

19 April 2004

User Participation Working Group
C/o Office of Energy Planning and Conservation
GPO Box 936
HOBART TAS 7001

Dear Sir/Madam

**Ministerial Council on Energy Standing Committee of Officials:
“Improving User Participation in the Australian Energy Market” -
Discussion Paper**

Introduction

The Australian Gas Light Company (AGL) welcomes the opportunity to comment on this discussion paper.

AGL has substantial interests across the Australian energy sector, including gas and electricity retailing, energy wholesaling, the ownership and operation of gas and electricity networks and interests in power generation. The issues raised in the discussion paper are of relevance to AGL's total business, although we have focused this submission on wholesale and retail matters.

Summary of AGL Views

The discussion paper puts forward a number of proposals for increased user participation in energy markets, focusing on the areas of demand side response, the possible use of interval meters and retail pricing issues.

Demand side response:

- AGL agrees that the Parer proposal for a levy on the pool to support demand side bidders is unworkable, and supports the SCO proposal to examine demand side aggregations as an alternative;
- We suggest that a group of retailers and DSR suppliers examine ways forward for the above proposal;
- Governments should ensure that there are no impediments to DSR and actively provide a supporting environment;
- However, the development of full demand side response should be left to market participants and end users.

Interval meters:

- AGL agrees that an interval meter roll-out to all customers is not cost effective at this stage of the market;
- A roll-out to smaller customer classes should not proceed until a number of preconditions have been met, including: a full cost-benefit analysis; availability of remote load technology; customer education; and cost-reflective retail tariffs;

- AGL supports the SCO conclusions that a study is required to determine which customer groups may benefit from interval metering, and that low cost alternatives to a roll-out should be examined;
- AGL supports a roll-out to larger customers where net benefits are demonstrated;
- The retail investment necessary to substantially upgrade IT systems (to use interval data to bill customers) is unlikely while retail tariffs are regulated;
- Until all customers are billed using interval meters, load profiling will remain an essential part of the market and must be retained.

Retail pricing:

- AGL considers that by 2006 energy markets will have reached a level of competitive maturity – formal price regulation should be removed and replaced with price monitoring under the TPA;
- AGL is concerned that the emphasis in the discussion paper is on methodologies for price regulation rather than whether price regulation will be necessary;
- While retail price controls remain, efficient market outcomes will be distorted and effective competition inhibited. Price controls may prevent innovations, and thus frustrate the very objectives that governments are seeking from demand side response;
- The establishment of an electronic price comparison website should only proceed when it has been demonstrated that consumer benefits will outweigh the costs of providing the service. Retailer funding or other support for the scheme would increase costs and this may have flow on effects to competition unless clear market benefits are evident.

We expand on these views in the attached submission.

Further information

If there any queries arising from matters in this submission, please contact Alex Cruickshank, Manager NEM Development, on (03) 9201 7694 or email acruicks@agl.com.au.

Yours sincerely

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1. Demand Side Response

Demand side response (DSR) is a growing part of the National Electricity Market, currently provided indirectly through retailers rather than (as was supposed prior to market commencement) directly through demand side bids into the pool.

AGL supports the comment in the MCE discussion paper that DSR can be used both by retailers to minimise energy costs and networks to reduce network costs. While both aspects are important, this section of our submission focuses on the retail aspects.

AGL believes that (DSR) in the market is part of the value relationship between a customer and a retailer. Except for customers relying on the spot price, the benefits of demand reduction at specific times derive almost totally from the benefits gained by the retailer by avoiding exposure to high prices or by offering a customer’s demand reductions through to the NEM. The primary aim of DSR is not to lower the prevailing spot price (DSR is usually not sufficiently large to achieve this objective) but to share the financial value of avoiding electricity use during high price times. Additional benefits of DSR may include improved environmental outcomes.

Retailers have worked, and continue to work, with their customers to develop means to harness the benefits of DSR through control systems and appropriate contractual relationships. DSR is generally limited to those customers that have sufficient operational flexibility to participate, and who anticipate sufficiently large commercial gain to justify the costs of lowering their demand.

It is worth noting that recent relatively lower price volatility has caused a reduction in appetite for DSR since there is little reward available to customers for their effort. Maximum DSR is achieved during times of highly volatile prices, and it should not be seen as market failure if the current level of DSR appears low.

AGL agrees with the Discussion Paper that the Parer proposal for demand side bidding is unworkable. We have two main concerns:

- a levy on the pool to support demand side bidders simply increases pool price risk to retailers since it would be unhedgeable. The levy would have to be paid by customers by increasing the final price of energy and, as mentioned above, the actual pool price is unlikely to be reduced;
- the value of the demand side bid would be difficult to compare to alternatives (including other demand side bids and generator offers). For example, it would be difficult to tell if a 10MW reduction priced at \$3,000/MWh for 2 hours was better than (a) the same reduction priced at \$4,500/MWh for 30 minutes; or (b) a generator offer for a 10MW reduction priced at \$8,000 for five minutes. The variations between offers in terms of firmness and required notice period make for an extremely complex dispatch and settlement algorithm, even before the integration with the supply-side stack is taken into account.

AGL therefore supports the SCO proposal to examine demand side aggregations as an alternative. We suggest that a group of retailers and DSR suppliers examine potential ways forward for this form of DSR.

AGL believes that the potential for limiting future increases in wholesale costs through DSR is most likely to be found where demand side response impacts on the level of risks being managed by retailers. This can be achieved where retailers can set up arrangements to reliably manage loads as

part of a risk management portfolio. A multi-faceted approach controlled by retailers or demand aggregators is required whereby:

- medium to large customers have arrangements with retailers to control blocks of demand and share the benefits. This approach allows retailers to incorporate the DSR into their risk management portfolio impacting the cost of energy supply. The sharing of benefits between customer and retailer is a competitive activity undertaken usually during the contract negotiation stage, and is determined by the firmness of the DSR and the notice required to be given;
- medium sized customers work with demand aggregators to present sizeable blocks of demand. A possible model has been trialled by the Energy Users Association of Australia. Again the demand side response must be reliable. This option would complement rapid adjustment of contract positions;
- small to medium customers arrange interruptible tariffs for equipment where loss of supply can be accommodated (including off-peak controllable loads) under the control of retailers. By controlling blocks of load this way, demand can be flattened.

AGL believes that a general rollout of interval meters will not, of itself, improve demand side response since most small customers are unable to provide the reliable response required. Rather, having technology that would allow retailers to control domestic loads in response to their market needs would allow the development of appropriate commercial signals to allow full user participation.

Governments have a role in ensuring that there are no impediments to DSR. AGL notes below that continued price regulation is a major impediment to DSR, inhibiting the product innovation that would enable customers to participate more fully in the market. We also note the recent investigation by IPART in NSW into ways of mitigating the bias that regulatory decisions can have against demand side investment by networks. Given the appropriate policy and regulatory settings, the development of full demand side response should then be left to market participants and end users.

Governments can also have an important role in the development of appropriate structural means to allow customers to understand and manage their energy use. Factors such as efficiency labelling, running costs and lifetime energy consumption information will be more useful for the general public and will allow them to correctly assess products for use in the home. Building standards and information on energy efficiency will also assist reducing energy use by homes, particularly during peak loads.

2. Interval Meters

AGL supports the MCE conclusion that at this stage of the market, an interval meter rollout to all customers is not cost effective. AGL believes that a rollout to smaller customer classes should not proceed until:

- *A cost benefit assessment is undertaken* identifying all retail, distribution and meter data agent costs including:
 - Significant information technology costs to enhance meter warehouse and billing systems;
 - Costs of the meters and increased meter collection costs;
 - Customer education and increased call centre costs.

(For the benefits to be robustly quantified, an interval meter trial would be necessary to determine the customer response to interval meter tariffs over time);

- *Remote load control technology can be rolled out.* Without this technology, any interval meter rollout program will not elicit a response from small customers when it is most required. Customers with air conditioners will still want to use them when temperatures peak;
- *customers are educated about the benefits of managing their load* (even if this is done on their behalf) in order to gain their support for a rollout and to obtain many of the benefits of demand side management. In addition, there must be significant cost savings for customers in order to encourage them to support and participate in the program;
- *Retail tariffs must be cost-reflective.* The ability to influence customers' behaviour through cost-reflective, time of use tariffs (both distribution and retail) is totally dependent upon the ability of both the distributor and retailer to charge these tariffs. In addition, unless retailers and distributors are able to recover the costs of managing an interval meter rollout, they will not be encouraged to participate.

AGL supports the SCO's conclusions that:

- A study is required to determine which customer groups may benefit from interval metering. AGL would expect that a rollout of interval meters to larger customers would have greater net benefits than a rollout to smaller customers. This is supported by the Victorian Essential Services Commission's conclusions in their recent Draft Decision;
- Low cost alternatives to a rollout to customers should be examined; for example, the introduction of summer and inverse block tariffs that can deter air conditioning use. In addition, off-peak hot water exclusion will improve the accuracy of the net system load profile;
- Where a jurisdiction is contemplating an interval meter rollout it should consider remote load control technology.

AGL supports an interval meter rollout to customers that are greater than 160MWh where it can be shown that net benefits exist. In order to make this determination, the jurisdictions should look at the benefit to the market of removing the customers' loads from the net system load profile. In addition, the costs of installing and managing the meters and their data should be considered. Large end users, and the market generally, will most likely benefit from the rollout of interval meters to this customer class. This is because the removal of the larger loads from the net system load profile will result in the profile being more accurate.

Smaller customers are less likely to benefit, due to the high costs involved in (a) rolling out the large volumes of interval meters; and (b) retailers and distributors managing data and billing on an interval basis. These costs must be compared to the small incremental benefit that individual customers and the market would receive for each interval meter rolled out. AGL believes that in order for the market to benefit from the rollout of interval meters to small customers, remote load control technology must be installed.

AGL supports a trial of different interval meter technologies (including remote load technology) in order to adequately determine what benefits are likely. Until such time as a trial is undertaken it is difficult to robustly assess the net benefits of any technology.

Distribution businesses have been installing interval meters on a new and replacement basis where it is less costly for them to do so. However, retailers do not currently have the IT systems to manage and bill large volumes of interval data and therefore may direct distributors to aggregate the data for their purposes. Until retailers invest in significant improvements to their IT systems they are unlikely to be in a position to use interval data to bill small customers.

Such a major IT system investment is unlikely to occur while retail tariffs are regulated. Currently retailers are not free to pass through such costs nor to introduce fully cost reflective tariffs.

Until such time as all customers are billed using interval meter data, load profiling will be a necessary part of the market and therefore AGL supports the retention of load profiling for an indefinite period.

3. Retail Pricing

The majority of jurisdictions where full retail contestability has been introduced are moving towards a light handed form of regulation of retail prices for residential and small business customers (small customers). A four-year price path (2004-2007) has been established in Victoria. In NSW pricing arrangements for the period to 2007 are currently under consideration and the South Australian Government has recently announced its desire for a three-year price path to be determined for electricity prices.

AGL notes that the Ministerial Council of Energy is still to decide whether retail pricing will transfer to the AER. Other regulatory arrangements for distribution and retail businesses are not currently planned to transfer until 2006.

AGL considers that by 2006 energy markets will have reached a level of competitive maturity, where formal price regulation should be removed and replaced with a regime of price monitoring under the Trade Practices Act 1974. The gas and electricity markets in Victoria, New South Wales and South Australia will have been subject to competition for 4-5 years. Currently, market systems are fully tested and operating effectively with low barriers to entry and with retailers offering dual fuel. A significant number of customers are receiving competitive offers and a large number have either switched retailers in these markets or have exercised their choice to remain with their current retailer. The Essential Services Commission of Victoria recently released a draft report on its review of the Effectiveness of Retail Competition, and concluded that part of the small customer market no longer needs the protection of a safety net.

AGL understands that some stakeholders potentially have reservations with the complete removal of price regulation, at this time. The pricing arrangements currently under consideration are seeking to address these concerns. AGL considers it imperative that current arrangements are seen as a transition phase to market based prices and that they adopt a light-handed approach that allows effective competition to continue to develop, consistent with the various government's policy objectives.

AGL is concerned that the emphasis in the discussion paper is on methodologies for price regulation rather than whether price regulation will be necessary.

AGL supports the view held by many regulators in Australia and overseas that competition is preferred over price regulation. For example, the United Kingdom (UK) regulator, where competition has been robust, suggests that price controls may inhibit competition and could also remove competitive pressures on prices for those customers who choose to remain with their traditional supplier. In the UK price controls for gas and electricity were removed in April 2002 and replaced with reserve powers existing under UK competition law after 4 and 3 years of full retail competition.

Further, AGL does not support the underlying premise of the Discussion Paper, that in the transition to effective competition, price regulation remains a legitimate and ongoing role for governments to facilitate consumer protection goals. Whilst based on an accepted premise that effective competition is the ultimate goal, it is the AGL's view that the causative link is the exact opposite – that price regulation is a key impediment of effective competition. For a market to be effectively competitive, prices must be determined by competitive market forces. Whilst retail price controls remain, efficient market outcomes will be distorted and effective competition inhibited. For example, demand side

response requires flexible and innovative pricing structures to be effective. Price controls may prevent these innovations from developing, and thus frustrate the very objectives that governments are seeking from demand side response.

With regard to facilitating consumer protection, the decision of governments in the mid 1990s to introduce competition into retail energy markets was based on, in our view, the correct presumption that competition provides the most effective form of customer protection available. This presumption is consistent with economic theory and a wealth of experience of the success of competitive markets in effectively and efficiently delivering most of the goods and services customers want.

AGL recognises governments' valid role in addressing social equity issues. To the extent that governments identify issues concerning equity and/or affordability, these should be addressed not through price controls which inhibit competition, but through direct and transparent government payments.

With regard to the question "How do we define what constitutes effective competition," it is AGL's view that competition in the retail energy market should be assessed as it is in other markets, via the Trade Practices Act. Potentially competitive markets are assumed to produce acceptable outcomes for consumers unless there is compelling evidence to the contrary, based on objective criteria and comparison to other comparable markets.

The general presumption that any potentially competitive market is effectively competitive is so strong that competition law generally places the burden of proof on identifying behaviour or circumstances that demonstrate that a market might become or be less effectively competitive, rather than the other way around. Attempting to establish criteria for effective competition, and in doing so reversing the burden of proof, is likely to be a highly subjective and arbitrary exercise.

Finally, AGL believes that current codes and regulations place adequate obligations on retailers with respect to price disclosure to ensure that customers are able to compare competing offers accurately and with ease. Although SCO has asked for stakeholder views on the establishment of an electricity price comparison website, AGL believes that this service should only proceed when it has been demonstrated that consumer benefits will outweigh the costs of providing the service. Retailer support for a scheme, through either funding or provision of information, will increase cost-to-serve and this may have flow on effects to competition unless clear market benefits are evident.

In particular, the current proposals fail to address a number of issues relating to non price characteristics, the potential use of price comparison services and the complexity of comparisons where consumption varies significantly. Evidence from the UK indicates that majority of customers who changed retailers used information provided by the marketers, as is the case in competitive markets at present. Only a small percentage of customers used fact sheets and on-line comparison services .