

Energy Markets Transformation Project Team

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### **Retail Electricity Pricing Inquiry**

The Australian Energy Council (AEC) welcomes the opportunity to make a submission to the Australian Competition and Consumer Commission's Retail Electricity Pricing Inquiry.

The AEC is the industry body representing 21 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

Competition in retail electricity markets, as competition does in other sectors of the Australian economy, incentivises electricity retailers to optimise efficiency, improve service, develop products that meet customer needs and achieve lower costs so they are competitive. Like other competitive consumer markets, competitive retail electricity markets are best placed to facilitate the development and deployment of new technologies to customers.

The AEC believes that is important to maintain both confidence in and the competitiveness of retail electricity markets in the National Electricity Market, as they facilitate the efficient and secure operation of the Australian energy market.

#### **Other relevant reviews**

There is no doubt that electricity price increases are of great concern to the community, and the inquiry background notes the previous work undertaken by other organisations, including the Australian Energy Markets Commission (AEMC), Energy Consumers Australia (ECA), and the Grattan Institute in this regard.

The Grattan Institute report 'Price Shock: Is the retail electricity market failing consumers?'<sup>1</sup> received broad coverage in the media. The general view of the energy industry is that the Grattan Institute report is not an accurate analysis of retailer competition in energy markets.

Managing the wholesale market risk is a material cost not accounted for in the analysis. The Grattan report assesses actual wholesale electricity costs with the benefit of perfect hindsight, which does not factor in sufficiently the difficulties faced by retailers in estimating future wholesale energy costs and the load they will have to supply each half-hour of the year. Wholesale pool prices are volatile and are expected to become more so with the closure of the Hazelwood on top of other base load power stations. Price increases are more directly a result of major changes in generation types and capacity, and how these changes impact on the wholesale electricity market, rather than the level of retail competition.

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<sup>1</sup> Grattan Institute, 'Price Shock: Is the retail electricity market failing consumers?'  
<https://grattan.edu.au/report/price-shock/>

In competitive markets large numbers of electricity retailers can compete with each other to attract and retain consumers with their offers, and there is sufficient evidence of this on the east coast of Australia.<sup>2</sup> Unrealistic reviews expect that competitive markets will deliver the lowest available offer to every customer every day; something that cannot reasonably be presumed. In reality price dispersion is a sign of a healthy competitive market. The policy goal is better prosecuted through ensuring that there are no barriers to customer engagement with the market. Thereafter, addressing the needs of the most vulnerable customer minority means providing specific support to their circumstances.

## International comparisons

International experience teaches us that well-functioning competition, not ongoing government and regulatory intervention, is the answer to effectively and efficiently providing the most competitive energy prices for all consumers over the long term.

Interventions in the United Kingdom retail electricity market were a product of concerns that competition had somehow not delivered enough for consumers in the UK, or had not delivered outcomes as intended. This discontent centred largely on retail price outcomes, despite there being real underlying drivers for these price rises.

UK regulators felt that getting consumers to actively engage in shopping around for their electricity was best facilitated by easier comparisons, and so sharply reduced the number of offers each retailer could make and constrained the shapes of the tariffs.

The outcomes were that<sup>3</sup>:

- Retail margins actually increased;
- Customers lost access to specific tariffs that suited their circumstances; and,
- Customer churn (switching to new retailers for a better offer) fell.

The Grattan Institute's report on retail pricing also conceded that the interventions of increased monitoring of prices, the simplification of tariff offers and even re-regulation may not reduce electricity costs.<sup>4</sup>

## Retail electricity costs

Retailers are selling a product that is, on the face of it, homogenous, and whose physical delivery is carried out by the regulated network. This simplicity is appealing to some commentators and often leads to an over simplification on what is in fact a comparatively unique customer proposition. There are few examples of products where customers can consume as much as they like, at what time they like, and pay for this later on unsecured terms. The retailer therefore has a complex role in the efficient procurement of electricity for customers without the customer having nominated either time of consumption or volume of consumption, and consumed their electricity on credit.

Competitive retailing means retailers strive to attract customers with differentiated price service offers. That said, the role of the electricity retailer extends well beyond the physical world of selling electricity to its customers. Amongst other mandated activities that influence retail electricity prices, retailers must competitively procure large and small renewable energy certificates, and in some cases energy efficiency activities, to comply with government policy. Additional schemes can

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<sup>2</sup> Australian Energy Market Commission (AEMC), 2016, "2016 Retail Competition Review – Final Report"

<sup>3</sup> Littlechild, S., 2014. Promoting or restricting competition? Regulation of the UK retail residential energy market since 2008. EPRG Working Paper.

<sup>4</sup> Price shock: is the retail electricity market failing consumers? <https://grattan.edu.au/report/price-shock/> p.30 Grattan Institute 2017, Wood et al

be introduced at short notice, such as the proposed South Australian Energy Security Target, for which draft legislation was released in May with a view to a 1 July start date. The competitive pressure to manage these costs means that these policy objectives are delivered more efficiently than would otherwise be the case. Each time a government adds such obligations to retailers, they are implicitly acknowledging that the market is competitive.

A more extensive – but not exhaustive - list of risks and costs that retailers face in relation to the supply of electricity include:

- Wholesale energy purchases;
- Renewable energy certificate purchases;
- Inconsistent jurisdictional customer protection obligations;
- Marketing and acquisition costs, given the high level of switching;
- IT costs (often driven or compounded by regulatory decisions such as metering competition or changes to jurisdictional schemes such as the FiTs);
- Credit and bad debt risk, and assistance to customers experiencing broader financial hardship;
- Government concessions schemes and their disparate jurisdictional administration and reporting requirements; and
- Energy efficiency schemes.

These factors clearly drive retailer costs and risk management. Where jurisdictional differences persist and expand, then losses in economies of scale will be borne largely by consumers. Competition may have the practical and desirable effect of making these costs more efficient than otherwise, but these additional risks and costs are ultimately priced into the charges that retailers pass on to customers.

In the physical world of customers, competition is about providing product and service choice. Competition has driven diversity of retail offers, and these choices include:

- Fixed versus variable tariff mixes;
- Extensive payment options;
- Special and conditional discounts;
- Bundled offers such as cinema tickets and discounted football club memberships;
- Access to usage information;
- Special feed-in tariffs; and
- Environmental products.

Retail electricity customers can already produce and consume their own electricity, as well as export to the grid, in a limited manner. Further technology changes, and reductions in cost of customer owned and operated storage, means that as much as the traditional price structure and service proposition may remain, new services such as demand response markets, or network support services markets, or markets for distributed generation must emerge. Concurrent with these developments are the rights of consumers to access the grid to import and sell surplus electricity under fair terms. This latter is critical to consumer participation.

Customers of electricity retailers will play a more direct role in the energy transition through associated products and services that will form part of a modern, clean and efficient energy system. We expect in the coming decade increased innovation will give customers greater choice in and control over service, product and price. There will undoubtedly be retailer costs associated with facilitating this consumer participation, along with an ongoing requirement to examine the regulatory and non-regulatory impediments to innovation such as:

- The ease by which customer projects have the right to access to the grid to import and sell surplus electricity on fair terms;

- The rivalry and price and product diversity in the provision of customer owned/controlled distributed generation or storage assets, and any related services;
- The competitive neutrality issues where local network providers are providing distributed generation assets and related services in their own service area.

### Competition between retailers

The AEMC has found that competition has been effective<sup>5</sup> in delivering value to consumers in South East Queensland, New South Wales, Victoria, and South Australia. Deregulated gas markets were also seen to be effective in delivering competition in New South Wales, Victoria and South Australia.

According to the AEMC, customers who shop around in deregulated markets can make substantial savings on their electricity bill. Figure 1 outlines the savings customers made by simply comparing offers and switching to a better offer with Victorians able to make the greatest savings.

Figure 1: Typical savings customers made switching from an electricity standing or default offer to a competitive market offer annual savings<sup>6</sup>



In addition the recent Energy Consumers Australia (ECA) Energy Consumer Sentiment Survey report<sup>7</sup>, states where prices are deregulated, consumers are much more likely to be satisfied with the level of competition in energy markets. Figure 2 shows the consumer survey’s findings.

<sup>5</sup> Australian Energy Market Commission (AEMC), 2016, “2016 Retail Competition Review – Final Report”

<sup>6</sup> Australian Energy Market Commission (AEMC), 2016, “2016 Retail Competition Review – Final Report”

<sup>7</sup> Energy Consumers Australia, 2016, “The Energy Consumer Sentiment Survey – July 2016”

Figure 2: Energy consumer sentiment.



It is apparent from the survey that Victorian, South Australians and New South Wales customers were satisfied with the level of competition. Customers in these states were also more likely to say the market is working in their interests and/or that it could provide value for money in the long term. Customers in states with state owned enterprises behind the greater proportion of the supply chain were less satisfied.

Competition in retail electricity supply and pricing has effectively kept prices low as customers take advantage of price offers and attractive deals. In comparison, UK regulatory intervention intended to simplify choice by constraining the number of tariffs on offer, resulted in the disappearance of bespoke tariffs that suited small groups of customers and a rise in average retail margins.<sup>8</sup>

### Network tariffs

Concern that there is a genuine ability amongst small consumers to both understand and react to more complex tariffs, and that this is preventing them from actively engaging in shopping around for a better deal, has led to assertions that price comparison is too difficult. One proposed solution to this problem of engagement is to make comparisons easier by sharply reducing the number of offers, and tariff shapes that each retailer could make, as occurred in the UK. Unfortunately this solution also ignores the complexity and variability across the underlying network tariffs.

The paradox is that reforms requiring network businesses to move towards cost-reflective network tariffs has driven the proliferation of additional network tariff types, each with unique characteristics. Network tariffs represent a significant proportion of the customer's charges and their diversity and sophistication is a major impediment to providing simpler end user pricing.

The AEC believes that cost reflective prices are an appropriate way to signal to consumers that they can benefit by changing their electricity consumption patterns. In the case of network tariffs a broader benefit accrues to all consumers in that the overall cost of providing the network capacity is also reduced. However recognition is required that the desire for cost reflective pricing may be inconsistent with any desire to have a simple, uniform retail customer tariffs.

### Vertical integration

Restructuring of the electricity supply industry began with the Council of Australian Governments (COAG) back in 1991. In that same year the Industry Commission had reported to COAG that significant increases in Australia's Gross Domestic Product (GDP) could be realized by, amongst

<sup>8</sup> Littlechild, S., 2014. Promoting or restricting competition? Regulation of the UK retail residential energy market since 2008. *EPRG Working Paper*, 15 August 2014, p.49.

other things, the vertical separation of generation and retail from the natural monopoly elements of transmission and distribution. This would be coupled with the introduction of competition into generation and retail.

By 1998 the industry structure of separate corporations for each of generation, transmission, distribution and retail had been accomplished. Retailers and generators needed a way of managing the risk of price volatility and by 2013, the partial vertical re-integration of generation and retail through acquisition or the development of new business arms was apparent. By this time there had also been the implementation of full retail competition in all NEM jurisdictions except Tasmania.

Between them AGL Energy, Origin Energy and EnergyAustralia jointly supply 76 per cent of retail electricity customers and 85 per cent of gas customers in eastern Australia<sup>9</sup>. They had increased their aggregate market share in generation from zero percent<sup>10</sup> in 1998 to 35 per cent in 2012<sup>11</sup>. Most major new entrant retailers since 1998 are also vertically integrated with entities that were previously standalone generators. Examples being Engie (trading as Simply Energy in retail markets), and Alinta. Government owned generators such as Snowy Hydro (Red/Lumo) are also vertically integrating.<sup>12</sup>

In each jurisdiction where state owned generation monopolies were broken up horizontally, and privatized, that reform has underwritten the diverse and highly competitive electricity generation in the NEM today. Queensland and Tasmania have been slow to relinquish Government ownership and control of electricity generation. Congruently, access to hedging products has also been noted as a particularly important barrier to retail market entry in Queensland and Tasmania.<sup>13</sup> The Queensland Government plan to direct Stanwell Corporation to undertake strategies to place downward pressure on wholesale prices<sup>14</sup> poses a greater risk to the benefits of the original reforms being sustained.

According to the AER<sup>15</sup> high levels of market concentration and vertical integration between generators and retailers give rise to a market structure that may, in certain conditions, provide opportunities for the exercise of market power. It should be noted that to date no court has agreed. In any acquisition or merger between a generator and a retailer contested on competition grounds, none has found a substantial lessening of competition as cause for disallowance. Meanwhile, new entrants continue to challenge the established players. In 2015, there were six new retail electricity market entrants in New South Wales, five in Victoria, and two in South Australia and South East Queensland.<sup>16</sup>

## **The future of electricity**

Not much more than a decade ago smart phones, widespread social media, and map apps didn't exist. Nor did the cloud.

The technologies that will provide and augment electricity services through the next decade and beyond are still fairly immature, and many are still at demonstration stage. What is important in this context is that cost reductions and technology improvements and business model innovations should not be delayed or inhibited by decisions taken today.

There is a popular skepticism about markets as a consequence of the pains of political and regulatory intervention. Many of the problems today are a function of unintended consequences of

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<sup>9</sup> The National Electricity Market – a case study in micro economic reform, KPMG (AEMC), 2015

<sup>10</sup> Pre privatisation and excluding gas customers

<sup>11</sup> Ibid

<sup>12</sup> Ibid

<sup>13</sup> AEMC, 2016 Retail Competition Review, Final Report, 30 June 2016

<sup>14</sup> Department of Energy and Water Supply, Powering Queensland Plan, May 2017

<sup>15</sup> State of the Energy Market Report, Australian Energy Regulator, 2014

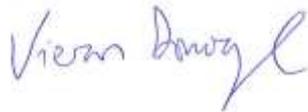
<sup>16</sup> AEMC, 2016 Retail Competition Review, Final Report, 30 June 2016

policy and regulatory approaches taken a decade ago. Curiously, in spite of this experience Governments are currently inclined even further towards approaches that feel like they provide more control over outcomes than they can directly exercise in the free market.

Electricity is evolved into a consumer good, and needs competitive and innovative retail markets to deliver cost reductions and technology improvements and business model innovations in electricity services.

Any questions about our submission should be addressed to David Markham, Corporate Affairs by email to [david.markham@energycouncil.com.au](mailto:david.markham@energycouncil.com.au) or by telephone on (03) 9205 3111.

Yours sincerely,

A handwritten signature in blue ink that reads "Kieran Donoghue". The signature is written in a cursive, flowing style.

**Kieran Donoghue**  
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