ensure that they are appropriately targeted to capture the types of customers that may face increased financial stress in transitioning to flexible pricing, including customers that would not be captured by current eligibility requirements for energy concession schemes.²¹⁵ Any review of energy concession schemes should be consistent with the MCE, Energy Community Service Obligations National Framework.²¹⁶ We consider that such a review should be undertaken where removing price caps is considered.

²¹⁵ AEMC, *Power of choice review - giving consumers options in the way they use electricity*, Final report, 30 November 2012, Sydney.

²¹⁶ Ministerial Council on Energy, Energy Community Service Obligations, National Framework, 2009. Available at

7.6.3 Regulation of contract terms

As described in sections 7.6.1 and 7.6.2, the NECF provides a good base for ongoing customer protection. However, some areas may merit further attention to enable as many customers as possible to benefit from the development of retail competition. One key area is that of contract terms. This is important because overly restrictive contract terms can inhibit or discourage customers from participating in the market. Further, the proliferation of different terms and conditions makes it difficult to compare offers.

Key contract terms are:

- late payment fees;
- early termination charges; and
- the process for customers at the end of a fixed term contract.²¹⁷

As a general matter, PIAC notes that it has detected some improvements in relation to additional fees and charges being applied to market contracts.²¹⁸ These improvements include some retailers offering a "house moving guarantee", where the customer will not face exit or connection fees if they move but stay with the same retailer, and some retailers removing account establishment and/or moving homes fees.

Late Payment Fees

Late payment fees refer to fees charged by retailers where customers do not pay their electricity bill on time. These fees are currently regulated by IPART in electricity. In the current regulatory period (2010-2013) IPART has set the maximum late fee that may be charged at \$7.50.²¹⁹ If price deregulation occurs, IPART may no longer regulate such fees.

As discussed above, under the NECF, retailers will be banned from charging late payment fees for customers in hardship.

PIAC has stated that it is of the view that applying late payment fees as part of regulated offers has impeded competition because this gives retailers an enhanced opportunity to apply such fees as part of market offers.²²⁰

http://www.ret.gov.au/Documents/mce/_documents/MCE_Energy_Community_Services_Obligation20080929151353.pdf.

²¹⁷ Late payment fees are currently regulated by IPART but none of these others are regulated. This means that IPART does not set maximum fees that may be charged other than late payment fees.

²¹⁸ PIAC, Issues Paper submission, 8 February 2013, p. 18.

²¹⁹ Under IPART's draft determination for the 2013-2016 regulatory period this will increase to \$10.90. See IPART, Review of regulated retail prices for electricity, 2013 to 2016: Draft report April 2013, p. 139.

²²⁰ PIAC, Issues Paper submission, 8 February 2013, p. 15.

The Commission does not have an in principle objection to late fees. Late payments can create additional costs for retailers, which they should be able to recover from the customers that have caused the cost. However, where the NECF is adopted retailers will no longer be permitted to impose late fees on hardship customers. In addition, any customer that participates in the market could choose an offer that did not include late fees, if the customer thought they may be at risk of missing payments. Effective measures to increase engagement, as discussed in chapter 8, may provide such customers with the tools to be able to select offers more appropriate to them.

Early Termination Fees

Early termination fees are fees imposed on customers for leaving a contract prior to the end of a certain period. Such fees could act as a barrier to switching since many customers may be more motivated by the prospect of losing money through the termination fee than the prospect of savings from switching. On the other hand, there is a need to avoid over-regulation that may stifle the development of fixed term contracts that offer benefits to customers.

Early termination fees are a feature of fixed term contracts in many markets, although it is most common for them to be included in fixed price contracts – for example, banks may offer fixed rate interest mortgages and savings accounts. The concern about early termination fees in the electricity and gas markets often relates to them being applied to fixed term contracts when other terms of the contract (notably price) have changed. Whilst the contract terms may state clearly that the “fix” relates only to a percentage discount off a variable price, it seems plausible that there is some customer confusion about what is “fixed” in a fixed term contract. The Australian Communications and Media Authority (ACMA) has recently acted on the use of term “cap” in mobile phone contracts because of the customer confusion this causes. Many customers think this caps the amount they can be charged when in fact it is the minimum amount payable each month rather than the maximum.

As part of its proposals for changes in the energy retail market in Great Britain, Ofgem has proposed a number of new protections for customers on fixed term contracts, including:²²¹

- banning price increases or other changes to fixed term tariffs (except trackers or structured price increases set out in advance which are fully in line with consumer protection law);
- banning practices whereby customers are rolled onto further fixed term contracts without their consent; and
- providing a no-exit fee and 42 day switching window before the end date to their fixed term tariff before switching to a new tariff.

²²¹ Ofgem, *The Retail Market Review - Final domestic proposals*, 27 March 2013.

The NSW Government has indicated that it intends to ban electricity retailers from charging an early exit (termination) fee to customers who leave their electricity contract due to a change in the contract's terms and conditions.²²² This implements a requirement in NECF. For contracts that include an early termination fee the retailer will need to set out the price or price path that will be charged. If retailers change any term or condition in the contract, including changes to the price or price path that are not already specified in the contract, customers will have the option of exiting the contract without incurring an exit fee.

PIAC says there is a need to go further and recommends that if prices for residential retail electricity and/or gas prices are deregulated in NSW, the NSW Government should ban all early termination fees on retail supply contracts.²²³

The Commission does not share PIAC's view that all early termination fees should be banned. These fees can be legitimate charges applied to recover additional costs borne by retailers as a result of a customer leaving a contract early, including to recover costs over which retailers have no control. Where such fees are appropriately notified in advance, customers should be sufficiently protected and put on notice. We support banning early termination fees for customers who leave their electricity contract due to a change in the contract's terms and conditions.

As a complement to this, much clearer product disclosure needs to be developed for fixed term contracts, particularly to clarify that prices can increase on the contract where this is a part of a contract.

End of fixed term contract

Where there are early termination fees in place as part of a fixed term contract, the time when customers may be able to move to a more preferable offer without incurring such fees is the end of the fixed term. This is the main opportunity for switching.

However, there is a risk that customers are not given sufficient opportunity to switch at this time. This may prevent customers from engaging in the market. EWON, has noted the following:²²⁴

"In EWON's experience, at the expiry of contracts some retailers automatically renew the contract for a similar period unless contacted by the customer. Other retailers just retain the customer on the current terms and conditions without a renewal of the contract for a specific set period. The renewal process appears to be ad hoc and one which varies from retailer to retailer."

²²² NSW Department of Investment Resources and Energy, *National Energy Customers Framework NSW Regulations - Policy Document*, 21 December 2012, pp. 2-3.

²²³ PIAC, Issues Paper submission, 8 February 2013, p. 19.

²²⁴ EWON, Issues Paper submission, 8 February 2013, p. 8.

The Commission's view is that customers should have sufficient opportunity at the end of a fixed term contract to switch to other offers. Customers should not be automatically rolled over onto a new contract at the end of a fixed term contract. All retailers should adopt the good practice of: notifying customers in advance; and providing clear information on the default option and clear details of other options available.

7.6.4 Price benchmarks

Price regulation provides customers with a benchmark against which to compare prices. If deregulation occurs, the regulated price benchmark will be lost.

In Victoria, where prices have been deregulated, all retailers are required to publish the prices and other terms and conditions that will apply to at least one market offer. Retailers are, however, free to develop other market offers. This provides a benchmark against which to compare market offers.

If price caps are removed, the Commission recommends that a legal obligation be placed on all retailers in NSW to determine and publish their own standing offer prices and other terms and conditions that will apply to their obligation to supply and deemed supply arrangements. This requirement would address concerns that the removal of regulated retail prices would leave customers without price benchmarks against which market offers could be compared. Publication of standing offer and one market offer prices and terms and conditions by all retailers will provide points of comparison against which customers can assess market offers and facilitate an appropriate level of price transparency in the absence of a regulated price.

7.7 Draft conclusions

The Commission considers that where competition is providing customers with a choice of energy products and efficient prices, price regulation is more likely to inhibit competition than promote it. Consequently, having found competition to be effective in providing these outcomes, the Commission recommends that price caps in both electricity and gas be removed. Customers are likely to benefit from increased product choice and innovation following price deregulation.

If the NSW Government decides to remove price caps, a consistent package of measures is required to support this move. These measures include:

- a clear path towards removing price caps that provides certainty for customers and retailers and does not impose unwarranted regulatory burden on IPART or retailers;
- a defined set of measures that will continue to be monitored and a transparent process for reintroducing price regulation;
- clear obligations on retailers regarding any non-price terms and conditions that may continue to be regulated; and

- a comprehensive and well targeted information and engagement campaign to inform customers of the benefits of actively seeking out energy offers, as discussed in chapter 8.

The Commission's draft recommendation is that price caps should be removed for all customers at the same time so that all customers are able to benefit from greater product choice at the same time. The Commission has found that there is no significant difference between the way that small business and residential customers participate in the market.

There may be some customers that are less likely to capture the benefit from competition and so may not necessarily be better off if price caps are removed, namely customers that are not currently participating in the market. However, the Commission's view is that these customers should be given the tools and skills to make effective choices and be encouraged to engage. Additionally, hardship customers should continue to be supported through well targeted rebates and concession schemes. The NECF will also continue to provide protection for customers in the absence of price regulation.

In addition, the NSW Government may wish to consider whether additional measures are required to continue to protect customers as they transition to deregulation, including continued regulation of certain non-price terms and conditions. While different terms and conditions provide customers with greater choice, they also introduce greater complexity and make it more difficult to compare offers. However, the Commission considers that well designed information and awareness programs combined with improved tools for comparing offers should assist customers to take advantage of the different products available.

8 Increasing customer engagement

Box 8.1: Summary of chapter

The Commission has found that competition could be further enhanced if the type and form of information provided to customers was improved. This would allow customers to better compare energy offers and make effective decisions on their energy tariffs. The Commission considers that well targeted information and engagement programs would be a desirable feature of a package of measures to support the removal of price caps. Such measures should enhance customer understanding of their energy consumption and provide them with tools and skills to make effective choices.

The AEMC will work with stakeholders to develop a blueprint that sets out the steps that will need to be taken to design an effective set of programs and measures. We recommend these are implemented prior to price caps being removed to provide customers with time to understand how they can benefit from increased choices of their energy products and allow additional comparison tools to be developed. We will consider:

- who should lead the programs and what groups should be involved;
- the principles and objectives of the information and engagement programs;
- how they can reach various sectors of the community and what ongoing support may be required; and
- what tools are required to allow customers to meaningfully compare offers and encourage participation in the market.

The blueprint will be set out in our final report. The Commission encourages stakeholders to provide specific suggestions for designing well targeted information programs and other measures to encourage customers to engage in the market and provide them with the tools they need to participate effectively.

8.1 Introduction

Energy markets are inherently complex and customers require a high degree of understanding and knowledge to participate effectively in the market. This issue is not unique to the energy industry. Similar issues have been raised in relation to telecommunications, for example, where steps have been taken to improve the comparability of offers.²²⁵ Both industries require customers to compare a number of different variables and tariff structures to choose not only their provider, but the specific tariff within the retailer's often wide array of offerings.

²²⁵ See Australian Communications and Media Authority, *Reconnecting the customer, Final public inquiry report*, September 2011.

Complexity also gives rise to choice. For example wider penetration of smart meters will provide customers with the ability to see and manage their consumption in real time, allowing them to shift their load and lower their bills. This provides benefits to customers, but also requires them to have a higher degree of understanding of the way that they use electricity. Further, one sign of a competitive market is that retailers are striving to offer new products that better meet customer preferences. Again, this can lead to increased complexity, particularly when trying to compare different offers, but it also provides customers with increased choice.²²⁶

To allow customers to make the most of the benefits that arise from increasing complexity, they need to have the tools and knowledge to participate in the market effectively. Customers require access to adequate information in order to engage in a market. Information about energy product and service offerings is likely to promote more effective competition if it is: easy to obtain; understand; relevant; up to date; and enables competing energy offers to be compared. Targeted and effective information channels will also need to evolve with the market to continue to empower customers. Furthermore, while there may be initial complexity, the market should develop mechanisms to help simplify the choices that customers have to make, where this is demanded by customers.

Over time, customers will become more confident in participating in the market as they learn and adapt to the different products available. This is why the transition phase set out in section 7.4 is so important: it allows customers to test the different offers but continue to have protection for a period of time. Similarly, it will take time for the market to determine the appropriate range of product offerings through experimentation by retailers and customers alike.

The Commission considers that before price caps are removed, it would be desirable to undertake measures to encourage customers to engage in the market and support them to make effective choices. Note that while this discussion is framed in the context of NSW, the principles could be adopted by other states and/or SCER in implementing the related recommendations from the AEMC's Power of choice review.²²⁷

The remainder of this chapter sets out:

- evidence that there is currently a gap in information provision; and
- the way forward for developing a set of recommendations for developing the programs.

²²⁶ For further discussion on why complexity can arise in a competitive market see Littlechild, S, *Protecting customers or suppliers? A response to Ofgem's consultation on its Retail Market Review - Updated domestic proposals*, 21 December 2012, pp. 30-31.

²²⁷ The AEMC advised SCER to develop a comprehensive communication/education strategy to support implementation of the recommended Power of choice reforms and to more broadly improve customer understanding of energy use and relationship to cost. See AEMC 2012, *Power of choice review - giving consumers options in the way they use electricity, Final Report*, 30 November 2012, Sydney.

8.2 The effectiveness of competition can be improved through better information

Evidence suggests that customers find information on energy tariffs difficult to understand and unhelpful for choosing an offer. While customers are aware they can choose their retailer and are increasingly exercising that choice, evidence to date suggest that customers are seeking more transparent and independent information, particularly regarding prices. In particular, customers appear to have a low level of understanding of how time of use tariffs work and the potential benefits of such tariffs.

While information is available to assist customers in comparing retail tariffs, it appears that the form in which it is provided could be improved. Surveys commissioned by the AEMC found that many customers consider that information provided by retailers:²²⁸

- is not easy to understand;
- does not make it easy to compare offers;
- is not sufficient to make an informed choice; and
- does not help to identify energy needs.

Customers that participated in focus groups held by Roy Morgan were also sceptical about the impartiality of information that is provided by retailers, and even some of the third party comparison websites because they do not appear to offer all retailers' products.²²⁹ Further discussion on the results of the customer surveys is set out in section 4.2.4.

Consumer groups have raised similar concerns about the effectiveness of information provision. For example, the Ethnic Communities Council (ECC) note that retailers do not always provide translated information or use media that is relevant for non-English speaking communities.²³⁰ The NSW Council of Social Services considers that there is little information that is readily available for consumers about the energy market. Further, customers may not be aware of who their retailer is or the benefits that their retailer may be able to offer.²³¹

²²⁸ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, pp. 15-16.

²²⁹ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Customers*, 28 February 2013, p. 16.

²³⁰ ECC, Issues Paper submission, 8 February 2013, p. 2.

²³¹ NCOSS, Issues Paper submission, 8 February 2013, p. 8.

CHOICE argued that:²³²

“the complexity of offers, lack of tools and low levels of confidence felt by consumers in their ability to navigate the energy retail market ... results in a significant number of consumers disengaging from the process when choosing a new energy retail offer.”

PIAC is concerned that existing comparison websites provided by jurisdictional regulators have problems with the accuracy and timeliness of information.²³³ EWON, on the other hand, considers the IPART website comparator is easy to understand, relevant and up to date.²³⁴

In contrast, retailers consider that information is available to support customer choice. For example, AGL stated:²³⁵

“There is a plethora of information available to small customers that enable competing energy offers of various energy retailers to be compared. Not only do individual retailers provide detailed information about their products on their websites or at a customer's request, but independent brokers, and comparison services and websites exist, to which retailers provide and verify the information about the products they offer. Such facilities enable customers to readily compare the energy products offered by various retailers and make their choices accordingly.”

Origin Energy²³⁶ and EnergyAustralia²³⁷ also refer to retailer and comparator websites as sources of information.²³⁸

However, survey results and consumer groups suggest that the current form, type and quantity of information provision is not providing all customers with the support they need to make the best decisions for them. While retailers are providing information, it does not appear to be in a form that customers can readily use or from a source that they trust. Roy Morgan found that “Many customers started with a scepticism that the energy retailer can't really be on their side, that is, interested in helping them save money, because the companies regularly increased prices and were, after all, in the business of making money from energy use.”²³⁹ This apparent lack of trust of energy

²³² CHOICE, Issues Paper submission, 8 February 2013, p. 9.

²³³ PIAC, Issues Paper submission, 8 February 2013, p. 18.

²³⁴ EWON, Issues Paper submission, 8 February 2013, p. 7.

²³⁵ AGL, Issues Paper submission, 13 February 2013, p. 10.

²³⁶ Origin Energy, Issues Paper submission, 8 February 2013, p. 17.

²³⁷ EnergyAustralia, Issues Paper submission, 12 February 2013, p. 8.

²³⁸ Retailers did, however, support employing an information in the context of removing price regulation. See AGL, Issues Paper submission, 13 February 2013, p. 13; Energy Retailers Association of Australia (ERAA), 8 February 2013, Issues Paper submission, p. 3.

²³⁹ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Group Report*, 28 February 2013, p. 20.

retailers makes it more difficult for customers to obtain the information they require, as trust and confidence tend to reduce the transaction costs of obtaining information.

The Commission has also found that time of use tariffs are a specific area where customers have a low level of understanding.²⁴⁰ Consequently they are not currently in a position to participate effectively in this segment of the market. Active steps are required in this area to improve information provision for customers and encourage a greater degree of customer engagement.

8.3 The way forward

The Commission will work with stakeholders to develop a blueprint for designing information and education programs and other measures to increase customer engagement. The blueprint will not set out the details of the programs, such as what forms of communication will be used. Rather, it will establish a process for deciding such details. The blueprint will form part of the Commission's recommendations in the Final Report for this review.

The Commission will consider issues such as:

- who should lead the programs and what groups should be involved;
- the principles of the programs;
- identify different sectors of the community who may need to be targeted differently and how the programs can reach all these sectors;
- the type of information required by customers and how they can best compare offers; and
- mechanisms for encouraging customers to engage that retailers may consider implementing, such as monthly billing.

The remainder of this section provides some additional detail on each of these issues. The Commission welcomes stakeholder views on what issues should be considered and how information can best be provided in a form that empowers customers and encourages them to engage.

The Commission would also welcome views on how to foster greater trust and confidence of customers in the market. In particular, does the government have a role in improving the flow of information to customers? Although this is a task for retailers, there may be a role for policy in helping develop a market framework whereby good behaviour by retailers is rewarded and bad behaviour mitigated. This should occur through customers switching to retailers that offer better service; however additional motivation may also be useful.

²⁴⁰ Ibid, pp. 2 and 10.

8.3.1 Who should lead the programs?

The Commission's initial view is that the information and education programs should be led by the NSW Government to provide a clearly independent source of information. As discussed above, customers do not always trust the information provided by retailers or even third party comparator services. Misleading marketing practices and insufficiently transparent pricing policies have resulted in a degree of mistrust of retailers.

Simply Energy submitted that retailers are best placed to know the type of communications required by customers and, if price caps are removed, the government should have limited involvement in communicating the changes to customers.²⁴¹ While retailers will play an important role in the information and education programs, including by explaining their own products and offers, the Commission considers that it should not be led by retailers for reasons discussed above. Customers need to be confident that the information they are provided with is current and impartial.

In addition to involving retailers, the programs will need to draw on the expertise and networks of consumer and welfare groups. These groups should be involved in ensuring the information reaches various sectors of the community, as well as providing ongoing support to customers.

8.3.2 Principles of the programs

The AEMC's Power of choice review identified four key principles for developing an effective customer engagement strategy. These were:

- clarity of goals;
- education and engagement first;
- clarify the different needs of different types of customers; and
- identify vulnerable customers.

We intend to further develop these principles and identify specific goals for the programs.

It is important that education, awareness and engagement start early. Customers must have sufficient time to develop their knowledge and understanding of the energy market as well as understand the implications of price deregulation.

Note that in Power of choice, vulnerable customers were defined as those with limited capacity to respond to price signals by changing their consumption. "Vulnerable" may need to be defined differently for the purpose of the information programs. Therefore an important step will be to define what is meant by a "vulnerable" customer before they can be identified.

²⁴¹ Simply Energy, Issues Paper submission, 11 February 2013, p. 3.

8.3.3 Reaching all sectors of the community

Different types of communication activities are needed to enable all sectors of the community to be reached. This will also involve identifying appropriate community groups to assist both in providing customers with information and providing ongoing support.

To do this the following steps could be taken:

- establish a time frame over which the programs will run and what information and support will need to be ongoing;
- conduct customer surveys and focus groups to identify where there are gaps in understanding and knowledge;
- conduct further customer surveys and focus groups to understand how information and education programs can best be designed;
- the NSW Government and IPART should work with retailers and consumer groups to refine customer information needs and identify strategies for conveying information to specific customer groups; and
- identify groups that should be trained and funded to provide advice on energy issues to individual customers.

Some customers will need additional help to be able to make effective choices. Face to face advice may be very important for many customers (particularly vulnerable households). There may be a role here for trusted third parties such as community and welfare organisations and financial counsellors. These organisations would need to be adequately resourced to engage in these activities.

The South Australian Government has engaged the AER to train people in various organisations in how to use the Energy Made Easy website (see Box 8.2). As noted in the Power of choice review there may also be a role for energy retailers to support this work by community organisations. This could be more cost effective (and more likely to gain the trust of customers) than retailers doing such work directly themselves.

In addition to drawing from the Victorian and South Australian price deregulation campaigns, other information campaigns such as the switch from analogue to digital television and Sydney Water's "Every drop Counts" campaign may provide useful examples to draw from.

Box 8.2: South Australia's education and awareness

South Australia removed price regulation for all customers and adopted NECF on 1 February 2013. To inform customers of the changes, the South Australian Government linked their information to their existing SA Energy Partners Program (EPP), which was established in 2010. The program offers information and advice about:

- how to save energy in the home and minimise energy bills;
- energy rebates, concessions and incentives; and
- renewable energy.

The EPP works with 60 organisations across South Australia, including local councils and social welfare organisations. Not for profit organisations, financial counsellors and the offices of MPs were identified as key avenues for information dissemination. These groups are being trained by the AER in how to use their Energy Made Easy website and to increase energy literacy. See www.sa.gov.au for more information.

8.3.4 Comparing offers

Price is an important mechanism for conveying information in an easy to understand format. Therefore tools are required to enable customers to compare prices easily. Further, not all offers will be attractive to all customers. For example, some customers will prefer offers with no late fees, while others may prefer an offer that has no fixed contract term. Customers need a way to quickly identify the more limited number of offerings that meet their requirements. This subset of tariffs may be much smaller and so easier to compare.

A core feature of the information and education programs will be to ensure that customers have the tools and skills to compare different offers. There are already a number of independent websites available for comparing offers, such as IPART's My Energy Offers and the AER's Energy Made Easy website will be available to NSW customers once the NECF is introduced. Customers should be encouraged to use these services, which need to be well promoted and kept up to date. Welfare organisations might assist low income and vulnerable customers to access the website, particularly for those customers who do not have access to the internet at home.

One option that could be considered is the Tariff Information Label being proposed by Ofgem in Great Britain.²⁴² The aim of this label is to provide an easy way to compare the terms and conditions of tariffs in the market on a "like for like" basis. The Tariff Information Label contains key facts about an energy tariff. Ofgem propose that it would appear on annual statements, switching sites and retailers' websites.

²⁴² Ofgem, *Getting the best deal from the energy market, Factsheet 115*, 21 February 2013.

Figure 8.1

Tariff information

About this electricity tariff			
Supplier	YourPower		
Tariff name	YourPower Fixed Renewables		
Tariff type	Green, Fixed price		
Payment method	Direct Debit		
Unit rate	14.01p per kWh		
Standing charge	17.41p per day		
Tariff ends on	18 February 2011		
Price guaranteed until	18 February 2011		
Exit fees (if you cancel this tariff before the end date)	£50.00		
Discounts and additional charges	No discounts		
Additional products or services included	Loyalty points		
Estimated electricity cost for typical households on this tariff			
	 Low user	 Medium user	 High user
Assumed annual consumption	1,650 kWh	3,300 kWh	4,600 kWh
Estimated annual cost	£294.71	£525.88	£708.01
Tariff Comparison Rate (TCR)	17.86p per kWh	15.94p per kWh	15.39p per kWh

Estimated costs include VAT and are based on current prices for the tariff shown above.

Source: Ofgem, *Getting the best deal from the energy market*, Factsheet 115, 21 February 2013, p. 3.

This proposal by Ofgem has been welcomed by consumer groups in Great Britain and even by some who are critical of Ofgem's proposals for tariff simplification.

8.3.5 Engaging customers: monthly billing?

Small customers are currently invoiced each quarter for their electricity and gas consumption. This can influence how customers participate within the energy markets:

- Given the rises in electricity prices over the past five years, quarterly billing can often lead to a significant increase in customer bills since the last quarter. Such increases which may not have been expected by the customers lead to price shocks.
- Quarterly billing creates a lengthy time gap between the decision to consume and the payment date. This can make it more difficult for the customer to take action to control its bills. Also, the customer does not immediately see the value of such actions.

- Quarterly billing makes it difficult for customers to pay unless they have adequate savings set aside.
- Customers that are only receiving information on their energy consumption and bills four times a year may only consider taking action on their energy bills (ie switching retailers) at each billing cycle.

Quarterly billing may also lead to costs for retailers as it could lead to increased billing queries and payment difficulties. This section discusses the possibility of moving to monthly billing as a one possible means to facilitate customer participation and identifies possible impediments towards this. It is important to recognise that monthly billing may not be for all small customers, and that there will be a proportion of customers who will prefer to continue to be billed on a quarterly basis.

The National Electricity Retail Rules require both electricity and gas bills to be issued at least every three months. Market customers can negotiate their billing cycle terms,²⁴³ but they are fixed for customers on standing offer contracts.

How a retailer could offer a monthly billing option will depend upon the metering capability at the customer's premise. This is because the metering capability will determine the availability of consumption data for use in determining the customer's bill.

Where the customer has a meter with remote metering reading capability, it should be relatively straightforward for retailers to offer a monthly billing option. This is because the retailer will have access to data on the customer's consumption over the monthly billing period. In this situation, two additional conditions are necessary. Firstly, that the retailer has billing systems and software to support monthly billing and secondly, that the AEMO's settlement processes allows validation of the metering interval data in sufficient time. We do not expect either of these conditions to be a problem.

Small customers in NSW tend not to have meters with remote metering reading capability and instead have accumulation and manually read interval meters.²⁴⁴ Where such meters are manually read at a customer premises, data availability will be limited by the date of the most recent meter read and AEMO's validation processes. We understand that quarterly meter reads are typically six weeks in arrears.

Under this current situation, retailers would only be able to offer a monthly billing option if meters start to be read on a monthly basis or if the retailer is prepared to offer a bill smoothing product based upon estimated usage.

²⁴³ For example, QEnergy and Dodo Power and Gas offer monthly billing.

²⁴⁴ We understand that most of the interval read meters installed in the Ausgrid Network are manually read meters and not remotely read meters. This means that such meters still required a meter reader on site to access the consumption data. This reflects the current policy in the National Electricity Rules that manually read interval meters are the exclusive responsibility of local distribution businesses, while remotely read meters are the responsibility of the retailer.

Moving from quarterly meter reads to monthly meter reads will need to be agreed to by the local distribution network service provider, who is the responsible person for such meters. It will also increase costs for the retailer, who will pass these costs onto customers.²⁴⁵ In addition, AEMO's settlement validation processes may need to be upgraded to deal with the increased flow of consumption data. Given the likely increase in meter reading costs, moving to monthly meter reads is unlikely to be pursued by retailers.

A number of retailers are starting to offer a bill smoothing product for residential customers, for example AGL and Origin Energy. The issue with this product is the risk of differences between the estimated consumption used to calculate the monthly payment and the actual consumption over the period. A periodic reconciliation adjustment to the customer bill will be needed to manage this risk.

However, the evidence that retailers are starting to offer such products points to retailers considering that this risk can be managed. To manage this risk, the retailer could add conditions on the customer to access such products. We understand that both these options are only available for direct debit customers on market offers.²⁴⁶

²⁴⁵ It is hard to estimate the current costs of manually meter reads in NSW as metering costs are bundled into network use of system charges. In South Australia, AER approved an annual meter read cost of approximately \$5 per meter. Moving to a monthly billing cycle could increase this cost three-fold (12 meter reads instead of four) to \$20 per meter.

²⁴⁶ Based on the customer's previous consumption history AGL assesses likely energy usage and calculates either fortnightly or monthly payment amounts for the customer's expected future usage. Under AGL's product, the customer has the option of either paying on a fortnightly or monthly basis. Every six months, AGL reviews the customer's bill smoothing amount against actual consumption and if required, adjusts the regular payment amount. For Origin Energy's Easipay option, customers also have the option of weekly payment.

Abbreviations

ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ACMA	Australian Communications and Media Authority
ACT	Australian Capital Territory
AEMA	Australian Energy Market Agreement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AFL	Australian Football League
AFMA	Australian Financial Markets Association
APG	Australian Power & Gas
ASIC	Australian Securities and Investment Commission
ASX	Australian Stock Exchange
BREE	Bureau of Resources and Energy Economics
CER	Commission for Energy Regulation
Commission	See AEMC
CSG	coal seam gas
DNSP	Distribution Network Service Provider
DVA	Department of Veterans' Affairs
EAL	Energy Assurance Limited
ECC	Ethnic Communities Council
EGP	Eastern Gas Pipeline
EMWRG	Energy Market Reform Working Group

ERAA	Energy Retailers Association of Australia
ESAA	Electricity Supply Association of Australia
ESC	Essential Services Commission
ESCOSA	Essential Services Commission of South Australia
ETEF	Electricity Tariff and Equalisation Fund
EWON	Electricity and Water Ombudsman of NSW
EWOV	Energy and Water Ombudsman of Victoria
FRC	Full Retail Contestability
GJ	gigajoules
HHI	Herfindahl–Hirschman Index
IPART	Independent Pricing and Regulatory Tribunal
IT	information technology
Jemena	Jemena Gas Networks
kWh	kilowatt hours
LNG	liquefied natural gas
LPG	liquid petroleum gas
MCE	Ministerial Council on Energy
MJ	megajoules
MWh	Megawatt hours
NCOSS	NSW Council of Social Services
NECF	National Energy Customer Framework
NEM	National Electricity Market
NERA	NERA Economic Consulting
NERL	National Electricity Retail Law
NERR	National Electricity Retail Rules

NMI	National Meter Identifier
NSLP	net system load profile
NSW	New South Wales
OTC	over the counter
PIAC	Public Interest Advocacy Centre
PJ	petajoules
PTB	Price to Beat
PUC	Public Utility Commission
PV	photovoltaic
RMR	Retail Market Review
Sapere	Sapere Research Group
SCER	Standing Council on Energy and Resources
SCO	Standing Committee of Officials
STTM	short term trading market
TCR	Tariff Comparison Rate
TJ	terajoule
TOU	time of use
UK	United Kingdom
WAPC	Weighted Average Price Cap

A Market Structure

Box A.1: Summary of chapter

The Commission's draft analysis has determined that the market structure is conducive to competition. Our draft findings are:

- Eight electricity and two gas new entrant retailers competing in NSW provides the Commission with confidence that the market structure is conducive to entry and effective competition. We note that Click Energy entered the NSW market in March 2013.
- The Commission found that barriers to entry and expansion are being felt most acutely in the wholesale gas market. Retail price regulation was said to be the most significant barrier to entry and expansion by large incumbent, new entrant and potential new entrant retailers alike during consultation.
- AGL, Energy Australia and Origin Energy make up approximately 95 per cent of the NSW retail electricity market. The Commission considers that this level of concentration is to a large extent due to legacy effects from government participation in the NSW retail and generation sectors. Concentration may decrease in the future as new entrants continue to take market share from the incumbent retailers.
- NSW is an appealing market for electricity retailers due to its high population. However, the retail gas market appears to be less attractive due to relatively low customer connections and sales volumes. Retailers entering the gas market may only be doing so to realise economies of scope from dual fuel offers.

Evidence of relatively low barriers to entry in electricity, manageable barriers to entry for gas and a market structure conducive to competition provides the Commission with confidence that price regulation is no longer required in NSW.

To assess the competitiveness of energy retailing in NSW, it is necessary to understand the structure of the market and whether barriers to entry, exit and expansion exist. It is also important to determine the extent to which there is independent rivalry between participants. These factors are interrelated in that market structure often depends on the presence of barriers to entry, which in turn influences the behaviour of participants, and the performance of the market in producing benefits for customers.

This chapter examines:

- the structure of the NSW electricity and gas retail markets, including number and type of participants;

- whether the population and demographics of NSW make it an attractive market for energy retailers; and
- barriers to entry, expansion and exit faced by retailers.

A.1 Supply side - structure of the energy retail markets

This section sets out the supply side features of the market that are relevant to our assessment of competition, including:

- a summary of reforms in the NSW electricity market and the resulting structure of the market;
- analysis of the active retailers and market concentration in electricity; and
- analysis of the active retailers and market concentration in gas.

A.1.1 History of reforms in the electricity market

This section reviews Full Retail Contestability (FRC) and the development of energy retailing since competition began in NSW. We also examine the issues that may affect the structure of the market in the future.

Introduction of Full Retail Contestability

FRC was introduced in NSW gas and electricity markets in 2002. In the initial design of FRC, the state owned electricity distributor of each region was also the standard retailer, who was required to offer a regulated tariff. Customers were given the option of remaining on the regulated tariff or transferring to a market offer, either with the standard retailer or with another company. IPART continues to have responsibility for setting the regulated retail tariffs.

Since 2007, IPART has used a Weighted Average Price Cap (WAPC) form of regulation as a stepping stone to the removal of regulation. IPART sets the average price cap taking into consideration estimates for the wholesale price, pass through costs from regulated network businesses and a retailer profit margin. Standard retailers are then able to set individual regulated tariffs in compliance with the WAPC and side constraints.

Gas tariffs are subject to a lighter handed form of regulation, whereby gas retailers propose the WAPC and IPART assesses the reasonableness of this. The standard tariff essentially acts as a price cap, as informed customers should be unwilling to pay a higher market rate.

Issues in early period of Full Retail Contestability

In the early years of FRC the level of competition was relatively low. As discussed below, possible reasons for this were the low level of the regulated tariff and the Electricity Tariff Equalisation Fund (ETEF).

Origin Energy stated that electricity tariffs set before 2010 may not have fully reflected the level required to maintain a profit margin and this is likely to have impacted the development of competition.²⁴⁷ Similarly, AGL's Chief Economist has also stated that the level of the regulated tariff between 2004 and 2006 inhibited effective competition.²⁴⁸

The ETEF was introduced as part of the package of reforms to begin FRC and was intended to prevent government owned retailers from being exposed to unacceptable financial risk. The ETEF was a fund that standard retailers contributed to when the wholesale price of electricity was below the level used to set the regulated tariff. When the wholesale price was higher than the amount determined for the regulated tariff, the standard retailers were paid from the ETEF. The government owned generators were required to cover any shortfall that may eventuate due to an extended period of above forecast prices.²⁴⁹ The ETEF was designed to ensure that volatility in the electricity wholesale prices would not result in large profits being accrued by state owned generators and large losses by state owned retailers.

New entrant retailers did not have access to the scheme and were required to manage their own risk. For this reason it is now recognised that the ETEF may have had a negative impact on competition in the retail market. Origin Energy considers that the ETEF reduced competition and led to standard retailers having a competitive advantage due to a lower risk profile.²⁵⁰ One retailer noted during consultation that the ETEF may have provided an incentive for standard retailers to shift market customers onto standard contracts during 2007-08, when prices were high due to the drought.²⁵¹ This is consistent with the observed drop in switching rates in this period that can be seen in Figure B.5. The ETEF was discontinued in 2011 as part of reforms that included retailer privatisation.

Privatisations in electricity

In March 2011, the standard electricity retailers were split from their associated distribution companies and privatised. The distribution companies were retained in government ownership and re-branded as Ausgrid, Endeavour Energy and Essential Energy. Figure A.1 shows the areas that each of these businesses serve.

²⁴⁷ Origin Energy, Issues Paper submission, 8 February 2013, p. 8.

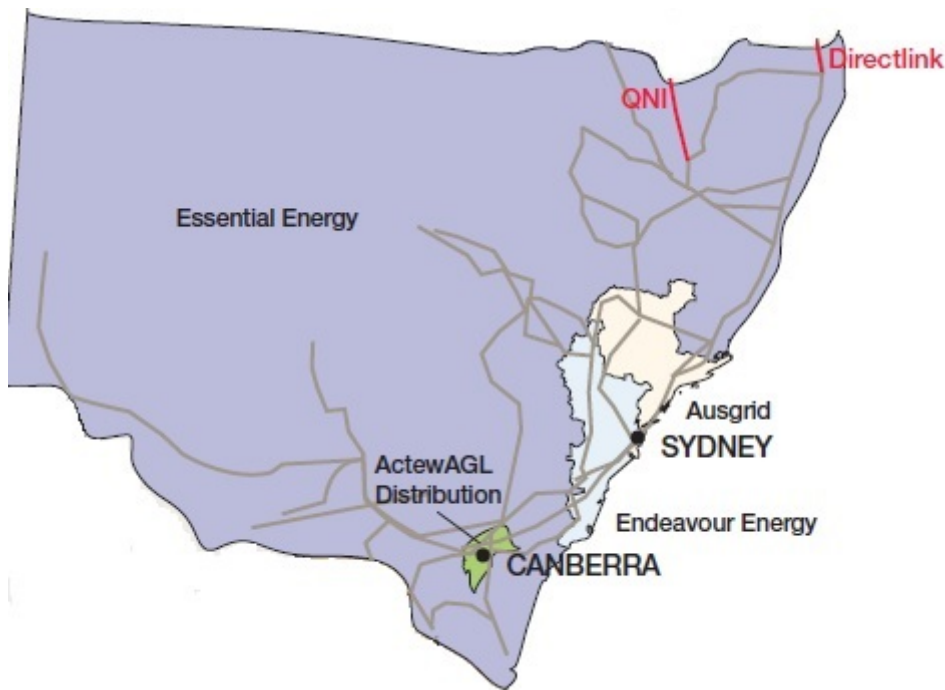
²⁴⁸ Simshauser, *When does retail electricity price regulation become distortionary*, July 2012, p. 6.

²⁴⁹ NSW Treasury, *Electricity Tariff Equalisation Fund – Information Paper*, December 2000, p. 2.

²⁵⁰ Origin Energy, Issues Paper submission, 8 February 2013, p. 8.

²⁵¹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales – Report of Interviews with Energy Retailers*, February 2013, p. 8.

Figure A.1 Map of NSW and ACT electricity distributors



Source: National map of distribution companies, AER, *State of the Energy Market 2012*, 20 December 2012, p. 61.

The retail assets of Integral Energy and Country Energy were both purchased by Origin Energy, while the retail arm of EnergyAustralia was purchased by TRUenergy. In 2012 TRUenergy was nationally rebranded as EnergyAustralia. As a consequence of these transactions, Origin Energy, through its subsidiaries, is the standard retailer for electricity in the Essential and Endeavour Energy regions. EnergyAustralia is the standard retailer in the Ausgrid distribution region.

In March 2011, the NSW government also privatised the trading rights for the Delta West and Eraring Generators. Under these gentrader agreements most of the trading rights to the state owned Eraring generators were sold to Origin Energy. Similarly, EnergyAustralia (then TRUenergy) purchased the trading rights to the Delta West generators. While the trading rights have been privatised, the government maintains ownership of the physical power plants. Furthermore, the government maintains ownership of both the trading rights and the physical assets of Macquarie Generation and Delta Coast. As discussed below, there are plans to privatise these remaining state owned generators.

Obsolete electricity tariffs

Historically, there were multiple electricity tariffs that were a product of the old "county council" electricity retailing system in place before the introduction of FRC. Some of these "obsolete tariffs" are still in place in certain areas of the Essential Energy region. PIAC stated that these tariffs cover about 20 per cent of customers in the

region.²⁵² As these tariffs can be more favourable to customers than the standard contract or available market tariffs, PIAC notes that there should be a clear plan to remove these tariffs without exposing customers to a sudden jump in prices.²⁵³

EnergyAustralia considers that the existence of obsolete tariffs makes it hard to develop appropriate offers and hence they do not offer market contracts in the far west of the state.²⁵⁴ This point is highlighted by EWON, who states that there have been complaints from customers in the Essential region that are unable to receive market offers.²⁵⁵ However, we note that the lack of market offers could be due to other reasons, such as relatively higher acquisition costs due to lower population densities. Origin Energy and EWON indicated that these tariffs are in the process of being phased out.²⁵⁶

In the recent draft electricity determination IPART has indicated that it "will remove the additional constraint that limited Origin Energy's ability to increase individual prices by more than a specified amount (in the Essential Energy supply area) and to remove the requirement for Origin Energy to obtain IPART's approval to transfer customers between prices."²⁵⁷ Origin Energy has been invited to submit a plan on how it will rationalise these tariffs.

The Commission notes stakeholder concerns around the negative impact that obsolete tariffs may be having on competition in the Essential region. Multiple standing offers in the same area makes it difficult for retailers to structure their market offers. Furthermore, in situations where an obsolete tariff is not cost reflective, new entrant retailers will be unable to effectively compete. Therefore, the Commission supports the ongoing processes to remove these tariffs.

Future changes

There are a number of regulatory and market changes currently underway that could influence the structure of the retail market in NSW. These include the privatisation of the remaining state owned generation assets, implementation of the NECF and establishment of an east coast LNG export industry.

The NSW government has announced that it will privatise much of the remaining state owned generation assets. The sale includes those assets covered by the gentrader agreement and some assets which currently maintain independent trading rights, such

²⁵² PIAC, Issues Paper submission, 8 February 2013, p. 10.

²⁵³ PIAC, Issues Paper submission, 8 February 2013, p. 12.

²⁵⁴ EnergyAustralia, Issues Paper submission, 12 February 2013, p. 5.

²⁵⁵ EWON, Issues Paper submission, 8 February 2013, p. 3.

²⁵⁶ EWON, Issues Paper submission, 8 February 2013, p. 3; Origin Energy, Issues Paper submission, 12 February 2013, p.9.

²⁵⁷ IPART, *Review of regulated retail prices for electricity, 2013 to 2016*, April 2013, p. 39.

as Macquarie Generation.²⁵⁸ Depending on the outcome of the sale process, the structure and competitiveness of the wholesale and retail electricity markets is likely to change. This is discussed further in section A.3.2.

The NSW government has committed to adopting the NECF on 1 July 2013, with some minor amendments. The NECF is a nationally consistent framework for the retail supply of energy governed by the National Electricity Retail Law (NERL) and National Electricity Retail Rules (NERR). Origin Energy and ActewAGL state that the adoption of the NECF could lead to a reduction in retailer's costs as there will be nationally consistent standards.²⁵⁹ The ERAA notes that the NECF was designed to be implemented in a deregulated market.²⁶⁰

Changes underway in Australia's eastern gas market have the potential to affect the availability and price of wholesale gas, and therefore the ability of gas retailers to compete. The establishment of an east coast LNG export industry is increasing the demand for gas and contributing to a tightening in the supply/demand balance. These issues are discussed further in A.3.2.

A.1.2 Current structure of the electricity market

PIAC considers that privatisation of the state owned retailers resulted in a decrease in competition, as in March 2011 the standard retailers only controlled 79 per cent of the market.²⁶¹ EWON notes that after privatisation the number of major participants in the market dropped from five to three.²⁶² However, EnergyAustralia notes that competitive activity has increased since retailer privatisation.²⁶³ Furthermore ActewAGL, AGL, Alinta and Origin Energy all consider the structure of the electricity market to be competitive.²⁶⁴

There are twelve companies active in electricity retailing in NSW.²⁶⁵ Of these, ten retail to residential customers and ten retail to small business customers.²⁶⁶ However, the market is mainly concentrated among three firms: AGL, EnergyAustralia and

²⁵⁸ NSW Treasurer, *NSW electricity generation sale scoping work underway* press release, 11 September 2012.

²⁵⁹ Origin Energy, Issues Paper submission, 8 February 2013, p. 8; ActewAGL, Issues Paper submission, 8 February 2013, pp. 1-2.

²⁶⁰ ERAA, Issues Paper submission, 8 February 2013, p. 8.

²⁶¹ PIAC, Issues Paper submission, 8 February 2013, p. 9.

²⁶² EWON, Issues Paper submission, 8 February 2013, pp. 1-2.

²⁶³ EnergyAustralia, Issues Paper submission, 12 February 2013, p. 4.

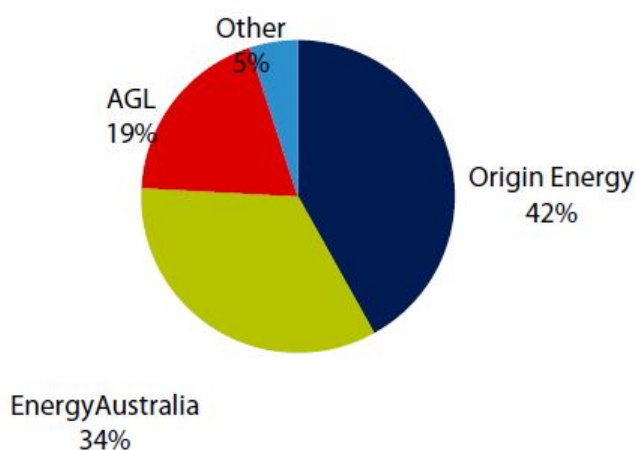
²⁶⁴ ActewAGL, Issues Paper submission, p. 1; AGL, Issues Paper submission, 13 February 2013, pp. 1-2; Alinta, Issues Paper submission, 8 February 2013, p. 2; Origin Energy, Issues Paper submission, 8 February 2013, p. 3.

²⁶⁵ We note that since this review commenced, Click Energy has entered the NSW market.

²⁶⁶ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 5. Note that Click Energy has entered the NSW market after the interviews were conducted.

Origin Energy, which results in a CR₃ ratio in electricity of 94 per cent.²⁶⁷ If the market share of the fourth largest retailer, Australian Power & Gas (APG), is included, the CR₄ ratio is 96 per cent. Figure A.2 from IPART shows the market share of the electricity retailers by the number of small customers.

Figure A.2 Electricity market share June 2012



Source: IPART, *Review of regulated retail prices and charges for electricity 2013 to 2016: Issues Paper*, November 2012, p. 25.

One indicator of market concentration is the Herfindahl-Hirschman Index (HHI). This is an index of market concentration that ranges from 0 to 10,000.²⁶⁸ A score of 10,000 indicates a perfect monopoly and a score of 0 indicates a state of theoretically perfect competition. The ACCC uses a score of 2,000 as a threshold when considering the level of competition when assessing mergers.²⁶⁹ Using this method, the HHI for electricity can be determined in NSW and is approximately 3,200.

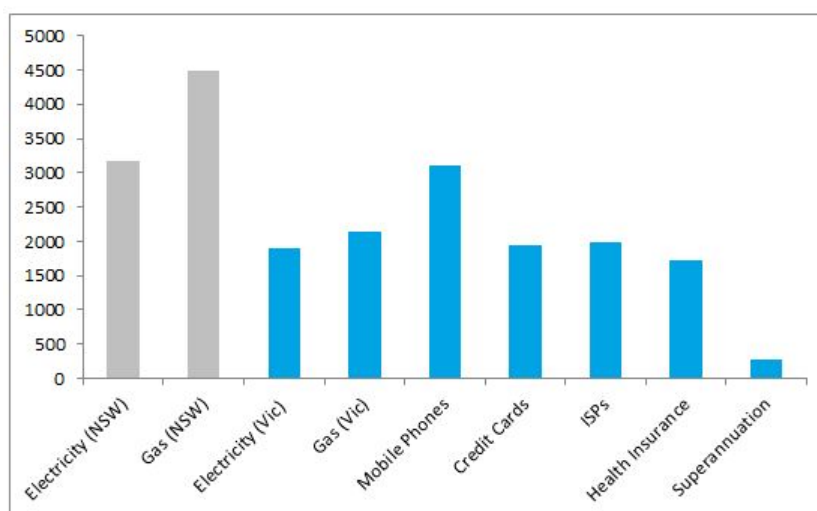
Figure A.3 shows the HHI for electricity retailing in NSW compared to other industries. It also shows the HHI for gas as elaborated in section A.1.3. It can be seen that the HHI for NSW energy retailing is above those for other industries and interstate energy.

²⁶⁷ The CR_X ratio of a market is the market share of the X largest companies. So the CR₃ ratio of the NSW electricity market is the combined market share of the three large retailers.

²⁶⁸ The HHI is determined by adding the square of the market share of all retailers in the market.

²⁶⁹ ACCC, *Merger guidelines*, November 2008, p. 37.

Figure A.3 Comparison of HHI across industries



Source: AEMC analysis²⁷⁰

These results could suggest that the market is highly concentrated. However, the HHI is a high level, indicative measure of competition, and not a definitive measure of whether a market is competitive. We also note that the market concentration in electricity is similar to that of mobile telephones, which is a competitive and deregulated industry. The Electricity Supply Association of Australia (ESAA) considers that "competitive pricing can be observed in markets with limited participants."²⁷¹ Furthermore, "[a]s long as the credible threat of new entry exists through low barriers to market entry, incumbent retailers will maintain their price and service offerings at cost reflective, competitive levels."²⁷²

The Commission agrees that market concentration is high, but considers that this by itself is not determinative of the state of competition. Rather, we have assessed a number of different measures that will together inform our views.

Regional issues

As discussed in section A.1.1, there are different standard retailers for electricity in different areas of the state. In all the regions, the standard retailer retains over 55 per cent of the market share. Additionally 40 per cent of customers in NSW remain

²⁷⁰ HHI for other industries sourced from CUAC, *Market Power in the Victorian retail energy market*, December 2012, p. 6; ACCC, 2012, *ACCC telecommunications reports 2010-11*, p21; Credit Card HHI determined with reference to survey data supplied by RFI; IBISWorld, *Internet Service Providers in Australia IBISWorld Industry Report J7124*, October 2012; Health insurance HHI calculated using combined Hospital Treatment and General Treatment data, PHIAC, <http://phiac.gov.au/> Accessed 30 January 2013; Roy Morgan, *Superannuation and wealth management in Australia*, Report May 2010, pp. 30-31, quoted in Commonwealth of Australia, *Super System Review Final Report Part One Overview and Recommendations*, 2010, p. 9.

²⁷¹ ESAA, Issues Paper submission, 15 February 2013, pp. 1-2.

²⁷² ESAA, Issues Paper submission, 15 February 2013, p. 1.

on the standard contracts. The standard retailer for each electricity distribution region is shown below along with the HHI in each distribution region.

Table A.1 Electricity standard retailers

Standard retailer	Distribution region
EnergyAustralia	Ausgrid
Origin Energy (through purchase of Integral Energy)	Endeavour
Origin Energy (through purchase of Country Energy)	Essential

Table A.2 HHI comparison between regions

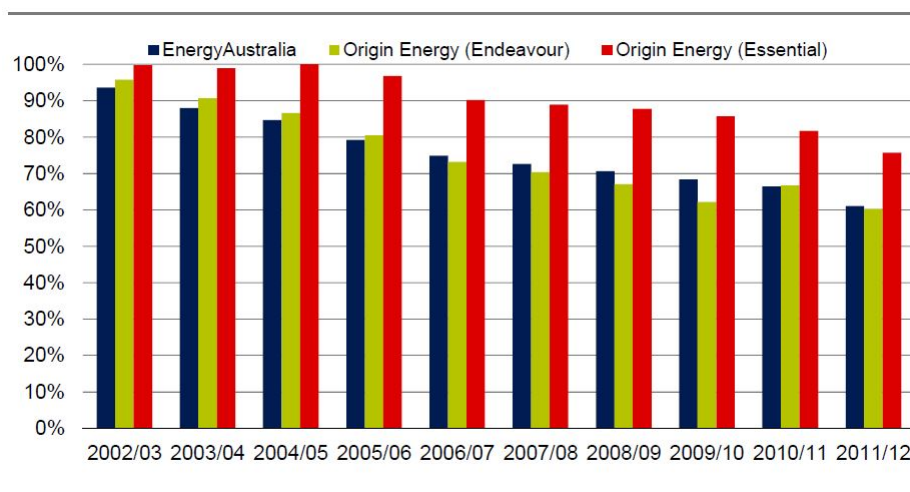
NSW electricity distribution region	Approximate HHI
Ausgrid	4,300
Endeavour	4,100
Essential	6,100

The results show that in each distribution region the market concentration is higher than in the state as a whole. The highest market concentration is in the Essential Energy region. PIAC consider that there is not effective competition in this market.²⁷³

However, we note that the standard retailers were privatised only two years ago. As discussed in section A.1.1, there is evidence that the market structure when the standard retailers were publicly owned was not as conducive to competition. The ETEF scheme hindered new entrants' capacity to compete as well as encouraging standard retailers to retain their customer base on standard contracts. Furthermore, there is the potential that government owned retailers may have been reluctant to aggressively compete against each other. Figure A.4 shows that the proportion of customers with standard retailers in each distribution region is declining. Therefore, the current market concentration may be a function of history and not representative of future outcomes

²⁷³ PIAC, Issues Paper submission, 8 February 2013, p. 10.

Figure A.4 Proportion of customers with standard retailers in each distribution region



Source: IPART, *Review of regulated retail prices for electricity, 2013 to 2016*, April 2013. p. 28.

A.1.3 Current structure of the gas market

There are five retailers active in the gas retail market: AGL, APG, EnergyAustralia, Lumo and Origin Energy. Additionally, ActewAGL is a gas standard retailer in some regions in the vicinity of the ACT and in the south east of the state. ActewAGL does not market outside of those regions and AGL does not compete in the ActewAGL distribution region.

Both Momentum and PIAC consider that the gas market is not competitive.²⁷⁴ Momentum is concerned that 98 per cent of the market for small customers is concentrated among three companies.²⁷⁵ Momentum stated that if ActewAGL was included as an incumbent then the market concentration would be closer to 100 per cent.²⁷⁶ This concentration compares unfavourably with Victoria where incumbents control 80 per cent of the market, while in South Australia incumbents control 50 per cent of the market.²⁷⁷ ActewAGL, AGL, Alinta and Origin Energy all consider the gas retail market to be competitive.²⁷⁸

Similar to electricity, the "Big 3" retailers have significant market share. For instance, the CR₃ ratio is 97 per cent, while the CR₄ ratio including APG is 99 per cent. IPART states that over 70 per cent of gas customers are on market contracts. The below graph

²⁷⁴ Momentum, Issues Paper submission, 15 February 2013, p. 4; PIAC, Issues Paper submission, 8 February 2013, p. 1.

²⁷⁵ Momentum, Issues Paper submission, 15 February 2013, p. 4.

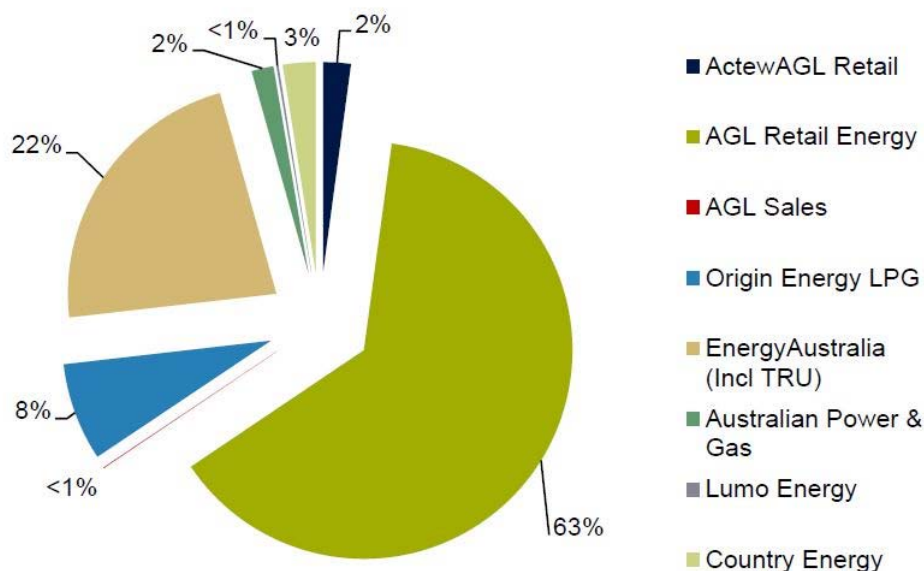
²⁷⁶ Momentum, Issues Paper submission, 15 February 2013, p. 4.

²⁷⁷ Momentum, Issues Paper submission, 15 February 2013, pp. 4-5.

²⁷⁸ ActewAGL, Issues Paper submission, p.1; AGL, Issues Paper submission, 13 February 2013, pp. 1-2; Alinta, Issues Paper submission, 8 February 2013, p. 2; Origin Energy, Issues Paper submission, 8 February 2013, p. 3.

shows the market concentration of gas retailers in NSW based on the number of small customers. Figure A.5 shows the market share of residential gas customers by retailer.

Figure A.5 Gas market share June 2012



Source: IPART, *Customer service performance of gas retail suppliers: 1 July 2007 - 30 June 2012*, December 2012, p. 6..

Regional

The standard retailers and their associated regions can be seen in Table A.3. The AGL region includes the main population centres of the state such as Sydney, Wollongong and Newcastle. Hence a majority of NSW small customers are in this region.

Table A.3 Gas standard retailers

Standard retailer	Region
AGL	Sydney and the surrounding regions: Dubbo, Orange and Parkes.
ActewAGL	Areas near the ACT border and to the south east of the state.
Origin Energy (through Country Energy)	Inland cities such as Tamworth and the south west of the state.
Origin Energy	Murray Valley and Albury.

We note that the market share held by standard retailers in the ActewAGL and Origin Energy regions is particularly high. Origin Energy and AGL state in their submissions

that the regulated rate in the Origin Energy areas is low.²⁷⁹ Origin Energy also state that the expected regulated rate in the County Energy region will provide a negative return in FY13.²⁸⁰ EnergyAustralia considers that retailers may not enter some gas distribution regions "unless they are confident that margins on the regulated tariff are reasonable and consistent in all years."²⁸¹ Dual fuel offers may be discouraged in a situation where the regulated rate is low in one fuel even if a profit can be made in the other fuel.²⁸²

A.2 Demand side - whether NSW is an attractive market for energy retailers

A.2.1 Introduction

In the following section we examine the distribution and fuel usage of small customers in NSW. This information is important to determine the attractiveness of NSW to potential new energy retailers. For this section, Victoria has been used as a baseline comparison as it is the most populous state to have previously been determined to have a competitive market in an AEMC retail competition review.

NSW is the most populous state in Australia with almost seven million residents according to the 2011 census.²⁸³ The population of NSW is largely located in the Sydney basin. About 4.4 million people live in the Greater Sydney region with approximately 400,000 in Newcastle-Maitland and 270,000 in Wollongong. There has been sustained population and income growth over the period of FRC in NSW.

A.2.2 Electricity customers

We note that the number of connections for electricity has increased since the beginning of FRC and that there are approximately 3.3 million electricity small customer connections in NSW. Approximately half of all small customers in NSW are in the Ausgrid region. About a quarter of the connections are in each of the Essential and Endeavour regions.

Across all NEM jurisdictions, there has been reduced demand for large scale network delivered generation in recent times. Increased energy efficiency measures and greater penetration of residential solar photovoltaic (PV) are potential factors. IPART estimates there have been around 160,000 installations of solar units by residential and small

²⁷⁹ AGL, Issues Paper submission, 8 February, 2013, p. 6; Origin Energy, Issues Paper submission, 8 February 2013, p. 8.

²⁸⁰ Origin Energy, Issues Paper submission, 8 February 2013, p. 8.

²⁸¹ EnergyAustralia, Issues Paper submission, 12 February 2013, p. 5.

²⁸² EnergyAustralia, Issues Paper submission, 12 February 2013, p. 5.

²⁸³ Australian Bureau of Statistics 2012, Australian Bureau of Statistics, viewed 5 March 2013, <http://www.censusdata.abs.gov.au/census_services/getproduct/census/2011/quickstat/1>.

business customers, with a combined capacity of over 358 MW.²⁸⁴ AEMO estimates that rooftop PV systems generated 0.7 per cent of demand in 2011.²⁸⁵ AEMO further consider that the installed capacity may reach approximately 1,900 MW for the NSW/ACT region, by 2020.²⁸⁶

The increasing penetration of solar PV may impact on the attractiveness of the market since there may be impacts on the demand and therefore profitability of solar PV generating customers.

A.2.3 Gas customers

Jemena notes that approximately 62 per cent of households in NSW have access to a gas connection and of these households only 70 per cent are actually connected to the gas network.²⁸⁷ This would indicate that just over 40 per cent of households are connected to gas in the state. Alinta notes that a lack of available gas supply is not a rural/urban divide as there are "significant pockets of urban areas" without available gas connections.²⁸⁸

As a consequence, the gas market in NSW is smaller than that of Victoria. In NSW there are approximately 1.2 million small customer connections in comparison to Victoria where approximately 1.9 million small customers are connected to the gas network. Furthermore the amount of gas used per connected customer is lower than in Victoria. The average Victorian small customer consumes 63GJ of gas per annum in comparison to an average NSW consumption of 23GJ per annum.²⁸⁹ Figure A.6 illustrates the difference in residential gas loads between Victoria and NSW.

²⁸⁴ IPART, Solar feed-in tariffs, March 2012, p. 24.

²⁸⁵ AEMO, Rooftop PV information paper, 2012, p. 16.

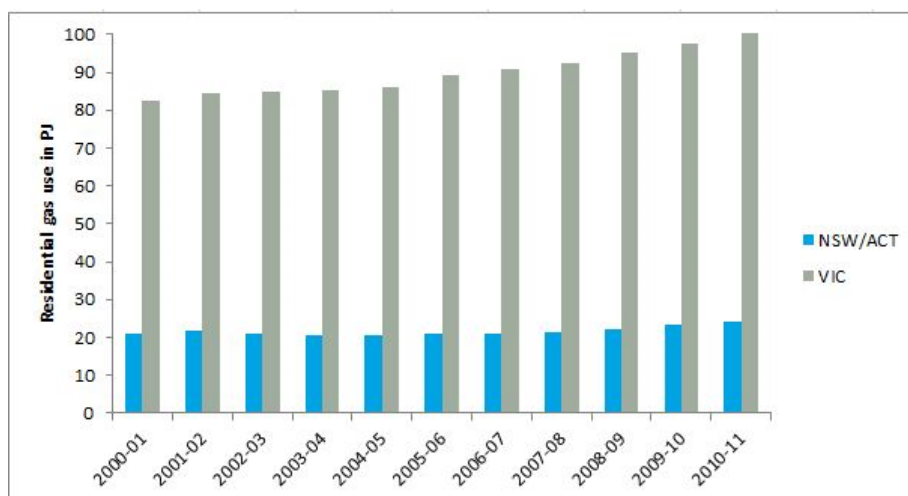
²⁸⁶ AEMO, Rooftop PV information paper, 2012, p. 15.

²⁸⁷ Jemena, Issues Paper submission, 8 February 2013, p. 2.

²⁸⁸ Alinta, Issues Paper submission, 8 February 2013, p. 3.

²⁸⁹ Hughson B & Johnson MM, *Gas wholesale markets and retail competition in NSW and Victoria*, July 2012, p. 39

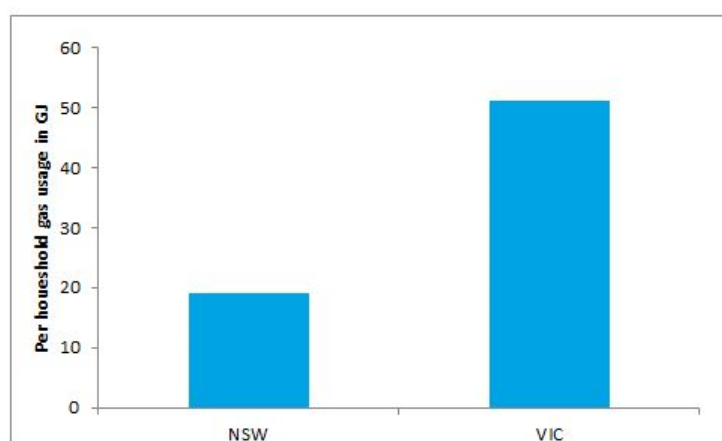
Figure A.6 Comparison between residential gas used in Victoria with NSW/ACT



Source: BREE, 2012 *Australian Energy Statistics* (<http://bree.gov.au/publications/aes-2012.html>).

Figure A.7 shows the estimated level of annual gas use per connected household in NSW and in Victoria. Note that the NSW data is from 2010, while the Victorian data is from 2007. Due to the lower gas usage in NSW, both in total and on a per customer level, this state may not be as attractive to gas retailers as Victoria. Customers may also be less willing to invest the time and effort of researching the best market offer in a situation where the gas bill represents a smaller proportional expense.

Figure A.7 Comparison between average residential gas usage in NSW and Victoria



Source: IPART, 2010, *Residential energy and water use in Sydney, the Blue Mountains and Illawarra*, p. 77. Source: Department of Sustainability and Environment (Victoria), *Household energy use*, 2009.

The combination of these factors may mean that new entrant retailers may be less willing to enter the gas market by itself. PIAC notes that some retailers apparently only offer gas products as part of a dual fuel offer.²⁹⁰ As such, gas does not in itself

²⁹⁰ PIAC, Issues Paper submission, 8 February 2013, p. 16.

represent an individual market for retailers, but rather is a component of a broader dual fuel market.

A.3 Barriers to entry, exit and expansion

A.3.1 Introduction

Entry, expansion and exit of firms plays a central role in determining the structure and level of competition in a market. A new entrant, or a firm who expands its existing business, can impose a competitive discipline on incumbent retailers, promoting effective competition. Where barriers to entry, expansion and exit exist, an incumbent firm's behaviour is less constrained. This can lead to prices being maintained above competitive levels and inefficient service delivery.

Barriers to entry may be regulatory, in the sense that government regulations impose costs that might deter new entrants. They could also be non-regulatory, such as an inability to access wholesale energy at competitive prices. A common barrier to expansion is the capital required to fund growth activities, while exit barriers are likely to deter new entrants if there are large fixed costs that cannot be recovered if a firm chooses to exit.²⁹¹

This section sets out the Commission's assessment of barriers to entry, expansion and exit for the NSW electricity and gas retail markets. The analysis is separated into two sections:

- non-regulatory barriers to entry, expansion and exit; and
- regulatory barriers to entry, expansion and exit.

A.3.2 Non-regulatory barriers to entry, expansion and exit

Electricity and gas retailers purchase energy in wholesale markets, or by acquiring electricity generation and/or gas production assets. They must also arrange for the energy to be transported from power stations/production facilities to customers. It is therefore important to examine whether retailers are able to access all sections of the supply chain that are required for the delivery of energy to customers.

We have identified the following potential non-regulatory barriers that will be discussed:

- access to wholesale markets and competitive hedging facilities;
- economies of scale and scope; and
- exit costs.

²⁹¹ These are known as sunk costs.

Access to wholesale markets and competitive hedging facilities

Electricity and gas is considered separately in this section due to different wholesale market arrangements. For example, electricity is traded in five minute intervals through the NEM, while wholesale gas and pipeline capacity is mostly traded bilaterally, on a confidential basis.

Electricity

Electricity retailers act as an intermediary between the wholesale market and customers. In doing so, they undertake risk management activities that shield customers from spot price volatility. Establishing a competitive retail business therefore depends on the ability of new entrants to access risk management facilities associated with purchasing electricity from the NEM.

For a new entrant retailer without generation assets, the most common strategy to manage price and volume risk is to enter financial contracts with generators and/or intermediaries that lock in the future price of electricity.²⁹² These contracts are known as derivatives and can be traded bilaterally in over the counter (OTC) markets or publicly on the Australian Securities Exchange.²⁹³

The effectiveness of derivatives as a risk management tool depends upon retailers being able to purchase these products at competitive prices, when required. One measure of the performance of over the counter and exchange traded markets is the degree of liquidity.

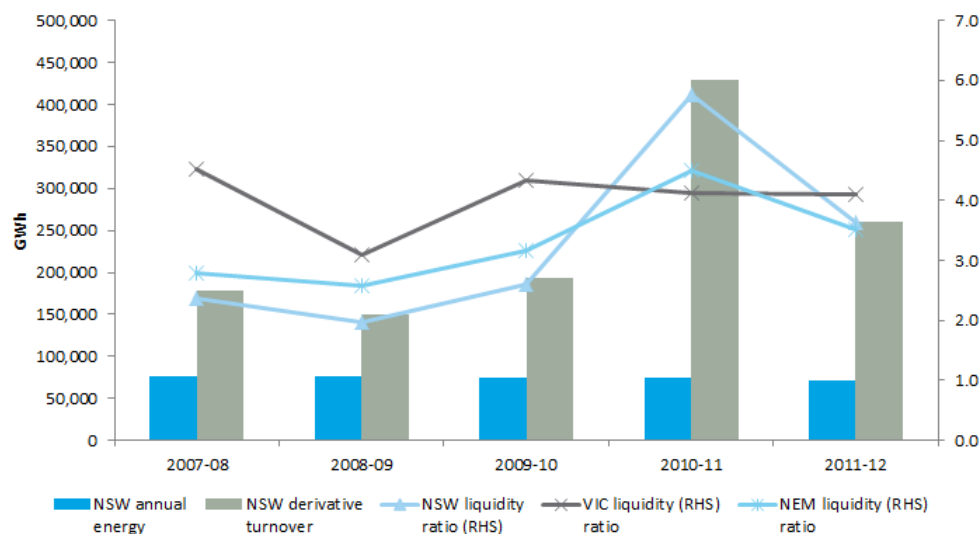
Contract market liquidity

Figure A.8 shows annual energy and electricity derivative turnover for NSW, and the ratio of derivative turnover to annual energy for NSW (liquidity ratio), Victoria and the NEM. Liquid markets usually have liquidity ratios several times above the rate of physical consumption. Factors that may affect the liquidity of NEM include the number and size of participants, the degree of interconnection and ability to hedge between regions, the level of vertical integration, and government ownership of generation assets.

²⁹² Price risk results from volatility of the spot price; whereas volume risk arises when the customer load exceeds the retailer's contracted load.

²⁹³ For an explanation of these markets, see: AEMC, *NEM financial market resilience*, Issues Paper, 8 June 2012, Sydney.

Figure A.8 Annual energy, derivative turnover and liquidity ratio comparison



Source: AFMA, *Australian financial markets report*, 2012; Excel data; d-cypha Trade; AEMC analysis.

On average, derivative trading in NSW was 3.3 times the underlying energy produced for the past five years. This compares with an average of 4 over the same period for the privatised Victorian generation sector. The NSW ratio was below the NEM average and Victorian market until 2009-10, before increasing sharply then returning back to the current level of 3.3 times energy generated. Since 2007-08, there has been an upward trend in the NSW liquidity ratio.

Three main reasons explain the relatively low levels of derivative trading in NSW between 2007-2008 and 2009-2010. The first two are interrelated: the uncertainty around the privatisation of state-owned generators and one continuation of the ETEF scheme. Trading was also likely affected by policy uncertainty from the Australian Government's decision to defer the introduction of the Carbon Pollution Reduction Scheme in 2010.

In 2011, the NSW Government privatised the trading rights of around 5,500 MW of state owned capacity, which likely initiated a balancing of hedging portfolios and contributed to the increase in 2010-11 volumes. Spot market volatility was also high that year, requiring participants to enter the market and adjust positions. Furthermore, renewed certainty around the introduction of a carbon price, and the adoption of standard terms in derivative contracts for dealing with the carbon price, may have increased the confidence of participants.²⁹⁴

Derivative market liquidity is likely to continue to improve once the privatisation process for the remaining NSW state-owned generators is finalised. This is expected to occur by 2014.²⁹⁵ Volumes were lower leading into the previous privatisation process

²⁹⁴ Australian Financial Markets Association (AFMA), *Australian Financial Markets Report*, 2011, p. 50.

²⁹⁵ NSW Treasurer, Green light for sale of NSW's electricity generators press release, 15 November 2012.

as the generation businesses shortened their trading horizons in anticipation of the assets being sold. Once the sale of the generators is finalised, this uncertainty will be removed and it can be expected that the new owners will recommence actively hedging output.

High levels of vertical integration can act to reduce derivative market liquidity, as businesses with balanced generation and retail portfolios may choose to contract internally and therefore not actively participate in these markets.²⁹⁶ Analysis from the AER shows that Origin Energy and EnergyAustralia supply over 75 per cent of retail electricity customers and control around 40 per cent of generation capacity in NSW.²⁹⁷ Of the remaining capacity, 55 per cent is controlled by state owned corporations, including Snowy Hydro.

Based on this analysis, around 60 per cent of generation capacity in NSW is largely operated on a merchant basis, supporting a view that access to the wholesale electricity market is not currently being impeded due to vertical integration.²⁹⁸ We note that the forthcoming privatisation of the remaining NSW state owned generators is expected to alter the ownership structure of the generation sector. This is discussed in the next section.

Retailer interviews and submissions

During retailer interviews, Sapere noted that some new entrants considered it more challenging to obtain hedging cover in NSW (as opposed to Victoria) since they find state-owned generators less willing to trade with smaller retailers. "Strict credit controls" of state-owned generators was identified as a barrier for smaller retailers, who commented that the NSW generation sector is seen as far less "proactive" in dealing with small retailers than the privatised Victorian sector.²⁹⁹

Retailers did note that the privatisation of trading rights for some generators had increased contract market liquidity in NSW, and that this was expected to continue to improve with the sale of the remaining assets. Sapere found that retailers are comfortable with the generation sector being privatised, although concerns exist around its future competitiveness if Macquarie Generation is not broken up when sold.

We note that Macquarie Generation and Delta Electricity generate a substantial amount of electricity consumed in NSW, with Macquarie Generation alone producing around 40 per cent of the state's requirements.³⁰⁰ The sale of these generators is therefore likely to alter the structure and behaviour of the market to varying degrees based on the outcome.

²⁹⁶ Vertical integration refers to an energy business with generation and retail assets.

²⁹⁷ AER, *State of the energy market*, 2012, p. 122.

²⁹⁸ Generated output, not just capacity, is also important to consider in this analysis. However, publicly available information is not available.

²⁹⁹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 38.

³⁰⁰ See: <http://www.macgen.com.au/>.

In submissions, Origin Energy and AGL put forward that wholesale electricity market risks can be hedged through a number of financial products and/or ownership of generation.³⁰¹

Summary

New entrant retailers can manage risk in the NEM through over the counter and exchange traded derivative markets. We found that the average liquidity ratio of these market for the past five years was 3.3 times underlying energy produced, which indicates a relatively liquid market. Overall, liquidity appears to be increasing as uncertainties around the ETEF, the first round of generator privatisations and the carbon price decrease. Finalisation of the forthcoming privatisation of state-owned generators may continue to support this upward trend.

No material issues were raised during interviews or submissions that gave the Commission cause for concern that efficient new entrants are unable to access electricity hedging facilities at competitive prices. However, the forthcoming sale of three large state-owned power stations is likely to change the market structure and competitive dynamic. In particular, increased vertical integration may have a negative impact on competition.

Access to wholesale gas and pipeline capacity

An energy retailer looking to enter the gas market requires access to gas supply and pipeline transportation capacity. This section will examine the market for natural gas and pipeline capacity, and whether barriers exist for new entrants.

Trading

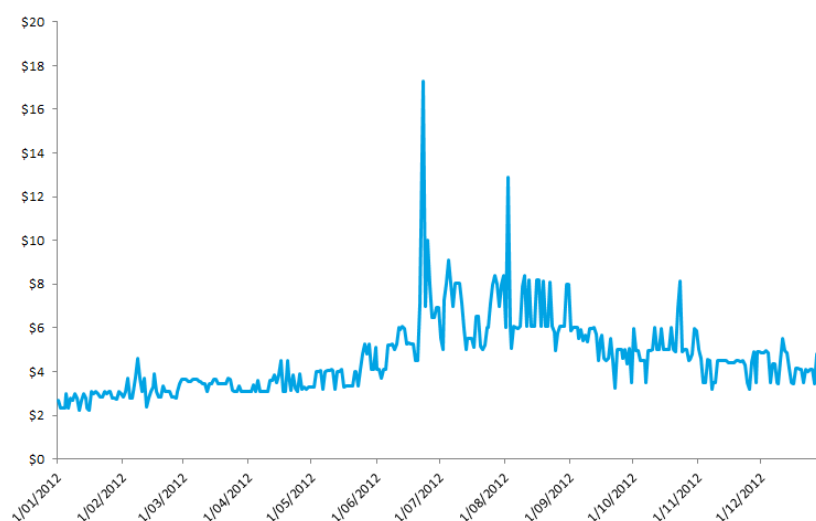
Wholesale gas and pipeline capacity is generally traded through long term bilateral contracts. For a retailer to enter the gas market, it must negotiate directly with a gas producer and pipeline owner.

The physical properties of transporting gas involve retailers nominating the volumes they require the day before delivery. As forecasting is uncertain, daily imbalances occur. Pipeline owners offer services to store or supply incremental gas to manage these imbalances. Imbalances can also be traded on the Sydney Short Term Trading Market (STTM). In this way, the STTM has increased the flexibility for retailers to manage their daily gas requirements.

A drawback of the STTM is that there are currently no financial products available to hedge price risk. Retailers looking to source large volumes of wholesale gas (as opposed to trading imbalances) from the STTM are therefore exposed to substantial price volatility. As can be seen in Figure A.9, the STTM price at the Sydney hub ranged from \$2-\$17/GJ in 2012, and could potentially rise to the current market price cap of \$400/GJ.

³⁰¹ Origin Energy, Issues Paper submission, 8 February 2013 p. 9; AGL, Issues Paper submission, 13 February 2013, p. 9.

Figure A.9 Sydney STTM daily ex-ante price 2012 (\$/GJ)



Source: AEMO 2012, STTM data.

Gas Supply

One measure of the availability of gas is the size and concentration of east coast proved and probable (2P) reserves.³⁰² As at February 2013, there was around 50,000 petajoules (PJ) of 2P reserves, compared to east coast consumption of 722 PJ in 2012.³⁰³ Although the quantity of reserves relative to domestic consumption is substantial, we understand that large volumes are committed to the east coast LNG projects.³⁰⁴

New entrant retailers do not require a large gas position, relative to east coast 2P reserves and domestic consumption, to enter the market. APG sold approximately 6.5 PJ of gas to its 128,000 retail gas customers across Victoria, NSW and Queensland in 2011-12. Of which, around 5.9 PJ was consumed in Victoria.³⁰⁵

Access to pipeline capacity

Gas is transported from production sites through transmission pipelines and delivered to lower pressure distribution networks, which are connected to residential properties. A new entrant retailer looking to transport gas to Sydney could do so via the South West Queensland Pipeline from Queensland, the Moomba to Sydney Pipeline from South Australia, the Eastern Gas Pipeline (EGP) from Victoria and/or through the Interconnect from the Victorian Transmission System. Gas is then delivered to customers via one of the three main distribution networks.

³⁰² Proved and probable reserves are defined as the volumes of gas reserves that are commercially recoverable with a probability of at least 50 per cent, under current economic and operating conditions.

³⁰³ EnergyQuest, *EnergyQuarterly*, February 2013, pp. 39 & 99.

³⁰⁴ While ownership of reserves is generally known, contracted volumes are not always publicly disclosed.

³⁰⁵ APG, Investor Roadshow, 12 September 2012; AEMC analysis.

Access to transmission pipeline capacity is predominately negotiated on a commercial basis between the pipeline owner and gas retailer. This is because the major transmission pipelines supplying Sydney are either unregulated or lightly regulated.³⁰⁶ The major NSW distribution networks are fully regulated with access governed by an AER approved access arrangement. Access arrangements set out the terms and conditions under which a third party can transport gas through the network.

Future market developments

As noted in the Australian Government's Energy White Paper, "Australia's eastern gas market has entered a period of extended transition as new coal seam gas (CSG) reserves and LNG developments reshape market dynamics and structure."³⁰⁷ There is considerable uncertainty as to the eventual size of the east coast LNG export industry and how increasing demand for gas will impact supply and prices.

The AEMC considers that any upward pressure on gas prices from a shift in demand is unlikely to decrease retail competition in the medium term. This is because supply contracts held by incumbent retailers are subject to price review mechanisms. One major NSW gas retailer is currently in price negotiations with major suppliers covering 80 per cent of existing contracts,³⁰⁸ while the majority of NSW gas supply contracts are set to expire by 2018.³⁰⁹

The AEMC notes that a number of initiatives are underway through the SCER to enable gas supply to respond flexibly to changes in market conditions. A major development is the establishment of a new gas supply hub based at Wallumbilla in Queensland, which is expected to improve transparency and facilitate the efficient trading of gas in upstream markets.³¹⁰ The supply hub is scheduled to commence operations in 2014 and will provide another option for NSW gas retailers to purchase wholesale gas.

Retailer interviews and submissions

During retailer interviews, Sapere found that participants consider gas a more complex business for new entrants than electricity. The reasons mostly relate to access to wholesale gas and pipeline capacity, and trading arrangements.

With respect to wholesale gas, some participants said they effectively have to "make a punt" on how fast they expect to grow when entering gas and pipeline contracts. New entrant retailers noted that it is difficult to purchase small amounts of gas from producers and that procuring wholesale gas in the STTM is too risky. An inactive

³⁰⁶ AER, *State of the energy market*, 2012, p. 109.

³⁰⁷ Australian Government, *Energy White Paper*, 2012, p. 140.

³⁰⁸ EnergyQuest, *EnergyQuarterly*, February 2013, p. 22.

³⁰⁹ Bureau of Resources and Energy Economics (BREE), *Gas market report*, 2012, p. 50.

³¹⁰ See: <http://www.scer.gov.au>.

second tier retailer said that it is not looking at entering the NSW gas retail market due to concerns around the market structure and wholesale arrangements.³¹¹

Smaller retailers commented on the difficulties of balancing gas on distribution networks. The main concern appears to be estimating how much gas is required at each delivery point and the penalties incurred if actual consumption is above or below forecast. Procedural issues related to transferring customers were also raised, with two retailers suggesting that there are no real Business to Business (B2B) procedures, which can make it difficult to acquire a customer.³¹² However, Jemena note that the NSW gas retail market design provides a ready means for retailers to enter and compete for small customers.³¹³ This issue is discussed further in Box A.2.

Uncertainty around future gas supplies in light of the emerging east coast LNG export industry was raised. One large retailer noted that currently there was plenty of gas, but this may change once LNG exports commence. Another put forward that there was uncertainty around future supply and price, although all retailers were facing the same issues. Some respondents noted that the development of NSW CSG may play a role in averting any gas shortages.³¹⁴

In submissions, Origin Energy indicated that there are no barriers to entry in gas retailing as two new retailers are actively competing in the market.³¹⁵ However, Momentum suggested that barriers are high for new entrants as producers seek a higher price from low volume purchasers, and entering long term contracts was risky due to uncertainties around retail price and volumes.³¹⁶

Evidence of new entry

A number of market participants have raised concerns around wholesale gas and pipeline capacity being a barrier to entry for new gas retailers. These issues generally relate to the arrangements for trading gas and pipeline capacity, which are based on bilateral contracts.

While the AEMC notes that securing competitive supplies of gas and pipeline capacity may be more difficult for smaller retailers (compared to electricity), two recent new entrants have proved that any barriers that do exist are not unmanageable.³¹⁷

³¹¹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 47.

³¹² Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 48.

³¹³ Jemena, Issues Paper, 8 February 2013, p. 1-2.

³¹⁴ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 48.

³¹⁵ Origin Energy, Issues Paper submission, 8 February 2013 p. 9.

³¹⁶ Momentum, Issues Paper submission, 15 February 2013 p. 2.

³¹⁷ Australian Power & Gas (APG) and Lumo are recent new entrant gas retailers in NSW. We note TRUenergy entered the market in 2004 before acquiring EnergyAustralia's customers.

APG and Lumo entered the NSW gas retail market in 2011 and 2012 respectively. As at 31 December 2012, APG had around 12,000 gas customers in NSW, up from 1,000 in 2011, and are actively seeking to increase their number of dual fuel accounts.³¹⁸ Lumo is supporting its expansion into NSW by leveraging existing Victorian gas arrangements.³¹⁹ The AEMC understands this strategy is not uncommon, particularly as the larger Victorian retail gas market creates opportunities for participants to expand at a faster rate and realise scale efficiencies sooner.

Box A.2: NSW business to business (B2B) processes

Issues relating to how retailers interface and communicate with distribution networks were raised during interviews. We understand that the system employed in NSW, which processes service order requests, customer transfer notifications, network billing and other services between retailers and distribution networks, is different to other states.

As discussed above, one potential strategy employed by NSW gas retailers is to leverage their existing position in the Victorian market. This allows retailers to seek economies of scale by increasing the utilisation of back office infrastructure and staff expertise. The efficiencies realised through this strategy may be reduced if retailers are required to learn and implement different network systems to those used in Queensland, Victoria and South Australia.

During consultation on this draft report, the AEMC would welcome further comments from market participants on:

- whether the NSW/ ACT B2B system is a material barrier to entry and/or expansion;
- estimated additional costs of expanding into the NSW retail gas market from another region to accommodate the system; and
- any other comments applicable to this issue.

Summary

Available evidence suggests that the structure of the wholesale gas market is not as conducive to entry as the electricity market. This is primarily due to difficulties smaller retailers may face in negotiating supply agreements with producers and pipeline owners, and the relatively inflexible nature of these contracts for a growing business. While the STTM supports on-market trade of daily gas imbalances, a lack of financial hedging products makes it risky for retailers to source wholesale gas from.

The AEMC acknowledges that, for some participants, the wholesale gas market can be a challenging environment to operate in. However, two recent new entrants indicate that any barriers to entry that may exist are not insurmountable.

³¹⁸ APG 2013, Investor update, March 2013.

³¹⁹ Intratil 2012, Infratil Investor day presentation, p. 33.

We note that SCER initiatives, including the development of a gas supply hub in Queensland and voluntary pipeline capacity trading, may provide retailers with additional flexibility when building gas portfolios.³²⁰ During 2013 the AEMC will be undertaking a scoping study to review the east coast gas market arrangements to identify issues that may benefit from more detailed market development work. The AEMC will use the findings to inform future discussions with SCER and industry stakeholders.³²¹

Economies of scale - electricity and gas

Economies of scale exist when a retailer's average costs decrease as they acquire customers and sell larger volumes of energy. They are present when a retailer faces high fixed upfront costs that do not vary as the business grows. Economies of scale are important to consider as they can provide a retailer with an absolute cost advantage relative to its competitors and therefore act as a barrier to entry. High fixed costs that provide for economies of scale may also deter new entrants.

In energy retailing, an example of economies of scale may be the cost of installing a billing system that collects customer usage information and calculates the amount payable. If the system costs \$2 million to install and can serve up to 500,000 customers, the average cost per unit of energy sold (or per customer) begins to decrease as the new retailer grows. Where economies of scale exist, there is often a critical mass of customers a retailer must acquire before cost reductions are realised. This can place new entrants at a competitive disadvantage relative to established retailers.

New entrant retailers have been adopting business models that render some of the fixed costs historically associated with energy retailing variable. For instance, APG claims to achieve lower operational costs per customer than incumbent retailers through a highly variable and outsourced business model.³²² Direct marketing, customer transfers, and billing and payments are all outsourced to specialist organisations. By engaging third parties to perform these functions, the retailer can scale its expenditure on these activities as appropriate, realising economies of scale and lower average costs sooner.

One of the benefits of outsourcing is that entry by small retailers is profitable more quickly. It can also reduce capital expenditure required to enter the market, which also reduces sunk costs and costs associated with financing. This can lower barriers to exit, further reducing barriers to entry and supporting greater competition.

³²⁰ SCER Standing Committee of Officials (SCO) 2013, Explanatory Material on the Draft National Gas (South Australia) (Gas Trading Exchanges) Amendment Bill 2013 and Draft National Gas (Gas Trading Exchanges) Rules.

³²¹ AEMC, Strategic Priorities for Energy Market Development Discussion Paper, p. 41.

³²² APG 2011, Australian Power & Gas FY11 Results, p. 32.

Interviews and submissions

In interviews, Sapere found that retailers generally recognised that there are economies of scale within energy retail businesses, although the importance depends on the business model. It was noted that large retailers are required to spend substantial capital to realise scale and operational efficiencies, where smaller retailers do not need to significantly invest in systems that can be outsourced.³²³

Several smaller retailers indicated that they can access economies of scale by outsourcing operations, with fully serviced local and overseas billings systems available. One retailer pointed out that economies of scale across regions was also relevant, explaining that its expansion into NSW could be done by absorbing customers into existing Victorian systems. Alternatively, some larger Victorian retailers were adopting an outsourcing approach when they expand interstate.³²⁴

Origin Energy put forward in its submission that “economies of scale can be accessed by outsourcing customer service and sales operations to service providers, with a competitive field of suppliers available”.³²⁵ AGL pointed out that a report by Frontier Economics for IPART in 2009 concluded that while there are economies of scale associated with retailing, “they are largely achieved at relatively low customer numbers, so that retailers operating at different scales can achieve similar average costs”.³²⁶

Summary

Retailer interviews and submissions indicate that economies of scale are likely present in energy retailing. However, evidence suggests that the extent depends on the retailer's business model and that new entrants are able to access efficiencies through outsourcing. Second tier retailers, who we would expect to be most affected, did not raise economies of scale as an unmanageable barrier to entry.

Based on the available evidence, the Commission does not consider that economies of scale are preventing the entry or expansion of efficient new entrant retailers.

Economies of scope - electricity and gas

Economies of scope occur when it is cheaper to produce two products together rather than separately. In energy retailing, economies of scope exist when a retailer is able to offer electricity and gas as one dual fuel product. Dual fuel reduces a retailer's average costs as fixed costs can be spread over a wider customer base. It can also decrease acquisition costs where customers sign up for electricity and gas at the same time.

³²³ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 43.

³²⁴ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 44.

³²⁵ Origin Energy, Issues Paper submission, 8 February 2013 p. 9.

³²⁶ AGL, Issues Paper submission, 13 February 2013 p. 6.

Interviews and submissions

Retailer interviews suggest that economies of scope primarily exist in customer acquisition and retention costs. However, it was noted that offering gas with electricity is not as important as being able to offer electricity only, given that not all customers are connected to gas in NSW. Of the retailers interviewed, no retailer holds a gas licence without holding an electricity licence and gas is generally not offered on a stand-alone basis unless a customer requests it.³²⁷

Sapere note that three new entrant retailers who do not retail gas in NSW, and that target medium to large business customers, considered that not retailing gas is not an impediment, but that having gas “could win a few extra customers”. Other retailers said dual fuel is an important part of their business proposition and helps them to win customers, while one of the big retailers indicated that having gas did help with selling electricity and vice versa.³²⁸

In submissions, Origin Energy noted that economies of scope are not a barrier for single fuel retailers and “they merely enhance the efficiency and competitiveness of dual fuel retailers”.³²⁹ EnergyAustralia put forward that there are some benefits to being a “one stop shop” in terms of cost to acquire, although customers shop around for the best deal in each fuel.³³⁰ Momentum’s view was that dual fuel contributes to overcoming low margins; however, barriers to entry in the NSW gas market prevent new retailers from realising these efficiencies.³³¹

Summary

Evidence from retailer interviews and submissions suggests that, while there are economies of scope in customer acquisition and retention costs, given that not all customers are connected to gas in NSW, this is not seen as a significant advantage for dual fuel retailers.

Based on the available evidence, the Commission does not consider that an inability to offer dual fuel products and achieve economies of scope is preventing the entry or expansion of efficient new entrant retailers.

Exit costs - electricity and gas

Barriers to exit exist where entry requires substantial capital investment that cannot be recovered on exit (sunk costs), in addition to actual costs incurred when a retailer goes through the process of exiting the market. For an energy retailer, these may include

³²⁷ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 67.

³²⁸ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. xi.

³²⁹ Origin Energy, Issues Paper submission, 8 February 2013 p. 6.

³³⁰ EnergyAustralia, Issues Paper submission, 8 February 2013 p. 3.

³³¹ Momentum, Issues Paper submission, 15 February 2013 p. 2.

breaking wholesale energy supply contracts and property leases, staff redundancies and reputational damage.

Interviews and submissions

Some interview respondents found the question around exit costs perplexing as “they did not enter the market with a plan to exit the market”. There was also a view that the costs of exiting were high due to protection measures that require a retailer to honour the retail supply contracts they have with customers. Another retailer said that the only barrier to exit was to find another retailer to novate or sell the contracts across to.³³²

Gas retailing costs were described as being more heavily fixed than electricity as wholesale gas and pipeline capacity are bought largely on take-or-pay terms.³³³ One retailer said that it will cost \$30 million to enter the gas market for one customer or 300,000 customers.³³⁴ It was also noted that exiting the market can occur when existing contracts expire, although as this can occur at different times, it can be a complicated process.

Summary

Exit costs were not emphasised as a barrier to entry or exit by participants during consultation. The Commission considers that exit costs are faced by new entrants and incumbents alike and established retailers are not advantaged. Moreover, a smaller retailer might find it easier to transfer its retail customers and on-sell electricity and gas supply contracts, as these may be more easily absorbed by a larger competitor. We also note that exit costs can be managed through timing of exit, on-selling of contracts and/or renegotiation with counterparties to minimise costs.

A.3.3 Regulatory barriers to entry, expansion and exit

Regulatory obligations governing energy retailing have an important influence on the way competition develops. Where regulation is prescriptive, or the compliance costs are high, potential new retailers may be dissuaded from entering the market.

The purpose of this section is to set out the Commission’s analysis of the regulatory obligations that are relevant for the NSW review. It is divided into the following parts:

- the effects of price regulation on the willingness or ability of new retailers to enter or expand;
- the capacity of retailers to comply with prudential requirements and credit support arrangements; and

³³² Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 43.

³³³ In this context take-or-pay is a contractual term that requires the retailer to pay for a minimum amount of gas and/or pipeline capacity regardless of whether it is used.

³³⁴ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 49.

- state-based regulatory costs and obligations.

Retail price regulation - electricity and gas

Retail price regulation can act as a barrier to entry in two ways. The first is if the regulated price is set below an efficient retailer's costs. If this occurs, new entrants will be deterred and existing ones may stop actively competing or exit the market. Conversely, if the price is set above the competitive level, customers may pay more than the efficient costs of supplying the service.

The second is the regulatory risk around future decisions by the regulator. For instance, in the current regulatory period the regulator may have determined a price that accurately reflects the costs of an efficient retailer. However, market entry decisions are based on an assessment of risks and expected revenues over a number of years. Future regulatory decisions are uncertain and these pose risks for existing and potential new entrant retailers looking to enter the market. Regulatory uncertainty, and the risk of the regulated price being set below efficient levels, can dissuade the entry of new entrants and expansion of existing retailers.

Interviews and submissions

During interviews, Sapere found that retailers consider price regulation to be hindering entry and expansion in NSW. Several inactive retailers looking to enter the market said that continuation of retail price regulation and IPART's 2013 to 2016 review of regulated electricity prices for electricity were major factors influencing their decisions.

An inactive retailer said that it was not just about the level of pricing today, but also about regulatory certainty going forward. One of the big three retailers said that regulatory risk is the number one topic that is raised in discussions with investors and that this was heightened after the Queensland Competition Authority's 2012-13 determination.³³⁵

Sapere considers that regulatory risk has been heightened in light of the electricity price freeze in Queensland for 2012-13 and the proposed (but now halted) reopening of the price determination in South Australia. While the regulatory process in NSW was for the most part viewed as "sensible", these events are said by retailers to be having a spill-over effect towards jurisdictions that are not yet deregulated.³³⁶

Sapere found that retailers considered that the regulated price had been set too low in the Ausgrid area and this was affecting their ability to expand. Two retailers indicated that small customers in the Ausgrid area are not profitable for new entrants due to the

³³⁵ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, pp. 36-37.

³³⁶ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 36.

regulated retail price.³³⁷ As a result, these retailers had reduced their marketing efforts for this region.³³⁸

Sapere also found that the lower margin allowed for gas, together with the complexity of the gas market arrangements, has reduced the entry and expansion plans of gas retailers. This in turn is hindering the entry of retailers offering dual fuel products.³³⁹

In submissions, Origin Energy put forward that the regulated retail gas tariff in the Envestra (ex-Country Energy) area is not cost reflective and it is expected that the 2013-14 determination will allow a negative margin.³⁴⁰

Summary

Retail price regulation can act as a barrier to entry and expansion due to risks around the regulated price being set below the efficient cost of supply in current and future determinations. Incumbent, new entrant and prospective retailers claim regulatory risk is the major factor in their investment decisions around whether to enter a market and compete.

Recent regulatory decisions look to be contributing to investment uncertainty in the sector. APG has stated that they have not actively marketed in Queensland since July 2012 due to the Queensland Government's decision to freeze regulated electricity prices for 2012-13.³⁴¹ Origin Energy estimates that this decision reduced its electricity gross profit by \$58 million, while the impact on AGL was around \$30 million.³⁴² Sapere found in interviews that several retailers had ceased marketing in Queensland due to the price freeze.³⁴³

The Commission notes that under retail price regulation there has been eight new entrant electricity retailers and two new entrant gas retailers enter the NSW market in recent times, including Click Energy in March this year, indicating that not all prospective retailers are deterred. This is consistent with NERA's profit margin analysis, which found that regulated price margins are currently attractive for most customer types.³⁴⁴

³³⁷ We note that this comment is consistent with NERA's profit margin analysis undertaken for this review. See Appendix C for further information.

³³⁸ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 37.

³³⁹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, pp. 67-68.

³⁴⁰ Origin Energy, Issues Paper submission, 8 February 2013 p. 8.

³⁴¹ APG, Investor Update, March 2013, p. 7.

³⁴² AGL, FY13 Interim Results presentation, 27 February 2013, p. 4; Origin Energy, United States Roadshow, March 2013, p. 15.

³⁴³ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 36.

³⁴⁴ The Ausgrid area is an exception - see Appendix C for further discussion of NERA's profit margin analysis.

Prudential and credit requirements - electricity and gas

An important factor in ensuring the stability and financial integrity of the NEM and STTM is maintaining adequate prudential requirements to manage financial risks and minimise the effect on the market of non-payment.

Prudential requirements are administered by AEMO, with the bulk provided in the form of bank guarantees. The amount of credit support required is calculated by AEMO in accordance with the National Electricity and Gas Rules. Retailers may also be required to provide credit support to distribution networks to manage the business's exposure to non-payment of distribution charges.

This section considers whether compliance with prudential requirements limits new entry or restricts existing retailers from expanding.

Interviews and submissions

Retailers commented during interviews that market prudential requirements make retailing a cash intensive business. Two smaller retailers explained that as market share increases, financial obligations around prudential obligations also increase.³⁴⁵

NSW network credit support arrangements were considered an impediment to expansion as they require retailers to have a credit agency rating. However, retailers noted that the NSW network credit support arrangements will be replaced under the NECF with the Victorian approach, and this should improve expansion conditions for smaller retailers.³⁴⁶

Summary

The Commission notes that retailers are required to commit a proportion of working capital to meet market prudential requirements and network credit support arrangements. However, as noted above and in retailer interviews, these costs are scalable. While financing costs associated with working capital facilities may be higher for new entrants than established retailers with credit histories, these should decrease as the business becomes established.

NSW network credit support arrangements are currently viewed as a barrier for smaller retailers; however, these will change to an approach in line with what is used in Victoria with the introduction of the NECF in NSW in 2013.³⁴⁷

Based on evidence presented in retailer interviews, including the limited emphasis placed on this issue by participants, the Commission does not consider prudential and

³⁴⁵ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 39.

³⁴⁶ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 39-40.

³⁴⁷ Noting that the revised credit arrangements will be phased-in during the next round of network regulatory determinations.

credit requirements to be an unmanageable barrier to entry or expansion by efficient new entrant retailers.

State-based regulatory costs and obligations - electricity and gas

NSW retail energy businesses must comply with a range of state-based regulatory obligations. Some of these obligations are prescribed by legislation, regulation or contained in licence conditions.

The focus of this section is whether the compliance costs of regulatory obligations that apply in NSW dissuade potential new entrants or impact adversely on the capacity of existing retailers to compete.

Interviews and submissions

Several retailers raised the issue of NSW regulatory and licensing requirements being a barrier to expansion in NSW. There was a view that the retail sector is highly regulated and that it is difficult for a small retailer to keep up with the requirements.

Retailers commented on the divergence of environmental and green schemes across jurisdictions as a factor that increases cost and complexity.³⁴⁸ A licensed but inactive retailer indicated that regulatory divergence is a consideration in terms of costs of entering a market.

Several retailers were critical of the NSW licensing requirement to print a message in “pentane red” ink, in a prescribed font, about the carbon price. Two retailers indicated that the requirement in NSW to offer green power to customers is a barrier to entry and expansion.³⁴⁹

One of the respondents commented that the postponement of the NECF in NSW has been a significant barrier to entering the NSW market. This is because the NECF will standardise some regulatory requirements across states and is expected to reduce costs for retailers operating in multiple states.³⁵⁰

Summary

Costs related to acquiring and complying with retail energy licences were not emphasised in interviews or submissions, other than noting that the retail sector is highly regulated and that it can be difficult for a small retailer to keep up with the requirements.

³⁴⁸ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 41.

³⁴⁹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 41-42.

³⁵⁰ Sapere, *Review of Competition in the Retail Electricity and Natural Gas markets in New South Wales*, February 2013, p. 41.

Implementation of the NECF in NSW on 1 July 2013 is intended to standardise regulatory requirements across some jurisdictions. This is expected to reduce costs and barriers to entry for retailers, especially those active in other jurisdictions.

The Commission considers that, on balance, the evidence suggests that the costs of regulatory compliance for NSW retailers are not deterring potential efficient new entrants. This is further reinforced by recent observations of new entry in the electricity and gas retail markets.

A.4 Draft conclusions

Eight electricity and two gas new entrant retailers competing in the NSW retail market provides the Commission with confidence that the market structure is conducive to effective competition.

We note that the high level of concentration between the three largest retailers that currently exists is most likely a legacy of the state-owned market structure. For instance, the ETEF is likely to have impeded competition by lowering the risk profile for regulated contracts compared to market contracts. Additionally, historical tariffs may have impeded competition by not being set a level that would encourage competition.

A number of market participants raised concerns around barriers to entry in the wholesale gas market. While the Commission acknowledges that the gas market may be more challenging for some retailers to participate in, two new gas retailers provide evidence that any barriers that do exist are manageable. We also note that SCER is implementing a number of initiatives that are expected to increase the flexibility and transparency of the wholesale gas market.

Retail price regulation can act as a barrier to entry and expansion due to risks around the regulated price being set below the efficient level. This risk was raised by incumbent, new entrant and prospective retailers alike as the major factor in whether they enter the market and compete for customers.

Evidence of relatively low barriers to entry in electricity, manageable barriers to entry for gas, and a market structure conducive to competition, provides the Commission with confidence that retail price regulation is no longer required in NSW.

B Market conduct

Box B.1: Summary of chapter

The Commission's draft finding is that retailer and customer behaviour in the electricity and gas markets is consistent with behaviour in a competitive market. Our main draft findings are:

- customer awareness of their ability to choose their retailer is high in both gas and electricity;
- information for customers to help them compare offers could be improved to enhance the effectiveness of competition;
- rates at which customers switch retailers are high compared to switching rates in other jurisdictions and other comparable industries indicating that customers are actively participating in the market;
- the majority of electricity and gas customers are on market offers;
- there is some evidence of independent retailer rivalry;
- in addition to high switching rates, electricity customers are gradually switching to small new entrant retailers indicating that smaller retailers are gaining customers;
- although product differentiation and innovation is more limited than in Victoria, this is largely driven by:
 - customer demand for lower prices;
 - the availability of advanced metering technology; and
 - the existence of price regulation.
- marketing expenditure has significantly increased since privatisation indicating that retailers are actively marketing to gain new customers and retain existing ones; and
- gas customers have experienced less direct sales approaches by retailers than electricity customers indicating that there is less retailer rivalry in gas.

These findings contribute to our conclusion that competition in the NSW electricity and gas markets is effective. The Commission has identified the need to provide appropriate and effective information to customers as an area for improvement by retailers and government to further enhance the effectiveness of competition.

B.1 Introduction

This appendix sets out the how customers and retailers of the energy retail markets in NSW behave and whether this behaviour is consistent with what we would expect to see in an effectively competitive market.

In assessing how customers behave we have considered the exercise of market choice by customers, their awareness of competition, and the extent of information available to inform their decisions. To further assess customer behaviour in the markets, customer switching trends since the introduction of FRC are investigated including why customers are switching. This includes an assessment of trends in customers moving onto market offers with their existing retailer, as well as trends in customers switching between different retailers.

In order to determine whether competition in the dual fuel market is effective we need to consider retailer and customer behaviour in both the electricity and gas sectors.

In assessing how retailers of the markets behave this appendix considers the degree of rivalrous conduct between retailers. This includes assessing the nature and extent of products and services in the market, whether retailers are developing innovative new products in response to customer demands and the extent to which retailers are marketing to solicit new customers.

The rest of this appendix sets out:

- whether customers are exercising choice in the market; and
- whether retailers are actively competing in the market.

B.2 Exercise of market choice by customers

Although retailers can differentiate energy services on the basis of price, service and other non-price terms and conditions, customers generally regard energy as a homogenous and low involvement commodity. These characteristics can contribute to a perception on the part of the customer that the costs associated with switching may outweigh the benefits. That is, the time taken to search for alternative supply arrangements outweighs the potential savings gained through switching retailers.

The ability and willingness of customers to respond to price and service quality differentials across product offerings is an essential condition for effective competition. Where enough customers respond to price or quality differences by switching to products that better meet their needs, retailers will be encouraged to respond to these signals or risk losing patronage and customer share. In the absence of customer-based competitive pressure, retailers may develop a degree of market power which, if exercised, could result in customers being adversely affected by higher prices, reduced output and/or lower service quality.

Customers' ability to exercise market choice and their participation in the market is determined by three key factors, which are discussed in this section:

- customer awareness;
- ease of obtaining, understanding and comparing information; and
- switching behaviour.

This section sets out the evidence provided from consultant reports and submissions before providing our own analysis and conclusions.

B.2.1 Consultant reports

To assess the behaviour and attitudes of residential and small business customers of electricity and gas in NSW, the AEMC commissioned Roy Morgan Research to undertake both qualitative and quantitative surveys. The results from the research are incorporated into the analysis section below.

The AEMC also commissioned Sapere to undertake interviews with retailers to seek their views on the markets. Sapere states that retailers consider that:

- the level of customer awareness about the ability to switch electricity retailer is reasonable to high, although not as high as in Victoria;³⁵¹
- a number of related factors have increased awareness including price increases, media attention, sales activities of retailers, the privatisation of the retailers, One Big Switch, and the carbon price;³⁵²
- the main barriers to customer switching are customer inertia or apathy;³⁵³ and
- customer awareness about the ability to switch in gas is the same or slightly lower than in electricity as there are fewer gas retailers engaging in marketing activities.³⁵⁴

B.2.2 Submissions

Retailers broadly consider that customers are increasingly exercising market choice evidenced by increased switching rates, changes in market share and the decrease in the number of customers on the regulated tariff.³⁵⁵ In addition, they consider there is a

³⁵¹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in NSW - Report of Interviews with Energy Retailers*, February 2013, pp. ix and 27.

³⁵² Id., p.ix.

³⁵³ Ibid.

³⁵⁴ Ibid.

³⁵⁵ See for example: ActewAGL submission, 8 February 2013, p. 2.

wide range of quality information available to customers about different energy market offers including retailer web sites and third party comparator web sites.³⁵⁶

Customer groups appear less convinced that customers are exercising market choice even where there is evidence of switching. PIAC considers it is important to know what motivates customers to switch and whether customers are able to identify a better offer.³⁵⁷ It considers that this is particularly important in gas.³⁵⁸ It suggests that customers may simply assume that a retailer with competitive electricity rates will also have competitive gas rates or alternatively that customers may not be overly concerned about their gas bill and value the efficiency of dealing with one single retailer.³⁵⁹

Customer groups thought that more needed to be done in to providing information to customers.³⁶⁰ Choice notes that tariff structures are complex making it difficult to compare different offers. It considers that in these circumstances customers are less likely to choose the best plan for their circumstances from those available.³⁶¹ Both Choice and PIAC identified problems with price comparison web sites provided by regulators.³⁶² PIAC states that it is reluctant to endorse further reforms and anything increasing the complexity of the market before governments show a commitment to funding customer information programs and ensure industry compliance with regulation.³⁶³

B.2.3 Analysis

This section analyses each of the factors that help determine whether customers are exercising market choice as indicated above.

Customer awareness

Electricity

In the Roy Morgan survey more than 90 per cent of customers were aware of their ability to choose their electricity retailer.³⁶⁴ The surveys also revealed that customers were able to identify a number of different electricity retailers when asked.³⁶⁵

³⁵⁶ See for example AGL, Issues Paper submission, 13 February 2013, p. 10.

³⁵⁷ PIAC, Issues Paper submission, 8 February 2013, p. 17.

³⁵⁸ I.d., pp.17-18.

³⁵⁹ Ibid.

³⁶⁰ See for example NCOSS submission, 8 February 2013, p. 8.

³⁶¹ Choice submission, 8 February 2013, p. 6.

³⁶² PIAC, Issues Paper submission, 8 February 2013, p.21; Choice submission, 8 February 2013, p. 5.

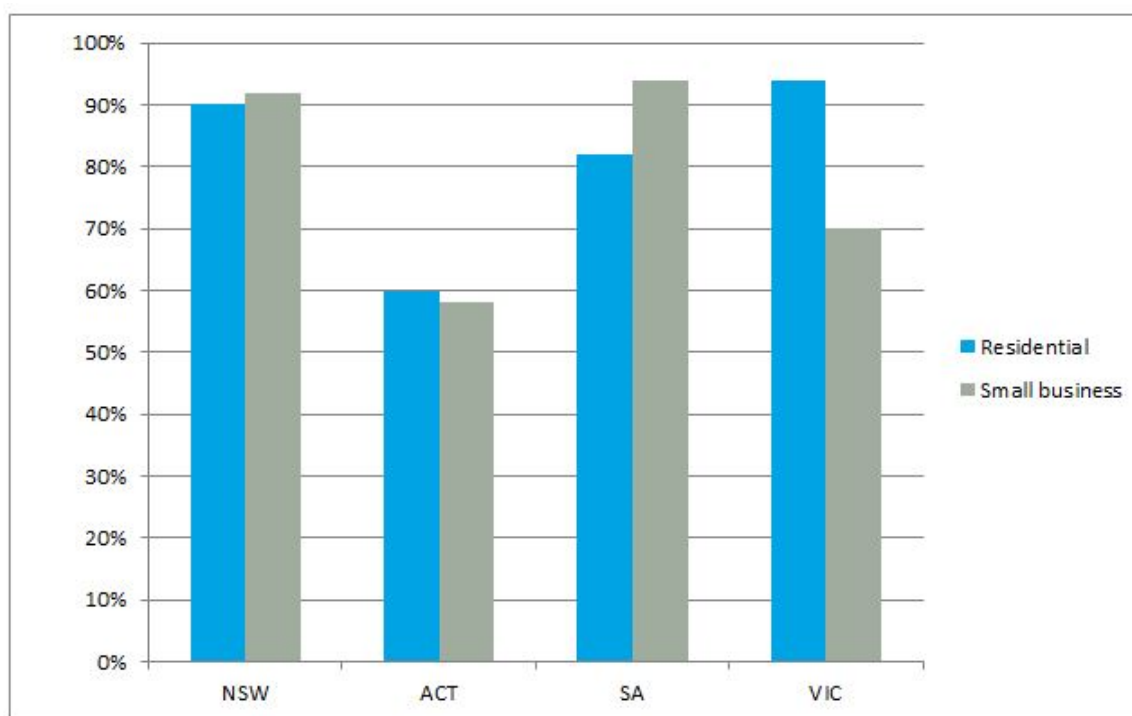
³⁶³ PIAC, Issues Paper submission, 8 February 2013, p. 21.

³⁶⁴ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 9; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 9.

³⁶⁵ I.d., p. 10; I.d., p. 10.

The results of the surveys are consistent with the results of IPART surveys covering Sydney, the Blue Mountains and Illawarra in 2010 and Hunter Gosford and Wyong in 2008 where 90 per cent of residential customers were aware that they could choose their retailer.³⁶⁶ In addition, the level of awareness present in NSW is high when compared to the levels of awareness in other states at the time of their reviews as set out in Figure B.1. The Commission considers these findings indicate that there is a high degree of awareness of residential and small business customers of electricity in NSW of their ability to choose their retailer.

Figure B.1 Customer awareness - electricity



Source: AEMC retail competition review surveys

To assist the AEMC determine whether customer experience of the markets differs by location Roy Morgan analysed the survey data by geographic area. For the purpose of assessing the data the different regions were categorised into metro and non-metro areas. Broadly Roy Morgan classified Greater Sydney and the Central Coast as metro areas and the rest of the state as non-metro.

Roy Morgan also provided the results of the survey when the Hunter and Illawarra regions are reclassified as metro areas. This was undertaken in light of a survey undertaken by PIAC outlined in Box B.2, which suggested that residential electricity customers in Sydney and surrounding areas (including the Hunter and Illawarra) were exposed to higher levels of competition than customers in regional centres. Where relevant we have referred to the results based on the reclassification. However, in general where we refer to the results of the survey we reference the original

³⁶⁶ IPART, *Residential energy and water use in Sydney, the Blue Mountains and Illawarra: Results from the 2010 household survey*, December 2010, p. 159.

categorisation. In general, the reclassification did not have a significant impact on the results.

Box B.2: PIAC survey³⁶⁷

- The PIAC survey was conducted in August 2010, before privatisation of the state-owned retailers.
- The survey was carried out in five regional areas. These were Cooma, Lismore, Bourke, Wagga Wagga and Orange. These regions were selected on the basis that they were geographically dispersed.
- The survey covered residential electricity customers only.
- The purpose of the survey was to consider the ability of customers of electricity in the areas surveyed to participate effectively in the market. It was undertaken to inform the AEMC's retail competition review.
- The study involved a household telephone survey of 200 electricity customers in each of the regions, in-depth interviews with 17 customers across the regions and a comparative analysis of the survey results with previous electricity customer surveys undertaken on behalf of the AEMC and IPART.

Based on Roy Morgan's initial classification of the regions, we observe that the level of customer awareness was higher in metro areas than non-metro areas. Only 86 per cent of residential customers in non-metro areas were aware that they could choose their retailer.³⁶⁸ However, this still represents a high degree of awareness. For example, the awareness of residential non-metro customers in NSW is still higher than the level observed in South Australia at the time the AEMC undertook its competition review. Eighty-two per cent of residential customers in South Australia were aware they could choose their retailer at this time.³⁶⁹

The results are slightly different from those of the PIAC survey. This survey identified that between only 63 and 82 per cent of respondents in the survey were aware of their ability to choose their retailer.³⁷⁰ On average, these results are lower than the results observed in the Roy Morgan survey. By comparison, according to the Roy Morgan survey 83 per cent of residential electricity customers outside of Greater Sydney, the Central Coast, Hunter and Illawarra were aware they could choose their electricity retailer. This evidence therefore suggests that the level of awareness amongst residential customers in non-metro areas has increased since the PIAC research was

³⁶⁷ PIAC, *Choice? What Choice?* June 2011.

³⁶⁸ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 9.

³⁶⁹ McGregor Tan Research, *AEMC Review of the Effectiveness of Competition in Electricity and Gas Retail Markets*, June 2008, p. 21.

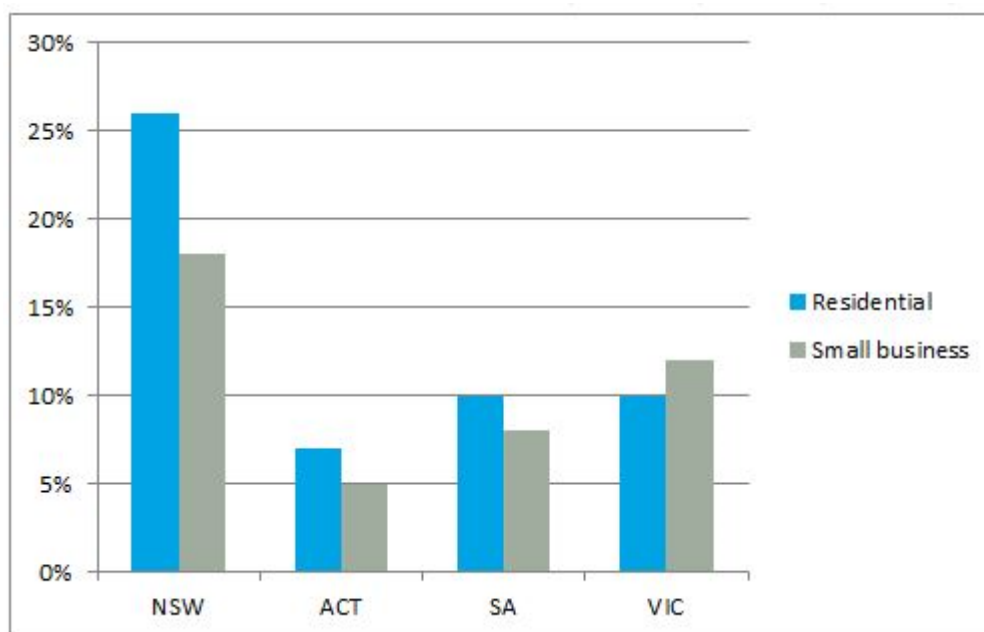
³⁷⁰ PIAC, *Choice? What Choice?* June 2011, p. 36.

undertaken in August 2010. Consequently, the Commission also considers the level of customer awareness in non-metro areas to be high.

Another measure of customer awareness is the extent to which customers search for a better deal either by contacting an energy retailer or just by looking for information related to switching energy arrangements.

According to the Roy Morgan survey about a third of electricity customers have looked for information relating to switching or changing energy arrangements in the last 12 months.³⁷¹ Twenty-six per cent of residential electricity customers and 18 per cent of small business electricity customers in the Roy Morgan survey had approached a retailer about buying energy from them.³⁷² A comparison of the results of the Roy Morgan survey in NSW with those surveys undertaken in other jurisdictions in Australia is set out in Figure B.2.

Figure B.2 Customer approaches to retailers



Note: customers were asked whether they had approached a retailer in the last five years in the Victorian survey whereas there was no time period in the Roy Morgan survey or the survey undertaken in South Australia.

Source: Customer surveys undertaken for AEMC retail competition reviews.

The figure shows that the level of customer approaches is much higher than found in the ACT, South Australia and Victoria at the time of their reviews. We note that the level of approaches by residential electricity customers in the Roy Morgan survey is also much higher than that observed in the PIAC survey undertaken in 2010. The

³⁷¹ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 40. and Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 41.

³⁷² I.d., p. 17; I.d., p. 18.

proportion of residential customers that had approached a retailer in the PIAC survey ranged from one per cent to ten per cent in the five regional centres surveyed.³⁷³

We consider this increase in the pro-active nature of customers and the increase in awareness from customers is a result of a number of factors:

- *Price of electricity:* The price of electricity has increased by 20 per cent in the 2012-2013 financial year in NSW.³⁷⁴ In addition, the Roy Morgan surveys found that the main reason given by customers for approaching a retailer was price.³⁷⁵ Price was also a concern that came through in the customer focus groups.³⁷⁶
- *Privatisation of the state-owned retailers:* The privatisation of the retailers may have led to increased customer participation in the market due to an increase in customer awareness of choice. Further, loyalty from customers towards the "local" state owned retailers may have disappeared following privatisation.³⁷⁷ In addition, as set out in section B.3 new entrant retailers have also increased their activity in the market since privatisation leading to an increase in competition and marketing to customers at this time.
- *Media attention:* Increased media attention such as the One Big Switch campaign may be another factor for the increase in the awareness and proactive nature of customers. According to One Big Switch one in four respondents of a survey that it conducted contacted their electricity retailer and got a better deal after taking part in the Big Electricity Switch.³⁷⁸

Gas

The Roy Morgan survey results suggest that gas customers have a similar degree of awareness that they can choose their retailer as electricity customers. More than 86 per cent of customers were aware of this.³⁷⁹ Gas customers were also able to identify alternative retailers to their gas retailer in the Roy Morgan surveys although there were fewer retailers mentioned in gas than electricity, most likely reflecting that there are

³⁷³ PIAC, *Choice? What Choice?* June 2011, p. 47.

³⁷⁴ AEMC, *Electricity price trends final report. Possible future retail electricity price movements: 1 July 2012 to 30 June 2015*, 22 March 2013, p. 41

³⁷⁵ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 18; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 19.

³⁷⁶ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Customers*, 28 February 2013, pp. 2 and 9.

³⁷⁷ I.d., pp. 2 and 11-12.

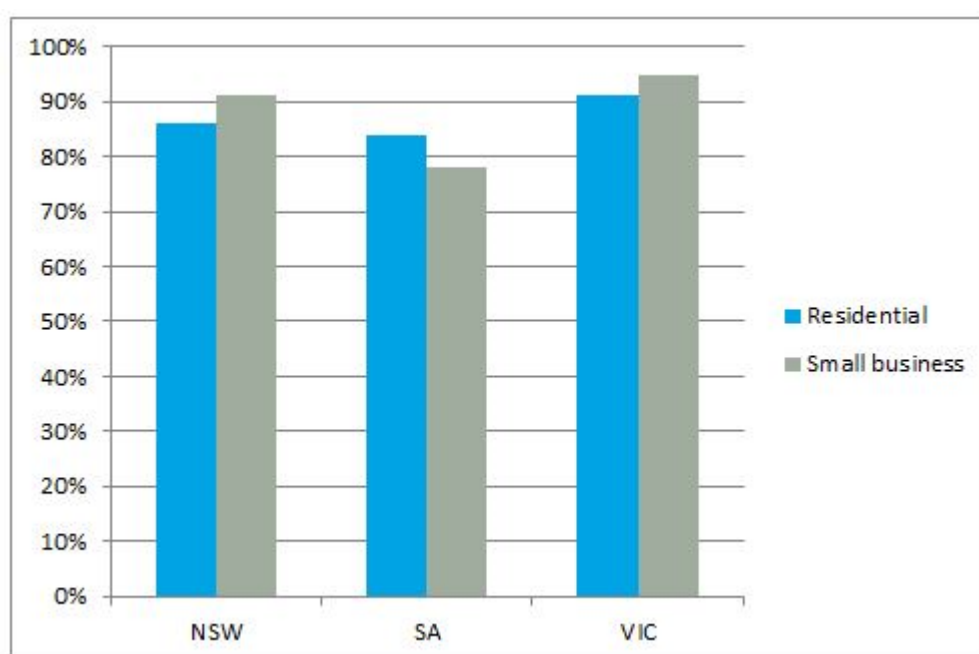
³⁷⁸ One Big Switch, News, "Survey Shines Light on Electricity Myths", Survey Report, viewed 8 April 2013, accessed through <https://www.onebigswitch.com.au/news/2012/09/survey-shines-light-on-electricity-myths/>.

³⁷⁹ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 9; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 9.

fewer retailers in gas.³⁸⁰ These results suggest that a high proportion of customers are aware of their ability to choose their gas retailer.

Figure B.3 compares the level of awareness by gas customers in NSW of their ability to choose their gas retailer with the awareness of gas customers in other jurisdictions in Australia when their reviews were undertaken. As can be seen the level of awareness in NSW is slightly higher than it was in South Australia but slightly lower than it was in Victoria. These findings support the view that there is a high level of awareness from customers of their ability to choose their gas retailer. These are also consistent with the views of retailers as reported by Sapere that there was a high level of customer awareness in electricity and the same or slightly lower level of awareness in gas.

Figure B.3 Customer awareness in gas since FRC across different jurisdictions



Source: Customer surveys undertaken for AEMC retail reviews.

We note that only 77 per cent of residential customers in the IPART survey covering Sydney, the Blue Mountains and Illawarra in 2010 were aware of their ability to choose their retailer.³⁸¹ However, 90 per cent of customers in the 2006 IPART survey for Sydney and the 2008 Hunter, Gosford and Wyong survey were aware that they could choose their retailer which is more consistent with the Roy Morgan results.³⁸² It is not clear what drove the reduction in awareness in the 2010 survey.

³⁸⁰ I.d., p. 10; I.d., p.10.

³⁸¹ IPART, *Residential energy and water use in Sydney, the Blue Mountains and Illawarra: Results from the 2010 household survey*, December 2010, p. 161.

³⁸² Ibid.

Roy Morgan also reports that there was a significant difference in the proportion of small business gas customers that were aware of their ability to choose their retailer by area type. Ninety-six per cent of small business gas customers in metro areas were aware that they could choose their gas retailer versus 75 per cent in non-metro areas.³⁸³ The Commission considers that the level of awareness in non-metro areas could be enhanced and that small businesses in non-metro areas should be targeted by the information and education programs discussed in chapter 8.

Less than one in four gas customers had looked for information relating to switching or changing their existing gas arrangements in the last 12 months in the Roy Morgan survey.³⁸⁴ As with electricity there was a much higher proportion of customers in the Roy Morgan survey that had approached a gas company to ask about buying gas from them than in surveys undertaken for other reviews. In the Roy Morgan survey about one in five gas customers had approached a gas retailer.³⁸⁵ By way of contrast about only one in 20 customers had approached a gas retailer in surveys undertaken in South Australia and Victoria at the time of retail competition reviews in these states as set out in Figure B.4.

Figure B.4 Customer approaches to gas retailers



Note: customers were asked whether they had approached a retailer in the last five years in the Victorian survey whereas there was no time period in the Roy Morgan survey or the survey undertaken in South Australia.

Source: Customer surveys undertaken for AEMC retail reviews.

³⁸³ Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 9.

³⁸⁴ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 40; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 41.

³⁸⁵ I.d., p. 17 and I.d., p. 18.

We consider that this increase in the pro-active nature of customers is a result of increases in electricity prices and associated media attention which has led to customers also seeking better deals on their gas. This link between behaviour in electricity and behaviour in gas is discussed further in chapter 3 and adds weight to the argument that gas is part of a dual fuel market and is not a separate market.

Summary: customer awareness

In summary, the Commission considers that there is a high level of awareness from customers of their ability to choose their electricity and gas retailer. Awareness has increased in recent years particularly in non-metro areas. A number of related factors appear to have caused this including electricity price increases, the privatisation of the state-owned electricity retailers and increased media attention. These factors also appear to have caused customers to be more active in the market by seeking better deals themselves. The one area of concern is small business gas customers in non-metro areas.

Ease of obtaining, understanding and comparing information

Electricity

Access to accurate, relevant and comprehensible information about the tariffs, terms and conditions of market contracts is important to enhance competition in energy retailing. Without access to such information, customers are unable to make an informed choice in relation to their supply options. Customer participation in a competitive market is affected by the amount and availability of information about the market and the products and prices being offered.

In the Roy Morgan surveys most electricity customers who were provided with information at the time of a sales encounter thought that the information was difficult to understand. As set out in Table B.1 less than a third of electricity customers that were provided information from a retailer at the time of a sales encounter agreed with positive statements about the information that they received.³⁸⁶

³⁸⁶ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 15; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 16.

Table B.1 Customer views on information received at the time of sales encounter - electricity

Statement	Residential customers agree with statement	Small business customers agree with statement
Information helped to identify energy needs	20%	17%
Sufficient information to make informed choice	31%	33%
Information made it easy to compare offers	19%	20%
Information easy to understand	31%	28%

Source: Roy Morgan survey reports undertaken for the AEMC for the NSW retail review.

There were no statistically significant differences between metro and non-metro areas for electricity customers regarding the information provided by retailers.

Customers that took part in the Roy Morgan survey who looked for information about energy offers themselves were generally more positive about the information that they received compared to those that had been approached by a retailer. Specifically, between 37 per cent and 58 per cent of electricity customers that had looked for information about electricity offers agreed with positive statements about the information they received as set out in Table B.2.³⁸⁷

Table B.2 Customer views on information obtained when actively looking for a better deal - electricity

Statement	Residential customers that agree with statement	Small business customers that agree with statement
Sufficient information to make informed choice	51%	47%
Information made it easy to compare offers	43%	37%
Information easy to understand	48%	41%
Information easy to obtain	57%	58%

Source: Roy Morgan survey reports undertaken for the AEMC for the NSW retail review.

³⁸⁷ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 42; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 43.

While the Commission considers that these results are not so unsatisfactory that they indicate that competition is not effective it considers that there is room for improvement in the availability and quality of information that customers receive from retailers. By making it more difficult for customers to find the best choice for them the results of the Roy Morgan survey indicate that lack of information is a barrier to switching. We note that:

- more than 16 per cent of customers had not switched due to the complexity of information;
- more than 13 per cent of customers had not switched due to insufficient information; and
- more than nine per cent of customers had not switched because they couldn't understand the information.³⁸⁸

Similarly, in the customer focus groups conducted by Roy Morgan there was a comment that it was easy to get lost in all the information and price plan options provided on the web.³⁸⁹

This view is also supported by the results of a CHOICE survey where a third of respondents tried to compare different electricity retailers but thought it was too hard to work out the best choice for them.³⁹⁰ A third of respondents in this survey also said that they needed more information about their usage to properly compare offers.³⁹¹

Although not directly comparable, findings in the IPART household survey conducted in Sydney in 2010 and Hunter, Gosford and Wyong in 2008 appear slightly more positive than the Roy Morgan research. However, the findings of these surveys, set out in Table B.3, still leave room for improvement. Further, when compared against each other and with the Roy Morgan results they could indicate a declining level of satisfaction from customers of the information they are receiving from retailers.

³⁸⁸ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 22; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 23.

³⁸⁹ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Customers*, 28 February 2013, p. 15.

³⁹⁰ CHOICE, Issues Paper submission, 8 February 2013, p. 14.

³⁹¹ Id., p. 15.

Table B.3 Results of IPART surveys on information received - electricity and gas combined

Relevant survey	Customers that were confident in their ability to access the information they need	Customers that were confident in their ability to choose a retailer
Sydney (2010)	57%	65%
Hunter, Gosford, Wyong (2008)	63%	66%

Source: IPART, *Residential energy and water use in Sydney, the Blue Mountains and Illawarra: Results from the 2010 household survey*, December 2010, pp. 182-183.

As identified above, CHOICE considers that the complexity of tariff structures is the reason that competing energy offers are not able to easily be compared. It states that the complexity of the tariffs mean customers typically need to analyse a significant amount of detailed information and consider a whole range of different scenarios to properly compare the available options.³⁹² CHOICE sets out some relevant factors that a customer needs to consider in order to be able to compare offers. These are set out in Table B.4.

³⁹² CHOICE, Issues Paper submission, 8 February 2013, p. 6.

Table B.4 Information considerations to evaluate energy offers

Typical characteristics of tariffs (for electricity and gas)	Relevant factors that a customer needs to consider
X per cent off the whole bill or Y per cent off the usage	Their usage profile (ie whether supply charges or usage charges are the major contributor to their bill) taking into account differences in their demand throughout the year (ie seasonal variances)
Lower fixed costs with higher usage costs or higher fixed costs with lower usage costs	Their usage profile taking into account differences in their demand throughout the year
Differing time-of-use tariffs (for electricity only)	How much electricity they use at different times of the day How much of their electricity consumption they are able to shift to a different time of day
The energy usage level(s) at which point a higher/lower tariff applies (ie graduated tariff)	Their energy consumption over a billing period taking into account seasonal differences
Discounts conditional on paying by a particular payment method	Preferred payment method
Discounts conditional on paying on time	Likelihood or not of paying on time
Late fees	Likelihood or not of paying on time
Whether to sign up to a longer term contract given that they typically offer higher discounts but exit fees would be incurred if they terminate the contract before the end of the contracted period	Possible changes in household type/size given the likely impacts this would have on energy usage Possible relocation and ability to move contract Risk that during the contract period, the tariffs change so as not to be as suitable for their circumstances compared with another retailer
Measurements in kilowatts or megajoules	What are kilowatts or megajoules How many kilowatts or megajoules each of the different appliances use in the household How many kilowatts or megajoules they would use in a billing period taking into account seasonal differences

Source: CHOICE, Issues Paper submission, 8 February 2013, pp. 7-8.

Similar to this PIAC raises concerns with the ability of some customers to be able to effectively participate in the market:³⁹³

“A cross tabulation of the survey data [from the findings of the PIAC survey] indicates that customers with the greatest confidence in their knowledge of the energy market are also those least likely to be approached by direct marketing practices. The survey found that those with higher incomes and higher levels of education were more likely to be able to participate effectively in the retail electricity market.”

Further, PIAC notes that:³⁹⁴

“Those individuals who indicated characteristics suggesting that they were more likely to be at home during the day, were more likely to be contacted by an electricity supplier. This included concession card holders, people in older age groups, households with an individual who had a health condition or disability, those on lower income levels.”

This is also consistent with the results of the CHOICE survey where, while most customers overall were confident that they made the best choice of retailer, less than half of those that had been contacted by direct marketing such as door to door sales were confident.³⁹⁵

Gas

The Roy Morgan survey results suggest that gas customers that had been approached by a retailer were slightly more positive than electricity customers in response to information that they received at the time of a sales encounter. Having said that, the majority of customers that had been approached by a retailer still did not have a positive view about the information they received as set out in Table B.5.³⁹⁶

³⁹³ PIAC, Issues Paper submission, 8 February 2013, p. 20.

³⁹⁴ PIAC, *Choice? What Choice?*, June 2011, p. 75.

³⁹⁵ CHOICE, Issues Paper submission, 8 February 2013, pp. 6,14.

³⁹⁶ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 16. and Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 17.

Table B.5 Customer views on information received at the time of sales encounter - gas

Statement	Percentage of residential customers agree with statement	Percentage of small business customers agree with statement
Information helped to identify energy needs	23%	28%
Sufficient information to make informed choice	35%	37%
Information made it easy to compare offers	23%	20%
Information easy to understand	38%	28%

Source: Roy Morgan survey reports undertaken for the AEMC for the NSW retail review.

Unlike in electricity, there was one difference between metro and non-metro areas for residential gas customers when asked about these statements. Forty per cent of metro residential gas customers disagreed with the statement that information provided by retailers was sufficient to make an informed choice whereas only 13 per cent of non-metro residential gas customers did. Overall 35 per cent of gas customers disagreed with this statement.³⁹⁷ This suggests that metro residential gas customers were less positive about the usefulness of information provided than their metro counterparts.

Consistent with electricity, gas customers that received information when looking for information were generally more positive about the information they received. As set out in Table B.6, between 30 and 65 per cent of gas customers agreed with positive statements about the information they received when looking for information about energy offers themselves.³⁹⁸ We note that the proportion of gas customers who had looked for information on switching that rated the availability and quality of information positively is noticeably lower for business customers than residential customers. It therefore appears that there is particularly a gap in the information available to gas small business customers.

³⁹⁷ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 15.

³⁹⁸ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 43; and Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 44.

Table B.6 Customer views on information obtained when looking for a better deal - gas

Statement	Percentage of residential customers agree with statement	Percentage of small business customers agree with statement
Sufficient information to make informed choice	54%	46%
Information made it easy to compare offers	47%	30%
Information easy to understand	53%	42%
Information easy to obtain	65%	46%

Source: Roy Morgan survey reports undertaken for the AEMC for the NSW retail review.

As identified in Table B.3 the findings in the IPART household survey conducted in Sydney in 2010 and Hunter, Gosford and Wyong in 2008 appear slightly more positive than the Roy Morgan research yet still left room for improvement. This could indicate a declining level of satisfaction from customers in NSW of the information they are receiving from retailers.

Summary: Ease of obtaining, understanding and comparing information

In summary it would appear that there is general room for improvement in the availability and quality of information available to electricity and gas customers which would enhance competition. Specifically there is room for improvement in the information that customers receive when they are approached through a sales encounter. Retailers could do more to think about the type and form of information provided to these customers that are more likely to have less knowledge of the market and may well be vulnerable. In addition, there the level and quality of information available to metro residential gas customers and small business gas customers could be enhanced. The Commission supports the introduction of information and education programs to help inform customers and empower them to make effective decisions. See chapter 8 for further discussion.

Switching behaviour

An important assessment of customer behaviour in a competitive market is the rate at which customers are actively switching energy retailer or are changing from a standing (or "regulated") offer customer contract to a market offer customer contract with their existing retailer. Where a sufficient number of customers are willing to switch to contracts with more attractive price or non-price terms, retailers are likely to be constrained in terms of the extent to which they can obtain or exercise market power in respect of any particular customer group.

While switching rates are a useful indicator of customer participation, they are not a perfect measure of the number of customers that are active in the market. Switching rates only tell us the number of switches that occur, not the number of customers that switch. Consequently we cannot differentiate between a single customer that switches three times and three customers that each switch once. Switching rates may also underestimate the number of customers that are actually participating in the market. As switching is defined as a customer changing their electricity provider, these figures do not capture those customers that may move off a regulated tariff onto a market contract with the same retailer or from one market offer to another market offer with their existing retailer.

It is also important to understand why customers are switching. A high switching rate could indicate dissatisfaction with retailers which does not necessarily imply customers are effectively participating in the market. On the other hand a low switching rate could indicate the market may be reaching maturity.

Further, some customers that remain on regulated tariffs may have considered changing but decided not to for one of a number of reasons. This does not necessarily imply such customers are not making an active choice and participating in the market.

The remainder of this section examines the level of customer switching between retailers since FRC. It also looks at the number of customers that have changed their arrangements with their existing retailer since FRC either by moving from a regulated contract to a market contract or from one market offer to another. It also identifies the proportion of customers that are on standing and market contracts in NSW.

Electricity

Switching refers to the proportion of customers who change, or switch, their electricity retailer during a given time period. It is sometimes also referred to as customer churn.

Figure B.5 below illustrates the switching trends observed in NSW as a whole since FRC was introduced in 2002. The blue bars indicate the number of switches by quarter. The chart also shows the cumulative number of switches. To the end of 2012 there had been over 2.3 million switches in NSW net of "move-ins".³⁹⁹

Figure B.5 shows a step change in the level of switching from the third quarter of 2011 until the end of 2012. During that time more than 150,000 customers switched each quarter. This means that more than five per cent of customers in NSW switched each quarter during this time. This increase in switching may be attributed to the privatisation of the state-owned retailers in March 2011. Privatisation may have caused new entrant retailers to increase their activity as they felt more comfortable to compete

³⁹⁹ A "move-in" occurs when a customer, who has a contract with retailer A, moves into a new residence where the former tenant or owner had a contract with retailer B. When the customer carries their old contract with retailer A to their new residence, the NMI at the new residence is then transferred to retailer A. For the purpose of switching data, this transfer will show up as a "switch" from retailer B to retailer A, even though there has been no actual active switch between retailers by the customer.

against private companies. Further customers that had previously been loyal towards the state-owned retailers may have been more inclined to switch retailer following privatisation. In addition to the privatisation of the state-owned retailers electricity prices had also started to increase at this time which may also have increased the level of customer switching.

Figure B.5 also shows an increase in the number of customers that switched during the latter half of 2012. This increase may be attributable in part due to the One Big Switch electricity campaign launched in June 2012.⁴⁰⁰ In addition to the number of customers that switched retailer as part of the campaign we note that a number of customers negotiated a better deal with their existing retailer as a result of the campaign. According to One Big Switch one in four respondents of a survey that it conducted contacted their electricity retailer and got a better deal.⁴⁰¹

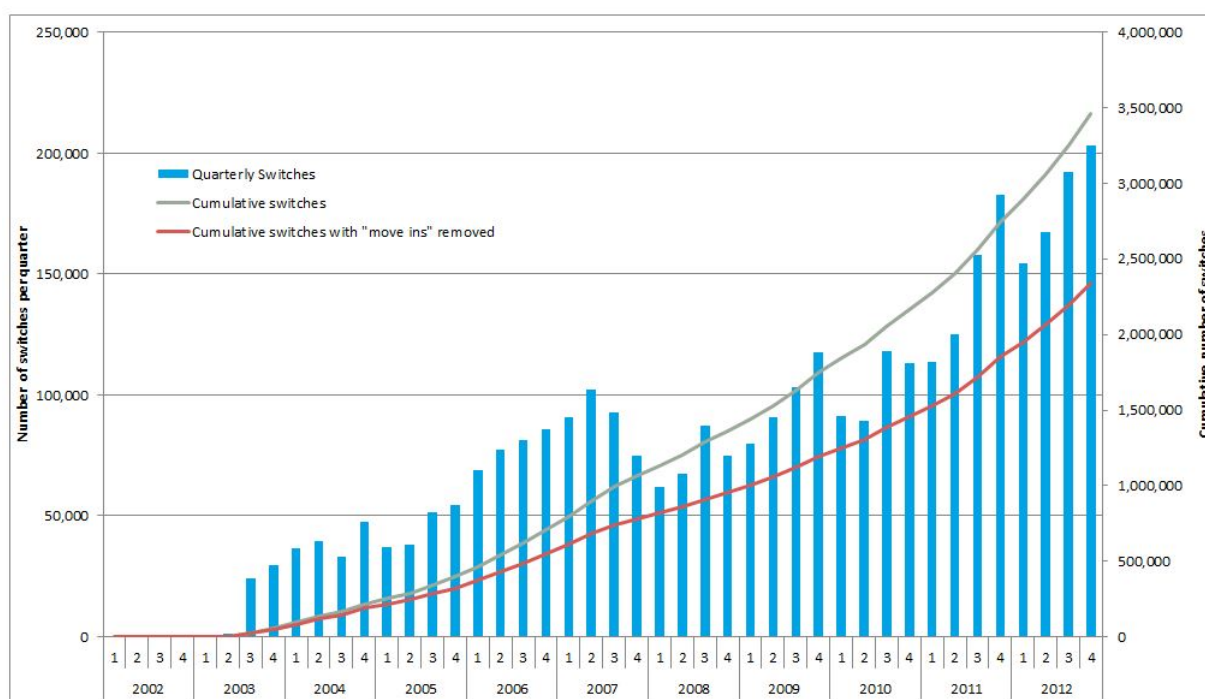
Prior to 2011 it is apparent that there was a significant increase in switching between mid-2006 and mid-2007 when switching dropped off before increasing again in 2009. In their interviews with Sapere retailers have implied that this was due to a combination of volatility in the wholesale market and regulated prices at levels below cost.⁴⁰²

⁴⁰⁰ One Big Switch, News, "Survey Shines Light on Electricity Myths", Survey Report, viewed 8 April 2013, accessed through <https://www.onebigswitch.com.au/news/2012/09/survey-shines-light-on-electricity-myths/>.

⁴⁰¹ One Big Switch, News, "Survey Shines Light on Electricity Myths", Survey Report, viewed 8 April 2013, accessed through <https://www.onebigswitch.com.au/news/2012/09/survey-shines-light-on-electricity-myths/>.

⁴⁰² Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in NSW - Report of Interviews with Energy Retailers*, February 2013, pp. 13 and 32.

Figure B.5 Cumulative and quarterly switching rates in NSW - electricity



Source: Data provided by AEMO.

As can be seen from Figure B.7 more than 20 per cent of customers in NSW as a whole switched retailer during 2012.⁴⁰³ This compares to 26 per cent in Victoria and 23 per cent in South Australia over the same time period.⁴⁰⁴

Switching rates in different jurisdictions across the world are measured by a global energy think-tank called VaasaETT. The current switching rate for electricity in NSW would place NSW fourth in the latest VaasaETT rankings list as indicated by many of the retailers in their submissions. The rankings list is based on switching rates in 2011. Victoria lies top of this list and South Australia in third place.⁴⁰⁵

The Commission therefore considers switching rates in the NSW electricity market to be high when compared with other energy retail markets in jurisdictions both in Australia and overseas.

It also considers switching rates to be high when compared to other industries. Box B.3 compares switching rates in the NSW electricity market with those in other comparable industries. The gas and electricity retail markets exhibit higher switching rates than most of the other industries surveyed.

⁴⁰³ AEMC calculations from AEMO data.

⁴⁰⁴ Ibid.

⁴⁰⁵ VaasaETT, *World Energy Retail Market Rankings*, 2012, p. 14.

Box B.3: Industry analysis of switching rates

While switching rates alone are not a good measure of an industry's competitiveness, they are commonly used as a guide for assessing how active customers are in a market. To provide context to the Commission's findings in the electricity and gas industries, we have analysed the switching rates in a number of other industries. The table below also sets out the number of active firms, market share and market concentration as measured by the HHI and market share of the largest three retailers. Note that different industries can be expected to have different switching rates depending on a number of factors including industry structure and the nature of the product.

We consider these markets to be broadly comparable to the NSW electricity and gas retail markets as they relate to products which are billed at regular intervals, often after the product has been consumed. The retail banking transaction account market is particularly comparable in that it is an essential service. However, we note that there is a much larger number of firms actively competing in this market which could explain the higher switching rate in this market compared to the NSW electricity and gas retail markets. We note that the switching rate in electricity and gas in NSW exhibits higher switching rates than most of the other industries surveyed.

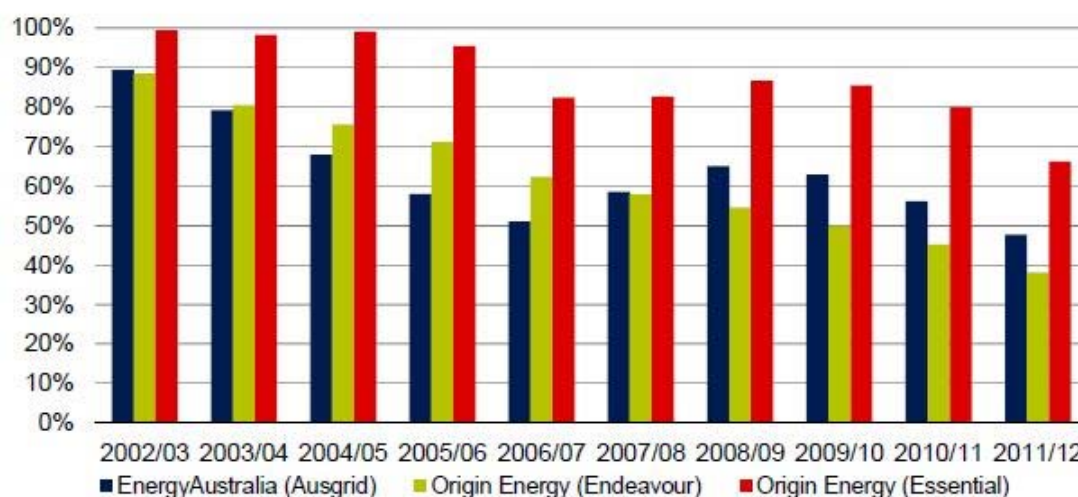
Product	Annual switching rate	Number of active firms	Market concentration
NSW electricity retail small customers	21%	11	CR ₃ :94%, HHI:3,200
NSW gas retail small customers	14%	5	CR ₃ :97%, HHI:4,500
Retail banking - transaction accounts	24%	61	CR ₃ :46%, HHI:1,009-1,109
Owner-occupier residential mortgages	7.5%	28	CR ₃ :46%, HHI:908-933
Investor mortgages	8%	27	CR ₃ :45%, HHI:950
Credit cards	9.2%	16	CR ₃ :53%, HHI:1,118-1,218
Internet Service Providers	15%	332	CR ₃ :57%, HHI:1,938-2,038
Health insurance	2.1%	35	CR ₃ :64%, HHI:1,725

Sources: Financial product information from RFintelligence; Internet Service Provider market share from IBISWorld, *Internet Service Providers in Australia*, IBISWorld Industry Report J7124, October 2012. Switching rates from Tindal, S. 2008, "Young churners the scourge of Aussie telcos", <http://www.zdnet.com/young-churners-the-scourge-of-aussie-telcos-1339288193/> Accessed 1 February 2013; Health insurance figures estimated from Private Health Insurance Administration Council data.

As noted above, switching rates may underestimate the number of customers that are actually participating in the market. In addition to those that had switched retailer the Roy Morgan survey found that an additional one in five customers had changed their arrangements with their existing retailer.

In addition, information from IPART indicates that as of April 2013 only around 40 per cent of small customers are on regulated prices in NSW, which indicates that the majority of customers have participated in the market at some time.⁴⁰⁶ The proportion of customers on regulated tariffs is also declining as set out in Figure B.6. Finally, customer satisfaction with their existing retailer was the main reason given by customers for not switching in the Roy Morgan survey, indicating that some customers would have made an active choice to remain on their existing contract.⁴⁰⁷

Figure B.6 Percentage of small customers on regulated prices by supply area



Source: IPART, *Review of regulated retail prices for electricity 2013-2016*, April 2013, p. 34.

The reasons for switching are also an important factor to consider. The Commission considers customers are switching as a result of a better offer from another retailer rather than as the result of a lack of satisfaction with their existing retailer. The main reasons given for switching or changing arrangements in the Roy Morgan survey were that they had been offered a better rate or that they were offered a rebate.⁴⁰⁸

⁴⁰⁶ IPART, *Review of regulated retail prices for electricity 2013-2016*, April 2013, p. 12.

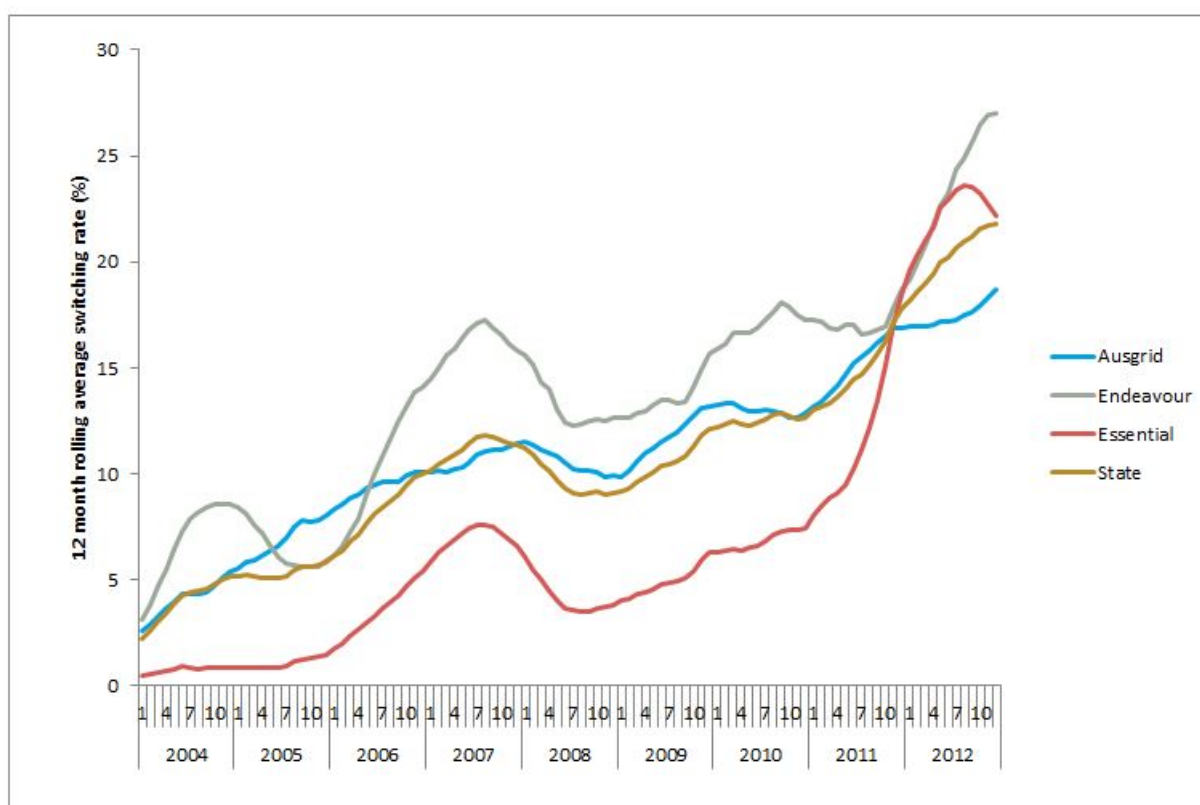
⁴⁰⁷ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 22; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 23.

⁴⁰⁸ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p.24; and Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 25.

Together, this information indicates that customers are actively participating in the market and that competition is effective. However, we note our earlier findings that information to help customers make the right choice could be improved, which would enhance competition.

In light of findings in the PIAC survey that there was less competition in non-metro areas, the Commission considered it appropriate to compare switching rates in each of the distribution areas in NSW. If customers were less active in non-metro areas, then a lower switching rate would be expected in the Essential area. The switching rates across the three distribution areas in NSW since FRC are set out in Figure B.7.

Figure B.7 Switching rates by distribution network



Note: We note that the switching rates in the Essential Energy distribution area are slightly overstated as some switches between two different Origin Energy meters have been counted as a switch. This has also occurred in the other network areas although to a lesser extent.

Source: AEMO data.

As can be seen from Figure B.7 there is not a significant difference in the current switching rates between the three distribution areas.

We note that up until the latter half of 2011 the switching rate was much lower in the Essential Energy distribution area than in the other distribution areas. In 2011 there was a steep increase in the switching rate in the Essential Energy area. This increase in switching coincides with the privatisation of the state-owned retailers.

We consider that customers in the Essential Energy area increased their level of switching following the privatisation of the state-owned retailers. This may have been because customers in the Essential Energy area were loyal to Country Energy prior to the privatisation of the state-owned retailer and had been less likely to switch up until then.

This observation is consistent with the results of a study conducted by Engineroom Infrastructure Consulting and Etrog Consulting.⁴⁰⁹ The study involved interviews with a selection of local government councils in non-metro areas in NSW and was conducted between November 2010 and April 2011. The study found that there was an increasing trend to greater retail competition over time in non-metro areas. However it noted that some customers in non-metro areas were still unaware of their ability to choose their electricity retailer, while others had been reluctant to switch because of strong brand loyalty to Country Energy or because they feared worse service from their distributor if they switched.^{410,411}

Increasing switching rates in the Essential Energy distribution area in recent years are also consistent with information from IPART. IPART reports the proportion of small customers on regulated prices in the Essential Energy area has dropped from 80 per cent to 66 per cent in the 12 months to June 2012. Figure B.6 sets out the proportion of small customers on regulated prices by distribution area since 2002/03.

In summary, we consider that participation from customers in non-metro areas has increased since the privatisation of the retailers and is now healthy.

Gas

Figure B.8 shows the trend in the switching rate in gas since 2002. As with electricity there was a step increase in switching in the third quarter of 2011. This suggests that switching in gas is driven by switching in electricity, which is one of the reasons we consider there is a dual fuel market rather than a gas only market.

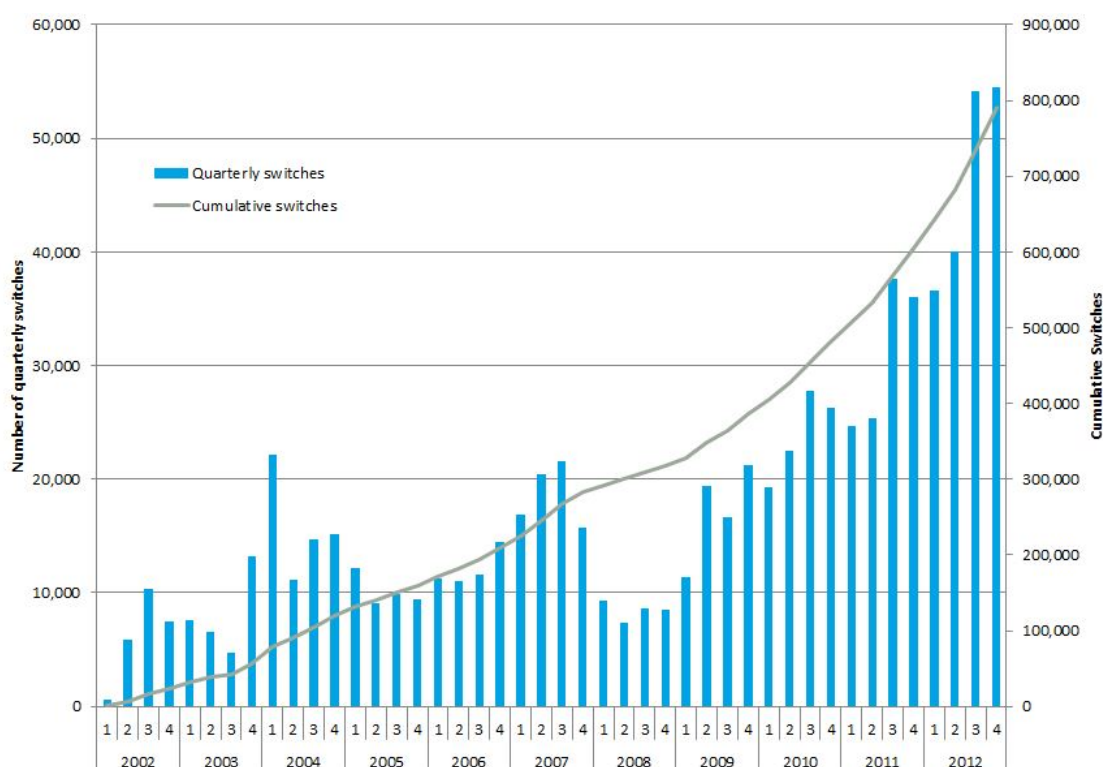
There was a second step increase in switching rates in the second half of 2012. The reasons for this step increase are not entirely clear. However, we note that there was also an increase in electricity switches at this time which are likely to have been due to the One Big Switch campaign. The increase in gas switching at this time may in part be driven by the increase in electricity switching. This again would indicate that there is a dual fuel market rather than a gas only market.

⁴⁰⁹ Berry and Prins, *Rural and regional energy issues - A qualitative survey of rural and regional councils in New South Wales and Queensland*, January 2012.

⁴¹⁰ Comments about fear of worse service from the distributor were made before the distributor was re-branded to Essential Energy.

⁴¹¹ Berry and Prins, *Rural and regional energy issues - A qualitative survey of rural and regional councils in New South Wales and Queensland*, January 2012, p. 14.

Figure B.8 Quarterly and cumulative customer switches



Source: AEMO data

Figure B.9 shows that the current annual level of switching sits at just below 14 per cent. This is lower than current rates of 23 per cent in Victoria and 16 per cent in South Australia.⁴¹² It is also lower than in electricity. Switching rates in gas in Victoria and South Australia are also lower than in electricity.

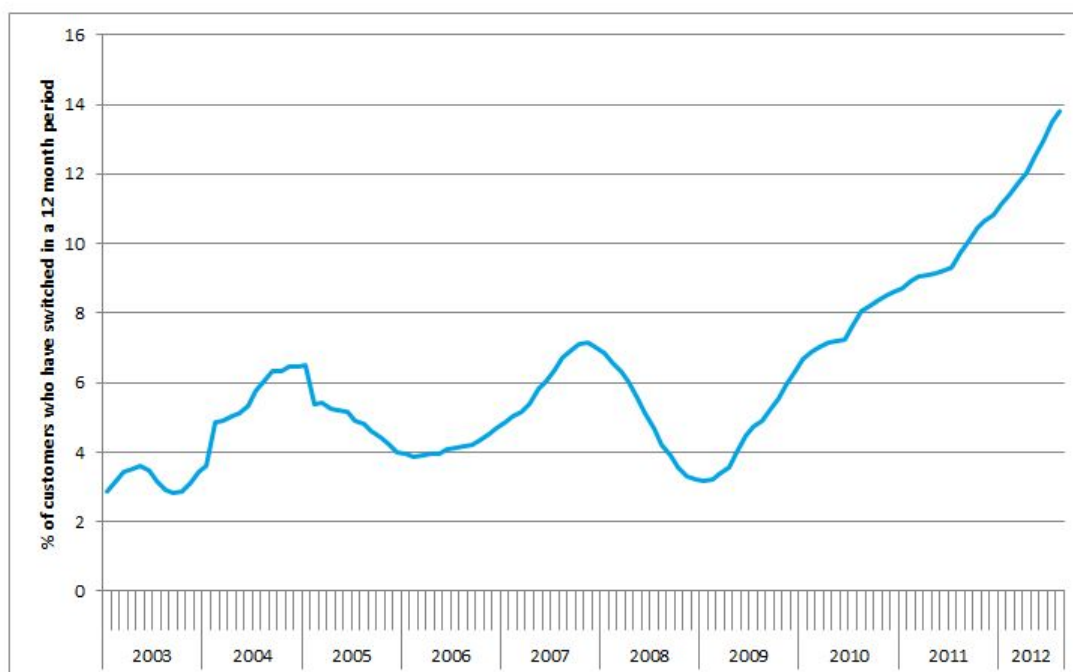
A lower switching rate in gas could be explained by gas bills typically being much lower than electricity, and so customers have less incentive to search for a better offer. This is supported by the fact that a much greater proportion of gas than electricity customers switched retailer or changed arrangements with their existing retailer, so that they could have the same retailer for both electricity and gas.⁴¹³

We also consider switching rates to be high when compared to other industries. Box B.3 compares switching rates in the NSW gas market with those in other comparable industries. The gas retail market exhibits higher switching rates than most of the other industries surveyed.

⁴¹² AEMC calculations from AEMO data.

⁴¹³ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p.24; and Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 25.

Figure B.9 Switching rates - gas



Source: AEMO data.

More than a quarter of gas customers in the Roy Morgan survey have switched retailer at least once since FRC.⁴¹⁴ While switching rates are lower than for electricity, according to IPART only around one third of customers are on regulated prices.⁴¹⁵ This suggests that customers are moving onto market contracts with their existing retailer perhaps to take advantage of dual fuel contracts.

Evidence also suggests that many of AGL's gas customers are switching their electricity to AGL as part of a dual fuel contract. Across NSW, Victoria, South Australia and Queensland AGL's overall gas customer base has reduced by more than 3,500 customers, yet the number of dual fuel accounts has increased by more than 50,000 customers. It appears that the majority of these dual fuel accounts have been acquired in NSW.⁴¹⁶ Such customers would appear as a switch for electricity but not for gas, suggesting that the switching rate underestimates the number of customers that are active in the gas market.

As with electricity, the offer of a better rate or a rebate were the main reasons for switching gas retailers indicating that switching was driven by customers seeking out better offers, rather than from a lack of satisfaction from customers with their existing

⁴¹⁴ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 21; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 22.

⁴¹⁵ IPART, *Review of regulated retail prices for gas 2013-2016*, April 2013, p. 75.

⁴¹⁶ AGL acquired 64,220 new electricity customers in NSW alone. AGL, *FY Interim Results*, 27 February 2013, p. 40.

retailer.⁴¹⁷ In addition a significant number of gas customers cited wanting to be with the same retailer for electricity and gas as the reason that they changed.⁴¹⁸ The main reasons given by customers that had changed arrangements were the same as those given by those customers that had switched.⁴¹⁹

Summary: Switching behaviour

The switching rates in electricity and gas are generally high compared to other jurisdictions and other comparable industries. In addition, customers have been switching at an increasing rate. There has been a particular increase in switching since privatisation of the state-owned electricity retailers. This increase is particularly evident in non-metro areas for electricity and there is no evidence to suggest that these switching rates will decrease. Importantly customers appear to be switching for a better deal rather than as the result of not being satisfied with their existing retailer.

Instead of switching a number of customers change arrangements with their existing retailer. Further, the majority of customers are on market contracts with their electricity and gas retailers. This would appear to indicate that the NSW electricity and gas markets are competitive.

B.2.4 Summary

Electricity

In summary there is a high degree of awareness of electricity retail competition and customers are exercising choice.

Customer survey results suggest that most customers know they can choose their retailer. In addition, customers can name alternatives to their own retailer indicating that customers are aware of competing retailers. Customer awareness of choice has been heightened by a number of recent events including:

- the privatisation of the government owned retailers;
- price rises; and
- the One Big Switch campaign.

This increased awareness is particularly evident in non-metro areas.

⁴¹⁷ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 24; and Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 25.

⁴¹⁸ Ibid.

⁴¹⁹ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 33; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 34.

Customers are also acting on this heightened awareness. Evidence shows that switching rates have increased rapidly since privatisation, particularly in regional areas. When compared to other jurisdictions and other comparable industries switching rates in electricity are high.

While customers are switching, surveys conducted by Roy Morgan for the AEMC reveal that many customers find the information provided by retailers to be difficult to understand and unhelpful for choosing an offer. This, in part may be due to the complexity of tariffs. The Commission considers that more could be done in relation to the availability and quality of information for customers about offers particularly for customers that are approached by retailers and who may have less knowledge of the market to start off with. This would enhance competition. The Commission supports the introduction of information and education programs to help inform customers and empower them to make effective decisions. See chapter 8 for further discussion.

Gas

The Commission considers there is also a high degree of awareness of gas retail competition and customers are exercising choice.

Similar to electricity, most gas customers knew they could choose their gas retailer. In addition, switching rates although lower than for electricity suggest that customers are active in the market. The upward trend of electricity switching rates is mirrored for gas, with switching rates increasing considerably since privatisation.

Although switching rates are lower in the gas market than in the electricity market more gas customers have moved onto market contracts than electricity customers. A prominent reason for switching gas was to have a single energy retailer and when considered alongside electricity as a dual fuel product it would appear that this market is competitive.

As with electricity the Commission considers that improvements to the clarity and accessibility of information are desirable to assist customers in making appropriate decisions.

B.3 Retailer behaviour

Independent rivalry between existing retailers is an important aspect of effective competition. In an effectively competitive market, retailers will seek to retain or increase their market share by offering products that meet the requirements of customers. Retailers achieve this by engaging in price and non-price rivalry with other retailers. Viewed in this way, retailer rivalry can facilitate the delivery of those products most sought after by customers and at prices that reflect the long-run efficient cost of supply. The extent to which retailers engage in marketing may also provide a further indication of the level of rivalry that exists between retailers.

The rest of this appendix will consider the following issues in coming to a view on retailer rivalry:

- evidence of retailer rivalry from customer switching behaviour;
- the range of retail products and services in the market; and
- the nature and extent of marketing by retailers.

First we set out information from our consultant reports.

B.3.1 Consultant reports

To assist the AEMC in ascertaining the nature and extent of retailer rivalry that has emerged since the commencement of FRC, and is likely to exist in the future, the AEMC engaged Sapere to undertake interviews with retailers licensed to operate in NSW, the Energy Retailers Association of Australia (ERAA) and the Energy Supply Association of Australia (ESAA).

Sapere asked retailers and their representatives to rate retailer rivalry on a scale of zero to ten (where zero means not competitive at all and ten means extremely competitive). Sapere notes that the majority of retailers interviewed rated the level of retailer rivalry in the NSW retail electricity market to be high to very high.⁴²⁰ A review of the Sapere findings would appear to indicate that this is a rating of seven to eight out of ten and above.⁴²¹ While Sapere observes that there were a wide range of factors influencing retailers perceptions it identifies that the retailers that rated rivalry very high (eight out of ten and above) based this view on:

- observations of increased door knocking activity and other forms of marketing including telemarketing and digital and social media;
- the high level of discounts on offer; and
- aggressive customer retention strategies by the three big retailers.⁴²²

Customer churn rates and the loss of market share by some retailers were also mentioned by these respondents as reasons as to why retailer rivalry was very high.⁴²³

⁴²⁰ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in NSW - Report of Interviews with Energy Retailers*, February 2013, p. viii.

⁴²¹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in NSW - Report of Interviews with Energy Retailers*, February 2013, p. 17.

⁴²² I.d., pp. viii and 7.

⁴²³ Ibid.

Those that scored it seven to eight out of ten did so because they considered that:

- market share in NSW is aggregated around the big three retailers; and
- new entrant retailers have less market share than in Victoria.⁴²⁴

In relation to the NSW retail gas market Sapere notes that all retailers rated the level of rivalry in this market lower than for electricity.⁴²⁵ However, respondents generally still considered retailer rivalry in gas to be high with half of respondents giving it a score of seven to eight out of ten and above.⁴²⁶ Views given as to the reasons for less rivalry in gas than electricity included:

- lower penetration rates and consumption levels than in electricity; and
- the gas market is harder to enter than the electricity market and by implication there are fewer retailers competing for customers.⁴²⁷

B.3.2 Retailer rivalry and customer switching

While the level of customer switching is a strong indicator of the extent to which customers are participating in the market it can also provide insights into the extent of retailer rivalry in the market. This is because in markets where customers switch to another retailer to obtain a better offer, high levels of switching is a sign that retailers are actively competing for new customers. The rate at which customers change offers with their existing retailer is also a measure of retailer rivalry and reflects customer retention strategies by retailers.

As set out in section B.2 switching rates in the NSW gas and electricity retail markets are high and customers switch retailers to get a better offer. This indicates that there is strong retailer rivalry in these markets. Further analysis of the switching data indicates that much of the switching in the last few years has been between the big three retailers. This is consistent with the fact that the smaller retailers have a very small share of the market as set out in appendix A. However, the next biggest proportion of switches is switches away from the big three indicating that the smaller retailers may be gaining customers. The number of customer switches between different types of retailer is set out in A below.

⁴²⁴ I.d., pp. 17-18.

⁴²⁵ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in NSW - Report of Interviews with Energy Retailers*, February 2013, p. viii.

⁴²⁶ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in NSW - Report of Interviews with Energy Retailers*, February 2013, p. 22.

⁴²⁷ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in NSW - Report of Interviews with Energy Retailers*, February 2013, pp. viii and 21-23.

Figure B.10 Customer switching between different types of retailers



Source: AEMO data.

B.3.3 Retail products and services

An indicator of retailer rivalry is product differentiation and innovation. Product differentiation encapsulates the variety in the products and services available to customers. That is, how different are the products from one retailer to another and within one retailer. Innovation is the introduction of new ideas to the market.

Product differentiation and innovation provide an indication of retailer rivalry and the extent that retailers are responding to customer preferences and needs. Different customers have different preferences and requirements, driven by, for example, type and quality of accommodation, income levels, lifestyles, what appliances they use. In an effectively competitive market, retailers are expected to tailor their products and services to different types of customers in an effort to gain more market share.

The Commission recognises that to a certain extent, the scope of retailer products and services are limited by the available technology. In energy retailing, the metering infrastructure dictates the possible tariff structures. For example, the majority of customers in NSW have accumulation meters, which measure the total amount of energy consumed compared with interval read meters which also measure *when* the energy is consumed. There is a far wider scope of possible tariff structure variations using interval read meters compared to accumulation meters. However, over the past decade developments in internet platforms, mobile technology and payments systems have expanded the possible ways for retailers to market and operate their businesses.

Consultant reports

This section draws on the retailer interviews conducted by Sapere and the Roy Morgan market research reports, all of which are available on the AEMC's website.

Product differentiation

Sapere asked retailers about their product offerings and whether there had been changes to the products they offer since entering the market. It also collated a number of offers from the interviewed retailers. It found that big retailers have a large range of products and service offerings compared to smaller retailers. The smaller retailers however did try to differentiate their offers from other retailers. The smaller retailers also stated that a strategy of offering a limited set of uniform products minimises costs and complexity and allows it to make more competitive offers than it otherwise could.⁴²⁸

Sapere noted that the main changes to products over the years since the introduction of FRC have been the level of discounts. However, several retailers recently launched new products:

- two retailers said that they had offered a pure fixed price product with prices fixed for two years; and
- three retailers stated that they had introduced a pay-on-time discount.

Retailers viewed green products as declining in popularity since the introduction of the carbon price.⁴²⁹

The market research by Roy Morgan indicates that small energy customers have somewhat mixed views about the level of variety on offer compared to last year. Specifically:

- 34 per cent of electricity residential customer respondents and 25 per cent of natural gas residential customer respondents stated that there was a greater variety of offers available from energy companies compared to a year ago. A similar proportion of small business respondents also stated that there was a greater variety of offers available from energy companies compared to a year ago; whereas
- six per cent of residential respondents and electricity small business respondents and 14 per cent of natural gas small business respondents all stated that there was a smaller variety of offers available from energy companies compared to a year ago; and

⁴²⁸ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, 28 February 2013, pp. 50-51.

⁴²⁹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, 28 February 2013, p. 55.

- 24 per cent of electricity residential customer respondents and 27 per cent of natural gas residential customer respondents stated that the variety of offers was about the same. A slightly higher proportion of small business respondents stated that the variety of offers was about the same compared to a year ago.

In both surveys, the proportion of respondents that did not know or were unsure was approximately a third.⁴³⁰

Unanimously, retailers told Sapere that products which offer a discount or rebate are the most popular.⁴³¹ This view is consistent with the market research conducted by Roy Morgan. In both the residential and business surveys a substantial proportion of respondents were encouraged to switch as a result of discounts:

- 78 per cent of electricity and 67 per cent of natural gas business customer respondents stated that lower prices was the most effective incentive to encourage switching;⁴³² and
- 76 per cent of electricity and 72 per cent of natural gas residential customer respondents stated that lower prices was the most effective incentive to encourage switching.⁴³³

Of the customers that actually switched, the reasons people gave were centred on money.⁴³⁴

Despite competitive offers being largely price driven at least four retailers stated that they have launched or will be launching a range of value added services. Some of the services are online portals that allow the retailers' customers to access information about their energy use and a range of other services including advice on managing energy use. This is in response to a clear view that customers are becoming more interested in their energy use. Retailers stated that the reasons for responding to customers' increasing interest in energy use are that:

- interval read meters have enabled the information to be available and presented to customers, such that retailers can be proactive and offer it to customers as a point of differentiation; and
- from a competitive perspective it is seen as a way of retaining customers.⁴³⁵

⁴³⁰ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 45; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 46.

⁴³¹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, 28 February 2013, p. 53.

⁴³² Roy Morgan, *Survey of business Customers of Electricity and natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 39.

⁴³³ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 38.

It was also considered that should retailers enable customers to better manage their load with time of use pricing and good information, the retailer benefits by having a flatter load profile which can help the retailer manage wholesale purchase costs better. Sapere formed the view that "energy retailing seems to be at the cusp of change which is being driven by the changing needs of customers and retailers are starting to better meet the changing needs of consumers."⁴³⁶

Sapere's view from retailers about changing customer needs is consistent with the focus group findings. Participants in the focus groups expressed a desire for more assistance from energy companies for reducing energy usage, saving money and tracking down the causes of unexpected spikes in bills. They also thought that the information on bills did not explain prices or price changes very well. Participants gave the example of Telstra as providing more understandable contracts and giving useful information to customers about their usage and the best plan to suit their usage.

Innovation

A common view from the retailer interviews was that there has not been a large amount of innovation in the types of products and services offered by retailers in NSW. Several retailers reported to Sapere that two key reasons for a lack of product innovation in NSW is ongoing price regulation and the lack of interval read meters.⁴³⁷ This is characterised by one retailer that said:⁴³⁸

"When you're marketing to a customer who you assume is - is a fair chance to be on it, [regulated price] you have to structure your offer so you can sell it based on ... - on the regulated rate [so as to say] 'Here is how I [retailer] compare.'"

In contrast, one retailer said that as a result of the removal of price regulation and the roll out of interval read meters there will be a raft of time of use type products introduced in Victoria this year. Specifically this retailer described the detriment to innovation caused by regulation as follows:⁴³⁹

"FRC does not give you the full suite of products. It allows people to switch retailers, but if you're controlling the profitability in the markets,

⁴³⁴ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 24.

⁴³⁵ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, 28 February 2013, p. 56.

⁴³⁶ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of interviews with Energy Retailers*, 28 February 2013, p. 53.

⁴³⁷ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, 28 February 2013, p. 57.

⁴³⁸ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of interviews with Energy Retailers*, 28 February 2013, p. 57.

⁴³⁹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of interviews with Energy Retailers*, 28 February 2013, pp. 57-58.

controlling the risk management markets...it's still not [a] fully open market as such. So in a deregulated market, I think the innovation levels are much higher and that's what you're starting to see in Victoria now."

The issue of retail price regulation also was also raised in the context of uncertainty making product innovation more difficult in particular when the terms of reference change at every three year reviews. Retailers said that under this uncertainty it was more difficult to create products than if the market determined prices. A retailer explained it as:⁴⁴⁰

"...it's much easier to make those investments [on product innovations] in an environment where you've got confidence that you will get rational pricing outcomes and that...you're making an investment in something that will help you compete in a market that has not got other sort of regulatory interventions laid out at the top. It's more difficult to that in a market where you're at the mercy of regulatory pricing."

Retailers expressed the view to Sapere that in order to operate successfully they needed to develop products and services that continue to meet the expectations of customers. Sapere observed a level of frustration among retailers with the regulated pricing arrangements, particularly among new entrant retailers, as an impediment to being able to innovate to meet customer expectations.⁴⁴¹

Submissions

Responses were generally consistent with survey responses. Both retailers and consumer groups agreed that product differentiation and innovation was limited particularly when compared to Victoria.

Origin Energy submitted that there is little activity based on differentiated tariff features. It further stated that tariff innovation is likely to require wider deployment of interval read meters and the removal of price regulation which will encourage retailers to invest in more innovation tariffs and services. It submitted that its recent investment in the SMART portal service in Victoria is an example of the availability of metering technology and market forces combining to encourage innovation.⁴⁴² Likewise, EnergyAustralia submitted that interval read meters will increase competitive capability and so will bring innovation and differentiation. It also submitted that price regulation stifles innovation and differentiation. It noted an increase in activity following the announcement of deregulation in South Australia.⁴⁴³ The ERAA echoed

⁴⁴⁰ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of interviews with Energy Retailers*, 28 February 2013, p. 69.

⁴⁴¹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, 28 February 2013, p. 70.

⁴⁴² Origin Energy submission, 8 February 2013, pp. 12,14.

⁴⁴³ EnergyAustralia, Issues Paper submission, 8 February 2013, Attachment pp. 4-5.

this view, as it stated that deregulation would enable retailers to set cost reflective, innovative tariffs.⁴⁴⁴

Similarly, PIAC submitted that tariff innovation was limited as tariff structures largely reflect underlying network tariffs as well as the regulated retail tariff. It stated that Victoria has more electricity product innovation than in NSW noting the most important difference is the number of standing offers. Utilising the same consumption assumption, PIAC submitted that NSW shows less bill differences between offers than in Victoria for customers with different consumption levels.⁴⁴⁵ NCOSS also submitted that product choice appears limited.⁴⁴⁶

A number of retailers submitted that a range of products are available offering customers choice.⁴⁴⁷ AGL submitted that products are developed with the capability to be launched across the NEM but launched first in Victoria is the market as viewed as less risky.⁴⁴⁸ However, CHOICE submitted that the complexity of tariffs and offers available means that competing offers are not able to be easily compared and require analysing a significant amount of information to properly compare offers.⁴⁴⁹

Analysis

There appears to be strong support for the view that product differentiation and innovation is currently limited compared to Victoria. In both the South Australian and Victorian reviews, the AEMC found limited evidence of product differentiation and innovation. The reasons given by retailers at that time were similar to those put forward in this review: that price regulation has impeded product innovation.⁴⁵⁰ This view is supported by a comparison with Victoria. As noted by PIAC, and retailers, product differentiation and innovation appears greater in Victoria, where price regulation has been removed and interval read meters progressively rolled out.⁴⁵¹

However, it may also be the case that there is limited customer preference for different products and services at this stage of market development. This possible explanation is consistent with the research undertaken by Roy Morgan. If that is the case, retailers are responding to customer preferences to focus on keeping prices low.

⁴⁴⁴ ERAA, Issues Paper submission, 8 February 2013, pp. 4-5.

⁴⁴⁵ PIAC, Issues Paper submission, 8 February 2013, pp. 19, 24-25.

⁴⁴⁶ NCOSS, Issues Paper submission, 8 February 2013, p. 8.

⁴⁴⁷ ActewAGL, Issues Paper submission, 8 February 2013, p. 2; EnergyAustralia, Issues Paper submission, 8 February 2013, p. 4; AGL, Issues Paper submission, 13 February 2013, p. 7; Origin Energy, Issues Paper submission, 8 February 2013, pp. 11-12.

⁴⁴⁸ AGL, Issues Paper submission, 13 February 2013, pp. 7-8.

⁴⁴⁹ CHOICE, Issues Paper submission, 8 February 2013, pp. 6-8.

⁴⁵⁰ AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria*, First Draft Report, 4 October 2007, pp. 60-61; AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia*, First Draft Report, 4 July 2008, pp. 85 – 87.

⁴⁵¹ PIAC, Issues Paper submission, 8 February 2013, p. 24

Retailers are responding to customer preferences for lower prices

The Roy Morgan customer research reveals that customers are overwhelmingly motivated to switch retailers based on price. Retailers also made this observation, which is consistent with results published in a recent survey by One Big Switch.⁴⁵² However, it is not clear whether customer preference for the lowest price is symptomatic of heightened awareness of rising electricity prices, given recent political and media attention to the issue. Indeed, Roy Morgan observed from the focus groups that discussions were dominated by the topic of rising electricity prices and a parallel concern about natural gas prices was not apparent.⁴⁵³

Retailers acknowledged that the market is heavily price focused and are finding ways to minimise costs. For example, NERA observed limited innovation in tariff structures but stated that:⁴⁵⁴

“In our opinion, the lack of innovation in the structure of tariffs reflects the desirability for retailers to pass network cost risks directly through to customers by matching the network tariff structure in retail tariff market offers.”

This may therefore represent a strategy to minimise costs and offer competitive rates to customers. Sapere also noted that the number of offers by smaller retailers was lower than larger ones as a strategy to minimise costs.⁴⁵⁵

Further, without large scale roll outs of interval read meters, retailers try to minimise the effect of high peak prices in the wholesale market by using financial hedges. With interval read meters, retailers would be able to offer prices to encourage customers to shift consumption away from peak periods. This would have the effect of reducing the cost of purchasing energy. Indeed, Sapere reported that time of use pricing provides incentives to customers to shift consumption into cheaper periods and so:⁴⁵⁶

“This can help to not only to reduce the customer bills but enables retailers that have a customer base with a flatter load profile (as opposed to a peaky load profile) to better manage wholesale purchase cost.”

Retailers also stated that bad debts were a significant cost. As a result retailers now offer pay on time discounts as a way of segmenting those customers that could be

⁴⁵² Of the 40 per cent of respondents who switched through One Big Switch, 88 per cent switched in order to save money. See One Big Switch, News, "Survey Shines Light on Electricity Myths", Survey Report, viewed 8 April 2013, accessed through <https://www.onebigswitch.com.au/news/2012/09/survey-shines-light-on-electricity-myths/>.

⁴⁵³ Roy Morgan, *Retail Competition in the NSW Electricity and natural Gas Markets: Focus Groups with Residential and Small Business Consumers*, 28 February 2013, p. 9.

⁴⁵⁴ NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, p. 32.

⁴⁵⁵ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, pp. 50-51.

⁴⁵⁶ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, February 2013, p. 64.

potentially more risky. Another payment innovation is linked with payment method, by providing discounts for using direct debit. Table B.7 below illustrates the range of discounts is moving away from a straight discount off the regulated tariff and segmenting customers based on payment. This means that some customers - those that have a risk of paying late or cannot access direct debit - will pay higher rates. It is also the case, as the table illustrates, that both guaranteed discounts and payment discounts are greater for longer term contracts.

Table B.7 Sample of discount conditions

	Electricity offers			Natural gas offers		
	No contract	1 year contract	2+ years contract	No contract	1 year contract	2+ years contract
Direct debit discounts	1% usage	1% - 6% usage	2% usage; up to \$20	1% usage	1% usage	2% usage
Pay on time discounts	3% bill; 7.5% usage	2% - 15% usage	4% - 10% usage; 5% - 12% bill	3% bill	2% usage	3% - 4% usage; 3% - 9% bill
Guaranteed rebates/discounts	\$30 rebate with \$30 more for each 12 month period; 3% usage	10% - 14% usage	\$100; 3% - 10% bill; 7% - 15% usage	3% usage; \$30	8% usage	7% - 8% usage; 3% - 8% bill
Early termination fees	n.a.	yes	yes; some waive if find a better deal and the contract provider cannot match it	n.a.	yes	yes
Late payment fees	some yes	some yes	some yes	some yes	some yes	some yes
Dual fuel discounts	n.a.	1% usage	n.a.	n.a.	1% usage	n.a.
Other benefits	\$200 credit if AFL club member or membership to the same value	monthly billing; rewards cards	renewable components; shop vouchers; rewards points; fixed rates for 2 years	n.a.	n.a.	reward points; shop voucher

Note: Shows the range of terms and conditions available returned from a search of one postcode in each of the three network areas: 2090 (Ausgrid); 2150 (Endeavour Energy); and 2650 (Essential Energy). There were no natural gas market offers returned for the Essential Energy area.

Source: Compiled from www.myenergyoffers.nsw.gov.au on 25 March 2013.

The range of parameters in the table reflects both differences between retailers, as well as between network areas. Using the same IPART database NERA identified:

- 31 electricity offers in the Ausgrid area, 41 in the Endeavour Energy area, and 30 in the Essential Energy area;
- 9 natural gas offers in the Jemena network area; and
- 7 dual fuel offers in the Ausgrid area, 9 in the Endeavour Energy area, and 6 in the Essential Energy area.

While there is some evidence of innovation in the additional benefits offered on some contracts, it is clear from the surveys and responses to this review that price is the main motivation for customers to switch and retailers have been tailoring their products in a way to attract those customers motivated by price. However, it is less clear whether customers fully understand the impacts of different quoted prices on their bills (which is ultimately what most customers are concerned about). It may be easier for some customers to understand the value of an Australian Football League (AFL) membership than a percentage discount on the usage component of their bill. This is because the impact on bills depends not only on the price level, but also the structure of the tariff and the individual customer's consumption patterns, as well as their payment mechanisms.

Customer ability to evaluate relevant offer variables

Product differentiation and innovation should allow all customers to select from a range of tariffs, and select one which minimises their bills given their individual circumstances. Undoubtedly, increased choice has the potential to improve customer outcomes. As PIAC stated, "while the increased price and product differentiation in Victoria does not protect households from overall price increases, it does offer customers a more meaningful choice when switching supplier."⁴⁵⁷ However, with increased product choice, the ability to effectively compare such offers becomes more complex. In the Victorian review, in relation to a lack of product differentiation the AEMC stated that:⁴⁵⁸

"On the one hand, the application of a standard tariff structure allows for a simple comparison of offers. On the other, the application of different pricing structures would improve choice for customers and allow tariffs to more accurately reflect the cost of serving different types of customers."

As identified in section B.2 the ability for customers to compare offers is important for enhancing competitive markets. However, the range of information a customer must evaluate to make a decision was highlighted in the CHOICE submission. Table B.4 in section B.2 sets out relevant factors that CHOICE suggests a customer needs to

⁴⁵⁷ PIAC, Issues Paper submission, 8 February 2013, p. 26.

⁴⁵⁸ AEMC, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria*, First Draft Report, 4 October 2007, p. 60.

consider and is reproduced from its submission. CHOICE submit that "the complexity of tariff structures means that competing energy offers are not able to be easily compared."⁴⁵⁹ It therefore recommended that the AEMC look into potential methods of addressing the issue of comparability.⁴⁶⁰ This is an area which is discussed further in Chapter 8.

A number of reforms in consumer regulation aim to address customer education and enable effective competition through easy comparison of market offers. For example, in mobile telephony, the Australian Communications and Media Authority (ACMA) require providers to issue a two page critical information summary with each plan describing in plain language what is on offer and all fees clearly set out with what is included and what is not.⁴⁶¹ Another example is in the consumer credit market. The Australian Securities and Investment Commission (ASIC) requires all credit providers to include a comparison rate which includes most fees and charges in the interest rate to enable comparison of products, such as mortgages, personal loans and credit cards, using the true interest rate.⁴⁶²

Since prices have been deregulated in Victoria, the variety of products on offer has increased. The roll out of interval read meters has also enabled a much greater product choice. Retailers noted that their innovation efforts are focused on Victoria with the launch of a number of online portals and that a number of new time of use products are planned to be launched this year.⁴⁶³ As interval read meters are progressively introduced in NSW, the need for customer education to enable effective evaluation of differentiated offers also increases.

Summary

Currently, there is limited product differentiation and innovation in the market compared to Victoria. However, the evidence of the surveys and responses to this report suggest customers are not unduly concerned about a lack of product choice at present. The evidence reviewed shows that customers are overwhelmingly motivated by price and that retailers are responding to this. The products on offer appear to be structured in a way so as to be delivered as efficiently as possible, reducing risk for the retailer and in turn bringing lower prices to customers.

However, given differences in consumption patterns across different customers, there is likely to be scope for a number of customers to reduce bills further through having access to different types of tariffs.

⁴⁵⁹ CHOICE, Issues Paper submission, 8 February 2013, p. 6.

⁴⁶⁰ CHOICE, Issues Paper submission, 8 February 2013, p. 11.

⁴⁶¹ ACMA, Media Release, "Cutting the fine print: New information tool for telecommunications consumers", 28 February 2013.

⁴⁶² ASIC website, National Credit Code, <http://www.asic.gov.au/asic/asic.nsf/byheadline/Consumer-Credit-Code#>, accessed 3 March 2013

⁴⁶³ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report of Interviews with Energy Retailers*, 28 February 2013, p. 57.

As the market develops, and interval read meters are increasingly adopted, the scope for product innovation will increase, as evidenced by the Victorian experience. This is likely to help many customers to identify ways to reduce their bills, through responding to more tailored value or service based product offers. However, at the same time, the need for effective information provision to enable customers to effectively compare products also increases.

B.3.4 Retailer marketing

The nature and extent of marketing undertaken by retailers is a measure of retailer rivalry. If retailers are undertaking a lot of marketing using a range of sales channels then this indicates that retailers are competing to gain and retain customers and that there is a high level of retailer rivalry. This section sets out the evidence provided from consultant reports and submissions before providing our own analysis and conclusions.

Consultant reports

In relation to marketing activities Sapere suggests that the most popular marketing channels for retailers who focus on the residential market are door knocking and telesales.⁴⁶⁴ There is also an increase in the importance of on-line channels.⁴⁶⁵

Most retailers said that they do not necessarily discriminate their retailing activity by location.⁴⁶⁶ Sapere suggests that retailers do however seem to take into account a variety of commercial factors before deciding whether to undertake a marketing campaign in a certain location. For example, Sapere suggests that the main driving factor influencing the location of where retailers target, is whether they can make a profit on customers in the area in question taking into account the regulated price that applies in an area. Another commercial factor influencing customer acquisition strategies is the credit rating of the customers.⁴⁶⁷ It was suggested by retailers that activity in regional areas had increased since privatisation of the retailers.⁴⁶⁸

Submissions

Retailers submitted that there is a high level of marketing using an increasing range of sales channels.⁴⁶⁹ A range of sales channels were identified in submissions by retailers

⁴⁶⁴ Interviews were undertaken prior to announcements from EnergyAustralia and AGL that they are to cease from door to door sales.

⁴⁶⁵ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in NSW - Report of Interviews with Energy Retailers*, 28 February 2013, p. xi.

⁴⁶⁶ I.d., p. 20.

⁴⁶⁷ I.d., pp. 20-21.

⁴⁶⁸ I.d., p. viii.

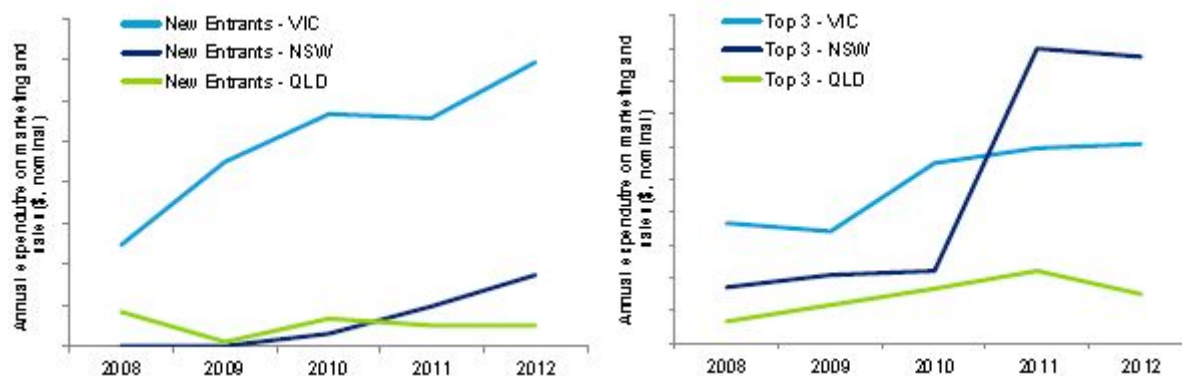
⁴⁶⁹ See for example EnergyAustralia Issues Paper submission, 8 February 2013, Attachment, p. 5.

including door to door, telephone and on-line.⁴⁷⁰ Origin Energy suggests that advertising campaigns are widespread in both metro and country areas.⁴⁷¹ EWON and the ECC raise concerns of misleading and pressure selling in relation to door to door sales.⁴⁷²

Analysis

Figure B.11 below shows that marketing expenditure by both small and large retailers has increased following privatisation. Retailers, particularly the big three, appear to be focussing their resources on both acquiring and retaining their customers. However, we note that this increase is more marked for the big three retailers and that the level of sales and marketing expenditure by the small new entrant retailers in NSW is much lower than that of small new entrant retailers in Victoria.

Figure B.11 Total marketing and sales expenditure



Source: Research undertaken by Deloitte Access Economics in 2012, supplied by the Energy Retailers Association of Australia.

The significant increase in marketing expenditure may partly reflect the fact that AGL did not purchase an incumbent retail business. Consequently it is now marketing heavily to attract new customers. AGL acquired 64,220 electricity customers in the six months to 31 December 2012.⁴⁷³ In contrast, EnergyAustralia and Origin Energy are working to retain their newly acquired customer base. Origin Energy lost 43,000 electricity customers in the six months to 31 December 2012.⁴⁷⁴ As discussed above, this demonstrates that competition can be fierce even between three retailers.

The findings from the customer surveys undertaken by Roy Morgan provide a further indication of the type and extent of marketing carried out by retailers. The proportion of electricity and gas customers surveyed who had been approached by an electricity

⁴⁷⁰ Ibid.

⁴⁷¹ Origin Energy, Issues Paper submission, 8 February 2013, p. 2.

⁴⁷² EWON Issues paper submission, 8 February 2013, pp. 4-5; and ECC Issues Paper submission, 7 February 2013, p. 3.

⁴⁷³ AGL, FY13 Interim Results, 27 February 2013, p. 8.

⁴⁷⁴ Origin Energy, 2013 Half Year Results Announcement, 21 February 2013, p. 33.

or gas retailer is set out in Table B.8 below. These results show that a large proportion of electricity customers have been contacted by a retailer. The proportion of customers approached by a gas retailer was much lower. This appears to indicate that the extent of marketing for gas is lower than for electricity. This may be because gas bills are lower and therefore there is less profit to be made out of gas customers from retailers. Given that gas appears to be marketed as a dual fuel product it is also possible that the level of approaches in gas has been understated.

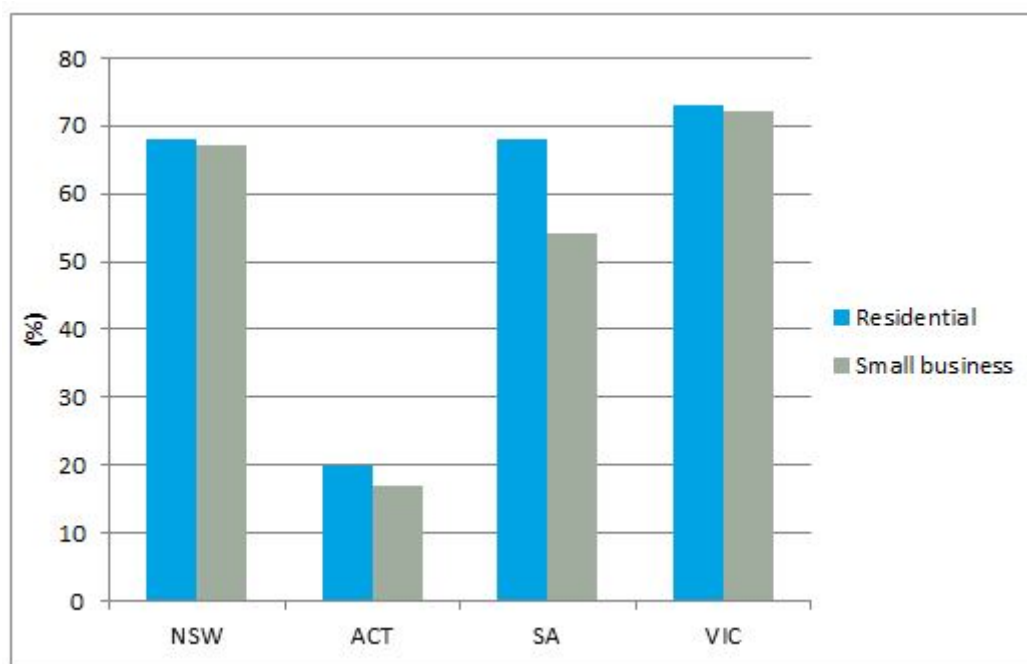
Table B.8 Proportion of customers that had been approached by an electricity or gas retailer

	Electricity	Gas
Residential	68%	32%
Small business	67%	37%

Source: Customer surveys undertaken by Roy Morgan for the AEMC.

The results for electricity are similar to those found in Victoria and South Australia at the time of their competition reviews as set out in Figure B.12. There was much smaller proportion of customers that had been approached by an electricity retailer in the ACT at the time of its review. This indicates that the extent of marketing in electricity in NSW is high.

Figure B.12 Customers that have been approached by a retailer - electricity

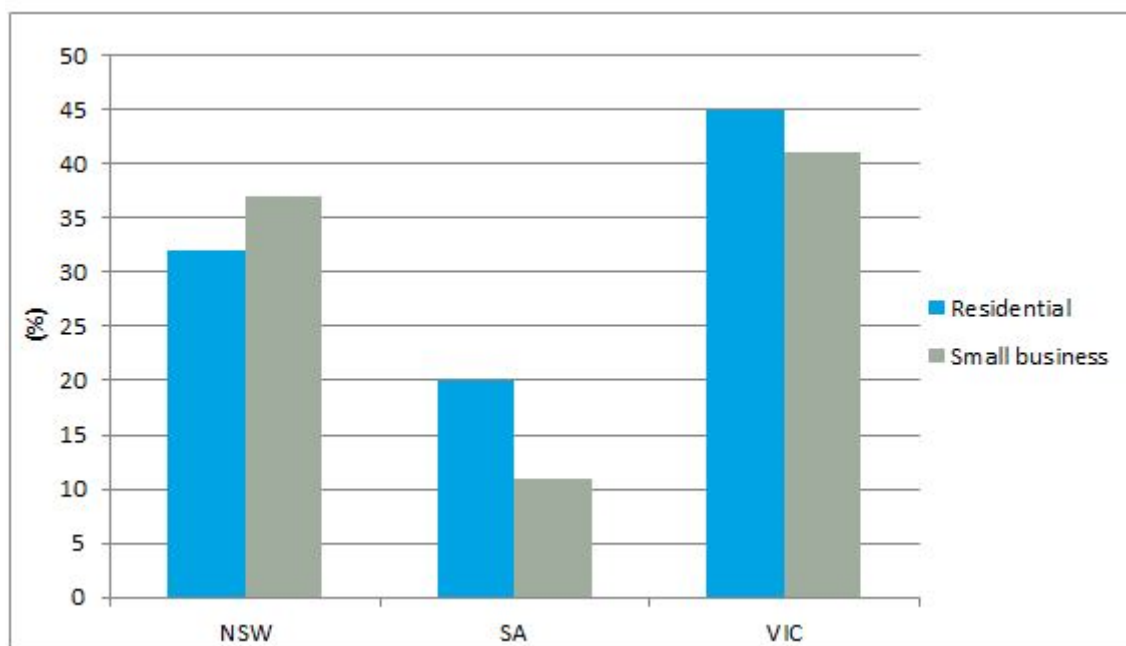


Source: Customer surveys undertaken for AEMC retail competition reviews.

Figure B.13 below compares the proportion of gas customers that have been approached by gas retailers in NSW with those that had been approached by retailers

in other states at the time their reviews were undertaken. It shows that a higher proportion of gas customers have been approached in NSW than in South Australia at the time of its review but lower than that which was experienced in Victoria at the time of its review. This indicates that although there is a lower rate of approaches in gas than in electricity this level of approaches is still a relatively healthy sign of competition.

Figure B.13 Customers that have been approached by a retailer - gas



Source: Customer surveys undertaken for AEMC retail competition reviews.

The Roy Morgan results also indicate that there is a difference in retailer marketing approaches to customers in metro and non-metro areas. Seventy-two per cent of residential electricity customers had been approached in areas that it classified as metro compared to 58 per cent of customers in areas that it classified as non-metro areas.⁴⁷⁵⁴⁷⁶ This is consistent with the results of the PIAC survey described in Box B.2.

However, a comparison of the results in the Roy Morgan survey with the results of the PIAC survey conducted in August 2010 indicates that there has been an increase in retailer activity in non-metro areas since the PIAC survey was undertaken. The PIAC survey showed that the proportion of residential customers in five regional centres in NSW who had been approached by an electricity retailer regarding an offer ranged from 35 per cent to 49 per cent.⁴⁷⁷ On average these figures are lower than the proportion of non-metro customers that had been approached by a retailer in the Roy Morgan survey.

⁴⁷⁵ Roy Morgan classifies Greater Sydney and the Central Coast as "metro" areas. It classifies all other geographic areas in the state as "non-metro" areas.

⁴⁷⁶ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p.12.

⁴⁷⁷ PIAC, *Choice? What Choice?*, June 2011, p. 45.

One of the potential reasons for a lower approach rate to customers in non-metro areas is due to the logistical issues in undertaking door to door sales. The Roy Morgan survey results show that door to door approaches were the most common form of sales approach adopted by retailers for residential customers while they were the second most common method for small business customers.⁴⁷⁸ Telephone sales were the main method of approaching small businesses by retailers, which is consistent with the Sapere report that states that retailers that focus on the small business segment are more likely to use direct mail or cold calling by salespeople.⁴⁷⁹

However, we note that some retailers may be turning towards alternative marketing techniques, particularly on-line marketing following the separate announcements by EnergyAustralia and AGL that they would no longer use door-to-door sales to acquire customers.⁴⁸⁰ Such techniques are likely to discriminate less between metro and non-metro areas in comparison to traditional marketing methods such as door knocking.

Summary

Marketing expenditure by electricity retailers in NSW has increased since privatisation suggesting that retailer rivalry and competition has also increased. Reflecting this increase in marketing expenditure a large proportion of electricity customers have been approached by retailers.

Results of the Roy Morgan survey indicate that direct marketing practices such as door to door sales and telephone sales are prevalent in the electricity and gas retail markets. Although the prevalence of these practices is less obvious in non-metro areas than metro areas there appears to have been an increase in direct marketing in non-metro areas by retailers in recent years. In any case some of the large retailers appear to be moving away from door to door selling and moving towards alternative forms of marketing such as on-line sales channels. These alternative forms of marketing are less likely to discriminate by geographic area.

There was a much smaller proportion of gas customers that had been approached by a retailer than electricity customers suggesting that lower levels of marketing expenditure have been incurred by retailers on retailing gas. In this way there appears to be less activity by retailers in the gas market than in electricity. However, given that gas is marketed as a dual fuel product the level of approaches in gas is likely to be understated.

⁴⁷⁸ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 14; and Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 15.

⁴⁷⁹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in NSW - Report of Interviews with Energy Retailers*, February 2013, p. 59.

⁴⁸⁰ See for example: EnergyAustralia news announcement, Knock Knock...Who's there? Not EnergyAustralia, 25 February 2013. Available at www.energyaustralia.com.au.

High customer switching rates also provide evidence of strong retailer rivalry in the electricity and gas markets.

In summary, the Commission considers that the level of marketing in the electricity market as a whole is high, indicating strong competition. While the evidence suggests the level of marketing is lower in non-metro areas for electricity and in gas the Commission considers that on balance there is sufficient rivalry in these areas to support competition.

B.4 Conclusions

This chapter has focussed on the conduct of both customers and retailers in the NSW electricity and gas market.

To gain an insight into customer experiences Roy Morgan conducted both qualitative (that is, focus groups) and quantitative (telephone surveys) studies. The research showed that both electricity and gas customers in NSW are aware of competition and the availability of choice in the electricity and gas retail markets. However, one area of concern is information available to customers to help them make the best choice for them.

In addition, to consider whether customers were able to exercise choice in the selection of an electricity retailer we analysed data from AEMO to determine the switching patterns of small customers in NSW. The data indicates that the number of small customers that have switched retailers in NSW is high when compared with other jurisdictions and other comparable industries. This is particularly the case in electricity. Switching rates are not so high but healthy in gas. There are also a large number of customers that are changing their arrangements with their existing retailer as well as customers that make a conscious decision to stay on the regulated tariff. These factors indicate that customers are actively participating in both the electricity and gas markets in NSW.

We used a variety of sources of information to gain an insight into retailer behaviour. High customer switching rates in both gas and electricity indicate there is strong retailer rivalry. There is less evidence of retailer rivalry in relation to product differentiation and innovation. However, retailers are responding to customer demands for lower prices and there are other factors that also effect the level of product innovation, including the availability of advanced metering technology and the existence of price regulation. The level of marketing activity in the market supports effective competition. Retailers have increased marketing expenditure in recent years and this is particularly evident in non-metro areas.

C Market performance

Box C.1: Summary of chapter

The Commission views the outcomes of the market performance assessment as consistent with an effectively competitive market for the following reasons:

- regulated margins appear to have allowed sufficient headroom for new entrants to come into the market and offer a discount from the regulated price in both electricity and natural gas;
- market offers illustrate that second tier retailers are taking advantage of the available margin to offer discounts to customers;
- changes in market share illustrate that price-based competition is occurring because customers are switching to new entrants' lower priced offers;
- incumbents appear to have responded by offering market offers below the regulated price; and
- the majority of customers appear satisfied with their retailers and with the switching process, but are demanding more transparent information, particularly in relation to prices. A minority of customers have had negative experiences, particularly in relation to marketing practices.

Such evidence of price-based competition provides confidence that price regulation is not required to constrain prices.

The performance of retail energy markets is a reflection of its structure and the conduct of participants in the market. In markets characterised by effective competition, rivalry between retailers and the threat of new entry, will provide retailers with an incentive to match and improve upon the price and non-price offers of their competitors. Over time these competitive pressures will cause prices to converge toward the efficient economic cost of delivery. A well performing market would be expected to have:

- *prices* that enable the recovery of the efficient cost of supply, including a reasonable margin commensurate with the industry risks; and
- *customers* who are satisfied with their suppliers' services and conduct.

The AEMC's draft findings in relation to each of these elements are described below.

C.1 Prices and profit margins

The profit margin of retailers in the retail energy market is an important indication of market performance. A profit margin is the difference between the price for a good or service and the cost of supplying it. Profit-maximising retailers will therefore seek to increase prices and/or reduce costs. However, they will be constrained from raising

prices or reducing costs through a reduction in service quality if there is a response to those actions from either:

- rival retailers, in the form of winning customers by offering lower prices, better service or more favourable terms;
- potential rivals, in the form of entering the market and winning customers by offering lower prices, better service or more favourable terms; or
- customers, in the form of reducing consumption or switching to alternative suppliers or products.

Profit margins therefore provide an indication of the attractiveness of entry to a market. If prices generate sufficient profits, the market will appear attractive and firms will have an incentive to enter the market. In circumstances where prices fall below the level where efficient retailers are able to recover their economic costs, some retailers may be forced to exit the market while potential entrants may be discouraged from entering. Existing market participants may also be discouraged from expanding their operations.

Measuring retailers' profit levels over time can therefore provide a good indication of the level of competition in the retail market.

In NSW, the standard retailer's standing offer price is capped by regulation. Analysing the profit associated with this regulated offer is therefore less informative about the level of competition that has prevailed to date. However, we can look at how competitors have priced in relation to regulated tariffs, and where incumbent retailers have priced their market offers. It can also provide indications about the historical prospects for new entry and competition. Assessing offers in relation to regulated prices can potentially provide evidence on levels of competition.

Estimating profit margins

Identifying an appropriate margin for the energy retailing industry is inherently difficult. This is because it is difficult to measure the level of capital in energy retailing in order to compare to an external benchmark cost of capital. For this reason, profitability tends to be assessed as the margin on sales. However, determining what is a "reasonable" margin on sales is difficult. Businesses will have different cost structures and strategies and so may require different rates of return for their investments. As well, at different points in the competitive process or investment cycles higher or lower margins would be expected.

A low profit margin can be indicative of low levels of industry risk. It can also be synonymous with low levels of competitive activity as there is little incentive for new entrants to enter the market and actively compete for customers. However, high profit margins can also be indicative of low levels of competitive activity since there is sufficient room for a new entrant to undercut incumbents, but entry has not occurred. It could also indicate that the risks in the industry are high. High profit margins for short periods can also be appropriate to reward high levels of innovation.

Profit margins are not stable indicators. As costs and risks vary over time so too will profit margins. Profit margins will also vary as retailers enter and exit the market, affecting the level of competitive activity. As a result, we would expect profit margins to vary over the study period.

Effective competition implies that retailers compete over the costs they can control. Consequently, over time prices will trend towards efficient costs, including an efficient retail margin (or return on investment). A retailer's cost base is comprised of the following elements:

- wholesale energy costs - the costs to purchase electricity or natural gas from the relevant market for delivery to the retailer's customers;
- network costs - the costs to utilise the relevant transport networks to delivery energy to the retailer's customer's premise (eg electricity transmission and distribution networks, transmission pipelines);
- retail operating costs - the costs to operate the retail business, including customer support and billing, marketing and corporate costs; and
- retail margin - the return on investment to the owners of the retail business.

Recently there have been significant increases in electricity prices. These have largely been driven by substantial increases in network tariffs.⁴⁸¹ As network costs account for approximately 50 per cent of retail electricity bills, changes in the network component have a direct impact on retail prices. However, electricity network prices are estimated to moderate going forward.⁴⁸²

Network costs are regulated by the AER and levied on retailers. As such, jurisdictional regulators have historically treated network costs as a pass-through. If retailers are unable to recover these costs from their customers, they will incur losses and no longer be able to continue their businesses. The remaining components are not separately regulated and so the competitive process would expect to reveal efficient levels of these costs.

C.1.1 Consultant report

The Commission engaged NERA to estimate the profit margin for small electricity and natural gas customers for the period between 2002 and 2012.⁴⁸³ The purpose of NERA's assessment is to examine whether the estimated margin since the introduction of full retail competition was sufficient to support effective competition. That is, whether retailers are competing over the costs which they can control.

⁴⁸¹ IPART, *Review of regulated retail prices and charges for electricity 2013 to 2016*, Electricity - Issues Paper, November 2012, p. 14.

⁴⁸² AEMC, *Electricity Price Trends Final Report - Possible future retail electricity price movements: 1 July 2012 to 30 June 2015*, 22 March 2013.

⁴⁸³ NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013.

To do this, first NERA calculated the cost of supply by adding estimates of wholesale energy costs, network costs and retail operating costs for a representative customer.⁴⁸⁴ It then collected historic regulated tariffs and market offers from which to subtract the estimated costs. The implied margin was then calculated as the difference between price and cost as a proportion of the price.

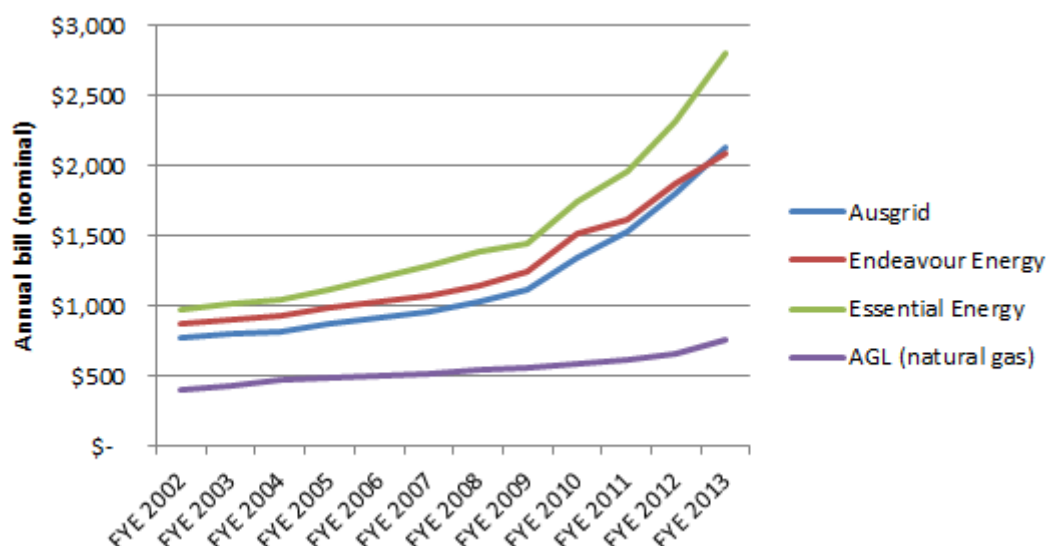
NERA largely utilised publicly available data to estimate the cost base, as opposed to directly observing incurred costs by retailers. Consequently, the profit margin estimate contains a significant degree of uncertainty. Small variations in costs can have large effects on margins, particularly with regard to wholesale energy costs since it is a large proportion of total costs. For this reason, NERA produced three separate scenarios for its wholesale energy cost estimates: low, medium and high.

Below is a high level summary of NERA's margin estimates starting with a discussion of its findings on prices. A full description of NERA's methodology and results is included in its report, which is published on our website.

Prices

Since 2002 estimated regulated representative customer bills have increased substantially, both in electricity and natural gas. The rate of increase has been higher in electricity than in gas. This is illustrated in Figure C.1 below.

Figure C.1 Estimated representative customer bills by distribution area



Source: Compiled using NERA data.

⁴⁸⁴ The representative customer is intended to reflect the average customer's consumption and usage profile. NERA acknowledge that different consumption levels and profiles will affect the results and in reality a retailer will have a number of different customer types. A sensitivity analysis was undertaken to illustrate the differences when using a range of different assumptions.

Representative bills in electricity are much higher than in natural gas because in NSW, where there is a relatively low demand for heating, the amount used is much lower than electricity.

NERA also observed that the structure of regulated retail tariffs have largely followed the structure of the regulated network tariffs. The only exception appears to be the commercial natural gas retail tariffs which are flat but have underlying declining block⁴⁸⁵ network tariffs.

Estimated profit margins - electricity

Table C.1 below presents the results of NERA's analysis using regulated electricity tariffs for each wholesale cost scenario in each distribution area.

Table C.1 Implied retail margins on regulated tariffs to supply a representative electricity customer by distribution area

Distribution area	Low wholesale cost	Medium wholesale cost	High wholesale cost
<i>FY2002 - FY2007</i>			
Ausgrid	10%	6%	2%
Endeavour Energy	10%	6%	2%
Essential Energy	13%	10%	6%
<i>FY2008 - FY2013</i>			
Ausgrid	9%	5%	2%
Endeavour Energy	13%	10%	7%
Essential Energy	11%	9%	6%

Source: NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, p. 37.

The results show that for regulated tariffs, estimated margins:

- were lowest in the Ausgrid distribution area and decreased by one per cent between the two time periods;
- increased by four per cent between the two time periods in the Endeavour Energy distribution area; and
- were highest in the Essential Energy distribution area and also decreased by one per cent between the two periods.

⁴⁸⁵ Declining block tariffs are price structures that decrease as higher amounts are consumed. As a result, the more a user consumes, the lower the average price per unit they will pay.

NERA states that its calculated margins in the medium wholesale cost scenario are higher than those allowed by IPART. It notes that the differences arise because of its lower wholesale electricity cost assumptions. However, it also notes that its results benefit from utilising observed data to estimate wholesale costs whereas IPART was forecasting them at the time. The results from its high wholesale cost scenario are closer to the IPART retail margin allowance.⁴⁸⁶

There is less available information on market offer prices over the study period to calculate margins. However, since 2010 IPART has required retailers to submit information on market offers that are generally available. IPART's database of offers was provided to NERA for the purposes of this study. Generally, the observed market offer prices were structured in a similar manner to the regulated retail tariffs. Discounts are then added relative to a retailer's "standard rate", which did not always correspond to the regulated rate.

Table C.2 below provides a summary of representative customer bill reductions from regulated bills using market offers.

Table C.2 Summary of market offer bill reduction analysis, FY2011 - FY13

Distribution area	Number of offers (all retailers)	Mean discount	Interquartile range
Ausgrid	31	6%	(4%, 8%)
Endeavour Energy	41	6%	(4%, 8%)
Essential Energy	30	5%	(3%, 8%)

Note: discounts are calculated using the assumptions for the standard customers and include all possible discounts and exclude penalties such as late payment fees or early termination fees.

Source: NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, Table 5.1.

The interquartile range over the period shows that half of the market offers provided a discount on the representative customer bill from the regulated bill of:

- between four and eight per cent in the Ausgrid and Endeavour Energy distribution areas; and
- between three and eight per cent in the Essential Energy distribution area. NERA also observed that most of the offers are made in July and August, following the release of changes to the regulated retail tariffs.⁴⁸⁷

NERA's analysis of implied margins using market offers is consistent with its regulated tariff findings. That is, margins under market offers are less than or equal to regulated

⁴⁸⁶ NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, p. 38.

⁴⁸⁷ NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, p. 34.

margins. However, some offers are slightly larger than estimated regulated margins. NERA states that:⁴⁸⁸

“This is to be expected - retailers may have different cost bases to supply customers, and this will be reflected in the size of the discount that they make available to customers.”

NERA also conducted a sensitivity analysis to illustrate the estimated margin differences under regulated prices when utilising different assumptions for its representative customer. These include a customer on a time of use (TOU) tariff ("TOU customer"), a customer using less electricity ("small residential customer") and a customer using more electricity ("commercial customer"). Table C.3 below contains the results.

Table C.3 Results of electricity sensitivity analysis - margins on regulated tariffs

Distribution area	Representative customer - medium wholesale cost	TOU customer	Small residential customer	Commercial customer
<i>FY2002 - FY2007</i>				
Ausgrid	6%	3%	4%	10%
Endeavour Energy	6%	-5%	3%	10%
Essential Energy	10%	12%	6%	11%
<i>FY2008 - FY2013</i>				
Ausgrid	5%	12%	1%	16%
Endeavour Energy	10%	4%	8%	12%
Essential Energy	9%	9%	7%	9%

Source: NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, p. 40.

⁴⁸⁸ NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, p. 39.

The table illustrates that there are observed differences in the time of use margins compared to the representative customer margins. NERA's examination of the network and margin components of the total bills for these types of customers shows that:

- in the Ausgrid distribution area, margins are higher as a result of lower network costs; however, the customer bills are approximately the same. NERA point out that in practice a different load profile may result in a different margin;⁴⁸⁹
- in the Endeavour Energy distribution area, margins are lower as a result of higher network costs; and
- in the Essential Energy distribution area, margins are similar for both customer types; however since network costs are lower for the time of use customer, the total bill is lower than the representative customer on an all day tariff.

The table also illustrates that margins are lower for smaller customers and higher for larger customers. NERA found that margins generally increase as usage increases and highlights that margins can vary considerably depending on a customer's usage.

NERA concluded that retail tariff profit margins in electricity "were adequate to support effective competition in New South Wales between 2002 and 2012."⁴⁹⁰

Estimated profit margins - natural gas

Table C.4 below presents the natural gas results of NERA's analysis using regulated tariffs for each wholesale cost scenario.

Table C.4 Implied retail margins on regulated tariffs to supply a representative natural gas customer

	Low wholesale cost	Medium wholesale cost	High wholesale cost
FY2002 - FY2007	12%	7%	1%
FY2008 - FY2013	14%	10%	6%

Source: NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, p. 44.

NERA note that the results for the medium wholesale natural gas cost scenario are similar to the retail margin used by IPART in the 2010 to 2013 retail price determination. NERA's higher estimate for the period from financial year 2007-08 to

⁴⁸⁹ NERA assumed the consumption profile was the same for a TOU customer as for a representative customer.

⁴⁹⁰ NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, p. 46.

financial year 2012-13 is largely a result of NERA's lower wholesale natural gas cost assumption.⁴⁹¹

As for electricity, there is less available information on market offer prices over the study period to calculate margins. NERA was provided with market offer information since 2010 from IPART. Table C.5 below provides a summary of representative customer bill reductions from regulated bills using market offers.

Table C.5 Summary of market offer bill reduction analysis, FY11 - FY13

Customer type	Number of offers (all retailers)	Mean discount	Interquartile range
Residential	9	4%	(0%, 8%)
Commercial	7	5%	(0%, 12%)

Note: discounts are calculated using the assumptions for the standard customers and include all possible discounts and exclude penalties such as late payment fees or early termination fees.

Source: NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, Table 5.2.

The table shows that the range of bill reductions available in natural gas is much wider compared to electricity. There appear to be a small number of market offers above the regulated tariff.

NERA also conducted a sensitivity analysis to examine the estimated margin differences when utilising different assumptions for its representative customer. This included a commercial customer with greater usage than the representative customer ("commercial") and a customer which takes both electricity and natural gas supply from the same retailer ("dual fuel"). Table C.6 below contains the results.

Table C.6 Results of the natural gas sensitivity analysis - margins on regulated tariffs

	Commercial	Dual fuel - Ausgrid	Dual fuel - Endeavour Energy	Dual fuel - Essential Energy
FY2002 - FY2007	14%	4%	4%	6%
FY2008 - FY2013	17%	5%	9%	9%

Source: NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, p. 45.

The table above illustrates that for both periods, the estimated margin is higher for the commercial customer. This reflects the declining block tariff structure in the network

⁴⁹¹ NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, p. 44.

tariff which is not carried through into the retail tariff. As a result, as consumption increases, network costs decrease; and without corresponding decreases in the retail tariff, the margin increases. In contrast, the results for the dual fuel customer are lower than the representative gas customer and are more similar to the electricity results.⁴⁹²

NERA concluded as for electricity, that natural gas margins were sufficient to support effective competition in New South Wales between 2002 and 2012.

C.1.2 Submissions

Retailers view current regulated prices as broadly cost reflective. The ESAA, ERAA and retailers support the removal of price regulation.⁴⁹³ EnergyAustralia stated that price regulation is complex and the risks are asymmetric. This is because if the regulated price is set too high, it can be competed down but if it is set too low, the cost is borne by the energy industry.⁴⁹⁴

Origin Energy submitted that tariffs under the current IPART determination are broadly cost reflective however there is still a group of tariffs which are not cost reflective. Further, Origin Energy submitted that NSW retailers will be able to both recover their efficient costs and be incentivised to compete for customers provided that IPART continues to set cost reflective tariffs.⁴⁹⁵

AGL also submits that the current regulated price levels as determined by IPART has been successful in providing a framework that facilitates competition. However, AGL submitted that previous determinations had provided insufficient headroom to enable discounting which had a detrimental effect on competition. AGL states that whether future margins will continue to be sufficient to encourage further retail competition will depend on the IPART determination. In particular, AGL stresses that the significant changes in the east coast gas market means there is a risk in underestimating retailers' costs.⁴⁹⁶

C.1.3 Analysis

NERA's assessment indicates that there has been available headroom in the regulated price for retailers to offer discounts. This is consistent with the views of incumbent retailers described above. However, Sapere found that whilst incumbents viewed the

⁴⁹² NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, p. 45

⁴⁹³ ESAA, Issues Paper submission, 15 February 2013, p. 1; ERAA, Issues Paper submission, 8 February 2013, p. 1; ActewAGL, Issues Paper submission, 8 February 2013, p. 2; Alinta Energy, Issues Paper submission, 8 February 2013, p. 1; Origin Energy, Issues Paper submission, 8 February 2013, p. 2; Simply Energy, Issues Paper submission, 8 February 2013, p. 1; EnergyAustralia, Issues Paper submission, 8 February 2013, p. 2; AGL, Issues Paper submission, 13 February 2013, p. 1.

⁴⁹⁴ EnergyAustralia, Issues Paper submission, 8 February 2013, Attachment p. 7.

⁴⁹⁵ Origin Energy, Issues Paper submission, 8 February 2013, p. 19.

⁴⁹⁶ AGL, Issues Paper submission, 13 February 2013, pp. 5, 7, 11.

current regulated prices as providing sufficient headroom to operate efficiently, new entrant retailers had concerns regarding how the regulated price was set.⁴⁹⁷

In this section we examine new entrants' concerns regarding the regulated price.⁴⁹⁸ We also consider whether effective competition would limit the ability of incumbent retailers to increase profit margins above cost reflective levels and if that would be likely if prices were deregulated.

Is there a sufficient margin in the regulated price to support competition?

The Commission agrees with NERA's analysis that there is sufficient headroom in the regulated tariff to support competition. The most compelling evidence in support of NERA's conclusion is that market offers include discounts from the regulated tariff (see Table C.8).

However, an inactive retailer stated in the retailer interviews that it is not operating in NSW because profits were not adequate, and so were awaiting the next IPART determination. One retailer in particular explained that the low profitability in the Ausgrid distribution area following the regulatory decision in July 2012 prompted its decision to cease actively marketing in that area.⁴⁹⁹ A recent statement by Australian Power and Gas is consistent with these views:⁵⁰⁰

“customer growth has consciously been slowed due to regulatory price settings in Queensland and parts of New South Wales. These regulatory settings prevent the company obtaining an effective margin on new customers signed within the affected regions. [Yet] underlying net profit after tax is expected to show strong growth due to the ongoing maturity of the existing customer base.”

Views of lower profitability in the Ausgrid distribution area are consistent with NERA's analysis. NERA found that profit margins in the Ausgrid distribution area, in particular for small customers, are lower than the other distribution areas.⁵⁰¹ The difference in the Ausgrid area margins for smaller customers appears to be the manner in which the regulated tariff is structured to recover fixed costs.

⁴⁹⁷ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report on Interviews with Energy Retailers*, February 2013, p. 66.

⁴⁹⁸ This section focuses on "flat" tariffs. An analysis of profit margins on time of use tariffs is included in the broader assessment of time of use tariffs included in Appendix D.

⁴⁹⁹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report on Interviews with Energy Retailers*, February 2013, p. 66.

⁵⁰⁰ Australian Power & Gas, Australian Stock Exchange (ASX) Media Release, "Australian Power & Gas September quarter cash receipts up 46% Guidance for 2012-13 shows continued strong growth in earnings", 31 October 2012, p. 2.

⁵⁰¹ We note that NERA calculated a negative margin for customers consuming less than 2.5 MWh per year. NERA stated that it expects relatively few customers would exhibit such low levels of consumption, and so it did not affect its overall conclusion.

For example, a customer consuming 2 MWh annually will pay 32 per cent of its bill in fixed charges in the Ausgrid distribution network, compared to 42 per cent in fixed charges in the Essential Energy network area. For customers consuming 7 MWh annually, the fixed contribution drops to nine per cent in the Ausgrid area and 14 per cent in the Essential Energy area. In the Endeavour Energy area, the contribution of fixed charges is more similar to the Ausgrid area, however network charges are a lower proportion of the total retail bill.⁵⁰² This means that revenues and profits depend more on volume in the Ausgrid area than in the other distribution network areas.

Nevertheless, we do not consider a lower margin in the Ausgrid area for smaller customers as adversely affecting the level of competition because:

- the level and availability of discounts in the Ausgrid distribution area appears consistent with that available in the other distribution areas; and
- retailers consider the margin to be earned across their entire customer base or for particular products rather than a particular customer. It is also difficult in practice for retailers to identify a customer's consumption level prior to acquiring the customer, therefore it would be difficult for retailers to discriminate based on consumption.

The view on the available headroom in the regulated price by new entrant retailers may be influenced by their reliance on discounting to gain market share. In the interviews, the new entrant retailers tended to view incumbents with existing customers as having an advantage because they do not need to offer a discount to those customers that do not switch. That is, incumbent retailers will have a subset of customers on regulated prices earning higher margins as long as those customers do not switch.

In contrast, in order for a new entrant retailer to gain any customers from incumbents, it needs to offer a better deal. That is, potentially all of a new entrant's customers are offered a discount, and so earn lower margins.⁵⁰³ Indeed, Australian Power & Gas' prospectus illustrates the importance of discounting as the primary strategy in energy retailing.⁵⁰⁴

⁵⁰² Figures compiled using published tariff schedules.

⁵⁰³ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report on Interviews with Energy Retailers*, February 2013, p. 66.

⁵⁰⁴ Australian Power and Gas, Prospectus, 17 November 2006, pp. 14-15.

“History and experience in the deregulated energy markets has shown that for consumers to choose an energy supplier it is a very low involvement decision for them and one that they rarely initiate themselves. It is for this reason that the most successful way to acquire customers is by face to face direct sales. The customer generally makes an immediate decision based on the proposition at the door. Generally the proposition involves offering the customer a saving from the price they are currently paying now and some form of inducement for them to sign at the door.”

In response to these comments from new entrant retailers, Table C.7 below compares estimated regulated margins and estimated market offer net margins. Estimated market offer net margin is calculated as the difference in representative bills under regulated rates and the average bill reductions available with market offers.

Table C.7 Illustrative weighted average available electricity profit margin comparison

Distribution area	Estimated regulated profit margin (FY08-FY13, medium scenario)	Mean market offer bill discount	Estimated mean market offer net margin
Ausgrid	5%	6%	-1%
Endeavour Energy	10%	6%	4%
Essential Energy	9%	5%	4%

Note: Mean market offer discount is the discount off representative customer bills compared to the regulated bill for the same customer. The net margin is the different between the two.

Sources: Profit margin and market offer discount data sourced from NERA.

Although this table is illustrative and highly dependent on the underlying assumptions, it highlights that because incumbent retailers have a proportion of customers on regulated tariffs they have higher total margins than new entrants that do not have regulated customers. However, it is important to recognise that:

- discounting is occurring, including by new entrant retailers (see Table C.8); and
- the discount is potentially larger than the estimated margin in the regulated tariff.

Given that these discounts are being offered, it would appear that there is sufficient headroom in the regulated tariff to support competition. The presence of net negative market offer margins indicates that retailers that are offering larger discounts may have lower cost bases, as NERA pointed out.⁵⁰⁵ NERA's analysis is also based on assumptions regarding costs that may differ between retailers based on the make-up of their customer base, such as location, consumption level or load profile.

⁵⁰⁵ NERA, *Prices and Profit Margin Analysis for the NSW Retail Competition Review*, 5 March 2013, p. 39.

Low or even high profitability can also reflect the competitive process whereby retailers enter and exit the market, affecting the level of marketing activity and in turn, margins. For example, Origin Energy recently announced that its half year profit was lower than the previous year as a result of lower demand as well as a reduction in profit margins. One of the reasons given for lower profit margins was increased competition.⁵⁰⁶

The next section examines the competitive process and whether discounting is a strategy pursued only by new entrants. That is, whether incumbents are responding to discounted market offers by offering discounts themselves.

Is competition keeping profit margins in check?

The level of profit margins earned by retailers can provide an indication of how effectively competition is working, since margins should be kept in check by competitive behaviour of rivals and/or responses by customers.

It is harder to draw conclusions about whether competition is keeping margins in check when the incumbent standing offer is regulated (ie its margin is already kept in check by regulation). However, if the incumbent retailer had market power, we might expect to see it retain its market share even with one of the highest priced offers in the market.

The data on market offers suggests this is not happening. Customers are switching to second tier retailers who are offering some prices below the regulated tariff (see Appendix B for switching rates). Rather than only offering the regulated tariff, incumbents are having to respond by reducing prices in order to maintain market share. This is also reflected in the switching rates of customers between the big three retailers (see Appendix B). Table C.8 below presents the market offers analysed by NERA by type of retailer for each distribution area and whether there was a discount relative to the regulated bill calculated by NERA.

⁵⁰⁶ Origin Energy, ASX/Media Release, "Origin posts \$524 million Statutory Profit for the first half, issues revised guidance and announces strong progress on Australia Pacific LNG", 21 February 2013.

Table C.8 Analysis of market offers by retailer type, FY11 - FY13

Distribution area	Total offers	Number of incumbent offers	Average incumbent offer bill relative to regulated bill	Number of other retailer offers	Average other retailer offer bill relative to regulated bill
<i>Electricity offers</i>					
Ausgrid	31	8	92.4%	23	94.5%
Endeavour Energy	41	9	93.9%	32	94.6%
Essential Energy	30	9	96.6%	21	93.9%
<i>Natural gas offers</i>					
Jemena	9	7	96.2%	2	97.5%
<i>Duel fuel offers</i>					
Ausgrid	7	7	94.0%	0	n.a.
Endeavour Energy	9	5	92.6%	4	96.0%
Essential Energy	6	4	93.6%	2	92.5%

Note: Data was provided to NERA from the IPART database as at December 2012, so more recent offers will not be included. We also note that not every offer that may be available by contacting a retailer will be captured in the database, only those that are "generally available" are included. That is, if an offer is only available in specific suburbs or by contacting the retail it will not be included in the IPART database.

Source: AEMC analysis based on NERA results.

The evidence on market offers and switching suggests that, if price regulation was removed, a strategy by the incumbent to raise prices is unlikely to be profitable, as they would lose more market share. Competition therefore appears to be keeping profits in check. That is, the level of discounting is quite high. This is consistent with the findings of a recent AGL paper which found that for all customers using more than 2 MWh per year they are better off on market contracts, regardless of their ability to meet the terms and conditions in the contract (eg late payment and early termination fees).⁵⁰⁷

Increased competition affects retailers not only because they may lose customers, but because they need to offer incentives to keep some customers or gain more. This

⁵⁰⁷ AGL, "Reconciling energy prices and social policy", AGL Applied Economic and Policy Research, April 2013, pp. 10 and 18.

includes marketing costs. For example, Reneweconomy reported that it cost AGL \$200 to acquire a customer.⁵⁰⁸ This was highlighted by the Australian Power & Gas statement above that it was costing too much to continue actively marketing in parts of NSW given competitive prices. However, it also highlights that the longer a customer is held once acquired, the more profitable the customer can be expected to be by the retailer if they do not need to respond to more aggressive marketing by their competitors.

Rising acquisition costs are expected as part of the competitive process. As new retailers enter and make compelling offers to gain market share, existing retailers must respond, which drives down margins. Margins may even be driven down to the point of some retailers exiting, withdrawing some marketing activity or price rationalisation to stabilise margins. Alternatively, they may look to differentiate their product or offer higher service levels than their competitors in order to maintain or gain market share. However, as margins stabilise and potentially rise, it again may incentivise another round of competitive activity. Such activity also encourages retailers to find other ways of reducing acquisition costs in order to compete without margin decline – such as utilising online marketing. For example, ActewAGL offers NSW customers a \$100 credit off their first bill if they sign up online.⁵⁰⁹

Based on the above, it appears that:

- new entrant retailers are offering discounts off the regulated price; and
- incumbent retailers are responding by offering discounts off the regulated price.

The next section considers whether this observed competitive activity is likely to be sustainable going forward.

Are profit margins sustainable going forward?

Sapere found that "several retailers questioned the sustainability of the prices and profit levels in light of the large discounts being offered by the big retailers."⁵¹⁰ This sentiment may reflect the nature of the competitive process, whereby the big retailers are responding to rigorous price-based competition from new entrants. If this is the case that margin levels are unsustainable, competitive activity may be pared back, as the limiting of marketing activity by some new entrants suggests. In time, as margins stabilise, it may spur another round of new entrant-led competitive activity. However, it will be important to monitor whether the incumbent's discounting is not overly subsidised by higher margin regulated customers. The decreasing share of customers on regulated contracts, however, indicates that this is unlikely.

⁵⁰⁸ Parkinson, Gilles, "Graph of the Day: Why Australian households hate energy companies", *REneweconomy*, 27 February 2013.

⁵⁰⁹ ActewAGL website, <https://www.actewagl.com.au/Product-and-services/Offers-and-prices/Promotional-offers/Energy-rewards.aspx>, accessed 5 April 2013.

⁵¹⁰ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report on Interviews with Energy Retailers*, February 2013, p. 68.

A key consideration for the Commission is the extent to which profit margins will be sustainable to deliver competitive outcomes to customers in the future. Declining demand is one of a number of challenges facing the electricity retailing industry. Volatility in the wholesale market, government environmental policies and increased regulatory risk all affect retailers. An appropriate profit margin needs to compensate retailers for the risks they bear. Sapere's report stated that:⁵¹¹

“One of the big three retailers said that regulatory risk is the number one topic that is raised in discussions with investors. This retailer is aware of smaller companies that have faced difficulties obtaining debt funding to finance their operations as a result of the uncertainty about regulatory decisions.”

Regulatory risk is important for new entrants to consider because the level of the regulated price affects the ability for these retailers to offer compelling discounts. Indeed AGL submitted that under a previous determination period, lower regulated prices inhibited discounting activity and in turn switching activity.⁵¹²

A further risk which was raised by several retailers is the credit worthiness of customers. They stated that given low margins, credit defaults are a significant problem. However, an innovative way retailers are addressing this risk is to provide incentives to customers to pay on time. This is discussed in Appendix B.

It was pointed out in the retailer interviews that the risks are also different in Australia compared to other countries as retailers in the national electricity market bear a large proportion of the default risk. This is because the retailer pays the network costs regardless of whether the customer pays. In other countries, the network costs are split between the network and the retailer when a customer defaults.⁵¹³ With high disconnection rates,⁵¹⁴ this can be expected to have a greater impact on new entrant or smaller retailers that operate with potentially lower margins.

In natural gas, changes in the east coast wholesale markets may make obtaining long term contracts more difficult, as well as putting upward pressure on wholesale natural gas prices, as asserted by Origin Energy in IPART's current review of regulated retail tariffs.⁵¹⁵ Without sufficient headroom in the regulated price, retailers will be unable to offer discounts or will be forced to cease actively acquiring new customers.

Retailers reported to Sapere that margins are lower in natural gas, which is the main reason why it is not offered on a standalone basis. NERA's analysis did not yield lower

⁵¹¹ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report on Interviews with Energy Retailers*, February 2013, p. 36.

⁵¹² AGL, Issues Paper submission, 13 February 2013, p. 7.

⁵¹³ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report on Interviews with Energy Retailers*, February 2013, p. 67.

⁵¹⁴ EWON, Annual Report, 2011-2012, p. 26.

⁵¹⁵ Origin Energy, *Submission to the Independent Pricing and Regulatory Tribunal on the review of regulated gas retail tariffs and charges from 2013 to 2016*, November 2012, p. 3.

results in natural gas, and for some periods suggested a higher margin. This may reflect different cost structures, NERA's assumptions or the small number of comments in relation to natural gas reported by Sapere relative to electricity. Nevertheless, Sapere concluded that "the level of prices set by regulation appears to have halted the entry and expansion plans of several new entrants in the NSW electricity market. Given the complementary nature of gas to electricity, the knock on effect of this is [that] it has stymied the entry of retailers that would be offering a dual fuel product."⁵¹⁶

However, as noted in submissions, the outcome of the IPART determination will have a pivotal influence on the profit margin going forward. We note that IPART recently released its draft determinations for electricity and natural gas prices. For electricity the draft margin allowance is 5.7 per cent⁵¹⁷ and for natural gas the range⁵¹⁸ is 6.3 per cent to 7.3 per cent of earnings before interest, depreciation and amortisation.⁵¹⁹

C.1.4 Summary

The Commission considers that, on balance, the regulated tariff currently has sufficient headroom to support competitive activity. This is evidenced by the estimated margins on the regulated price and retailers offering discounts to the regulated price. New entrants are gaining market share by offering prices below the regulated tariff, and incumbents appear to be responding by also offering discounts on the regulated price. This suggests there are competitive constraints on incumbents raising prices.

This price-based competition is raising some uncertainty about the sustainability of discounting going forward for some retailers. However, this is consistent with the competitive process. It will be important to monitor entry and exit of retailers, and switching levels between retailers if price regulation is removed, to protect against smaller retailers and new entrants being squeezed out by potentially unsustainable low margins.

In general, headroom in recent years appears to have been sufficient to allow new entrants to offer prices below the regulated price while still maintaining a small profit margin. A possible exception is headroom in the Ausgrid area for low consumption customers. However, the difference in the profit margin does not appear to have impeded discounting activity compared to the other network areas.

For existing and potential new retailers, future marketing activities may depend largely on the forthcoming final decision from IPART. This is the case both in terms of

⁵¹⁶ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales - Report on Interviews with Energy Retailers*, February 2013, p. 68.

⁵¹⁷ IPART, *Review of regulated retail prices for electricity, 2013 to 2016*, Electricity - Draft Report, April 2013, p. 78.

⁵¹⁸ Note that due to the difference in the regulatory approach of natural gas, IPART estimates a range for a reasonable cost allowance and if the standard retailer's proposal is within that, it is approved. In contrast, for electricity IPART makes a determination on the level of costs to be included in the allowance.

⁵¹⁹ IPART, *Review of regulated retail prices and charges for gas*, Gas - Draft Report, April 2013, p. 87.

the margins available under regulated prices, and the regulatory risk that is perceived from the decision for investors.

C.2 Customer satisfaction

The other indicator of market performance is customer satisfaction. This provides an indication of retailer rivalry and the extent that retailers are responding to customer preferences and needs. Specifically, customer satisfaction is an indicator of whether retailers are competing on the basis of service. It also provides context to interpret switching rates - that is, whether customers are switching retailers because they are dissatisfied with the level of service.

Effective markets do not necessarily require that customers never encounter difficulties or raise complaints. However, we expect retailers in effectively competitive markets to address, resolve and ultimately avoid repeated and ongoing customer complaints. Ineffective competition can allow poor service to flourish as customers have limited alternatives.

This section examines whether customers are satisfied with the level of service they receive from retailers, as distinct from prices, and if not, what they do about it.

C.2.1 Consultant reports

This section draws on the Roy Morgan market research reports, all of which are available on the AEMC's website. The relevant results for customer satisfaction are split between the quantitative results arising from the survey and the qualitative results, obtained from the focus groups.

Quantitative research

Roy Morgan found that the majority of customers that had switched retailers were motivated for monetary reasons, rather than poor service. A small proportion, five per cent of residential electricity users and three per cent of residential natural gas users, switched retailers because they were unhappy with their retailer.⁵²⁰ The results were similar for small business customers.⁵²¹

Similarly, for residential customers that did not switch, their reasons were to do with satisfaction with their existing arrangements (36 per cent electricity, 40 per cent natural gas) as well as inertia (25 per cent electricity, 28 per cent natural gas).⁵²² Similar results

⁵²⁰ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 24.

⁵²¹ Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 25.

⁵²² Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 22.

were observed in the small business survey for electricity.⁵²³ The proportion of residential customers that reported being satisfied with their current company was higher among low income respondents (46 per cent electricity, 52 per cent natural gas) whereas the proportion of customers that reported inertia as a reason was higher among higher income respondents (32 per cent electricity, 31 per cent natural gas).⁵²⁴

For those customers who did switch, an overwhelming proportion in both the residential and small business surveys, around 80 per cent for both electricity and gas, found the process easy.⁵²⁵ For about half of the respondents in both surveys, switching took about as long as expected, with around 20 per cent for residential customers across electricity and natural gas finding it took less time and a similar proportion stating it took more time. Results were similar for small business electricity customers with a slightly lower proportion of natural gas customers stating it took less time than expected and a higher proportion stating it took more time than expected.⁵²⁶

A majority of those respondents that did switch reported, being satisfied with their new energy retailer. The results are replicated in Table C.9 below.

⁵²³ Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 23.

⁵²⁴ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 22.

⁵²⁵ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 25; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 26.

⁵²⁶ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 26; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 27.

Table C.9 Degree of satisfaction with new energy company

	Electricity		Natural gas	
	Residential	Small business	Residential	Small business
Very satisfied	23%	21%	23%	17%
Somewhat satisfied	34%	35%	42%	38%
Total satisfied	57%	56%	65%	55%
Neither satisfied nor dissatisfied	27%	31%	29%	21%
Somewhat dissatisfied	9%	8%	2%	8%
Very dissatisfied	4%	3%	2%	8%
Total dissatisfied	13%	11%	5%	16%
Don't know/not sure/can't say	3%	3%	2%	8%

Source: Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, p. 28; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 29.

The results in the table above differed somewhat on a regional basis for residential natural gas respondents, as 27 per cent reported being very satisfied in metro areas versus only seven per cent in non-metro areas.⁵²⁷ The highest proportion of responses for reasons of dissatisfaction had to do with the price, at about 30 per cent of residential energy users and 25 per cent of small business electricity users.⁵²⁸ Similarly, the residential respondents' reasons for satisfaction with the new company was largely price driven, at 26 per cent electricity and 21 per cent natural gas.⁵²⁹ Similar results

⁵²⁷ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, p. 28.

⁵²⁸ The responses for reasons of dissatisfaction for gas customers was based on a small sample for the residential results and was too small to report for the small business survey. Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, p. 29; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 30.

⁵²⁹ Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, p. 30.

were reported for small business for natural gas and a much higher proportion (41 per cent) reported being satisfied due to a competitive price.⁵³⁰

Roy Morgan also asked whether customers had experienced any specific negative situations with their energy companies. The examples included pressure to sign a contract or a contract that did not match what had been quoted. About a fifth of small businesses surveyed reported having had such experiences, with less than ten per cent in each specific situation.⁵³¹ The results were similar for residential natural gas respondents and higher for electricity. The highest specific situation for residential electricity respondents was pressure to sign a contract.⁵³² The results are contained in the table below.

⁵³⁰ Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 31.

⁵³¹ Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 28 February 2013, p. 45.

⁵³² Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, p. 44.

Table C.10 **Percentage of surveyed customers who have experienced specifically identified negative situations with their retailer⁵³³**

	Electricity		Natural gas	
	Residential	Small business	Residential	Small business
Actual price charged did not match prices quoted	8%	8%	4%	5%
Entered into contract in order to get more information	4%	3%	2%	3%
Felt pressured into signing contract with company	15%	8%	7%	4%
Told things about terms and conditions of contract that did not prove to be true	11%	7%	7%	7%
Transferred to another energy company without explicit consent	7%	6%	2%	4%
Unable to terminate energy contract during cooling off period	2%	1%	1%	3%
Entered into contract simply to get person to leave house/business and/or hang up phone	5%	3%	4%	4%

Source: Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, p. 44; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, p. 45.

⁵³³ Note that customers that have experienced none of the identified negative situations could have either experienced no negative experiences at all or could have experienced negative experiences that were not identified in the survey.

Table C.11 below shows that the majority of respondents reported being satisfied with the response times and assistance provided by their energy retailers. However, satisfaction was lower among small business natural gas respondents.

Table C.11 Degree of satisfaction with response timeliness (and assistance) from energy retailer

	Electricity		Natural gas	
	Residential	Small business	Residential	Small business
Very satisfied	29% (31%)	23% (27%)	27% (32%)	8% (8%)
Somewhat satisfied	37% (36%)	35% (31%)	44% (39%)	25% (21%)
Total satisfied	66% (67%)	58% (58%)	71% (71%)	33% (29%)
Neither satisfied nor dissatisfied	15% (14%)	20% (20%)	15% (9%)	38% (38%)
Somewhat dissatisfied	10% (9%)	14% (11%)	7% (7%)	8% (13%)
Very dissatisfied	8% (9%)	8% (10%)	8% (12%)	21% (21%)
Total dissatisfied	18% (18%)	22% (21%)	15% (19%)	29% (34%)

Note: the results for the degree of satisfaction with assistance is included in brackets.

Source: Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, p. 47; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, p. 48.

The survey also measured whether customers would seek appliance and energy savings advice from their energy retailers. A similar proportion of respondents across both residential and small business would seek retailers' advice for appliance use in electricity and natural gas. A higher proportion of respondents stated that they would seek their retailer's advice in relation to energy savings. The results are summarised in Table C.12 below.

Table C.12 Usefulness of energy company for energy appliance and savings advice

	Energy appliance advice		Energy savings advice	
	Residential electricity (natural gas)	Small business electricity (natural gas)	Residential electricity (natural gas)	Small business electricity (natural gas)
Agree strongly	5% (9%)	2% (7%)	10% (8%)	7% (8%)
Agree somewhat	12% (18%)	17% (23%)	29% (25%)	34% (32%)
Total agree	18% (27%)	19% (30%)	39% (33%)	41% (40%)
Neither agree nor disagree	20% (20%)	21% (28%)	24% (23%)	26% (32%)
Disagree somewhat	30% (24%)	25% (19%)	19% (23%)	17% (11%)
Disagree strongly	30% (27%)	30% (20%)	16% (20%)	11% (12%)
Total disagree	60% (51%)	55% (39%)	35% (43%)	28% (23%)
Don't know/not sure/can't say	3% (2%)	4% (4%)	3% (2%)	4% (4%)

Source: Roy Morgan, *Survey of Residential Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, pp. 48 - 49; Roy Morgan, *Survey of Business Customers of Electricity and Natural Gas in New South Wales: Effectiveness of Retail Competition*, 15 February 2013, pp. 49 - 50.

Qualitative research

The focus groups echoed the findings of the quantitative research. Roy Morgan found that "switching was rarely motivated by a desire for better customer service, a better array of product offerings, or by simply being fed-up with the provider."⁵³⁴

However, the report notes that participants expressed annoyance at long wait times on the telephone and being passed from one department to another requiring them to explain their problem to multiple personnel.⁵³⁵ There was also strong annoyance expressed at having a counter-offer from the original company after starting the switching process enticed by a better deal.⁵³⁶ Respondents also claimed experiencing:

⁵³⁴ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Consumers*, 28 February 2013, p. 14.

⁵³⁵ Ibid.

⁵³⁶ I.d., p. 18.

- price savings that were mentioned in a sales call or sales visit that never materialised. An example of this was a promised percentage discount on gas pricing for bundling the service with electricity that did not show up on the bill;
- promised savings from switching that were apparent on bills received early in a contract that were rapidly offset by a price increase; and
- being switched or renewed without being informed adequately.

Focus group participants also stated that information on bills does not explain prices or price changes very well.⁵³⁷ Roy Morgan noted a trend in the way that Telstra was favourably viewed. Telstra's contracts were described as being easier to understand, further it reported usage patterns and inform customers about plans that could save the customer money. Other Telstra services which were favourably viewed were notifying the customer when they were getting close to their standard monthly usage amount, and checking in on the customer periodically to ask if they were happy.⁵³⁸

As a result of the comparatively negative experiences, Roy Morgan concluded that:⁵³⁹

“Taken together, these corporate behaviours fostered mistrust and cynicism and undermined other corporate efforts such as brochures and newsletters that offered energy saving tips and promoted conservation. Such bill inserts were described in mainly derogatory terms such as "flowery" and all about "puffing themselves up." Many customers started with a scepticism that the energy retailer can't really be on their side because regulatory increased prices and in the business of making money from energy use.”

C.2.2 Submissions

Few stakeholders commented explicitly on the level of customer satisfaction with retailers or market arrangements generally. The Ethnic Communities Council submitted that responses from its survey indicated that culturally and linguistically diverse communities were not being provided with information about how they can reduce energy use. It also stated that the main factor that contributes to the difficulties experienced by culturally and linguistically diverse communities was a lack of information that is appropriate and effective, particularly that they would prefer to receive information in their first language.⁵⁴⁰

CHOICE submit that the results of its national survey indicated that customers were unlikely to have high levels of overall satisfaction. It also states that a smaller proportion of respondents rated their provider as "excellent" compared with a similar survey conducted for the banking industry. CHOICE also submit that a quarter or less

⁵³⁷ I.d., p. 21.

⁵³⁸ I.d., p. 21.

⁵³⁹ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Consumers*, 28 February 2013, p. 20.

⁵⁴⁰ Ethnic Communities Council, Issues Paper submission, 7 February 2013, pp. 3 and 5.

of its survey respondents rated their electricity company as very good or better in terms of value for money, customer service, helping customers understand how to reduce usage and updating them on key issues such as electricity prices. Finally, CHOICE also report that dissatisfaction with their previous company was the second-most frequently cited reason for switching providers in the last three years following "a cheaper option".⁵⁴¹

C.2.3 Analysis

According to the surveys conducted for this review, customers appear to be generally satisfied with their arrangements with retailers. A small proportion, five per cent of residential electricity and three per cent of residential natural gas users, switched retailers because they were unhappy with their retailer.⁵⁴²

These results are similar to those reported by the One Big Switch survey which found that less than three per cent of customers surveyed switched because they were unhappy with their current provider.⁵⁴³ Similarly, a survey published by PIAC found that less than five per cent of those surveyed across five regional centres in NSW left their current retailer because they were unhappy.⁵⁴⁴ CHOICE also conducted a survey of energy customers in NSW, ACT, Victoria, Queensland and South Australia. It reported that nearly 70 per cent of participants rated their electricity retailer as excellent, very good or good. A further 23 per cent rated their provider as fair. The remaining seven per cent and three per cent rated their retailer as poor and terrible, respectively.⁵⁴⁵ This is consistent with the other research that negative experiences, whilst a concern, are in the minority.

Customer complaints are a small proportion of customers. IPART reported that complaints to retailers were 1.6 per cent of electricity customers and 1.5 per cent of natural gas customers in financial year 2011-12, however it has increased around one per cent over previous years.⁵⁴⁶ IPART reported that one retailer stated that increased complaints were the result of increased direct marketing activity.⁵⁴⁷

Similarly, in South Australia, the regulator reported an increase in complaints to electricity retailers driven by "an increase in retailer activity such as marketing,

⁵⁴¹ CHOICE, Issues Paper submission, 8 February 2013, p.10.

⁵⁴² Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Consumers*, 28 February 2013, p. 24.

⁵⁴³ One Big Switch, News, "Survey Shines Light on Electricity Myths", Survey Report, viewed 8 April 2013, accessed through <https://www.onebigswitch.com.au/news/2012/09/survey-shines-light-on-electricity-myths/>.

⁵⁴⁴ PIAC, *Choice? What Choice?*, June 2011, p. 60.

⁵⁴⁵ CHOICE, Issues Paper submission, 8 February 2013, Appendix, Figure 7.

⁵⁴⁶ IPART, *Customer service performance of electricity retail suppliers 1 July 2007 - 30 June 2012*, December 2012, p. 23; IPART, *Customer service performance of gas retail suppliers 1 July 2007 - 30 June 2012*, December 2012, p. 23

⁵⁴⁷ IPART, *Customer service performance of electricity retail suppliers 1 July 2007 - 30 June 2012*, December 2012, p. 23.

increased prices, as well as increased public awareness and willingness to express dissatisfaction and seek resolution". However, the overall rate is higher than in NSW at 2.7 complaints per 100 electricity customers in 2011/12.⁵⁴⁸ In Victoria, complaints to retailers are higher for electricity at 4.7 per 100 customers in 2011/12 but are similar for natural gas at 1.5 per 100 customers in the same year and complaint rates increased in both fuel markets over the previous year.⁵⁴⁹

Increased complaints related to increased marketing activity coincides with the Roy Morgan survey results, which found a slightly higher incidence of negative experiences reported by residential electricity customers, specifically in the pressure to sign a contract category. This may be related to the prevalence of door knocking as a direct marketing channel in the residential sector.

However, on the whole incidents of negative experiences are in the minority across both electricity and natural gas and door knocking appears to be waning as a marketing channel.⁵⁵⁰ In February, EnergyAustralia⁵⁵¹ and AGL⁵⁵² both announced that they would no longer be utilising door knocking as a sales channel. EnergyAustralia stopped the practice since the company had recognised its customers did not want to be disturbed and that door-to-door sales was the most complained about channel.⁵⁵³ AGL stated that its decision to withdraw door knocking in South Australia and Queensland in 2011 had received significant positive feedback and demonstrated they were still able to expand their business with other means. As a result, it decided to withdraw its remaining activities from NSW and Victoria.⁵⁵⁴

Complaints related to billing are the dominant concern and represent about half of all complaints to retailers. IPART reported that increased market awareness of energy price rises and consumption issues have contributed to an industry-wide increase in billing complaints.⁵⁵⁵ Of the complaints which are raised with the Energy and Water Ombudsman, billing complaints are the number one issue.⁵⁵⁶ Complaints to the

⁵⁴⁸ Essential Services Commission of South Australia (ESCOSA), *Performance of the South Australian retail energy market - customer service - 2011/12*, p. 3.

⁵⁴⁹ Essential Services Commission, *Energy retailers comparative performance report - customer service 2011-12*, 10 December 2012, p. 48.

⁵⁵⁰ We note that the Australian Competition and Consumer Commission (ACCC) has filed proceedings in the Federal Court of Australia against EnergyAustralia and four marketing and sales companies in relation to door-to-door selling practices. This is third of such proceedings to be initiated by the ACCC against retailers. ACCC, "ACCC targets door-to-door sales tactics", Media Release, 8 March 2013.

⁵⁵¹ EnergyAustralia, "Knock Knock...Who's there? Not EnergyAustralia", News release, 25 February 2013.

⁵⁵² AGL, "AGL withdraws from unsolicited door-to-door sales", Media Release, 26 February 2013.

⁵⁵³ EnergyAustralia, "Knock Knock...Who's there? Not EnergyAustralia", News release, 25 February 2013.

⁵⁵⁴ AGL, "AGL withdraws from unsolicited door-to-door sales", Media Release, 26 February 2013.

⁵⁵⁵ IPART, *Customer service performance of electricity retail suppliers 1 July 2007 - 30 June 2012*, December 2012, p. 23; IPART, *Customer service performance of gas retail suppliers 1 July 2007 - 30 June 2012*, December 2012, p. 23.

⁵⁵⁶ EWON, *Annual Report*, 2011-2012, p. 17.

Ombudsman in NSW are low relative to other Australian states, as shown in Table C.13 below.

Table C.13 Complaints to ombudsman per 1,000 customers

	New South Wales	Victoria	South Australia
Electricity	5.5	18.7	9.5
Natural gas/dual fuel	3.4	8.3	3.6

Sources: Compiled using information from EWON, *Annual Report*, 2011-2012, p. 16; Energy and Water Ombudsman Victoria, *Annual Report*, 2012, pp. 34, 35, 39, 40; ESCOSA, *Performance of the South Australian retail energy market - customer service - 2011/12*, pp. 3-4.

The level of complaints to the Energy and Water Ombudsman in NSW contrasts with Victoria, where the largest category for complaints to the Victorian Ombudsman in 2011/12 were in respect of tariffs, rather than billing as in NSW. Specifically, the tariff related complaints in Victoria largely related to solar feed in tariffs. As the Premium Feed in Tariff ended, the ombudsman received a surge of calls from solar customers concerned that their new solar installation may not qualify for it.⁵⁵⁷ Another point of difference in complaints is that 5,234 electricity complaints were made to the Victorian ombudsman in 2011/12 relating to concerns about the roll-out of smart meters.⁵⁵⁸

We note, however, that complaints to energy ombudsmen generally are comparatively higher than in other industries such as in telecommunications and financial products.⁵⁵⁹ This may represent the proportion of income spent on energy as well as the increased awareness of prices given recent price increases. It may also indicate that energy retailers are not handling complaints well themselves and so there is room for improvement in this area. However, a CHOICE survey found similar results in customer satisfaction ratings among energy companies and financial products.⁵⁶⁰

On the whole, customers appear to be motivated by positive reasons to switch, such as finding a better deal, which is a sign of retailer rivalry and customer engagement in the market.

⁵⁵⁷ Energy and Water Ombudsman of Victoria, *Annual report 2011-2012*, p. 21.

⁵⁵⁸ Energy and Water Ombudsman of Victoria, *Annual report 2011-2012*, p. 25.

⁵⁵⁹ Complaints to the Telecommunications Ombudsman were reported as 8.7 complaints per 1,000 customers, however complaints are calculated as a proportion of residents and so may not be entirely comparable (<http://annualreport.tio.com.au/statistics/complaints-by-state/new-south-wales>). Complaints to the Financial Ombudsman Service are less than 1 per 1,000 customer (<http://www.fos.org.au/comparativetables/2011-2012/>).

⁵⁶⁰ The CHOICE survey found 63 per cent were satisfied with regard to home loans and 65 per cent were satisfied for credit cards. CHOICE website, <http://www.choice.com.au/reviews-and-tests/money/banking/saving-money/bank-satisfaction-survey-2009/page/home%20loans.aspx>, accessed 5 April 2013.

C.2.4 Summary

Customers appear to be generally satisfied with their retailers and with the switching process, but are demanding more transparent information, particularly in relation to prices. The upcoming introduction of the National Energy Customer Framework (NECF) may help to some degree in respect of pricing information with the AER's comparator website, for example.

Negative experiences appear to be the exception, rather than the norm, and with the decline of door knocking as a marketing channel, complaints in this respect would be expected to decline. As well, prices are expected to moderate going forward.⁵⁶¹ This may reduce the number of billing and credit related complaints as well as disconnections.

C.3 Draft conclusions

The Commission views the outcomes of the market performance assessment as consistent with an effectively competitive market. This is because regulated margins appear to have allowed sufficient headroom for new entrants to come into the market and offer a discount in both electricity and natural gas. The NERA report also gathered evidence of market offers, which illustrate that second tier retailers are taking advantage of the available margin to offer discounts to customers.

Changes in market share illustrate that price-based competition is occurring because customers are switching to new entrants' lower priced offers. Incumbents appear to have responded by also offering market offers below the regulated price. Such effective price-based competition provides confidence that price regulation is not required to constrain prices. Moreover, the majority of customers appear satisfied with their retailers and with the switching process, but are demanding more transparent information, particularly in relation to prices. A minority of customers have had negative experiences, particularly in relation to marketing practices.

⁵⁶¹ AEMC, *Electricity Price Trends Final Report - Possible future retail electricity price movements: 1 July 2012 to 30 June 2015*, 22 March 2013.

D Time of use tariffs

Box D.1: Summary of chapter

Another matter that SCER has asked the AEMC to undertake a review of, and provide advice on, is the availability and take up of time of use tariffs by small electricity customers in NSW and the effect such tariffs may have on competition.

Information on the prevalence and take up of time of use tariffs by small customers in NSW is not publicly available. However, data provided by AGL, APG, EnergyAustralia, Lumo and Origin Energy indicates that approximately:

- 13 per cent of all small customers in NSW are currently on a time of use tariff (residential: 12 per cent and small commercial: 25 per cent); and
- of those small customers with an interval read meter in NSW 97 per cent are currently on a time of use tariff.

To determine whether there are any competition issues associated with time of use tariffs we have examined a number of structure, conduct and performance indicators. This examination has revealed that while there are a large number of retailers offering time of use tariffs, there are still a number of competition issues affecting participants in this segment of the market.

First, it appears that the range of tariff structures offered to small customers with an interval read meter in the Ausgrid network has depended more on the network charging policies employed by distribution network businesses than customer preferences. In the AEMC's Power of choice review we recommended that a policy framework be developed to clarify whether customers should have a choice between a flat or inclining block tariff and a time of use tariff.

Second, small customers are not currently in a position to make informed choices about the tariff structures and retail offers that best suits their needs because their understanding of time of use tariffs is limited. An effective information and engagement program, as discussed in chapters 7 and 8, would provide customers with the tools they require to make informed decisions about alternative tariff structures and retail offers. Processes are also in place to provide customers with access to their consumption data to inform their decisions.

Finally, there is some preliminary evidence to suggest that the retail margin available under the regulated time of use tariff in the Ausgrid network has been higher for a representative residential customer than an equivalent customer on an inclining block tariff, because the discount on time of use network charges offered by Ausgrid has not been fully passed on to customers. The fact that higher margins have persisted is surprising given the large number of retailers competing to supply this segment of the market. Reasons for this may include:

- customers have been unable to participate effectively in this segment; and
- retailers are not competing on the basis of the conditions prevailing in this segment of the market. Instead, the regulated time of use tariff is used as the reference point for their market offers and then offering the same discounts as those offered to customers on a flat or inclining block tariff and across networks.⁵⁶²

The removal of retail price caps should go some way to addressing higher margins since the regulated tariff would no longer operate as a focal point for competition. Further, as time of use tariffs become more prevalent and customers' understanding improves, retailers should start competing more actively in this segment of the market by offering discounts that reflect the specific conditions in this segment. Further, this issue will continue to be monitored as part of the market and price monitoring regime described in chapter 7.

D.1 Introduction

The roll out of a large number of interval meters in Ausgrid's network, and, to a lesser extent, in Endeavour Energy and Essential Energy's networks over the last eight years, has paved the way for a greater take up of time of use retail tariffs in NSW. While a small number of residential and small commercial customers are currently subject to a time of use tariff, this tariff structure is expected to become more prevalent in the future, as more interval read meters are rolled out and as customers' understanding of these products improve. It is therefore timely to consider whether there are any competition issues associated with time of use tariffs and, if so, whether any additional measures may be required to address these issues.

These issues are explored in the remainder of this appendix, which is structured as follows:

- section D.2 provides background information on time of use tariffs and the metering technology that must be installed to enable this type of product to be offered to small electricity customers;
- section D.3 contains a summary of the submissions received on time of use tariffs;
- section D.4 provides an overview of the availability, prevalence and number of small electricity customers on time of use tariffs in NSW; and
- section D.5 examines whether there are any competition issues associated with time of use tariffs.

⁵⁶² To the extent the regulated time of use retail tariff incorporates a higher margin than the regulated inclining block tariff, the difference will be preserved when retailers compete in this manner.

D.2 Background

A time of use tariff, as its name suggests, can vary depending on the time of the day, the day of the week and/or the time of the year that electricity is consumed. This type of tariff can therefore be used by retailers to send a signal to customers of the different costs associated with supplying electricity during peak, shoulder and off-peak periods. This signal may, elicit a demand-side response. For example, a customer faced with a higher tariff in peak periods may defer some of its consumption to off-peak periods (eg by running the washing machine late at night) and/or conserve energy during the peak period (eg by not turning on an air conditioner). Over the long run, this type of response can be expected to result in a more efficient use of, and investment in, network and generation assets.

The time of use tariffs offered by electricity retailers may be structured in a number of different ways. For example, retailers may offer a simple daily peak/off-peak, a weekly peak/shoulder/off-peak, or a seasonal time of use tariff structure. Critical peak prices and critical peak rebates are two other more complex forms of time of use pricing that may be offered to small electricity customers to try and encourage reductions in demand in periods where the network or wholesale market is experiencing constraints.⁵⁶³

To be able to offer time of use tariffs, a retailer must be able to measure the amount of electricity a customer consumes at different times throughout the day. To be offered a time of use tariff, a customer must have either an interval or a smart meter⁵⁶⁴ installed at its premises that is being read on an interval basis for settlement purposes, rather than the traditional accumulation meter.⁵⁶⁵ In addition to this technical requirement, the decision to offer a customer a time of use retail tariff will depend, to varying extents, on:

- whether the network and wholesale energy costs it incurs when supplying a particular customer have a time of use structure;

⁵⁶³ Critical peak pricing involves the application of a tariff that is substantially higher than the normal peak tariff in critical peak periods while critical peak rebates involve the payment of a rebate to customers that reduce their consumption in pre-defined critical peak periods.

⁵⁶⁴ The key point of distinction between a smart meter and an interval meter, is that smart meters are coupled with communication technology, which means that they can be read remotely and provide other services remotely (eg connection and disconnection services). Smart meters can also be connected to other devices that can be used to assist customers managing their consumption, eg, an in-home display or a home area network. Interval meters, on the other hand, do not have remote reading or control capabilities, so consumption data must be retrieved through a manual read.

⁵⁶⁵ A single accumulation meter can only measure the total amount of electricity consumed between meter reads (eg every quarter) and not the time at which the electricity is consumed. It cannot therefore be used to implement time of use tariffs. It is worth noting though that, if a customer has appliances that are directly controlled either through a timer or by a remote agent (ripple control) to operate in off-peak periods only and these are connected to a separate accumulation meter (controlled load), then it will be possible to measure the electricity used in off-peak and other periods but it will not be possible to identify the day of the week or the hour of the day in which the electricity was consumed.

- whether the wholesale energy costs are based on the customer's actual load profile or the net system load profile (NSLP);
- the relationship between the daily variation in the network time of use charges, and the daily variation in the retailer's wholesale energy costs;
- whether the retailer can recover any meter related investment it makes if a customer switches to another retailer; and
- customer understanding and preferences for time of use tariffs.

In relation to the first of these issues, it is worth noting that both the network and wholesale components of the retail tariff can have a time of use tariff structure. According to retailers, time of use retail tariffs in NSW tend to reflect a straight pass through of the network time of use charges and, to varying extents, also include a time varying wholesale electricity cost component.⁵⁶⁶ Box D.2 contains further detail on the relationship between retail tariffs, network charges and wholesale energy costs.

Box D.2: Retail product offerings, network charges and wholesale energy costs

The costs incurred by a retailer supplying electricity to small customers include:

- the cost of acquiring electricity from the wholesale market;
- the cost of transporting the electricity to a customer's premises through the transmission and distribution networks; and
- retail operating costs (eg billing and IT systems, customer management and regulatory costs).

Of the costs incurred by retailers, network costs in NSW account for more than 50 per cent of a typical retail electricity bill (see for example Figure D.2 and Figure D.3). It is not therefore surprising that network charges have such a significant influence on the products offered by retailers.

In a study carried out by PwC for the AEMC in the context of the Power of choice review, PwC examined the relationship between network charges and retail tariffs,. It found that retail tariffs tend to mirror the basic structure of the network charge. For example, if the network charge is a time of use based charge then retailers tend to offer time of use products using the same consumption periods as the network owner. If the network charge is an inclining block tariff, retailers tend to offer an inclining block retail tariff using the same consumption blocks as the network. In addition to being influenced by network charges, PwC found that retail time of use tariffs tend to vary in line with changes in wholesale electricity

⁵⁶⁶ Response to AEMC questionnaire provided by AGL, APG, EnergyAustralia, Origin Energy and Lumo.

prices, although the extent to which wholesale prices were taken into account varied across retailers.⁵⁶⁷

PwC's findings are consistent with the observations that have been made by retailers in both the retailer interviews conducted by Sapere and in a number of submissions received from the retailers. In the retailer interviews, a number noted that tariff structures offered to small customers depend on the meter that is in place and the structure of the network charges applied to customers in that distribution area.⁵⁶⁸ This point was also made by a number of retailers in their submissions: stating that they can face significant risks when the structure of a customer's network charge differs from the structure of its retail tariff.

PwC's findings are also consistent with our own analysis of the regulated time of use tariffs currently applying in NSW as at 1 July 2012. Based on our analysis it would appear that:

- the peak, shoulder and off-peak periods adopted by retailers in each network area are the same as those applying under the regulated time of use tariffs, which are based on the periods underpinning Ausgrid, Endeavour Energy and Essential Energy's network time of use charges. While it is possible that peaks in the network and wholesale market may differ, the peak periods adopted by these three DNSPs (ie, 2 pm to 8 pm, 1 pm to 8 pm and 5 pm to 8 pm respectively) appear to be sufficiently broad to capture both network and wholesale peaks; and
- the general structure of the retail time of use tariffs tend to mirror the structure of network time of use charges, although the ratio of peak to off-peak and peak to shoulder rates adopted by the retailers don't appear to be as high as the network time of use charges.⁵⁶⁹ It is unclear from the analysis we have carried out whether the difference in the ratios adopted by retailers stems from including wholesale energy costs in the retail tariff, or whether retailers consider that the relatively high peak to off-peak and peak to shoulder ratios adopted by some DNSPs could not be marketed to small customers.

Time of use tariffs are just one of a number of different tariff structures that retailers can offer small electricity customers. Two other tariff structures commonly employed, can be applied irrespective of the type of meter a customer has installed which are:

⁵⁶⁷ PwC, *Investigation of the efficient operation of price signals in the NEM*, December 2011, pp. 29-35.

⁵⁶⁸ Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in NSW – Report of Interviews with Energy Retailers*, February 2013, p. 53.

⁵⁶⁹ In Ausgrid's network, the ratio of peak to off-peak rate (peak to shoulder rate) under the regulated retail time of use tariff in 2012/13 was 4:1 (2.5:1) while at the network level the ratio was 10:1 (5:1). In Endeavour Energy's network, the ratio of peak to off-peak rate (peak to shoulder rate) under the regulated retail time of use tariff in 2012/13 was 2:6 (1.3:1) while at the network level, the ratio was 4:1 (1.7:1). In Essential Energy's network, the ratio of peak to off-peak rate under the regulated retail time of use tariff in 2012/13 was 2:1 while at the network level, the ratio was 3:1.

- the flat tariff, which requires customers to pay a fixed service availability charge and a flat rate for every⁵⁷⁰ kWh of electricity consumed in the period. This tariff structure is currently available in Essential Energy's network; or
- the inclining block tariff, which requires customers to pay a fixed service availability charge and a rate for each kWh of electricity consumed that increases once a certain consumption threshold has been reached in the period. This tariff structure is currently available in Ausgrid and Endeavour Energy's networks.

In contrast to time of use tariffs, the price paid by customers on a flat or inclining block tariff does not differ depending on the time of the day, the day of the week or the time of the year in which is consumed. Customers on these tariffs are therefore provided no incentive to reduce their consumption in peak periods.

Whether or not a small customer will be better off under a time of use tariff or a flat/inclining block tariff will depend on:

- the extent to which the customer is able to respond to the price signals provided by time of use tariffs by reducing their consumption in peak periods;
- the customer's load profile relative to the net system load profile, which is used to determine the charges payable by a customer with an accumulation meter; and
- the structure of the time of use tariffs and the periods over which the time of use tariffs apply.

If it is assumed that the time of use tariffs are appropriately structured, then time of use tariffs will be considered more attractive by customers that can reduce their consumption in peak periods, because they provide a means by which the customer can reduce its overall electricity bill. However, for customers that are unable to respond⁵⁷¹ and have a peakier load profile than the net system load profile, a constant flat or inclining block tariff may be considered more attractive, even if that tariff incorporates an additional premium to compensate the retailer for price related risks.

Finally, time of use tariffs are not unique to the electricity industry. Rather, they are used in a number of other industries to provide customers with an indication of the costs associated with providing services during particular periods and to discourage (encourage) utilisation during peak (off-peak) periods. For example:

- the NSW Government has introduced time of use tolling on the Sydney Harbour Bridge and Tunnel to ease traffic congestion during peak periods and encourage

⁵⁷⁰ The one exception to this is where appliances are directly controlled by a remote agent to operate in off-peak periods only. In this case, the customer will pay a separate tariff for the electricity consumed by these appliances in the off-peak period to that payable for all other consumption.

⁵⁷¹ Customers that may be unable to respond include those that are at home during the day, eg, the elderly, people with chronic medical conditions, the unemployed, shift workers and parents with pre-school aged children.

motorists that do not need to use these assets during peak periods to use them in off-peak periods;⁵⁷²

- CityRail uses time of use pricing to encourage passengers that do not need to travel during peak periods to travel during off-peak periods by offering discounted off-peak fares;⁵⁷³ and
- providers of mobile phone, broadband and wireless services have, at various times, used time of use pricing to encourage customers to utilise these services during off-peak periods.

While there are many other examples of time of use pricing that one could cite, these few examples highlight the prevalence of this tariff structure in other industries.

D.3 Submissions on time of use tariffs

Comments on time of use tariffs were received from a range of interested parties and through a number of different forums, including submissions to the Issues Paper and the retailer interviews conducted by Sapere. The topics touched on by interested parties relate to:

- the availability, prevalence and take up of time of use tariffs;
- the effect that time of use tariffs may have on competition;
- the effect that time of use tariffs may have on customers;
- the ability of customers to switch between time of use and flat or inclining block tariffs and vice versa; and
- the effect of retail price regulation on time of use product offerings, what might occur if retail price regulation is removed and the additional protections that may be required in a deregulated environment.

The responses received on the first of these topics are discussed in further detail in section D.4, which provides an overview of the availability, prevalence and take up of time of use tariffs. The remainder of this section focuses on the latter four topics.

D.3.1 Effect of time of use tariffs on competition

The effect that time of use tariffs may have on competition was discussed, in EnergyAustralia, Origin Energy, AGL and PIAC's submissions. EnergyAustralia, Origin Energy and AGL are of the view that time of use tariffs are likely to enhance

⁵⁷² See NSW Roads & Maritime Services website
http://www.rta.nsw.gov.au/usingroads/motorwaysandtolling/shb_cashless.html

⁵⁷³ See CityRail website <http://www.cityrail.info/tickets/which/mytrain>

competition, encourage innovation, and provide a greater level of choice.⁵⁷⁴ PIAC, on the other hand, has some concerns about the ability of new retailers to compete with the larger retailers in a time of use environment given the "added complexity and risk" associated with time of use pricing and the need to offer additional value add products, such as a customer interface.⁵⁷⁵

To get some further insight into the issue raised by PIAC, we asked a number of small and larger retailers whether there were any barriers or additional costs associated with marketing time of use retail tariffs. The retailers informed us that while there were no major barriers or additional costs associated with time of use retail tariffs, there were some risks associated with offering this type of product if the structure of a customer's network charge does not match the structure of its retail tariff.⁵⁷⁶

D.3.2 Effect of time of use tariffs on customers

The effect that time of use tariffs may have on customers was explored in the AGL, ECC and NCOSS submissions. AGL submits that its recent research indicates that, more than 75 per cent of customers could be better off with a time of use product if customers are free to choose a properly structured time of use tariff.⁵⁷⁷ The potential for some customers to be better off under a time of use tariff structure was not disputed by either NCOSS or the ECC. NCOSS and the ECC do, however, have concerns about customers that are unable to respond to time of use price signals and consider that all customers should have access to the appropriate level of information about time of use tariffs to make an informed decision about these products.⁵⁷⁸

D.3.3 Ability to switch between tariff structures

The ability of customers with an interval read meter to switch between tariffs was touched on by both the ECC and EWON. According to the ECC, customers with an interval read meter currently have no choice but to be subject to a time of use tariff unless they obtain their electricity from the standard retailer.⁵⁷⁹ EWON, on the other hand, states that EnergyAustralia is the only retailer in NSW currently offering retail customers with an interval read meter a choice between alternative tariff structures.⁵⁸⁰

Based on information provided by retailers it appears that, with the exception of EnergyAustralia, retailers will only offer customers with interval read meters a choice

⁵⁷⁴ EnergyAustralia p. 7, Origin Energy p. 15 and AGL p. 8, Issues Paper submission.

⁵⁷⁵ PIAC, Issues Paper submission, 8 February 2013, p. 20.

⁵⁷⁶ Response to AEMC questionnaire provided by AGL, APG, EnergyAustralia, Origin Energy and Lumo.

⁵⁷⁷ AGL, Issues Paper submission, 13 February 2013, p. 8.

⁵⁷⁸ NCOSS, Issues Paper submission, 8 February 2013, p. 8; ECC, Issues Paper submission, 7 February 2013, p. 2.

⁵⁷⁹ ECC, Issues Paper submission, 7 February 2013, p. 2.

⁵⁸⁰ EWON, Issues Paper submission, 8 February 2013, p. 3.

between tariff structures if the Distribution Network Service Provider (DNSP) allows this choice at the network level.⁵⁸¹

While other retailers are unwilling to take on the risk of different retail and network tariff structures, EnergyAustralia has confirmed that it currently allows most customers to switch between retail tariff structures.⁵⁸² However, it has informed us that it would, in the first instance, offer these customers a time of use retail tariff because its systems are set up to align retail and network tariff structures. EnergyAustralia has also informed us that there are significant commercial risks associated with offering customers this choice, where the structure of network charges cannot be aligned with the retail tariff structure.⁵⁸³

The requirements for customers with an accumulation meter seeking to switch to a time of use tariff were outlined in DNSP's and retailers responses to some further questions we posed about time of use tariffs. According to these responses, as long as a customer is prepared to pay the costs associated with installing an interval read meter, then it will be able to switch to a time of use tariff. While it would appear relatively straightforward for a customer to have their accumulation meter replaced with an interval read meter, we found the opposite to be true when carrying out the Power of choice review.⁵⁸⁴ It was for this reason that the Power of choice final report contained a number of recommended changes to the current metering arrangements.⁵⁸⁵

D.3.4 Effect of retail price regulation and deregulation on time of use products

Another topic that attracted the attention of retailers is the effect that retail price regulation could have on product innovation. Retailers are of the view that the risks associated with retail price regulation and, in particular the risk of not recovering costs, have the potential to impede the development of innovative time of use products and product differentiation in NSW.⁵⁸⁶ This view was echoed in the ERAA's submission,⁵⁸⁷ who went on to note that if there was a market led roll out of smart meters, retail price regulation could "stifle investment in smart meters" because "the introduction of time of use tariffs would impact the business case for a roll out."⁵⁸⁸

581 Response to AEMC questionnaire provided by AGL, APG, EnergyAustralia, Lumo and Origin Energy.

582 The only customers that EnergyAustralia does not allow to switch are small commercial customers that are subject to a network tariff, which has a capacity charge (ie, low voltage small commercial customers in Ausgrid's network consuming 40-160 MWh of electricity).

583 Response to AEMC questionnaire provided by EnergyAustralia.

584 AEMC, *Supplementary Paper - Power of Choice Review Draft Report*, 6 September 2012.

585 AEMC, *Power of Choice Review – Final Report*, 30 November 2012, Chapter 4.

586 See for example, EnergyAustralia, Issues Paper submission, 8 February 2013, pp. 6-7; Origin Energy, Issues Paper submission, 8 February 2013, p. 14; AGL, Issues Paper submission, 13 February 2013, p. 7.

587 ERAA, Issues Paper submission, 8 February 2013, p. 4.

588 ERAA, Issues Paper submission, 8 February 2013, p. 5.

PIAC and the ECC also raised a number of issues regarding deregulation. One particular concern PIAC and the ECC have with deregulation is the potential for retailers to increase the fixed supply charge, to hedge against reduced revenue from customers responding to time varying prices.⁵⁸⁹ To reduce the risk of this occurring and to provide appropriate protection against any other adverse issues, PIAC suggests that the responsible regulator should be required to monitor time of use tariffs and the ease that customers can switch as interval read meters are introduced. PIAC has also noted that if retail price regulation is removed, the regulatory framework could still play a role in determining the structure of time of use tariffs, as has occurred in the lead up to the removal of the moratorium on time of use tariffs in Victoria.⁵⁹⁰

The concerns raised by PIAC and the ECC about fixed supply charges are explored in further detail in Box D.3.

⁵⁸⁹ ECC p. 2 and PIAC p. 2, Issues Paper submission.

⁵⁹⁰ PIAC, Issues Paper submission, p. 4.

Box D.3: Fixed supply charges and time of use tariffs

Both PIAC and the ECC have raised concerns about the potential for retailers to raise the fixed supply charges to offset any reduction in revenue arising as a result of customers responding to the price signal provided by time of use tariffs. Within its submission, PIAC has also pointed to the significant increase in the fixed supply charge that has occurred in Ausgrid's network area over the last five years as evidence of this occurring.

The potential for retailers to raise the fixed supply charge to hedge against the risk of reduced revenue was considered in detail in the Power of choice review. It concluded this was unlikely to occur because any reduction in revenue arising from customers deferring or reducing their consumption was likely to be met by a reduction in the retailer's energy purchase costs. Given that a retailer's behaviour is driven by profit rather than revenue, we concluded that any attempt by a retailer to try and retain a certain level of revenue even though their costs had fallen, would place the retailer at risk of losing market share.⁵⁹¹

Notwithstanding the above conclusion, we have reviewed the fixed supply charges paid by residential customers on a regulated time of use tariff in Ausgrid's network area over the period 1 July 2008-30 June 2013. Based on this review, it would appear that:

- the 120 per cent increase in the retail fixed supply charge between 1 July 2008 and 30 June 2013 can largely be attributed to the increase in the network fixed supply charge, which rose by 126 per cent over the period; and
- the retail and wholesale component of the fixed supply charge (ie, the retail fixed supply charge less the network fixed supply charge) rose from 12 to 25 cents under the regulated time of use tariff, while under the regulated inclining block tariff, it rose from 18 to 25 cents. The fact that the retail and wholesale component of the fixed supply charge is the same for time of use and inclining block tariffs implies that retailers do not consider time of use products to be any more risky than inclining block products.

D.4 Customers on time of use tariffs in NSW

Time of use retail tariffs are becoming more prevalent in NSW following the installation of a large number of interval meters in Ausgrid's network and, to a lesser extent, Endeavour Energy and Essential Energy's networks. The remainder of this section contains an overview of the availability and prevalence of time of use tariffs, and number of small electricity customers on these tariffs in NSW.

⁵⁹¹ AEMC, Final Report - Power of Choice Review, 30 November 2012, p. 169.

D.4.1 Availability of time of use tariffs

To be offered a time of use retail tariff, a customer must have either an interval meter installed at its premises, which is being read on an interval basis. The availability of time of use tariffs in NSW will therefore depend on both the penetration of interval read meters and the products offered by retailers. These two issues are considered, in turn, below.

Penetration of interval read meters in NSW

Table D.1 sets out the number of small electricity customers' meters in each network that are currently being read on an interval basis. As the information in Table D.1 and the notes to this table reveal:

- 446,009 of the meters installed in small customers' premises in NSW are currently being read on an interval basis for settlement purposes, which equates to 13.5 per cent of the small customer metering installations in NSW; and
- another 343,500 meters, which are currently being read on an accumulation basis for settlement purposes, could be read on an interval basis in the future if some incremental capital expenditure was undertaken to ensure they comply with the relevant metrology procedures.

Table D.1 shows that the distribution of interval read meters varies markedly across networks, with Ausgrid having the greatest number, followed by Endeavour Energy and Essential Energy. All other things being equal, a larger number of customers in Ausgrid's network would be expected to be subject to a time of use tariff given the greater penetration of meters in this network.

Table D.1 Small electricity customers' meters being read on an interval basis (as at 1 January 2013)

Distribution Network Area	Total No. of Small Customer National Metering Identifiers(NMI) ⁵⁹²	NMI's Being Read on an Interval Basis	
		Number	% of Total
Ausgrid	1,609,282	440,666 [#]	27%
Endeavour Energy	896,542	3,414 [*]	0.4%
Essential Energy	806,647	1,929 [^]	0.2%
Total	3,312,471	446,009	13.5%

Sources: AEMO NMI data and information provided by Endeavour Energy, Essential Energy and Ausgrid.

Notes: [#] Excludes around 100,000 meters that are currently being read on an accumulation basis for settlement purposes and which are either capable of being read on an interval basis or could be read in this manner if further money was spent to ensure the meters comply with metrology procedures ^{*} Excludes approximately 11,500 interval meters currently supporting trials and demand management programs that are still being read as accumulation meters for settlement purposes. Also excludes around 17,000 Type 6 meters that are capable of measuring consumption on an interval basis but which require further expenditure to ensure they comply with metrology procedures. [^] Excludes approximately 215,000 electronic meters capable of measuring consumption in particular periods but which are still being read as accumulation meters for settlement purposes.

Looking forward, the number of interval read meters installed in NSW is expected to increase, either as a result of DNSPs installing the meters on a new or replacement basis, or a NSW Government endorsed market-led or mandated roll out. The precise manner in which these meters should be deployed in the future is currently the subject of a review by the NSW Smart Meter Task Force, which we understand is due to report to the NSW Government in the next couple of months.

Finally, while small customers with an accumulation meter can request that their meter be replaced with an interval read meter, we understand that the process is complex⁵⁹³ and can cost several hundreds of dollars.⁵⁹⁴ Customers with an accumulation read meter are therefore unlikely to pursue this option unless:

⁵⁹² A NMI is an identifying code that uniquely defines a 'metering installation' for the purpose of NEM settlements.

⁵⁹³ See AEMC, *Supplementary Paper - Power of Choice Review Draft Report*, 6 September 2012.

⁵⁹⁴ The AEMC understands from information provided by DNSPs that the costs a customer has to pay will differ depending on the network in which they are located. For example, customers located in Endeavour Energy's network seeking to switch to a time of use tariff would be required to pay the incremental capital cost of the interval or smart meter and the installation costs. Customers located in the Essential Energy and Ausgrid networks, on the other hand, would only need to pay the installation costs because these DNSPs provide the meter.

- they are sure the benefits of moving to a time of use tariff (ie, lower electricity bills) will exceed the costs of installing the meter; and
- they are prepared to work through the complex metering arrangements.

This issue was considered in detail in the Power of choice review and in our final report we recommended a number of changes be made to metering arrangements to reduce the level of complexity for small customers.⁵⁹⁵ In the absence of these changes, we expect few customers to pursue this option.

Time of use product offerings

The only type of time of use product currently being marketed to residential and small commercial customers in NSW is a weekly peak/shoulder/off-peak time of use tariff structure.⁵⁹⁶ The retailers currently offering this type of product in NSW are set out in Table D.2. As the information in this table indicates, there are a large number of retailers currently marketing time of use tariffs to residential and small commercial customers in NSW. Not all of these retailers are currently operating in every network.

Table D.2 Retailers offering time of use tariffs in NSW (February 2013)

Customer Type	Retailers	Total
Residential	AGL, EnergyAustralia ¹ , Origin Energy, APG, ActewAGL ² , Dodo, Lumo ³ , Momentum, QEnergy ⁴ , Red 10	10
Small Commercial	AGL, EnergyAustralia ¹ , Origin Energy, Lumo, Momentum, QEnergy ⁴ , Red, Simply ⁵	8

Sources: Retailer websites.

Notes: ¹ Available in all network areas except the far west region of Essential Energy's network. ² Available in parts of the Endeavour Energy and Essential Energy networks. ³ Offers made in all networks but focused on urban areas at present. ⁴ Available in the Ausgrid and Endeavour Energy networks. ⁵ Available in Ausgrid's network only.

⁵⁹⁵ AEMC, *Power of Choice – Final Report*, 30 November 2012, Chapter 4.

⁵⁹⁶ It is worth noting in this context that while the regulated retail time of use tariff in Essential Energy's network consists of three time periods, the tariffs applying in peak and shoulder periods are currently the same, so the tariff structure may be viewed as a simpler weekly peak/off-peak tariff.

⁵⁹⁷ For residential customers, the time of use products also include an optional controlled load tariff for customers with appliances directly controlled by a remote agent, eg off-peak hot water systems.

Based on our review of the products offered by these retailers,⁵⁹⁸ it would appear that, with one or two exceptions:

- the regulated retail time of use tariffs applying in each network act as the reference point for market offers,⁵⁹⁹ with the same discounts,⁶⁰⁰ rebates and benefits⁶⁰¹ that are available to customers seeking a flat or inclining block tariff also offered to customers seeking a time of use tariff.⁶⁰² The same discounts, rebates and benefits are also offered across each network; and
- the peak, shoulder and off-peak periods adopted by retailers in each network area are the same as those applying under the regulated time of use tariffs, which are based on the periods underpinning Ausgrid, Endeavour Energy and Essential Energy's network time of use charges.

The regulated retail time of use tariffs and peak, shoulder and off-peak periods that are currently acting as the focal point for competition in each network are set out in Table D.3. Before examining these tariffs it is worth noting that IPART currently utilises a weighted average price cap to regulate prices in NSW. Under the weighted average price cap approach, IPART determines the maximum average percentage by which each standard retailer can increase the weighted average regulated tariff in each year of the determination period. The standard retailer therefore has some freedom to determine the level and structure of individual regulated tariffs, as long as the weighted average price does not increase by more than the maximum percentage set by IPART.

⁵⁹⁸ In most cases retailers offer more than one time of use product, with the difference between products tending to reflect the term of the contract or the type of discount/ benefit offered.

⁵⁹⁹ Based on analysis using IPART, My energy offers website (<http://www.myenergyoffers.nsw.gov.au/search-offers.aspx>), accessed 30 March 2013 and EnergyAustralia, Everyday Saver Home, FlexiSaver Home and Pure Energy Saver Energy Price Fact Sheets dated 1 July 2012, EnergyAustralia website (<https://secure.energyaustralia.com.au/EnergyPriceFactSheets/PricingFactSheets.aspx>).

⁶⁰⁰ These discounts, which may be applied to either the usage component of the customer's bill or its total bill, are applied for a range of reasons such as: the customer committing to a fixed term contract; the customer paying their bill on time and/or agreeing to pay by direct debit; and the customer purchasing both gas and electricity from the same retailer. As at February 2013, the discounts offered to residential customers ranged from 1 per cent-15 per cent while the discounts offered to small commercial customers ranged from 1 per cent-17 per cent. Rebates of \$20-\$100 were also offered by some retailers.

⁶⁰¹ In addition to offering discounts, some retailers also offer residential customers other enticements such as frequent flyer points, credit card reward points, home energy services, store vouchers and green energy components.

⁶⁰² Sapere, *Review of Competition in the Retail Electricity and Natural Gas Markets in NSW – Report of Interviews with Energy Retailers*, February 2013, p. 53.

Table D.3 Regulated retail time of use tariffs by network (Effective 1 July 2012)

Network (Standard Retailer)	Ausgrid (EnergyAustralia)	Endeavour (Origin Energy)	Essential (Origin Energy)
Residential			
Peak (c/kWh)	47.77	35.37	34.89
Shoulder (c/kWh)	19.40	27.13	
Off-peak (c/kWh)	11.90	13.67	17.37
Service charge (c/day)	74.70	89.14	125.48
Small Commercial*			
Peak (c/kWh)	44.3	33.39	31.93
Shoulder (c/kWh)	20.7	27.13	
Off-peak (c/kWh)	11.6	13.39	18.75
Service charge (c/day)	133.05	91.84	433.73
Timing of Periods			
Peak	Working weekdays: 2pm-8pm	Working weekdays: 1pm-8pm	Weekdays: 7am-9am and 5pm-8pm
Shoulder	Working weekdays: 7am-2pm and 8pm-10pm	Working weekdays: 7am-1pm and 8pm-10pm	Weekdays: 9am-5pm and 8pm-10pm
	Weekends/public holidays: 7am - 10pm*	Weekends/public holidays: 7am-10pm^	
Off-peak	All other times	All other times	All other times

Sources: EnergyAustralia, Residential Customer Price List and Business Customer Price List effective 1 July 2012; Origin Energy-Integral Energy, New electricity rates of charges, 1 July 2012; Origin Energy-Country Energy Retail Price List, 1 July 2012.

Notes: * Applicable to customers consuming less than 40 MWh. ^ Applicable to residential customers.

Drawing on the information contained in Table D.3, it is apparent that the service availability charge, the time of use rates and the ratio of peak to off-peak and peak to shoulder rates applying to residential and small commercial customers vary markedly across networks. Based on our review of these charges, it would appear that the variation stems from differences in:

- the time of use network charges levied by the DNSPs (see Box D.2); and
- the retail margins applied by the standard retailer in each network (see Table D.6).

D.4.2 Prevalence of and customers on time of use tariffs

Information on the prevalence of and number of customers on particular types of tariff structures by small electricity customers is not publicly available. We have therefore asked retailers to provide information on the number of small electricity customers currently being supplied under a flat, inclining block or time of use tariff structure. AGL, APG, EnergyAustralia, Lumo and Origin Energy were the only retailers to provide this information. The data contained in Table D.4 and the observations that follow are based on the aggregated information provided by these five retailers, and AEMO.

We have measured the prevalence of and proportion of customers on time of use tariffs as follows:

- the prevalence has been measured by dividing the number of AGL, APG, EnergyAustralia, Lumo and Origin Energy's customers that are subject to a time of use tariff by the total number of customers supplied by these retailers; and
- the proportion of customers on time of use tariffs has been measured by dividing the number of customers AGL, APG, EnergyAustralia, Lumo and Origin Energy have informed us are currently subject to a time of use tariff by the number of interval read meters currently installed in NSW (see Table D.1). Due to the aggregated nature of AEMO's meter data, it has not been possible to estimate a take up rate for residential and small commercial customers. Table D.4 therefore contains a single estimate of the take up of time of use tariffs by all small customers

Table D.4 Prevalence of and customers on time of use tariffs

	Prevalence	Customers with an Interval Read Meter on time of use tariffs
Residential	12%	n.a.
Small Commercial	25%	n.a.
Total Small Customers	13%	97%

Source: Aggregated information provided by AGL, APG, EnergyAustralia and Origin Energy and meter type data from AEMO.

Prevalence of time of use tariffs

As the information in Table D.4 indicates, 13 per cent of small customers in NSW are currently subject to a time of use retail tariff (12 per cent of residential customers and 25 per cent of small commercial customers). The small percentage of customers currently subject to a time of use tariff appears to reflect a range of factors, such as

- the small number of interval read meters currently installed in NSW *vis-à-vis* accumulation read meters;
- the limited awareness and understanding of time of use tariffs amongst small customers and, in particular, residential customers;⁶⁰³ and
- customer preferences and the perceptions held by small electricity customers about whether they will be financially better or worse off under a time of use tariff.

Although not reported in Table D.4, we understand from the information provided by the five retailers that time of use retail tariffs are more prevalent in Ausgrid's network. This observation is not surprising given both:

- the number of interval meters that have been installed in this network relative to the number that have been installed in Endeavour Energy and Essential Energy's networks (see Table D.1); and
- the default position for the network charges applied by Ausgrid to small customers with an interval read meter was, until 28 August 2012, a time of use network charge (see Table D.5). This issue is explored in further detail below.

⁶⁰³ Roy Morgan, Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Consumers, 28 February 2013, pp. 2 and 10.

Customers with an interval read meter on time of use tariffs

The proportion of small customers with an interval read meter on time of use tariffs is currently around 97 per cent. Some care should, be taken when considering this metric, because the take up of time of use tariffs in the Ausgrid network appears to have depended more on Ausgrid's network charging policy than customer preferences.

This is because, with the exception of EnergyAustralia, retailers have been unwilling to take on the risk of customers having different network and retail tariff structures (see section D.3.3). EnergyAustralia was the only retailer willing to offer most customers with an interval read meter in Ausgrid's network a choice between time of use and inclining block tariff structures while Ausgrid's old policy of placing all small customers with an interval read meter on a time of use network charge was in effect.⁶⁰⁴ Given the response of retailers to the network charging policies, it is not surprising that the time of use retail tariffs are more prevalent in Ausgrid's network or that 97 per cent of customers with an interval read meter are currently subject to a time of use tariff.

Under Ausgrid's new network charging policy, which came into effect on 28 August 2012, residential customers that have an interval read meter installed will only move onto a time of use network charge if they select a time of use retail tariff. The new policy also allows residential customers to revert back to an inclining block network charge if they switch to an inclining block retail tariff. The influence of Ausgrid's network charging policy on the take up of time of use tariffs by residential customers in its network area should therefore start to diminish if this change is communicated to customers. For small commercial customers, Ausgrid's network charging policy is still expected to have a significant influence on the take up of time of use tariffs because they are still subject to the old policy, ie, they are automatically moved onto a time of use network charge when an interval read meter is installed.

The influence of network charging policies on the take up of time of use tariffs only appears to have been an issue in Ausgrid's network. This is because under the policies employed by both Endeavour Energy and Essential Energy, small customers will only move onto a network time of use charge if they elect to be on a time of use retail tariff and the retailer then requests they be transferred to a network time of use tariff. These two DNSPs also allow, to varying extents, small customers to revert back to a flat or inclining block tariff structure when their retail tariff structure changes. Our understanding of the network charging policies currently applying in each network is set out in Table D.5.

⁶⁰⁴ The only customers that EnergyAustralia does not allow to switch are small commercial customers that are subject to a network tariff, which has a capacity charge (ie low voltage small commercial customers in Ausgrid's network consuming 40-160 MWh of electricity).

Table D.5 DNSP policies on network charges to apply to interval read meters

Network	When a customer will be moved onto time of use network charge	Ability for customer to revert back to a flat/inclining block network charge
Ausgrid	<i>Prior to 28 August 2012</i>	
	All small customers moved onto time of use network charge when interval meter installed.	No reversion allowed.
	<i>Post 28 August 2012</i>	
	Residential customers that have an interval meter installed remain on an inclining block tariff until such time as they decide to move onto a time of use retail tariff. Small commercial customers automatically moved onto time of use network charge when interval read meter installed.	Irrespective of when their interval read meter was installed, residential customers can revert back to an inclining block network charge if they revert to an inclining block retail tariff. However, small commercial customers cannot.
Endeavour Energy	Network time of use charges optional for small customers with an interval read meter. If the customer elects to be subject to a retail time of use tariff, the retailer may then request the customer be transferred to a network time of use charge	Residential customers can revert back but Endeavour Energy reserves the right to prevent small commercial customers reverting back.*
Essential Energy		All small customers can revert back to a flat network charge if they switch to a flat retail product.

Source: Information provided by Ausgrid, Endeavour Energy and Essential Energy.

Note: * Although this is Endeavour Energy's current policy, it has informed us that in practice this type of request is rare and would be dealt with on a case by case basis.

Finally, we have been unable to ascertain how many customers with an accumulation read meter have sought to move onto a time of use tariff and have taken steps to have their meters replaced. We would expect, however, the number to be low given the complexities and costs associated with customers taking this sort of action (see section D.4.1).

D.4.3 Conclusion

On the basis of the information set out above, the following observations can be made:

- the penetration of interval read meters is increasing in NSW;
- there are a large number of retailers currently offering time of use tariffs; and
- 13 per cent of all small customers in NSW are currently subject to a time of use tariff while 97 per cent of small customers with an interval read meter are currently subject to a time of use tariff.

Going forward, time of use tariffs are expected to become more prevalent as more interval read meters are rolled out and as small electricity customers' understanding of time of use tariffs improves. Therefore it is relevant to consider whether there are any competition issues associated with time of use tariffs and, if so, whether any additional measures may need to be put in place to address these issues. These two issues are considered in the following section.

D.5 Competition issues associated with time of use tariffs

To determine whether there are currently any competition issues associated with time of use tariffs, we have analysed a number of structure, conduct and performance indicators. The results of this analysis are summarised in Table D.6.

Table D.6 Findings on structure, conduct and performance indicators

Structure	
No. of retailers	There are currently a large number of retailers marketing time of use tariffs to residential (ten retailers) and small commercial (eight retailers) customers with interval read meters in NSW. EnergyAustralia is, the only retailer offering most customers with a time of use network charge the choice between a time of use retail tariff and a flat/inclining block tariff.
Market concentration	At this point in time, the top three retailers account for around 98 per cent of customers on a time of use tariff, which is higher than the overall share of small electricity customers accounted for by these retailers.
Barriers to entry	<p>While there are a range of additional requirements for marketing time of use products <i>vis-à-vis</i> flat or inclining block retail tariffs (eg customers must have an interval read meter, the retailer's billing system must be set up appropriately and additional time must be spent explaining this product to prospective customers), these requirements apply equally to existing retailers and new entrants and appear to be surmountable.</p> <p>One other potential barrier to entry identified by PIAC is that smaller retailers may find it more difficult than larger retailers to supply time of use products because they do not have a varied customer portfolio to manage the "added complexity and risk" associated with these products. While it is possible that time of use pricing may give rise to some initial uncertainty for new retailers, this risk should diminish over time as retailers get better at predicting customer responses to peak price signals. The fact there are a large number of small retailers currently marketing time of use tariffs and that none of these retailers have raised this as an issue (see section D.3.1), also indicates that even if this was considered a barrier to entry, it is surmountable.</p>
Barriers to expansion and exit	There do not appear to be any additional barriers to expansion or exit applying in this segment of the market.
Regulatory constraints	There are no additional regulatory constraints faced by retailers seeking to market time of use tariffs. The large number of retailers currently operating in this segment of the market also indicates that retail price regulation is not deterring entry into this segment of the market.

Conduct	
Rivalry	Based on our review of the time of use products offered by retailers, there appears to be a reasonable degree of rivalry between retailers. The same discounts, rebates and other benefits are being offered to prospective time of use and flat/inclining block customers with one or two exceptions (see section D.4.1). The rivalry between retailers does not therefore necessarily reflect the conditions prevailing in this segment.
Customer switching	The aggregated nature of switching data means that it has not been possible to identify the switching (either between retailers offering time of use tariffs or between tariff structures) undertaken by customers with an interval read meter.
Informed customer choice	The customer survey conducted by Roy Morgan indicates that the level of understanding of time of use retail tariffs amongst residential customers, in particular, is limited. The complexity associated with comparing time of use and flat or inclining block tariffs also makes it difficult for small customers to make an informed choice about retail tariff structures.
Ability to choose different tariff structures	The ability of small customers with an interval read meter to choose between a time of use and a flat or inclining block retail tariff structure has, in Ausgrid's network depended more on Ausgrid's network charging policy than customer preferences. This is because, with the exception of EnergyAustralia, retailers have been unwilling to take on the risk associated with customers having different retail and network tariff structures (see section D.3.3).
Performance	
Price and non-price competition	Our review of the time of use products currently offered by retailers indicates that the regulated time of use tariff is currently acting as the focal point for competition amongst retailers, with the same discounts, rebates and other benefits offered to prospective time of use customers as those offered to customers seeking a flat or inclining block tariff (see section D.4.1). The concerns we have with regulated tariffs acting as the focal point for competition are outlined in chapter 7.
Products and services	With one or two exceptions, the time of use products currently offered by retailers have the same structure as the regulated retail time of use tariffs, which are based on the structure of the network time of use charges (see section D.4.1). While it is possible that as small customers' understanding of time of use tariffs increases, more innovative time of use products may be developed, the range of products offered by retailers will still depend, to a large extent, on the network charging options offered by DNSPs.

Retail margins	<p>The margin analysis carried out by NERA indicates that over the period FY2008-2013 the retail margin for a representative residential customer on a regulated time of use tariff vis-à-vis on a flat or inclining block tariff was:</p> <ul style="list-style-type: none"> • 2.4 times higher in Ausgrid's network (12 per cent vs 5 per cent); • the same in Essential Energy's network (9 per cent); and • 0.4 times lower in Endeavour Energy's network (4 per cent vs 10 per cent). <p>A closer examination of NERA's analysis reveals that while the total bill for a representative customer on a time of use tariff in Ausgrid's network has been roughly the same as that for a representative customer on an inclining block tariff, Ausgrid's network time of use charge was considerably lower than its inclining block network charge. The standard retailer does not therefore appear to have passed on the benefit of the lower time of use network charges applying in this network to customers on a regulated time of use retail tariff.</p>
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On the basis of the analysis set out in Table D.6, it would appear that while there is a reasonable degree of competition to supply this segment of the market and customers can choose between a number of different retailers, there are still a number of competition issues affecting participants in this segment of the market. Specifically, that:

- small customers are not currently in a position to participate effectively in this segment of the market because their understanding of time of use tariffs is limited and they are not sufficiently equipped to make informed decisions;
- the range of tariff structures offered to small customers with an interval read meter in Ausgrid network has depended more on the network charging policy than customer preferences and, as a consequence, some small customers that have wanted to switch to a flat or inclining block retail tariff have found it difficult to do so; and
- there is some preliminary evidence to suggest that the retail margin available under the regulated time of use tariff has been higher for a representative residential customer in Ausgrid's network than an equivalent customer on an inclining block tariff, because the discount on time of use network charges offered by Ausgrid have not been fully passed on by retailers.

It also appears that retail price regulation may be having a number of unintended consequences on competition in this segment of the market.

Each of these issues is explored in further detail in the remainder of this section, along with our assessment of the effect that a wide scale deployment of interval read meters could have on competition in this segment of the market.

D.5.1 Customer participation

To be able to participate effectively in this segment of the market, small electricity customers must have a reasonable understanding of electricity charges and be in a position to make informed decisions about the tariff structure and retail offer that best suits their needs. If selecting a time of use tariff, customers must also know how to manage their energy use, which, in turn, requires a good understanding of:

- the amount of electricity they typically consume and the pattern of their energy usage over the day, week and year (ie their load profile); and
- the costs of running appliances at different times of the day and measures they can put in place to defer or reduce consumption in peak periods.

Notwithstanding that time of use tariffs have been available for some time now, the results of the customer survey conducted by Roy Morgan indicates the level of understanding of time of use tariffs amongst residential customers, in particular, is

limited.⁶⁰⁵ Our own work in this area also indicates that it can be difficult to compare time of use and flat or inclining block retail tariffs and to make informed decisions about the relative merits of alternative retail tariff structures and the circumstances in which it would be beneficial to switch to an alternative tariff structure, where such an option is available to the customer.

The ability of small customers to make informed decisions and to participate effectively in this segment of the market appears limited at this time.

This is one of the more significant issues currently affecting this segment of the market and unless steps are taken to address the imbalance, there is a risk that customers (or groups of customers) will not necessarily select a tariff that best suits their needs. It is also possible in this type of environment that retailers may be able to engage in inefficient forms of price discrimination, which would operate to the detriment of small customers operating in this market segment.

The Commission considers that this is an area that would particularly benefit from a strategic and co-ordinated approach to enhancing the level of customer participation, as discussed in chapter 8. As part of the information and engagement programs, particular focus could be given to:

- improving the level of understanding of time of use tariffs amongst small customers; and
- ensuring small customers are equipped to participate in this segment of the market by providing them with access to:
 - their energy usage data (both their overall use and their load profile);
 - an independently operated and reputable price comparison tool that enables customers to make direct comparisons between alternative tariff structures and offers and to understand the effect that these will have on their electricity bill; and
 - general information on the measures they can put in place to defer or reduce their consumption in peak periods.

Further detail on the strategies that may be employed to improve small customers' understanding of and engagement in the electricity market is provided in chapter 8 while Table D.7 sets out measures that will need to be put in place to enable small customers to make informed decisions, as described previously in the Power of choice review.

In the future authorised third party customer agents could play a more active role in helping customers understand their consumption patterns and advising them on the tariff structures and offer that best suits their needs. However, for this to occur, the

⁶⁰⁵ Roy Morgan, *Retail Competition in the NSW Electricity and Natural Gas Markets: Focus Groups with Residential and Small Business Consumers*, 28 February 2013, pp. 2 and 10.

customer agents must be able to access a customer's metering data. It is for this reason that the measures set out in Table D.7 also refer to customer agents being provided access to energy usage data, where the customer has provided explicit informed consent for the agent to be provided with the information.

Table D.7 Measures required to enable customers to make informed decisions

Recommendation	Measures to Give Effect to Recommendation
Energy usage data	
Small customers with an interval read meter should have access to their energy usage data (overall use and load profile) and, ideally, should have access to this data for a reasonable period before being offered a time of use tariff. Access to this data is required to enable customers (or their agents) to use price comparison tools and to manage their energy usage over time. Third party customer agents should also be able to access this data if explicit informed consent has been provided by the small customer.	To give effect to this recommendation the National Electricity Rules will need to be amended to clarify the arrangements and provide a framework for customers to request and receive their energy data. The National Electricity Retail Rules will also need to be amended to provide customers with access to their load profile. Further detail on these amendments is set out in chapter 3 of the Power of choice Final Report.
Price comparison tool	
Small customers should have access to an independent and reputable price comparison tool, which enables them to make direct comparisons between alternative tariff structures and retail offers.	IPART currently provides access to such a tool and once NECF is implemented in NSW the AER will be required to include NSW in its price comparator tool (Energy Made Easy). Both of these tools allow customers to compare the effect of adopting alternative tariff structures and retail offers. Once customers have access to their energy usage data, it is possible that these tools could be improved by allowing customers to upload their actual load profile data so that a more accurate assessment of the effect of different retail tariff structures on the customer's annual bill can be carried out.

D.5.2 Choice of retail tariff structures

Another issue we have identified is that the range of tariff structures offered to small customers with an interval read meter in the Ausgrid network has depended more on Ausgrid's network charging policy than customer preferences. As a consequence, some customers that have wanted to revert to a flat or inclining block tariff have found it difficult to do so.

This issue appears to have arisen because, with the exception of EnergyAustralia, retailers have been unwilling to take on the risks associated with customers having different retail and network tariff structures and so have only been prepared to offer a

choice of retail tariff structures if such a choice is allowed at the network level.⁶⁰⁶ EnergyAustralia has therefore been the only retailer willing to offer most customers a choice to revert back to a flat or inclining block tariff in circumstances where the DNSP has required the small customer to move onto a time of use network charge.

EnergyAustralia is not required by any form of regulation to offer customers this choice. Rather, its decision to offer this appears to have been made in response to customer preferences. EnergyAustralia has informed us that there are significant commercial risks associated with offering customers this option where the structure of network charges and retail tariffs cannot be aligned. EnergyAustralia has also informed us that it would, in the first instance, offer customers with an interval read meter a time of use tariff because its systems are set up to align retail and network tariff structures.⁶⁰⁷ It is possible, that customers with an interval read meter that would prefer to remain on a flat or inclining block tariff but do not ask EnergyAustralia if this is possible, may be unaware that they can make such a choice.

The influence of network charging policies on the tariff structures that retailers have been prepared to offer small customers is not surprising given that network charges account for over 50 per cent of a customer's retail bill (see for example Figure D.2 and Figure D.3). That said, it is surprising that more retailers have not responded to the preference some customers have for flat or inclining block tariffs by developing a tariff that incorporates a higher margin to compensate the retailer for the risks associated with the lack of alignment between network and retail tariff structures. Retailers may not have responded in this manner because:

- there is insufficient demand for this type of product to warrant the development of such a product; and/or
- the regulated flat or inclining block retail tariff is acting as a constraint on the ability of retailers to respond in this manner because the margin available under this tariff is insufficient to compensate retailers for taking on the risk.⁶⁰⁸

To get some additional insight into the effect that the removal of retail price regulation would have on the choices offered to customers with an interval read meter, we have sought further information from a number of retailers. The responses we received were varied, with EnergyAustralia stating it would still have an incentive to offer customers a choice between tariff structures while the other retailers stated that it would still

⁶⁰⁶ Although the network policies may have affected the range of tariff structures offered to customers, they do not appear to have affected the level of competition amongst retailers offering time of use retail tariffs.

⁶⁰⁷ Response to AEMC questionnaire provided by EnergyAustralia.

⁶⁰⁸ That is, if the margin available under the regulated flat or inclining block tariff is lower than what retailers require to compensate them for taking on the risk of a customer having a different network and retail tariff structure, then it may be difficult for retailers to market these products to customers that are subject to a time of use network charge because their tariffs would be higher than the regulated tariff.

depend on whether the DNSPs network charging policy accommodated such a choice.⁶⁰⁹

The responses received from retailers suggest that:

- competition cannot be relied upon at this point in time to ensure that customers with an interval read meter are offered a choice between alternative retail tariff structures; and
- irrespective of whether or not retail price regulation is retained, network charging policies will continue to have a significant influence on the retail tariff structures offered to small customers.

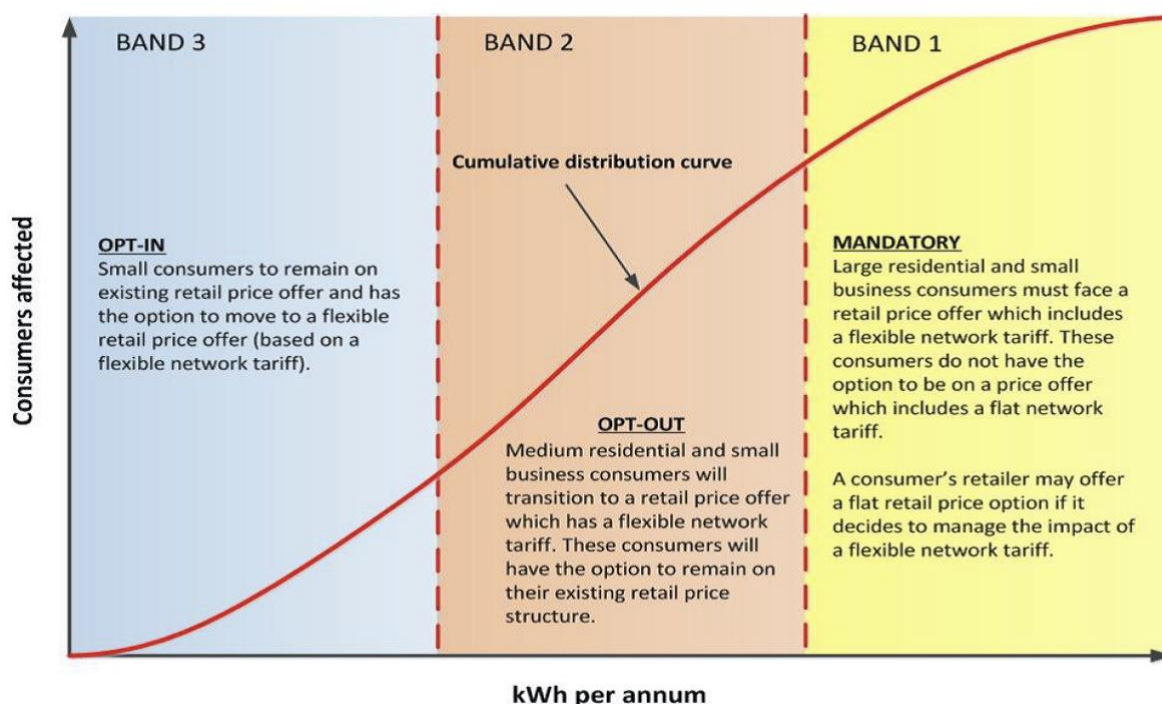
There is a trade-off between offering customers with an interval read meter a choice between tariff structures and trying to maximise the level of demand side response that time of use tariffs can elicit. This issue was explored in the Power of choice review. We concluded that if time of use tariffs were implemented in the manner depicted in Figure D.1, then it would enable a significant portion of the demand side response benefits associated with time of use pricing to be captured while also protecting vulnerable⁶¹⁰ customers that are unable to respond to time of use tariffs.

As the information in Figure D.1 reveals, under our proposed approach retailers would only be required to offer small residential customers (band 3) and medium sized residential and small commercial customers (band 2) a choice between a time of use and a flat or inclining block retail tariff. For larger residential and small commercial customers (band 1), retailers would not be required to offer a choice, but they could do so if they were willing to take on the risk associated with different network and retail tariff structures.

⁶⁰⁹ Response to AEMC questionnaire provided by AGL, APG, EnergyAustralia, Lumo and Origin Energy.

⁶¹⁰ The term "vulnerable customers" is used in this context to refer to those customers for whom the movement to a time of use tariff results in increased financial distress and adversely affects their ability to pay electricity bills.

Figure D.1 Power of Choice Recommendations



The circumstances in which customers with an interval read meter should be offered a choice between a time of use and flat or inclining block retail tariff have also recently been considered by both:

- the Energy Market Reform Working Group (EMWRG) in the context of the National Smart Meter Consumer Protection and Safety Review;⁶¹¹ and
- the Victorian Government in the lead up to removal of the moratorium on the wide scale introduction of time of use (flexible) pricing in Victoria.

A summary of the positions taken by both the EMWRG and the Victorian Government on this issue and the recommendations contained in the Power of choice review is contained in Table D.8.

⁶¹¹ EMWRG, *the National Smart Meter Consumer Protection and Safety Review*, November 2012, Chapter 2.

Table D.8 Customer choice - alternative options

Review	Customers to have a choice	Customer Choice	Retailers	DNSPs and Choice of Charges	Reversion Without Penalty?
AEMC - Power of Choice Review	Band 1: Larger residential and small business customers	Mandatorily moved on to retail tariff with a time of use network charge.	Retailers only required to offer a standing offer with a time of use network charge but may also offer a flat/inclining block retail tariff if willing to take on risk of mismatch.	DNSPs to offer time of use network charge only.	Yes for transitional period only
	Band 2: Medium small customers	Transition to retail tariff with time of use network charge but can opt out of time of use.	Retailers required to develop both a standing offer with time of use network charge and a standing offer with a flat/inclining block network charge.	DNSPs to offer time of use and flat/inclining block network charges. Choice between network charges will depend on customer's choice at retail level.	Yes for transitional period only
	Band 3: Smallest customers	Remain on existing retail tariff with flat/inclining block network charge but can opt in to time of use.			
EMWRG - Smart Meter Consumer Protection and Safety Review	All small customers	All small customers to have a choice between a flat/inclining block retail tariff and a time of use retail tariff.	Retailers required to develop both a standing flat/inclining block and standing time of use retail tariff.	<p>DNSPs at a minimum to offer a flat/inclining block network charge and a time of use network charge.</p> <p>Choice between network charges to be made by retailer</p>	Yes for transitional period only

Review	Customers to have a choice	Customer Choice	Retailers	DNSPs and Choice of Charges	Reversion Without Penalty?
				so that there is alignment between network charge and retail tariff.	
Victoria	All small customers	All small customers to have a choice between a flat/inclining block retail tariff and a time of use retail tariff and only to move onto time of use if providing their explicit informed consent	Retailers required to offer at least one flat standing offer to customers.	<p>The following only applies to residential customers and for a transitional period that ends on 31 Dec 2015 although the Victorian Government has signalled its intention to carry out a review during this period to determine whether the measures may be required for a longer period.</p> <p>DNSPs to offer at least one flat/inclining block network charge and a flexible network charge that complies with certain requirements. Choice between network charges to be made by retailer so the network charge and retail tariff are aligned.</p>	Yes for residential customers and only until 31 March 2015

Sources: AEMC, *Power of Choice – Final Report*, 30 November 2012, Chapter 6; EMWRG, *the National Smart Meter Consumer Protection and Safety Review*, November 2012, Chapter 2.

D.5.3 Pass through of discounts on time of use network charges

A further issue that NERA's profit margin analysis has revealed is that over the period from 1 July 2007 to 30 June 2013 the retail margin in Ausgrid's network appears to have been higher for a representative residential customer on a regulated time of use tariff than an equivalent customer on a regulated inclining block tariff.⁶¹² We note that NERA has not calculated the actual margin earned by retailers offering time of use tariffs. Rather, it has developed an estimate of the margin that the standard retailer would have earned under the regulated time of use tariff if it had:

- supplied a residential customer that consumed 7.5 MWh of electricity per annum and had the same load profile as the net system load profile (the "representative residential customer"); and
- incurred the wholesale energy, network and retail operating costs estimated by NERA.

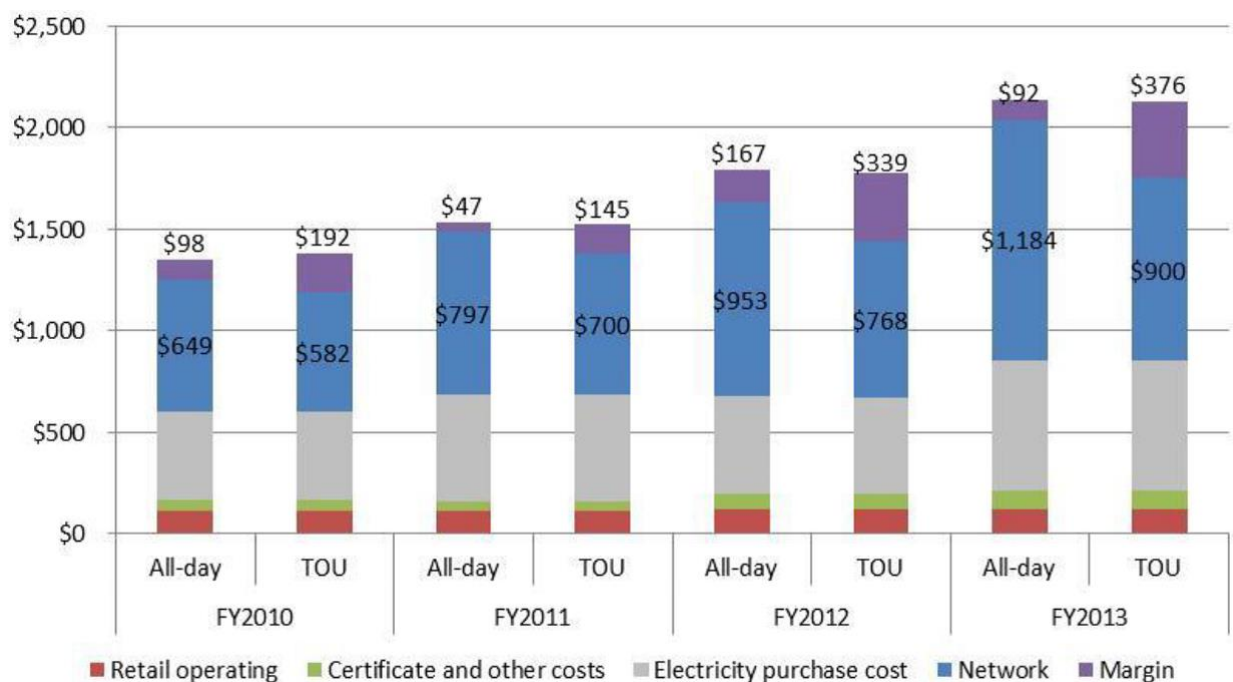
NERA's estimate is therefore based on a number of significant assumptions.

As discussed previously the standard retailer has some freedom to determine the level and structure of individual regulated tariffs within a weighted average price cap. NERA's finding that a higher retail margin may have been earned under the regulated time of use tariff in Ausgrid's network, should not therefore be construed as an explicit decision by IPART to allow a margin of this magnitude.

In terms of the possible source of the higher margin, it would appear from NERA's analysis of the bill payable by a representative customer on a regulated inclining block and regulated time of use tariff that the higher margin may have arisen because the discount Ausgrid has offered on time of use network charges has not been passed on in full to time of use customers (Figure D.2).

⁶¹² NERA, Prices and Profit Margin Analysis for NSW Retail Competition Review, 5 March 2013, p. 40.

Figure D.2 NERA's representative customer bill - Ausgrid network

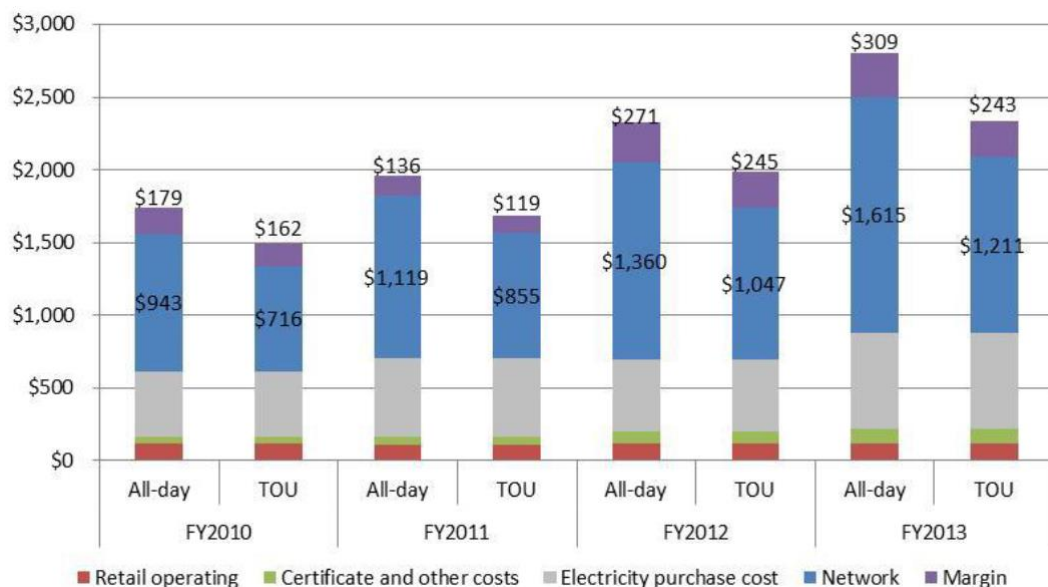


Source: NERA, *Prices and Profit Margin Analysis for NSW Retail Competition Review*, 5 March 2013, p. 41.

The behaviour observed in Ausgrid's network is in direct contrast to what NERA's analysis indicates has occurred in Essential Energy's network over the same period.⁶¹³ In a similar manner to Ausgrid, Essential Energy's network time of use charges for a representative customer have been lower over the last four years than its flat network charges. However, unlike customers in Ausgrid's network, the benefit of the lower time of use network charges appears to have been passed on by the standard retailer to time of use customers in this network (see Figure D.3).

⁶¹³ According to NERA's analysis, the time of use network charges in Endeavour Energy's network have been higher than the inclining block network charges.

Figure D.3 NERA's representative customer bill - Essential Energy Network



Source: NERA, *Prices and Profit Margin Analysis for NSW Retail Competition Review*, 5 March 2013, p. 42.

While the higher margin available under the regulated time of use tariff in Ausgrid's network might be expected to attract a greater degree of discounting in this network, all but one⁶¹⁴ of the retailers are currently offering the same discounts from the regulated tariffs to customers across networks and tariff structures. It is possible that the full benefit of the discounted time of use network charges in Ausgrid's network has not been passed on to time of use customers in this network by the majority of retailers.⁶¹⁵

⁶¹⁴ The one exception to this is Momentum Energy, which is offering a higher discount on the peak, shoulder and off-peak tariffs applying in Ausgrid's network than the discount offered in Endeavour Energy and Essential Energy's networks.

⁶¹⁵ It is worth noting in this context that while the margin earned by other retailers offering time of use products in this network would not be as high as NERA's 12 per cent estimate (ie, because discounts are applied to the regulated retail tariff), the margin they could earn when supplying a representative customer on a time of use tariff would still be higher than what could be earned when supplying the same customer on an inclining block tariff.

The fact that this issue has persisted for the last four years is surprising given the number of retailers offering to supply this segment of the market. This may have occurred because:

- customers are not in a position to participate effectively in this segment of the market (see section D.5.1); and
- retailers are not competing on the basis of the conditions prevailing in this segment of the market. Rather, they are using the regulated retail tariff as the reference point for their market offers and then offering the same discounts on time of use tariffs as the discounts offered on inclining block tariffs.⁶¹⁶ To the extent that the regulated time of use retail tariff incorporates a higher margin than the regulated inclining block tariff, then the difference will be preserved because the discounts offered by retailers do not currently reflect the conditions prevailing in this segment of the market.

While the removal of retail price regulation will go some way to addressing this issue (ie because the regulated tariff would no longer act as the focal point for competition), we would also expect it to be eroded over time as:

- the number of customers that can take up time of use tariffs increases;
- customers' understanding of time of use tariffs improves; and
- retailers start competing more actively by offering discounts that reflect the conditions prevailing in this segment of the market.

We are not therefore recommending any specific measures to deal with this issue. However, we would expect that if retail price regulation is removed, retailer margins will continue to be monitored by either IPART or the AER as part of the market and price monitoring regime described in section 7.5.

⁶¹⁶ The same discounts are also being offered across networks.

D.5.4 Influence of retail price regulation on competition

An additional matter that we have considered when undertaking this review is the effect that retail price regulation is having on competition in this segment of the market. It appears that retail price regulation may be having the following unintended consequences on competition in this segment of the market:

- the regulated retail tariffs may be limiting the ability of retailers to offer customers on a time of use network charge a flat or inclining block retail tariff, and vice versa, because they place a cap on the margin that retailers can earn for taking on the risks associated with customers having different network and retail tariff structures (see section D.5.2);
- the regulated time of use tariff may be enabling the higher margin observed in Ausgrid's network to persist because it acts as the reference point from which retailers apply their discounts (see section D.5.3); and
- the presence of the regulated retail time of use tariff may, to some extent, be discouraging diversity in the time of use products offered by retailers because it acts as the focal point for time of use product offerings. The term "to some extent" is used, because the ability of retailers to offer different time of use products will also depend on the preferences of small customers and the network charges offered by DNSPs. The removal of retail price regulation will not therefore, in and of itself, result in a wider range of products being offered.⁶¹⁷

As more customers move onto time of use tariffs it will become more difficult to develop a regulated retail tariff that enables the standard retailer to recover the efficient costs of providing electricity to customers on these tariffs. This is because customers on time of use tariffs will have their electricity bills determined by their actual load profile, rather than the average NSLP. It will therefore be more complicated to determine what allowance should be made for network and wholesale energy costs when calculating the regulated retail tariff.

D.5.5 Effect of a wide scale roll out of interval read meters

Looking forward, the number of interval read meters installed in NSW is expected to increase, either as a result of DNSPs installing the meters on a new and/or replacement basis, or a NSW Government endorsed market led or mandated distributor led roll out. We have therefore given further consideration to whether a wide scale roll out of interval read meters is likely to give rise to any additional barriers to entry and the effect that such a roll out is likely to have on competition in this segment.

⁶¹⁷ One other point that is worth noting is that because the majority of interval read meters installed in NSW are interval meters, the range of products and services that retailers can offer may be more limited than what they could offer if smart meters were installed. For example, retailers would not be able to offer monthly billing because the interval read meters are still being read manually on a quarterly basis.

Barriers to entry

If a decision is made to proceed with a wide scale roll out of interval read meters then, depending on the form that the roll out takes, it could have implications for the direct costs that a retailer seeking to supply this segment of the market will incur. That is, if a decision is made to proceed with a market led roll out, retailers may⁶¹⁸ incur the costs of installing the interval read meters (and any associated devices such as in-home displays) and the costs associated with meter reading.

While this will increase the costs faced by retailers seeking to supply this segment of the market, there is no reason to expect the costs will be any different for existing retailers and new entrants, particularly given the presence of third party meter providers and meter data providers. There is also no reason to expect the costs would be so high as to deter entry. Thus, to the extent that the costs associated with a market led roll out are considered a barrier to entry into this segment of the market, we would expect the barrier to be surmountable.

Effect on competition

If the wide scale deployment of interval read meters is coupled with measures that address the issues outlined in sections D.5.1 - D.5.2 and D.5.4, we would expect competition in this segment of the market to become more effective as the pool of customers that can move onto time of use tariffs increases from its current level. Specifically, we would expect that as the number of customers that can move onto a time of use tariff increases and the level of customer participation improves, retailers will have a greater incentive to focus on competing in this segment of the market by:

- offering discounts and rebates that reflect the conditions prevailing in this segment of the market rather than applying the same discounts and rebates that are made available to customers on flat or inclining block tariffs; and
- differentiating their products and services and offering products that reflect customer preferences.

As long as customers are suitably equipped to participate effectively in this segment of the market, then over time these competitive responses should result in:

- any high retail margins being eroded and discounts at the network level being passed through;
- the degree of market concentration currently prevailing in this segment of the market diminishing; and
- customers benefiting from greater choice in products and services and more cost reflective pricing.

⁶¹⁸ The term "may" is used because under a market led roll out the decision to install the meter may be made by customers, retailers, distributors or meter providers.

Finally, if a wide scale deployment of interval read meters is not coupled with measures that effectively address the customer participation, customer choice and retail price regulation issues set out in sections D.5.1 - D.5.2 and D.5.4, then the same issues will continue to affect competition in this segment of the market.

D.5.6 Conclusion

Based on the discussion set out above, it is clear that there are a number of competition issues currently affecting small customers and retailers operating in this segment of the market and that retail price regulation may be having a number of unintended consequences on competition.

Some of the issues identified have been addressed elsewhere, such as clarification of customer choice between a time of use and flat/inclining block tariff. Other issues, such as increased understanding and engagement by customers could be addressed through a specific information and engagement program as discussed in chapter 7 of this report. Increased customer engagement combined with the removal of price caps should address the issue of higher margins on time of use tariffs. Finally, time of use tariffs should specifically be captured in the market and price monitoring regime outlined in section 7.5.

E International survey - paths to deregulation

This appendix sets out an overview of the process by which price regulation has been removed in Great Britain, Ireland and one state in the United States of America, Texas. Brief details are also included on market developments since price deregulation.

E.1 Great Britain

Competition was introduced in phases in Great Britain. For non-domestic gas customers, competition was introduced between December 1986 and May 1998. Competition for non-domestic electricity customers was introduced between April 1990 and May 1999.

Competition in the domestic gas sector was phased in between April 1996 and May 1998. For domestic electricity customers, competition was phased in between September 1998 and May 1999. In each case the phase in was undertaken on a region by region basis.

When competition was introduced for domestic customers, those that did not switch remained subject to price caps – the form of price regulation that was introduced at privatisation. Within 2-3 years, competition in gas supply was judged to be effective for some payment methods - prompt pay and direct debit; but not for others - prepayment and late pay. British Gas's gas prices were made subject to relative price regulation. This removed direct regulation for prompt pay and direct debit customers, but capped differences between those prices and British Gas' combined prepayment and late pay prices. In electricity, the former "public electricity suppliers" (equivalent to the Australian standard retailer) were subject to price caps in their retail area.

In April 2000, the Office of Gas and Electricity Markets (Ofgem) removed price caps on direct debit electricity prices. In April 2002 Ofgem lifted all remaining electricity price caps. Price caps on the retail prices of the gas incumbent were removed in April 2001, except for a relative price cap on pre-payment meters and the late pay tariff because competition was deemed to be less effective for this sub-group. Relative price regulation capped the differential between the Direct Debit and LatePay/ PrePayment tariff, and between the PromptPay and LatePay/PrePayment tariff. All remaining price caps were lifted in 2002.

In 2008, Ofgem initiated a review of competition ("Energy Supply Probe") in the energy retail market. This found:

- there were six substantial companies competing for domestic consumers and this compared favourably with many other UK consumer services sectors;
- market shares of the Big 6 suppliers in their former monopoly markets continued to fall year-on-year;
- an annual switching rate of 18 per cent;

- that energy suppliers had widened the range of tariffs available to domestic consumers and responded to consumer demand for greater certainty by offering a range of fixed or capped price tariffs;
- dual fuel, direct debit tariffs offered the lowest prices and were the prime focus of competition. Eight and a half million consumers benefited - 38 per cent of all consumers;
- no collusion between retailers; and
- that changes in wholesale costs were passed through in changes in retail prices.

However, Ofgem also found that:

- the national gas market and each of the former regional electricity markets were still highly concentrated;
- 17 per cent of customers were “active” – ie switched regularly to get the best deal;
- some consumers:
 - find it difficult or time consuming to assess offers;
 - are not confident they can make a sound choice;
 - are sceptical about scale of benefits and whether they will be sustained;
 - worry about moving inadvertently to a worse deal; and
 - are unable to get the best deals because they do not have internet access, a current bank account or both;
- around half of the less active consumers engage if approached directly by a sales person. “We have evidence that most consumers who change supplier in response to such an approach do not investigate alternative deals in the market, and may not therefore be making well informed switching decisions.”; and
- almost all customers surveyed by Ofgem said they switched to save money but as many as one third may not have achieved a price reduction. This was for consumers who switched as a result of a direct sales approach (48 per cent for gas, 42 per cent electricity).

Following the review Ofgem placed a range of specific requirements on suppliers (for example on conduct of marketing and the price differentials between payment methods) and voluntary standards of conduct and rules on the information they provide to customers. These requirements aimed to help customers become more engaged in the market.

In late 2010, Ofgem launched the Retail Market Review (RMR). While there had been some improvements in the information provided to customers since the previous review, Ofgem concluded that many of the problems with customer engagement remained. Since the end of 2011 Ofgem has undertaken further consumer research and been consulting on proposals for new requirements on retailers to address its continuing concerns. The culmination of this was the announcement in February 2013 of a package of proposals on which Ofgem has launched statutory consultation.⁶¹⁹ A decision on whether or not to implement the reforms will be published in May. If a decision is made to implement the reforms, licence holders (including suppliers), trade bodies representing licence holders and Consumer Focus (the energy consumer body) will have 56 days to decide whether they should appeal against the reforms to the Competition Commission. The changes are due to come into effect between July and December 2013.

The main proposals are:

- a limitation on the number of core tariffs that can be offered. There will be four “core” tariffs per fuel type (electricity and gas), (relating to different payment types including direct debit, prepayment meters etc);
- all tariffs have a standing (daily) charge and unit rate;
- simplification of discounts and removal of some obsolete tariffs;
- new rules to protect customers on fixed term contracts;
- new enforceable standards of conduct to enable Ofgem to take action against suppliers where they have failed to treat customers fairly; and
- various measures to improve information provided to customers and a new Tariff Comparison Rate (TCR) tool to make it easier to compare tariffs.

E.2 Ireland

Wholesale market competition was progressively introduced from February 2000. Retail market competition was introduced progressively with full market opening in February 2005.

The CER consulted on proposals to deregulate retail electricity prices in December 2009. The CER found that there were four separate markets: Large Energy Users, Medium-Sized Business, Small Business and Domestic. In light of significantly reduced market shares of the incumbent (ESB) and high levels of switching, the Commission concluded deregulation could be considered for all markets and set out the following criteria to decide on the deregulation of each market:

- (i) at least three suppliers active in the relevant market; and

⁶¹⁹ Ofgem, Ofgem starts countdown to a simpler, clearer and fairer energy market, Press release, 21 February 2013.

- (ii) at least two independent suppliers, each of which has at least ten per cent share (GWh) in the relevant market; and
- (iii) an ESB market share of 50 per cent (MWh) or less (60 per cent (MWh) or less in the domestic market).

The CER also set two additional requirements for the domestic market:

- switching rates must be greater than ten per cent; and
- ESB must be re-branded prior to deregulation of the domestic market.

The CER decided these conditions were met for the domestic market and prices were deregulated in April 2011. This led to the removal of all obligations of tariff regulation from ESB (which was rebranded to Electric Ireland). The deregulation decision saw Electric Ireland promote a range of single and dual fuel offers and also take a position in the gas market.

The domestic market in gas is the only remaining retail market sector that is still subject to tariff regulation. Bord Gáis Energy's domestic market share was approximately 70 per cent for both customer numbers and consumption at the end of Q2 2012.

With the increase in competition and progressive deregulation of the retail markets, the CER has recognised the need for enhanced customer protection and 2011 saw the introduction of a number of customer protection initiatives. These included strengthening of the codes of practice to incorporate additional provisions such as: minimum charter payments; presentation and publication of tariffs; mandatory notice periods for tariff changes; and escalation points on complaint handling.

There was a focus on providing improved information to customers with the launch of the price comparison website accreditation framework. Under the accreditation framework, a website providing an energy price comparison service is only accredited by the CER if it meets defined standards for accuracy, transparency, and reliability. Accredited sites will be audited at least annually to ensure a high standard of service. Ireland's first accredited energy price comparison website was introduced in March 2012.⁶²⁰

The CER also decided to produce a market monitoring report every six months. Where the report shows that the market is at risk of anti-competitive behaviour the Commission will consider appropriate remedies, including the reintroduction of price caps if appropriate. The market monitoring reports review:

- number of suppliers;
- market share for all suppliers;
- switching – total level of switches and switching between independents;

- revenue – revenue earned for all suppliers; and
- range of tariffs on offer and average prices paid by tariff.

Based on the market monitoring reports produced by the CER, developments in the market since price deregulation have been:

- switching rates peaked in May 2009 at 80,000 per month. They fell to 50,000 in Oct 2009 then fluctuated between 30-40,000 to April 2011. Since then they have been in the range of 15-20,000 per month;
- Electric Ireland had an average net gain of 2,600 customers a month between June 2011 and June 2012; and
- at the end of Q2 2012, Electric Ireland had a 57 per cent (MWh) market share.

E.3 Texas

Texas introduced retail competition for electricity in 2002. Until January 2007, it had regulated rates - the Price to Beat (PTB). Under the PTB a customer supplied by an affiliated utility supplier (not a competitive supplier) paid a regulated rate for their electricity. The PTB applied to residential and small business customers. There was no PTB tariff for industrial and large commercial customers. The initial PTB tariff was set by the Public Utility Commission (PUC), and changes occurred at twice yearly intervals to allow flexibility to adapt to changes in underlying costs.

Under the PTB system a retail affiliate was required to offer the PTB until it lost 40 per cent of customers on the PTB tariff. If this occurred, the retail affiliate was no longer restricted to charging the PTB. From 1 January 2007, the requirement that the retail incumbents charge a regulated PTB tariff for electricity expired as the market was judged to be sufficiently competitive.

From the beginning of deregulation, Texas adopted extensive policies to promote consumer engagement in retail competition.⁶²¹

A 2009 review of the Texas market⁶²² found that:

- over 70 per cent of eligible residential customers had switched contracts or supplier by the end of 2006 (before price deregulation);
- by the end of 2008, following price deregulation, 83 per cent had switched;

⁶²⁰ See www.Bonkers.ie.

⁶²¹ See www.powertochoose.org.

⁶²² Moselle, B, *An assessment of the effects of tariff regulation on the Dutch residential retail markets for energy*, Brattle, June 2009.

- retail prices for new customers tracked wholesale gas prices reasonably closely (gas-fired generation is main price-setting technology). No dramatic increase in price of average offers for new customers at price deregulation;
- sticky customers were paying more than those who switched;
- price dispersion – as measured by the difference between average and lowest offers to new customers - was large and had increased since price deregulation;
- average offer for new customers at November 2008 was approximately the same as in January 2006, but the lowest offer for new customers had fallen significantly; and
- the difference between the average and lowest offers - about 2.3c/kWh in January 2006, increased to about 4.0c/kWh in January 2007, and stood at about 3.8c/KWh in November 2008.

The PUC's 2013 report on the state of market at August 2012 states that:⁶²³

- 59 per cent of residential customers are no longer with their incumbent retailer;
- in five of the distribution areas there are 40 or more retailers serving residential customers and 230+ different products. In one distribution area there are ten retailers and 40 products; and
- every area in Texas has some retail rates available that are up to 3c/kwh cheaper than the national average (although so too, do some states where prices are still regulated).

⁶²³ Texas Public Utility Commission, Report to the 83rd Texas Legislature Scope of Competition in Electric Markets in Texas, January 2013

F Submissions

Market definition

Stakeholder	Issue	AEMC response
AGL	The main reason for cost variances between geographical areas is network costs. p. 3.	The AEMC considers that there is little difference between retail operations in different regions of the state as described in section 3.3.
AGL	Consider it is appropriate for the Commission to consider the retailing of electricity in NSW as constituting part of a NEM wide market for the retailing of electricity. The relevant market in gas should be the east coast. p. 4.	We do not agree that there is a single NEM wide market, as elaborated in section 3.3.
EnergyAustralia	Gas and electricity are substitutes for each other for a number of small customer applications, eg heating, cooking and cooling. p. 4.	As described in section 3.2 we consider that in dual fuel areas gas and electricity are substitutable goods to some extent where customers have access to both.
EnergyAustralia	There is a significant increase in the number of customers substituting away from centralised supply via small scale solar PV. Small customers are also substituting through the use of more energy efficient products. p. 4.	We discuss the impact of household solar in section 3.2 and appendix A.2.
EnergyAustralia	There are regional variations in costs due to networks and the cost of site visits. However, there is no major differences in retailer activity in different regions. p. 4.	The AEMC considers that there is little difference between retail operations in different regions of the state as described in section 3.3.
Momentum	While there is potential for gas and electricity to be substituted in certain circumstances, the actual ability of customers to substitute in NSW is much lower than in Victoria and South Australia due to the lower levels of penetration of gas. p. 1.	We discuss the impact of household solar in section 3.2 and appendix A.2.

Stakeholder	Issue	AEMC response
Origin Energy	The cost of supplying energy varies by geographic area due to differences in network costs. However, there is not a significant difference in the retail operating costs of supplying electricity or gas to small customers in different geographical areas or distribution networks. There may be a slightly higher cost of selling through some sales channels, eg door to door. p. 7.	The AEMC considers that there is little difference between retail operations in different regions of the state as described in section 3.3.
PIAC	Differences in customer density, network charges and marketability are more important for retail competition than the consumption level of a customer. The three network areas should be examined as different areas. The <i>Choice? What Choice?</i> survey of residential customers in some regional centres showed that these customers were exposed to much lower levels of competition than those in Greater Sydney p. 8.	As above. We note that the <i>Choice? What Choice?</i> survey was done before the privatisation of the standard retailers and there has been an increase in market activity in the Essential Energy region since then.

Market Structure

Stakeholder	Issue	AEMC response
ActewAGL	There are low barriers to entry for retailers entering the gas and electricity markets. p. 1.	The Commission's draft view is that there are low barriers to entry in electricity but there are some barriers to entering the gas market. See sections 4.3, 5.3 and appendix A.3.
AGL	Barriers to entry for both electricity and gas are low with regulatory uncertainty in pricing decisions being the main structural element impacting on competition. pp. 3-4.	As above.
Alinta	There are areas of the state where there is limited access to the gas network. For areas that can be connected, usage is discretionary. p. 3.	Noted.
Alinta	Price regulation creates uncertainty that is a barrier to entry. p.1.	The AEMC agrees that price regulation can cause uncertainty; however, it does not appear to be an

Stakeholder	Issue	AEMC response
		insurmountable barrier to entry. See section 4.3.
EWON	The privatisation of government owned retailers reduced the number of large retailers in the market from five to three. pp. 1-2.	Noted. However, market concentration is only one measure of competition and the Commission considers that on balance there is effective competition.
EWON	Obsolete Country Energy tariffs stifle competition. IPART and Origin Energy are working to resolve the situation. Customers in the Essential Energy region have complained that they may not receive offers. p. 3.	As described in section 4.3 and appendix A.1 the AEMC considers that the obsolete tariffs are reducing the effectiveness of competition in pockets of the Essential Energy network and supports the ongoing process to remove them.
EnergyAustralia	EnergyAustralia does not supply customers in the Far West region of Essential's area due to the legacy tariffs increasing possibility of billing errors. p. 5.	As above.
EnergyAustralia	Main barrier to entry is regulation being inconsistent with other states or where it introduces risk. p. 5.	The AEMC agrees that price regulation can cause uncertainty however it does not appear to be an insurmountable barrier to entry. See section 4.3.
EnergyAustralia	In some gas distribution areas retailers may not have confidence that the regulated price will be reasonable in all years. If margins in one fuel are too low retailers may be reluctant to enter a region. p. 5.	As above.
ESAA	Market does not need many participants to be effective. As long as there is a credible threat of a new entrant retailer competitive prices will be offered. p. 1.	The Commission considers there is no one measure of competition. Rather, we have used a number of indicators to inform our analysis.
ESAA	Main barrier to entry is risk from regulated tariffs. p. 1.	The AEMC agrees that price regulation can cause uncertainty; however, it does not appear to be an insurmountable barrier to entry. See section 4.3.
Momentum	Obsolete tariffs and low customer density reduce competition in the	As described in section 4.3 and appendix A.1 the AEMC considers that the obsolete tariffs are reducing the

Stakeholder	Issue	AEMC response
	Essential region. p. 3.	effectiveness of competition in pockets of the Essential Energy network and supports the ongoing process to remove them.
Momentum	The gas market is almost wholly concentrated among three companies. The barrier to entry are high due to difficulty procuring wholesale gas, low supply and transport options and a heavy reliance on bilateral contracts. pp. 2,4.	The AEMC's views on the barriers to entry for retailers of gas are described in section 5.3 and appendix A.3. The AEMC considers that there are barriers to entry, but the existence of new entrant gas retailers indicate that the barriers are manageable.
Momentum	Vertical integration lowers contract liquidity and can be a barrier to entry. p. 5.	The AEMC considers that currently there is enough liquidity in the wholesale market for this not to be a problem as discussed in section 5.3 and appendix A.3. However we acknowledge that the sale of the government owned generators may affect liquidity in the future.
Origin Energy	Historically the regulated tariffs and the ETEF scheme hindered competition. pp. 7-8.	The AEMC considers that historical government intervention through the ETEF and a low regulated price may have reduced competition in the market.
Origin Energy	There are no barriers to entry or exit for retailers for either electricity and gas. p. 9.	The Commission's draft view is that there are low barriers to entry in electricity but there are some barriers to entering the gas market. See sections 4.3, 5.3 and appendix A.3.
PIAC	The electricity market is more concentrated than it was prior to deregulation and in Victoria when it deregulated its market. p. 9.	A comparison of the state of the gas market in NSW compared to the jurisdictions examined in previous reviews can be found in section 4.1.
PIAC	Obsolete tariffs cover about 20 per cent of Essential Energy area customers. These are geographically concentrated. These customers will not switch as these tariffs are better than the standard contract. p. 10.	As described in section 4.3 and appendix A.1 the AEMC considers that the obsolete tariffs are reducing the effectiveness of competition in pockets of the Essential Energy network and supports the ongoing process to remove them.

Stakeholder	Issue	AEMC response
PIAC	The Gas Market is smaller, more concentrated and with lower margins than Victoria. Some "gas" retailers will only connect as part of dual fuel, indicating a lack of competitiveness. p. 16.	The AEMC considers there are some barriers to entering gas retailing, however customers have some ability to substitute to other products and services.
PIAC	There are barriers to entry including high market concentration, wholesale arrangements and the setting of regulated tariffs. pp. 8-9.	The Commission's draft view is that there are low barriers to entry in electricity but there are some barriers to entering the gas market. See sections 4.3, 5.3 and appendix A.3.
PIAC	The STTM adds complexity to wholesale arrangement for gas. pp. 15-16.	As above.

Market Performance

Stakeholder	Issue	AEMC response
ActewAGL	There is evidence of differentiated products and services with competition on price and non-price terms. Some market contracts offer alternative contract terms and incentives such as loyalty program points or ability to purchase from renewable sources. Also discounts to customers who sign up online or pay bills on time. p. 2.	The AEMC considers that there is an active market with some product differentiation. This is described in section 4.4 for electricity and section 5.4 for gas with details provided in appendix B.3.
AGL	Current IPART approach is successful in providing a framework that facilitates competition as evidenced by recent levels of customer switching. Retailers have different cost structures and required returns. p. 11.	As described in section 4.6 for electricity and section 5.6 for gas and elaborated appendix C.1 the AEMC considers that the regulated prices have been set with enough headroom to allow effective competition.
EnergyAustralia	Price regulation is complex and risks are asymmetric: if the regulated price is set too high it can be competed down, but if it is set too low the cost is borne by energy industry. p. 6.	The Commission considers that there are risks associated with continued price regulation where competition is effective. See section 7.2.

Stakeholder	Issue	AEMC response
EnergyAustralia	Retailers compete strongly for customers and offer a range of products. p. 6.	The AEMC considers that there is an active market with product differentiation. This is described in section 4.4 for electricity and section 5.4 for gas with details provided in appendix B.3.
ERAA	Once prices are deregulated, retailers will be able to set more cost reflective innovative tariffs. The Productivity Commission considers that retail price deregulation is a necessary precondition to realising the full benefits of cost reflective pricing. pp. 4-5	The Commission considers that there are risks associated with continued price regulation where competition is effective. See section 7.2.
NCOSS	Retailers appear to be providing similar deals with the exception of the market for environmentally friendly products. p. 8.	The AEMC considers that while product differentiation is more limited than in Victoria, retailers are responding to customer demand for lower prices. This is described in section 4.4 for electricity and section 5.4 for gas with details provided in appendix B.3.
Origin Energy	Current price determination is broadly cost reflective - there are still some gas tariffs which are not cost reflective but NSW retailers will be able to recover efficient costs and are incentivised to compete provided that IPART continues to set cost reflective retail tariffs. p. 19.	As described in section 4.6, the AEMC considers that the regulated prices have been historically set with enough headroom to allow effective competition.
PIAC	Some market offers make customers worse off from the regulated rates if they pay late. Note that late payment fees banned in Victoria and although able to, don't apply to market offers. Recommend investigating impact on competition and potentially banning late payment fees in NSW.	There are a variety of products available, some of which do not impose late fees. The commission does not have an in principle objection to late fees and notes that the NECF limits the circumstances in which they can be charged. See section 7.6.
PIAC	There is no tariff innovation in the market. Tariff structure reflects underlying network tariffs as well as regulated retail tariff. Only minor divergences in tariffs and PIAC question whether it has anything to do with competition rather than billing systems or differences in network tariffs. p. 19-20.	The AEMC considers that while product differentiation is more limited than in Victoria, retailers are responding to customer demand for lower prices. This is described in section 4.4 for electricity and section 5.4 for gas with details provided in appendix B.3.

Market Conduct

Stakeholder	Issue	AEMC response
AGL	The expansion of different and more innovative marketing techniques and products in response to customer demand such as online sales channels indicates retailers responsiveness to customer demand and a tendency towards product innovation and differentiation in order to grow their customer base. pp. 9-10.	The AEMC agrees that there is innovation in the electricity market as described in section 4.4. We also consider that there is limited independent rivalry in the gas market as described in section 5.4. The marketing activities of suppliers are also examined in appendix B.3.
AGL	Customers are influenced by a range of factors when choosing to switch from a regulated contract to a market contract or switching retailers. These include price, convenience (eg different payment options), the availability of loyalty programs and an ability to reduce their overall energy consumption. pp. 9-10.	The reasons why customers switch are evaluated in section 4.2 for electricity and section 5.2 for gas. Further analysis is provided in appendix B.2.
AGL	Customers are provided with options available to them prior to expiry of a contract. If the customer does not make a choice it will roll onto a new market contract. p. 10	The Commission considers customers should have sufficient opportunity at the end of a contract to consider offers.
Alinta	Competition increase shown by the increase in switching for electricity retailers. Annualised transfer rate sits at around 20 per cent for electricity according to AEMO statistics. It can be deduced that the NSW market is operating under a high level of competitiveness when comparing the current switching rate with that of other retail markets in the world as provided by VaasaETT. p. 2.	The AEMC considers that the high switching rate for electricity is only one measure of a competitive market, This is elaborated both in section 4.2 and appendix B.2.
Alinta	The NSW retail gas market would be defined as a "warm active market" and on the cusp of moving to a "hot active market" under the VaasaETT rankings which indicates that competition in the NSW gas market is occurring at a significant level. p. 2.	As we describe in section 5.2 and appendix B.2 we consider that the switching rate in gas is only one measure of a competitive market.
CHOICE	The complexity of offers, lack of tools and low levels of confidence felt by consumers in their ability to navigate the market results in a	The AEMC considers that customer interaction in the market is increasing as discussed in section 4.2 for electricity,

Stakeholder	Issue	AEMC response
	significant number of consumers disengaging from the process when choosing a new energy retail offer. This reduces the level of competition as there is reduced pressure on retailers to deliver what consumers want. pp. 5-10.	section 5.2 for gas and in appendix B.2. However we note that improved information can be provided to customers as discussed in Chapter 8.
EnergyAustralia	There is a high degree of competitive rivalry with strong price and non-price based competition between large and small retailers. Agree with IPART that competition in the NSW gas market has increased since the last IPART review. p. 5.	The Commission agrees that there is some innovation in the electricity market but as described in section 4.4 this mostly reflects price based competition. We also consider that there is some evidence of independent rivalry in the gas market as described in section 5.4. The marketing activities of suppliers are also examined in appendix B.3.
EnergyAustralia	Switching rates in the NSW retail electricity market make it one of the most active markets in the world. p. 5.	The AEMC considers that the high switching rate for electricity is only one measure of a competitive market. This is elaborated both in section 4.2 and appendix B.2.
EnergyAustralia	Fewer customers remain on regulated tariffs in gas and significant discounts to the regulated tariff are available and accessible to customers via IPART's comparator website. p. 5.	Noted.
EnergyAustralia	As a second tier retailer in the gas market it has seen a net increase in customer numbers each year since the last IPART review which shows that switching activity in gas is strong and sustainable. p. 5.	The reasons why customers switch are evaluated in section 4.2 for electricity and section 5.2 for gas. Further analysis is provided in appendix B.2.
EnergyAustralia	Retailers have looked to develop new products to meet the needs of customers and improve service for example through upgraded billing and customer management IT systems. p. 6.	The Commission agrees that there is some innovation in the electricity market but as described in section 4.4 this mostly reflects price based competition. We also consider that there is some evidence of independent rivalry in the gas market as described in section 5.4. The marketing activities of suppliers are also examined in appendix B.3.
EnergyAustralia	There is a high level of marketing activity. Different types of marketing activity are pursued including on-line, door to door, kiosks and telephone marketing. This suggests the market is very competitive.	As above.

Stakeholder	Issue	AEMC response
	Suggest that retailers wishing to obtain or maintain a presence in NSW need to be proactive in developing new sales approaches. p. 7.	
EnergyAustralia	In addition to marketing channels led by retailers customers have also experienced third party marketing such as independently developed third party switching websites and One Big Switch. There is also an increase in the influence of digital market through on-line. p. 7.	As above.
EnergyAustralia	Customers are becoming increasingly aware of competition and willing to shop around. Customers switch looking for the offers that suit their needs and preferences e.g. large discounts, fixed rate products, plans with more flexibility. p. 9.	The AEMC considers that customer interaction in the market is increasing as discussed in section 4.2 for electricity, section 5.2 for gas and in appendix B.2. However we note that improved information can be provided to customers as discussed in Chapter 8.
EnergyAustralia	A range of comparison sites are available from private providers and government supported sites including IPART's my energy offers. Pricing fact sheets available on its website increased publicly available information on energy efficiency.	Noted.
EnergyAustralia	EnergyAustralia customers receive a letter 28 days prior to the expiry of their current contract outlining their new offer. Customers automatically go onto this offer unless they contact us within a certain timeframe.	The Commission considers customers should have sufficient opportunity at the end of a contract to consider offers.
ERAA	Increase in competition has brought related benefits to customers as retailers strive to improve their price and service in an effort to obtain new customers and retain current customers.	The AEMC agrees that there is price based competition in the electricity market as described in section 4.4.
ERAA	The level of switching in electricity in NSW has been increasing at a steady rate since early 2008. The transfer rate is now 19 per cent per year according to AEMO statistics which makes it one of the most active switching markets in the world according to statistics provided by VaasaETT.	The AEMC considers that the high switching rate for electricity is only one indicator of a competitive market. This is elaborated both in section 4.2 and appendix B.2.

Stakeholder	Issue	AEMC response
ESAA	Switching rates in gas are lower than electricity but exhibit a similar upward trend. In December 2012 the switching rate in gas was 14 per cent. Suggest that retailers will continue to seek gas customers as part of their dual fuel strategies.	The reasons why customers switch are evaluated in section 4.2 for electricity and section 5.2 for gas. Further analysis is provided in appendix B.2
Ethnic Community Council	There is anecdotal evidence that door to door sales persons use inappropriate methods to gain new contracts.	Though there are legitimate customer grievances, customers have generally positive experiences with retailers as described in section 4.5 for electricity and section 5.5 for gas.
EWON	The adverse impact on vulnerable customers of misleading and pressure selling is significant. Transfer processes need to be improved if further competition is to be encouraged. p. 7.	As above.
EWON	The contract renewal process is ad hoc and varies from retailer to retailer. Some retailers automatically renew the contract unless contacted by the customer. Others retain the customer on the current terms and conditions without a renewal of the contract for a set period. p. 8.	The Commission considers customers should have sufficient opportunity at the end of a contract to consider offers.
Exigency Management	Lack of access to meter and tariff data is a problem for customers. Customers also have no easy means of deconstructing their energy bills into contestable and non-contestable elements, which hampers their ability to manage energy and comparing competitor offers on a consistent basis. pp. 1-2.	The Commission considers customers need access to their consumption data to participate effectively in the market. See section D.5.
Exigency Management	Information provided to customers at the expiry of their energy contract differs by retailer. Potentially this includes: initiation of a new retail market contract if the customer does not notify retailer; or a roll back to standing or regulated tariff. p. 5.	The Commission considers customers should have sufficient opportunity at the end of a contract to consider offers.
Jemena	An increasing number of customers are exercising choice by switching between retailers year to year. p. 3.	The reasons why customers switch are evaluated in section 4.2 for electricity and section 5.2 for gas. Further analysis is provided in appendix B.2

Stakeholder	Issue	AEMC response
Origin Energy	Customers have a high level of awareness of their ability to switch retailers and receive a high level of information regarding competitive market offers. pp. 2, 11-12.	While customers have a high degree of awareness of their ability to switch, further work is required to convey this information in an appropriate and meaningful way.
Origin Energy	Competitive outcomes demonstrated by high customer switching rates and shifting market shares. Current levels of churn are approaching levels in Victoria which is the highest ranked energy retail market in the world by VaasaETT. The level of churn in the NSW retail market is also high relative to churn rates in other industries. pp. 12-13.	The AEMC considers that the high switching rate for electricity is only one indicator of a competitive market, This is elaborated both in section 4.2 and appendix B.2.
Origin Energy	At present competition in NSW is primarily based on discounts and rebates off a tariff. Retailers also offer incentives such as pay on time, direct debit and dual fuel incentives. Most marketing activities are heavily based on these. There is little activity based on differentiated tariff features. p.11.	The Commission agrees that there is some innovation in the electricity market but as described in section 4.4 this mostly reflects price based competition. We also consider that there is some evidence of independent rivalry in the gas market as described in section 5.4. The marketing activities of suppliers are also examined in appendix B.3.
Origin Energy	In general customers have experienced positive marketing or business practices. This is evident by the level of switching conducted and subsequent retention of customers. The use of door knocking has at times led to poor customer experiences. p. 16.	Though there are legitimate customer grievances, customers have generally positive experiences with retailers as described in section 4.5 for electricity and section 5.5 for gas.
Origin Energy	Customers switch or change plans in response to advertising and promotion by retailers. Marketing activities are the primary driver for switching rather than comparison sites. p. 16.	Noted.
PIAC	Clear that customers continue to switch between retailers and contract types. However, it is important to know what motivates customers to switch between retailers and/or contract types and whether customers are able to identify a better offer. In particular, the AEMC should assess the proportion of customers that switch gas supplier independently of switching electricity supplier. p. 17.	The reasons why customers switch are evaluated in section 4.2 for electricity and section 5.2 for gas. Further analysis is provided in appendix B.2.

Stakeholder	Issue	AEMC response
PIAC	Can find little evidence that competition has improved service levels. In addition PIAC is concerned that some customers may be worse off under market contracts due to late payment fees. However there are some improvements to product offerings such as a "a house moving guarantee" where the customer will not face exit or connection fees if they move but stay with the same retailer. Unable to detect any significant tariff innovation in NSW. p. 18.	The majority of customers appear satisfied with their retailer although a minority have had negative experiences. See section 4.5 for electricity and section 5.5 for gas. Further detail is in appendix C.2.

Time of use pricing

Stakeholder	Issue	AEMC response
AGL	AGL has offered time of use (TOU) pricing to customers with interval meters since around 2007. This involves a straight pass through of the TOU network tariff component. Almost 15 per cent of AGL's small customers in NSW are on TOU price. p. 8.	How retailers pass through network tariffs to customers with interval meters is examined in section 4.7 and appendix D.4.
AGL	Research undertaken by AGL showed that more than 75 per cent of customers would be better off with a properly structured, retail TOU tariff. Will lead to greater choice and enhance competition. pp. 8-9.	The Commission has not analysed whether customers would be better off on a TOU tariff.
EnergyAustralia	Offers TOU tariff to both residential and small business customers. Has the greatest number of TOU tariff customers in NSW because of the prevalence of type 5 meters in Ausgrid's area. Over time it is likely that this number will increase as competitive capability and consumer understanding increases and will open a new field of innovation and differentiation. p. 5.	How retailers pass through network tariffs to customers with interval meters is examined in section 4.7 and appendix D.4.
ERAA	Smart meter task force discussion paper recommended introduction of market lead smart meter rollout - should it be formalised, continuation of price regulation could stifle investment in smart meters as the	The roll out of TOU meters is out of the scope of this review.

Stakeholder	Issue	AEMC response
	introduction of TOU tariffs would impact the business case for a roll out. pp. 4-5.	
Ethnic Community Council	Customers are not able to choose standard tariff from any retailer if they have an interval meter. Instead they are required to go with the default. Respondents to research were not aware of TOU tariffs. Impact of TOU on competition is not known but it is important that fixed charge is not used as buffer for lost revenue. Important to explain to customers how it works, especially those that cannot shift use or are low energy users. pp. 2-3.	The Commission considers that there are a number of competition issues with TOU tariffs, including a lack of customer understanding. See section 4.7 and appendix D.4.
Origin Energy	TOU offers featured in all distribution areas but do not feature heavily from a competitive standpoint with discounts tending to mirror the existing regulated TOU tariff. p. 12.	As above.
Origin Energy	TOU predominantly in Ausgrid distribution network, more than 250,000 customers are on TOU tariffs and Origin Energy's acquisition of customers on TOU tariff exceeds the penetration generally - suggesting that TOU tariffs support customers switching. p.15.	As above.
PIAC	Important to consider tariff shapes as TOU usage is growing. The fixed component of the TOU regulated rates in Ausgrid network is increasing which doesn't encourage customers to change, other rates increased by less.	How retailers pass through network tariffs to customers with interval meters is examined in section 4.7 and appendix D.4.
PIAC	TOU can and should reduce peak demand and give consumers more control over energy costs. Concerned the market is not competitive enough for customers to get away from high fixed charges to reduce risk of response to TOU. Largest retailers are best equipped to deal with risk. Main concern in relation to TOU pricing and competition is the added complexity and risk it brings to retailing. Recommend regulator develop thorough market monitoring process. pp 4-6, 20.	See Box D.2 for discussion of this issue or section 4.7 for draft recommendations on improving the effectiveness of competition for TOU tariffs.

Social Policies

Stakeholder	Issue	AEMC response
EnergyAustralia	Support targeted measures to help low income and disadvantaged customers. EA takes a number of actions including referrals to government programs and tailored payment to help support these customers. Will also be part of the energy affordability roundtable.	The Commission considers a review of energy concession schemes and other government assistance programs is appropriate prior to price caps being removed. See section 7.6.
NCOSS	The Energy Accounts Payment Assistance (EAPA) is too low at \$30. This amount should be \$50. Furthermore, from PIAC surveys, about 50 per cent of customers facing disconnections are ignorant of the scheme.	We note that the NSW government will increase the EAPA voucher value from 1 July 2013.
NCOSS	There have been administrative delays in customers receiving the Family Energy Rebate.	This is outside the scope of this review.

Paths to deregulation

Stakeholder	Issue	AEMC response
ActewAGL	Prices should simply be deregulated, a phased removal is a second best solution. p 3.	The AEMC recommends price caps be removed for all customers at the same time so that all customers are able to benefit from increased product choice. See section 7.3 for more detail.
AGL	There is no reason to stagger price deregulation. p.12.	As above.
AGL	In principle supports the "opt-in" model as a means to reduce price regulation but consider it is not an ideal approach. p.12.	As above.

Stakeholder	Issue	AEMC response
Alinta	A gradual reduction in the eligible consumption threshold would be appropriate, such as 100MW to 40MW and similar for gas. p. 2.	As above.
Alinta	Ideally price regulation would be removed for all customers at the same time that NECF is implemented. p. 2.	As above.
EnergyAustralia	If regulation is phased out, it should be done based on customer type rather than by usage bracket as in Victoria. p. 8.	As above.
EnergyAustralia	Price regulation should be completely removed as soon as practical. p. 8.	As above.
NCOSS	Prices need to be brought down before any further deregulation. p. 6.	The Commission considers that the retail prices should reflect the underlying efficient costs of providing retail services.
Origin Energy	Deregulation does not need to be phased in. However, if it is then Origin Energy conditionally supports IPART's opt-in model as a transitional measure. p. 21.	The AEMC recommends price caps be removed for all customers at the same time so that all customers are able to benefit from increased product choice. See section 7.3 for more detail.
PIAC	Not necessary that gas and electricity deregulation should happen at the same time as they are different systems. p. 30.	As above.
Simply Energy	Consumption thresholds are arbitrary as similar customers on either side of the boundary value are treated differently.	As above.

Information campaign

Stakeholder	Issue	AEMC response
AGL	A public awareness and education campaign would be important. It should include: guidance on how and where to source information on the range for energy offers available; and the nature of the protections available. p. 13.	The Commission will work with stakeholders to develop a blueprint for designing an effective customer engagement strategy.
CHOICE	A third of respondents who had recently joined a new electricity provider said they didn't know where to start with finding information to weigh up the options. p. 5.	As above.
CHOICE	CHOICE recommends a number of research tasks be conducted. They also consider that key information about a customer's plan should be included on their bill such as: the name of the plan they are on; details of the pricing of the plan including discounts, charges and the profile of charges; the length of the contract; and any other relevant details p. 11.	As above.
ECC	Information needs to be tailored to meet the needs of the non English first language communities. p. 6.	As above.
NCOSS	Customers need to be offered information about energy market and sustainable energy options including accurate information about TOU energy consumption and billing, together with tailored information about ways households can reduce energy consumption. pp. 4, 8.	As above.
NCOSS	There is potential for retailers to provide information directly to consumers when they bill each quarter, which is more user friendly than door-knocking. p. 8.	As above.
PIAC	Existing comparison websites provided by jurisdictional regulators have all had problems with accuracy and timeliness of information. Direct	As above.

Stakeholder	Issue	AEMC response
	marketing appears to be the main method of marketing by retailers. Customer information needs to go beyond websites and price comparison services. Accessible, accurate and timely information about energy prices is crucial to create a competitive energy market. p. 18.	
Simply Energy	Retailers are best placed to know the type of communications required by customers. p. 3.	As above.
Simply Energy	Any additional info provision requirements should be tested against best regulatory practice. p.3.	As above.