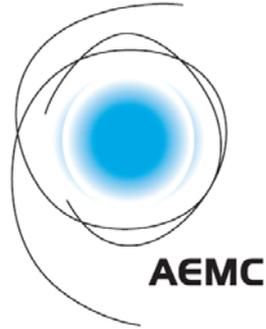


## Appendix A – Statement of Approach

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Australian Energy Market Commission

**Review of the effectiveness of competition in  
the gas and electricity retail markets**

Statement of Approach

19 April 2007

**Commissioners**

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## **About the AEMC**

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy markets. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market. It is a statutory authority. Our key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council as requested, or on AEMC initiative.

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# 1 Introduction

The Australian Energy Market Commission (AEMC) is required under the Australian Energy Market Agreement (AEMA) to review and publicly report on the effectiveness of retail competition in jurisdictions participating in the National Electricity Market (NEM) (the retail competition reviews).<sup>1</sup>

In response to a request for advice by the Ministerial Council on Energy (MCE), this Statement of Approach sets out the proposed methodology and consultation approach the AEMC will adopt in conducting the retail competition reviews.

The Commission published a draft of the Statement of Approach on 15 March 2007 in order to obtain the views of stakeholders on the proposed approach to ensure that its response to the MCE's request reflects and is informed by the comments and opinions of interested stakeholders. The Commission received eleven submissions,<sup>2</sup> and has considered the matters raised in each submission in finalising the Statement of Approach.

The submissions also raised a number of issues that inform specific activities to be undertaken by the Commission during various stages of each review, for example, the preparation of issues papers or avenues for data collection. The Commission has noted these matters and will revisit them at the appropriate juncture.

The scope of the competition reviews is set out in clauses 14.11(a) and (c) of the AEMA (see Appendix A). According to the AEMA, the aim of the competition reviews is to assess the effectiveness of competition in the electricity and gas retail markets for the purpose of the retention, removal or reintroduction of retail energy price controls. The assessment is required to be conducted on the basis of criteria developed by MCE.<sup>3</sup>

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<sup>1</sup> The Economic Regulatory Authority (ERA) of Western Australia is required to undertake the review for its jurisdiction at an appropriate time.

<sup>2</sup> Submissions were received from AGL Energy, the Centre for Credit and Consumer Law at Griffith University, the Consumer Action Law Centre, the Energy Retailers Association of Australia (ERAA), the Energy Supply Association of Australia (ESAA), Origin Energy, the Public Interest Advocacy Centre, the Total Environment Centre, Tenants Union of Victoria, TRUenergy and a joint submission from Victorian consumer groups (the Consumer Utilities Advocacy Centre, the Victorian Council of Social Service, the Alternative Technology Association and the St Vincent de Paul Society Victoria). Submissions can be viewed on the Commission's website at [www.aemc.gov.au](http://www.aemc.gov.au).

<sup>3</sup> AEMA, Clause 14.11(a)(i).

To develop the criteria for the retail competition reviews the MCE published a Consultation Paper in July 2006 providing Draft Effective Competition Criteria.<sup>4</sup> Following comments received from interested parties at the 12<sup>th</sup> meeting of the MCE on 27 October 2006, the Australian Government, State and Territory Energy Ministers finalised criteria that will form the basis of assessments of the effectiveness of retail competition in energy markets for each jurisdiction. The following are the criteria, determined under clause 14.11(a)(i), which the Commission is to apply:

- independent rivalry within the market;
- ability of suppliers to enter the market;
- the exercise of market choice by customers;
- differentiated products and services;
- price and profit margins; and
- customer switching behaviour.

The MCE recognised that the criteria are set at a level which provides the Commission with the capacity to determine the method of applying the criteria and flexibility in relation to the indicators to which it will have regard.

In correspondence to the Commission,<sup>5</sup> the Chairman of the MCE requested that the Commission provide advice, by 23 April 2007, on its proposed approach to conducting the reviews. This advice is to include the following:

- the consultation process;
- the proposed methodology; and
- the process for defining relevant gas and electricity markets.

The remainder of this Chapter provides a brief background on the history of retail reform in the energy market and the ongoing reform of the sector. In addition, it will describe the current role of price cap regulation in each of the relevant jurisdictions.

## **1.1 Reform of the retail energy sector**

Since the commencement of reforms in the Australian energy industry, State and Territory jurisdictions have adopted a staged approach to the introduction of retail contestability for all consumers. The desire to introduce competition to all retail customers stems from the efficiency and resource allocation benefits that can be

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<sup>4</sup> Ministerial Council on Energy Standing Committee of Officials, *Phase Out of Retail Price Regulation for Electricity and Natural Gas – Draft Effective Competition Criteria*, Consultation Paper, July 2006.

<sup>5</sup> Letter from the Ministerial Council on Energy (MCE) to Dr John Tamblyn, 17 November 2006.

derived from competitive pressure in markets. Competitive pressure is seen to potentially lower prices, improve services, encourage the introduction of innovative products for consumers and provide effective choice to energy consumers through a range of competitive price and service offerings.

Prior to the commencement of the market reforms for electricity and gas, small customers had no choice regarding their preferred supplier of energy.<sup>6</sup> Instead, energy customers were required to take supply from the incumbent retailer for their region. However, today Victoria, New South Wales, South Australia and the Australian Capital Territory (ACT) allow small customers to choose their supplier of both electricity and gas. Tasmania has full retail contestability (FRC) for gas, and Queensland is currently introducing full retail contestability for its electricity and gas customers. The following table provides details of the status of electricity and gas contestability in each jurisdiction.

**Table 1: Introduction of FRC in Australian jurisdictions**

<b>NEM Jurisdiction</b>	<b>Availability of Competition</b>	<b>Timetable</b>
ACT	All customers	Electricity: 1 July 2003 Gas: January 2002
New South Wales	All customers	1 January 2002
Northern Territory*	Electricity customers above 750MWh/year; there is no reticulated gas in the NT	Electricity: full competition is expected 1 April 2010
Queensland	Electricity customers using above 100MWh/year and gas customers using above 1TJ	Full competition expected 1 July 2007
South Australia	All customers	Electricity: 1 January 2003 Gas: 28 July 2004
Tasmania	Electricity customers using above 20GWh/year and all gas consumers	Full competition in electricity expected 1 July 2010 Gas: since inception
Victoria	All customers	Electricity: 13 January 2002 Gas: 26 October 2002
Western Australia*	Electricity customers using over 50MWh and all gas customers	Electricity: Introduction of FRC to be reviewed end of 2009 Gas: full competition since 31 May 2004

*NB: NT and WA are not part of the NEM but are signatories to the AEMA*

<sup>6</sup> The small customer consumption threshold for electricity in NSW, Victoria, South Australia, Western Australia and the ACT is usage less than 160MWh per annum; less than 20GWh per annum in Tasmania and less than 100MWh per annum in Queensland. The small customer consumption threshold in gas is usage less than 1 TJ per annum in NSW, Queensland, Western Australia, South Australia and the ACT; less than 5TJ in Victoria; and less than 10TJ in Tasmania: see Retail Policy Working Group, *National Framework for Distribution and Retail Regulation – Working Paper 1*, November 2006, pp. 6-7, 8.

At the commencement of FRC in the energy sector it could not be expected that there would be sufficient competition to deliver all the benefits of competition to end use customers. That is, competition itself could not be relied upon to provide adequate protection to consumers in terms of price and service offerings for an essential service. Therefore, jurisdictions sought to provide protection to consumers through regulatory mechanisms, including retail price regulation<sup>7</sup>, until competition was seen as effective in providing that protection.

The regulatory mechanisms introduced by jurisdictions generally involved a price control as well as imposing obligations for retailers' interactions with customers (such as information requirements). The price controls were intended to ensure that retailers did not take advantage of any residual market power by charging excessive prices to small customers during the transition to effective retail market competition. The price controls were intended to act as a cap on prices with competitive pressures allowing customers to receive price offerings below the cap.

While each jurisdiction with full retail contestability has some form of price cap, the implementation of the price cap differs from state to state. In addition, as competition progressed, each jurisdiction has developed individual market characteristics and regulatory arrangements. For instance, Queensland and NSW have introduced measures that manage the wholesale cost of energy that relates to the energy needs of small customers within the price cap,<sup>8</sup> while Victoria and South Australia have introduced measures that attempt to reduce the price differential between metropolitan and rural areas.<sup>9</sup> In the course of the retail competition reviews, the Commission will be mindful of these differences.

The remainder of this Statement of Approach is structured follows:

- **Chapter 2** considers the concept of “effective competition” for the purpose of the retail competition reviews;
- **Chapter 3** sets out the framework for the Commission’s reviews and its approach to analysis; and
- **Chapter 4** outlines the timetable for the reviews and the Commission’s approach to public consultation, confidentiality and privacy.

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<sup>7</sup> The Commission notes that some jurisdictions regulate the prices offered to all small customers, for example, as currently applies in Queensland. Other jurisdictions, such as Victoria, have in place a regulated “safety net” tariff that consumers can opt to move away from. References in the Statement of Approach to “retail price regulation” (or similar terminology) should be taken to refer to all forms of tariff regulation, however, the Commission further notes that the operation and competitive effect of different jurisdictional regimes will vary.

<sup>8</sup> See, in NSW, the Electricity Tariff Equalisation Fund and in Queensland, the Benchmark Pricing Agreement.

<sup>9</sup> See, in South Australia, the Country Equalisation Scheme and, in Victoria, the Grid Equalisation Scheme.

## 2 Effective competition

### 2.1 Competition and the market

Competition refers to the process of rivalry between firms, where each market participant is constrained in its price and output decisions by the market activity and competitive responses of other market participants.<sup>10</sup> Competition is widely accepted as a means by which economic efficiency can be improved, thereby delivering a range of economic and social benefits. In a competitive market, there exists rivalry between firms seeking profitable business and the exercise of choice by customers seeking the best offers available. This competitive process is likely to exert pressure on incumbents' market shares as competing firms are forced to adopt cost effective prices, and prompt the introduction of a variety of product and service offerings that respond to consumer preferences. The benefits of competitive markets were noted by the Hilmer Committee which stated:<sup>11</sup>

*[t]he promotion of effective competition and the protection of the competitive process are generally consistent with maximising economic efficiency.*

Where competition is facilitating the delivery of economic efficiency, there is no need for regulatory intervention. This approach is reflected in clause 14.11 of the AEMA in relation to retail energy markets, which provides for price controls to be phased out of those markets that are effectively competitive. The task of the Commission is to determine if the retail markets for electricity and gas are delivering these benefits through competition such that the retail price controls can be removed.

In order to assess the effectiveness of competition, the Commission must first determine an appropriate benchmark or reference point against which to assess the current and expected future state of competition. To undertake this assessment, the Commission will have regard to a range of market characteristics, including the extent to which market power is evident or not, the presence of co-ordinated conduct (or peaceful co-existence) between rival firms, the quantity and quality of information disclosure and the exercise of choice by customers. These and other market characteristics will serve as important guides to the Commission in its assessment of the effectiveness of competition.

The figure below illustrates the spectrum of different levels of competition that can exist in a single market as that market moves, at one extreme, from a monopoly to, at the other extreme, a perfectly competitive market.<sup>12</sup>

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<sup>10</sup> Australian Competition and Consumer Commission (ACCC), *Merger Guidelines*, 1999, p. 22.

<sup>11</sup> Hilmer Committee, *National Competition Policy: Report by the Independent Committee of Inquiry*, August 1993, p. 4-5.

<sup>12</sup> The Commission recognises that a truly perfectly competitive market is, as a general rule, rarely observed and as such does not presume that an effectively competitive market will emulate the

**Figure 1.1: Progression of competition**



Monopoly → oligopoly → monopolistic competition → perfect competition

The spectrum of market categories presented in this diagram illustrates that markets are rarely competitive from the outset and tend to evolve over time into what is considered to be effective competition. In other words, the benefits derived from competition increase as the pressure from the new entrant(s) constrains the incumbent firm's power to act without regard to its rivals. Ultimately, the competitive pressures increase to such a level that the market is characterised by "effective" or "workable competition".

However, it cannot be said that there is a single point on this spectrum that, once reached, signals that a market has reached an effective level of competition. Rather, there will exist points on the spectrum that reflect different combinations of the structural and performance-based characteristics of different markets which may correspond with the existence of effective competition. The Commission notes that these points may differ from market to market. The question then becomes, where in this range of market characteristics is competition likely to be effective in providing incentives for efficiency and protection of consumers in terms of price and service for energy markets.

Trade practices and anti-trust cases have also sought to identify when markets are effectively or workably competitive. Effective competition was explained by the Australian Competition Tribunal in this way:<sup>13</sup>

*As was said by the U.S. Attorney General's National Committee to study the Antitrust Laws in its report of 1955 (at p. 320): 'The basic characteristic of effective competition in the economic sense is that no one seller, and no group of sellers acting in concert, has the power to chose its level of profits by giving less and charging more. Where there is workable competition, rival sellers, whether existing competitors or new or potential entrants in the field, would keep this power in check by offering or threatening to offer effective inducements...'*

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model of perfect competition. However, the Commission considers that a market that is effectively competitive will exhibit a number of the characteristics that are fundamental to perfect competition.

<sup>13</sup> *Re Queensland Co-operative Milling Association; Re Defiance Holdings Ltd* (1976) 25 FLR 169 at 188.

The Tribunal went on to say:<sup>14</sup>

*Competition expresses itself as rivalrous market behaviour. ....*

*In our view effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and that there should be independent rivalry in all dimensions of the price-product-service packages offered to consumers and customers.*

Similarly, the Hilmer Report noted the effects on a market in which effective competition does not exist:<sup>15</sup>

*Where the conditions for workable competition are absent – such as where a firm has a legislated or natural monopoly, or the market is otherwise poorly contestable – firms may be able to charge prices above the efficient level for periods beyond those justified by past investments and risks taken or beyond a time when a competitive response might reasonably be expected. Such ‘monopoly pricing’ is seen as detrimental to consumers and to the community as a whole.*

While there is agreement that monopoly conditions rarely provide competitive pressure on firms (except where countervailing market power is present)<sup>16</sup> and perfect competition provides the best competitive pressure, it can be argued that to some degree a range of market conditions can facilitate effective or workable competition for the benefit of consumers. For instance, the Bertrand Model of competition suggests that an oligopoly or a duopoly is sufficient for effective competition to exist. For this model, Joseph Louis François Bertrand demonstrated that two firms supplying a homogeneous product with constant unit costs would compete on the basis of price, such that the price would spiral down towards the perfectly competitive price.<sup>17</sup>

While economic theory suggests that market type can be a good indicator of the effectiveness of competition in a market, the Commission recognises that the conditions particular to an individual market may create circumstances where competition is effective outside a theoretical range. This view is reflected in criteria that the Commission is required to consider in conducting these reviews. Accordingly, the Commission will be guided by the market characteristics that are

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<sup>14</sup> *Ibid.* at 188-189.

<sup>15</sup> Hilmer Committee, *National Competition Policy: Report by the Independent Committee of Inquiry*, August 1993, p. 269. This passage was referred to by the Full Court of the Supreme Court of Western Australia in *Re: Dr Ken Michael AM; ex parte EPIC Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231 at para 144.

<sup>16</sup> Harold Demsetz, “Why regulate monopolies?”, *Journal of Law and Economics*, Volume 11, No 1, April 1968, p55.

<sup>17</sup> See, for example, Jeffrey Church and Roger Ware, *Industrial Organization: A Strategic Approach*, McGraw Hill, Boston, 2000, p. 256.

most likely to combine to provide outcomes that are effective in delivering competitive markets.

The Commission has also been mindful of the importance of incorporating quantitative and qualitative analysis in its assessments of competition. It is evident, however, that there is no single criterion, nor pre-defined set of criteria, that can be applied to determine whether a market is effectively competitive. Understanding the level of competition in a market is dependant on the interaction of a number of interrelated factors. The next Chapter discusses how the Commission plans to consider these factors in relation to the effectiveness of competition.

## 3 Framework and approach for analysis

### 3.1 Introduction

This Chapter discusses the Commission's proposed analytical approach to assessing the effectiveness of competition. This approach is based on looking at the dynamic interrelationship between the relevant market, its structure, the conduct of participants and resulting performance.

The dynamic of competition and the rivalry among retailers is linked to the market structure, conduct and the resulting performance. These factors are interdependent and need to be considered concurrently rather than in isolation. Competition is a rivalrous process and thus effective competition hinges on the degree of rivalry between retailers in the market, the threat of new entrants and the extent to which informed consumers are willing to change suppliers in response to more attractive offers. The degree of rivalry impacts on the aggressiveness of the conduct of retailers in terms of designing price service offerings and the market strategies that are attractive to customers. Importantly, customer responses in exercising choice drives competition, i.e. risk of loss of market share motivates competitive response by retailers.

Maintaining pressures on retailers to compete for customers is influenced by the structure of the market, including the size and composition of the retailers. However, competition cannot work unless customers are willing and able to switch retail contracts as a result of better offers. In economic terms, competition is working effectively where services are meeting customer needs and preferences at a price that is not greater than the long term efficient costs.

As foreshadowed in Chapter 2, a series of quantitative and qualitative indicators have been developed that are based on the MCE criteria. It is against these criteria and indicators that the Commission will assess the degree to which the energy retail markets of each jurisdiction are competitive. A number of submissions questioned the scope and relevance of the indicators the Commission proposed to consider in assessing the effectiveness of competition.<sup>18</sup> While the Commission will draw guidance from antitrust/trade practices law jurisprudence and academic commentary, the reviews are intended to consider a broader range of issues than a "traditional" trade practices law analysis would provide for.

Importantly, the Commission is concerned not to undertake a static analysis of competition in each of the markets being reviewed. Australian energy markets have been changing and evolving over the last decade as evidenced by the creation of the NEM, privatisation, expiration of vesting contracts, full retail contestability and the recent surge in consolidation. Therefore, changes to the number and size of competitors, and to market shares and market concentrations over time also provides

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<sup>18</sup> See, for example, submissions from AGL Energy, the ERAA, the ESAA, Origin Energy and TRUenergy.

useful information about current levels of competition. In addition, the Commission also recognises that the interaction between these factors is an important consideration for assessing the market.

While the Commission has identified indicators that it will use to guide its analysis, it does not intend that the specific factors referred to in this Statement of Approach amount to an exhaustive list of matters that the Commission will have regard to for the purpose of these reviews. It is probable that each jurisdiction will have certain unique characteristics or trends that make relevant issues that are not referred to in this Statement. To maximise the effectiveness of these reviews, it is important that the Commission have regard to all relevant matters.

Notwithstanding the Commission's preference for a flexible approach, there are a number of important criteria and indicators that combine to form a useful framework for analysis. These criteria are discussed in further detail in this Chapter.

### 3.2 Market definition

An important first step in analysing the competitiveness of a market is to define the relevant market. This sets the boundaries of the firms and the products that will be the focus of the review. A helpful explanation of a market, and the key concepts it embodies, has been proffered by the Australian Competition Tribunal:<sup>19</sup>

*We take the concept of a market to be basically a simple idea. A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them .... Within the bounds of a market there is substitution – substitution between one product and another, and between one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive.*

In defining a market definition, regard is had to four dimensions:<sup>20</sup>

- **Product:** as the quote above from the Tribunal indicates, a market will include buyers and sellers of the same or similar products, and includes all actual and potential products that serve as a close substitute in the event that the price of the original product increases.
- **Geographic:** this is the area or areas over which the relevant product is supplied and to which consumers can practically turn.

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<sup>19</sup> *Re Queensland Co-operative Milling Association, Re Defiance Holdings Ltd* (1976) 25 FLR 169 at 190.

<sup>20</sup> In describing these concepts, the Commission has had regard to the approach adopted by the Australian Competition and Consumer Commission (ACCC) and set out in its *Merger Guidelines* (1999) at paragraphs 5.34-5.81.

- **Functional:** a market typically involves multiple stages of production, for example, production, wholesale and retail. As part of the market definition process, it is necessary to determine which functional level (or levels) is to be included in the analysis.
- **Temporal:** it is necessary to determine the time over which the substitution possibilities should be considered.

The Commission considers that it is appropriate to approach the question of market definition afresh at the commencement of the review of each jurisdiction. While it proposes to adopt the same framework for its analysis, the Commission is aware that its reviews will be focused on the competitive market experience of small energy users in specific jurisdictions and that those jurisdictions may have unique characteristics that must be taken into consideration.

In developing its market definitions, the Commission proposes to have regard to the following resources:

- the approach to market analysis adopted by domestic and international energy regulators;
- judicial pronouncements on competition analysis and market analysis by relevant judicial bodies; and
- commentary from economic and anti-trust experts.

The Commission notes that due to the nature of these retail competition reviews and the guidance provided by the AEMA, each review may be limited in the extent it can consider issues of market definition. For example, the requirement that each jurisdiction (i.e. state or territory) is to be the subject of its own review limits the scope that an assessment of the geographic dimensions of the market can be undertaken.

### **3.3 Market structure**

#### **3.3.1 Proposed approach to analysis**

The existence of, or potential for, competition in a market and the extent to which competition can be said to be effective is influenced by structure of the market.

The starting point for analysis is to examine the demand-side of the market. This includes the number, type and size of contestable customers. An important aspect of the review of customers is to consider the extent of any demand-side bargaining power, e.g. through customer aggregation arrangements. Variations in the effectiveness of competition for different customer segments in the market will also be considered. For instance, differences may be observable depending on the geographic location of the customer, i.e. rural and remote or urban, and on differences in consumption volumes.

On the supply-side, the number of firms supplying gas and electricity in the market is another relevant consideration. At the extremes, perfect competition assumes an infinite number of sellers that have no price influencing power, while a monopoly assumes one seller who can set the price. In general, a market comprising a larger number of suppliers is likely to be more competitive than a market with fewer suppliers. However, this conclusion should not be assumed as the level of competition may be dependent on other structural or behavioural issues.

Similarly, the relative market share of retailers operating in the market can affect competition outcomes. Retailers with large market shares, or retailers that operate in multi-markets around Australia (or the world), may be able to maintain and attract market share better than a smaller new entrant. This may arise because there are economies of scale associated with the relatively large fixed costs involved in the provision of retail services, including those involved in establishing call centres and customer billing systems. The Commission will consider the extent of economies of scale and scope and the impact on competition.

There are a number of economic tools used for assessing the likely impact the number of firms and their market shares has on the competitive nature of the market. In North America, regulatory bodies and anti-trust agencies such as the Department of Justice frequently measure the concentration of a market using the Herfindahl Hirschmann Index (HHI).<sup>21</sup> The ACCC's Merger Guidelines currently use the four-firm concentration ratio.<sup>22</sup> These indices and ratios indicate whether the majority of market share is held by a small number of firms (a concentrated market, suggesting low levels of competition) or shared across a broad number of firms (a less concentrated market, suggesting higher levels of competition). It is noted that market structure (e.g. the size and number of participants) can provide a good indicator of the competitive landscape. It alone, however, is not a conclusive indicator and it must be considered together with the ability of retailers to enter and exit the market and the extent of rivalry in the market. As noted by the European Union, "[m]arket shares and concentration levels provide useful first indicators of the market structure and the competitive importance of both the merging parties and their competitors" (emphasis added)<sup>23</sup>.

The extent of barriers to entry is a key input into the analysis of the structure of the market and the scope for effective competition. Barriers to entry are costs that limit the ability of a firm to enter the market or a firm's profitability when entering a market.<sup>24</sup> It follows that the higher barriers to entry are, the less likely a new entrant

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<sup>21</sup> Department of Justice, *Horizontal Merger Guidelines*, 1997, at section 1.5. A copy is available at <http://www.usdoj.gov/atr/public/guidelines/guidelin.htm>.

<sup>22</sup> ACCC, *Merger Guidelines*, 1999 at paragraph 5.95.

<sup>23</sup> *Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentration between undertakings*, Official Journal of the European Union, 5.2.2004 C31/5 - C31/18 at paragraph 14.

<sup>24</sup> For example, see ACCC, *Merger Guidelines*, 1999 at paragraph 5.116-5.128.

firm will be able to establish itself in the market within a reasonable period of time and on a sufficient scale to constrain the incumbent's pricing decisions.

The ability for new retailers to enter the market is essential to ensure competition between retailers and efficient price levels for customers. This is because the threat of entry will constrain incumbents to behave competitively.<sup>25</sup> A credible threat of new entry prevents an incumbent retailer from extracting excessive monopoly rents from customers lest the new entrant commence offering a competing product on improved price (or non-price) terms. The threat of a new entrant requires incumbents to consider the longer term revenue implications of charging higher prices in the shorter term.

In considering barriers to entry, the ability of retailers to access wholesale energy markets and manage risk will be considered in each review. Retailers' ability to enter and operate in the energy retail markets is affected by the extent of competition in the wholesale energy market and the ability to contract for the purchase of wholesale energy.

In electricity retail markets particularly, the liquidity in the financial contract market and the ability to manage the risk of exposure to the wholesale spot market is a critical requirement for existing and potential new entrant retailers. In assessing the extent of barriers to entry in the retail market, the Commission intends to examine the arrangements in the upstream markets and the ability of retailers to contract for wholesale energy and manage financial risks.

The deterrent effect of market structure can manifest itself in a number of forms. For example, in the context of merger analysis, the ACCC will have regard to:<sup>26</sup>

- sunk costs;
- legal or regulatory barriers such as licensing requirements, safety obligations and industry standards;
- economies of scale and scope;
- product differentiation and brand loyalty;
- the threat of retaliatory action by incumbents; and
- access to scarce inputs.

Several of the submissions received in response to the Draft Statement of Approach submitted that barriers to entry, and other structural characteristics that give rise to

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<sup>25</sup> Dr Maureen Brunt, "Australian and New Zealand Competition Law and Policy", 19<sup>th</sup> Fordham Conference on International Antitrust Law and Policy, 1992 as quoted in ACCC, *Merger Guidelines*, 1999 at paragraph 5.125.

<sup>26</sup> ACCC, *Merger Guidelines*, 1999 at paragraph 5.124.

market failure, should be the primary focus of the reviews.<sup>27</sup> The Commission considers that these factors identified by the ACCC form a strong basis upon which to assess the height of barriers to entry to the markets under review. However, the Commission is of the view that a comprehensive analysis requires consideration of market characteristics that go beyond barriers to entry, market shares and market concentration. While the Commission considers these factors are a strong starting point, the resulting analysis will be more robust if regard is had to a broader range of factors.

The Commission recognises and will be guided by the wealth of anti-trust and trade practices law jurisprudence and academic commentary on issues relating to market structure. However, as the AEMA and the MCE criteria require consideration of a broader range of issues than would form part of a “traditional” trade practices law analysis, the Commission proposes to have regard to additional matters where appropriate. These may include, for example, the impact of the effectiveness of competition in the retail market, retail tariff regulation, vertical integration, financial costs of entry, access to energy contracts in wholesale markets and competitive conditions in the wholesale energy markets.

### **3.3.2 Market structure indicators**

In analysing market structure, the Commission proposes to have regard to the following indicators:

- the number, type and size of contestable customers, and changes in the number and size of those customers over time;
- the number, type and size of competitors, and changes in the number and size of competitors over time;<sup>28</sup>
- market concentration indices;
- the market shares of competitors, and changes to those shares over time;<sup>29</sup>and
- barriers to entry, including the extent and effect of economies of scale and scope, and access to wholesale markets and risk management vehicles.

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<sup>27</sup> See, for example, submissions from the ERAA, the ESAA, Origin Energy and TRUenergy.

<sup>28</sup> Principle 4, Annexure 3 of the AEMA.

<sup>29</sup> Principle 5, Annexure 3 of the AEMA.

## 3.4 Market conduct

### 3.4.1 Proposed approach to analysis

Market conduct analysis focuses on the behaviour of participants on both the demand-side and supply-side of the market. Although the behaviour of firms and consumers is affected by the structural features of the market, the behavioural responses of retailers and customers are also reflective of the level of competition present in the market. As noted by the Australian Competition Tribunal<sup>30</sup>, competition is a process of rivalrous behaviour; it is “a process rather than a situation”.

Considering the demand-side aspects of market conduct, the competitiveness of a market can be gauged by the number and frequency of customers choosing to switch retailers. Customer switching data demonstrates the preparedness of consumers to seek more competitive service offerings, which acts as a catalyst for increasingly competitive and innovate offerings. The quantitative analysis of switching behaviour will be considered together with qualitative research undertaken by the Commission on the experiences of customers in the retail market. This will help the Commission to assess the reasons for customer switching behaviour. For example, in a mature market, a slowdown in switching rates may be reflective of satisfied customers and thus effective competition. While the quality and comprehensiveness of demand-side data can vary, the Commission will consider various analytical processes and techniques to overcome such limitations.

An effectively competitive market is likely to comprise customers who are aware that they can choose their energy supplier and are relatively well informed about the types of service offerings available in the market. Such awareness may stem from a variety of sources such as a retailer contacting a customer directly or through marketing or via the customer attempting to find a market offer from a retailer. Governments and regulatory agencies may also play an active part, particularly in the early stages of FRC, in making consumers aware that they can chose their energy suppliers.

In an effectively competitive market, retailers have an interest in making information about their service offerings freely available and will seek to communicate it clearly and effectively.<sup>31</sup> Where competition is ineffective, asymmetric information between retailers and customers may confer a level of market power on retailers. The Commission will consider the experiences of customers in relation to their ability to understand and compare the range of retail services on offer. The availability and

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<sup>30</sup> *Re Queensland Co-operative Milling Association; Re Defiance Holdings Ltd* (1976) 25 FLR 169 at 188, 189. See also *Australian Gas Light Company (ACN 052 167 405) v Australian Competition & Consumer Commission (No 3)* (2003) ATPR 41-966 at 47,705.

<sup>31</sup> Minimum standards will be in place governing marketing conduct to prevent misleading or deceptive conduct, contact with customers, customer consent and dispute resolution. It may be appropriate to consider whether such intervention affects the level of competition in a market.

complexity of information is a key indicator in assessing the effectiveness of competition in the small customer end of the market.

The content of the offer may vary between customer classes, whereby a more competitive offer is directed towards the class of customer where competition is greater, e.g. urban customers in favour of rural and remote customers.

The prevalence of consumer complaints and instances of anti-competitive behaviour also provide information about the conduct of market participants. Regulators, consumer bodies and the retailers themselves may receive complaints concerning the provision of misleading or incomplete information about the terms and conditions of supply in order to secure a transfer request. Similarly, complaints can be made by competitors in response to false representations being made by competitors about its offer for supply. Anti-competitive behaviour can include incumbents refusing to process requests to transfer customers, or new entrants initiating unauthorised requests for transfer. In some circumstances such conduct may reflect the exercise of market power; in other instances it may reflect competitive forces.

On the supply-side, the Commission will consider evidence of rivalrous behaviour among the retailers. The extent of rivalrous behaviour is a key indicator of the effectiveness of competition. The types of behaviour that will assist in assessing the extent of competition include the marketing strategies of retailer and target customers; the aggressiveness or defensiveness of marketing strategies; the extent and scope of any coordination; the content and innovation in service offers; and the format of information to customers.

Importantly, the trend of competitive behaviour over time may help inform the Commission about the way competition can be expected to increase (or stagnate, as appropriate) in the future. The level of competition that can be expected going forward is an important consideration for any recommendations the Commission may make concerning the removal of retail price regulation, or for strategies to improve existing levels of competition.

The Commission notes the concerns expressed in submissions about the availability and accuracy of demand-side and supply-side data.<sup>32</sup> In order to address these difficulties and to maximise the opportunities to obtain relevant information, the Commission proposes to engage in a comprehensive investigative process in conjunction with wide-ranging consultation, both in relation to the data that it proposes to collect and its analysis.

### **3.4.2 Market conduct indicators**

In considering market conduct, the Commission proposes to have regard to the following indicators:

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<sup>32</sup> See, for example, submissions from AGL Energy, the Centre for Credit and Consumer Law, the Consumer Action Law Centre and the joint submission from the Victorian consumer groups.

- the number of customers accepting market offers and/or switching retailers, and whether switches are by first tier or second tier customers;
- market research on customer awareness of competition and choice;
- market research on ease of obtaining, understanding and comparing information;
- extent and type of marketing activity;
- extent of offers being sought and made;
- the nature and frequency of customer complaints; and
- the nature of regulatory enforcement investigations.

### **3.5 Market performance**

#### **3.5.1 Proposed approach to analysis**

The outcomes or performance of the market is a reflection of both its structure and the collective conduct of market participants. One of the key indicators of market performance – and therefore of the effectiveness of competition in that market – is the prices being charged for the products and/or services in question relative to the cost of supply and the profit margins being earned within the price.

While earning a competitive profit margin is necessary to provide an incentive for retailers to enter and stay in the market, evidence of sustained excessive profit margins may indicate that competition is not effective. At the same time, above normal margins can also be an incentive for competition from rivals to win market share by offering competitive prices. The size of the available profit margin will impact on the decisions of potential new entrants to a market and provide an indication of the competitive stage of the market.

However, the practical application of this market performance measure is particularly difficult in the energy retail sector. This is because this type of analysis requires an assessment of the efficient and actual costs compared to the prices offered. Unfortunately, these costs are not easily observable. For instance, calculating the costs of providing retail energy requires a detailed analysis of the input costs, which include: wholesale costs; network charges; retail costs (including customer billing, information systems and call centres); and a retail margin. Except for network charges (which are transparent), other input costs can be difficult to determine and require a number of assumptions.

However, in reality it would be inefficient for retailers to conduct such a cost build up for each type of customer in their customer base. Cost efficiencies are more likely to be sought by retailers across the customer base rather than for specific customer types. Despite this being the case, in a competitive market it can be efficient for a retailer to obtain a different sized margin from different customer types based on the willingness of the customer to pay. It is also important, in this context, to recognise that liquidity and efficiency in the wholesale market can affect the size of the retail

profit margins available, particularly for new entrants. Where there are difficulties in purchasing contracts or products to manage risk, the costs of wholesale energy are likely to increase. Where this is the case the size of the retail margin will be diminished by factors that are not necessarily related to the extent of competition in the retail sector. Determining the efficient costs of energy will enable the Commission to identify where this may be a factor.

In order to ensure some meaningful analysis for the reviews, the Commission proposes undertaking an examination of the efficient economic costs compared to prices over time. This will involve obtaining a “snapshot” of efficient input costs, including a reasonable profit margin, at particular historical points in time and comparing this to the historical price. In addition, the analysis will seek to be reflective of market conditions and marketing strategies with a view to a business seeking a commercial margin across their entire customer base. From this, the Commission will be able to analyse the gap between prices charged and the efficient long term economic cost of supply. The Commission expects that in a competitive market the difference between these two parameters should converge over time.

The Commission recognises that obtaining accurate and reliable data about input costs is problematic. As previously indicated, even when the efficient costs of these components can be accurately determined, there may be economically efficient variances in profit margins across customer classes. Therefore, it is possible there may be multiple “right” answers to the appropriate size of the profit margin. As such, the degree with which the profit margin analysis can be relied upon to provide evidence of effective competition may be diminished. On that basis, the Commission considers the profit margin analysis is likely to largely provide supporting analysis on the question of the effectiveness of competition in the market rather than being a deterministic factor.

Another important indicator of effective competition is product innovation and differentiation. One of the earlier examples of competition-driven innovation was the introduction of dual fuel offers. When retailers recognised that many single customers were contestable for the supply of gas and electricity, retailers looked for opportunities to provide attractive service offerings to secure customers for both energy products. Examples of this kind of behaviour may include the bundling of products or offering consumers niche products, such as green energy.

### **3.5.2 Market performance indicators**

In evaluating the performance of each market, the Commission proposes to have regard to the following indicators:

- evidence of changes in the retail price of gas and electricity;
- evidence of prices converging to an efficient long term cost of supply; and

- evidence that differentiated and innovative products and services are being offered to the market which meet customer preferences and needs.<sup>33</sup>

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<sup>33</sup> Principle 3, Annexure 3 of the AEMA.

## **4 Timetable and consultation**

### **4.1 Timetable for the reviews**

The Commission has proposed a preliminary timetable to the MCE for conducting the retail competition reviews in each of the six jurisdictions. The MCE is currently considering the timetable proposed by the Commission.

The AEMA requires that, unless the Commission recommends otherwise, reviews will be conducted biennially until all retail energy price controls are phased out or thereafter at the request of a party to the agreement.<sup>34</sup>

### **4.2 Liaison with jurisdictional governments and regulators**

Given the requirements of the AEMA and the role of the reviews in informing policy decisions on the promotion of competition policy and the reduction or phasing out of price caps, effective liaison with the relevant jurisdictional governments will be essential. To this end, at the commencement of each review, the Commission will consult with the relevant jurisdictional Minister on issues concerning the timing for completing the review and offering the Minister the opportunity to provide the Government's views as they are relevant to the review. The Commission will ensure that it maintains an open dialogue to ensure that each Minister is able to participate in each stage of the review.

The Commission recognises that the jurisdictional regulators will possess a wealth of knowledge and experience in relation to the local energy markets that will be an important input into each review. Accordingly, the Commission will consult closely with each jurisdictional regulator in order to draw on the regulator's insight and information.

### **4.3 Consultation process**

#### **4.3.1 Process for consultation**

The Commission will adopt a process for conducting the retail competition reviews that gives all interested stakeholders the opportunity to provide input at each stage of the review process. Consistent with its approach in other reviews conducted to date, the Commission considers that all public consultation should be conducted in an open and transparent manner. As required by clause 14.16 of the AEMA, the Economic Regulation Authority (ERA) will conduct its review of the Western Australian retail energy market in consultation with the Commission and in accordance with the national methodology developed and adopted by the Commission.

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<sup>34</sup> Clause 14.11(a)(iii), AEMA.

The Commission intends that each review would follow a similar structure:

- prior to the commencement of the review, the Commission will issue a public notice setting out the terms of reference for the assessment and a proposed timetable for completing the assessment. The public notice will be published in *The Australian* newspaper and on the Commission's website;
- at the time it issues the public notice, the Commission will publish on its website a high level Issues Paper that sets out the Commission's analytical approach, and calls for submissions on the issues relevant to the jurisdiction under review;
- the Commission will undertake a process of gathering quantitative and qualitative data relevant to the review. The Commission's approach is discussed in further detail at 4.3.2 below;
- the Commission will publish a draft report on the effectiveness of competition in the jurisdiction being reviewed, and submissions will be sought on the draft findings;
- after considering the submissions, the Commission will prepare its final report. Where competition is found to be effective, the Commission will publish a draft advice outlining ways that retail price regulation can be phased out of the jurisdiction, including a draft timeframe to give effect to its recommendations. Where competition is not found to be effective, the draft advice will outline ways in which the effectiveness can be improved, including a draft timeframe to give effect to its advice. Submissions will be sought on the draft advice; and
- after considering the submissions on the draft advice, the Commission will prepare its report on the phasing out of retail price regulation or improving the effectiveness of competition (as appropriate), including an appropriate timeframe for implementing the Commission's recommendations.

The Commission will consult with the relevant jurisdictional government as part of the process of developing its assessment and advice on the implementation options and an appropriate timeframe.<sup>35</sup> In accordance with the AEMA, the jurisdiction would provide a public response within 6 months of receiving the Commission's advice.

Each review will be limited to a period of no more than 12 months. As noted above, subsequent reviews would be conducted on a biennial basis, where needed.

#### **4.3.2 Stakeholder consultation**

It is important to the success of these reviews that the Commission is able to hear the views of a range of stakeholders, ranging from generators and wholesalers to retailers and consumer groups. Accordingly, the Commission will use a variety of approaches to obtain quantitative and qualitative data, and to ensure that

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<sup>35</sup> This requirement will be made explicit in the direction from the MCE.

stakeholders have the opportunity to engage in full and frank discussion of the issues.

A key stakeholder group that the Commission wishes to engage with is the gas and electricity retailers of each jurisdiction. The Commission considers that it shares with retailers the common goal of conducting a review that delivers findings based on probative facts. The Commission also recognises that retailers will be an integral source of factual information relevant to the review, and that much of this information is likely to be confidential or commercially sensitive.

Accordingly, the Commission wishes to develop a co-operative framework within which retailers can interact with the Commission in a frank, open and meaningful way. To facilitate the meaningful exchange of ideas and information, the Commission proposes to conduct a series of confidential face-to-face briefings with individual retailers, supplemented by independent surveys of retail businesses. The Commission's approach to the confidentiality of data collected during the interviews and through the surveys is discussed at 4.4.

The Commission also wishes to consult with other energy market participants who operate at different functional levels. For example, the Commission considers that wholesale suppliers are likely to provide insight into the operation of the retail market. The Commission will seek to implement a similarly co-operative framework to encourage open communication while protecting the confidentiality of suppliers' information and data.

The Commission recognises that there are a range of other stakeholders whose views are an important input into the reviews. For example, the Commission expects that consumer groups, particularly community and welfare groups, will be an important source of information about the effects of energy pricing on consumers, particularly disadvantaged and vulnerable customers. The Commission considers that consumer groups are also likely to be well placed to provide valuable insight in relation to demand-side data collected about customers.

In order to capture the views of all interested stakeholders, the Commission proposes to:

- consult with jurisdictional Ombudsman and, as noted above, government Ministers and their departments and jurisdictional regulators;
- conduct a series of briefings, interviews and/or public meetings with a range of stakeholders, including small customers and consumer, community and welfare groups. Such meetings would be held in metropolitan and regional/rural areas to enhance opportunities for small retail customers to participate;
- conduct surveys of retailers and a representative sample of retail customers, and interviews with retailers;
- undertake quantitative and qualitative research formulated and undertaken specifically for each review; and

- consider data obtained from publicly available sources, including corporate reporting information, academic literature and reports and analysis conducted by other regulatory bodies.

A number of submissions raised the importance of public consultation and the opportunity for stakeholders to have an open dialogue with the Commission.<sup>36</sup> To facilitate interaction with the Commission, it is considering establishing a list of registered stakeholders to enable interested parties to be notified directly of developments throughout the reviews, such as notice of public meetings to be held or the release of issues papers and draft reports.

#### **4.4 Management of confidential information**

Information will be provided to the Commission on a voluntary and co-operative basis for the purposes of the retail competition reviews and some information will be commercially sensitive or otherwise confidential information. Given the likely sensitivity around some of the information that will necessarily be part of the reviews, the Commission considers it appropriate to set out more fully its proposed approach to the treatment of commercially sensitive or otherwise confidential information.

The Commission has developed its approach to managing confidential information for the retail competition reviews in accordance with the following principles:

1. The retail competition reviews will be most effective if information can flow freely to the Commission.
2. The information that is relied upon by the Commission in relation to the retail competition reviews should be published, commented upon and tested in open debate.
3. Persons (such as retailers and wholesale suppliers) who provide confidential information and data at the request of the Commission for the purposes of a retail competition review should have the necessary assurances that such confidential information:
  - (a) will not be used for purposes other than the retail competition reviews; and
  - (b) will be treated as confidential by the Commission; and
  - (c) will not be published or disclosed in such a way as to disclose confidential information.
4. The procedures for dealing with confidential information should be set out clearly in advance of parties providing information.

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<sup>36</sup> See, for example, the submissions from the Consumer Action Law Centre, the Public Interest Advocacy Centre and the Total Environment Centre.

The Commission notes that it is obliged by law to take all reasonable measures to protect from unauthorised use or disclosure information given to it in confidence in or in connection with, the performance of its functions or the exercise of its powers.<sup>37</sup>

The Commission will, to the extent permitted by law, treat as confidential information provided to it by a retailer or other market participant (such as a wholesale generator) that is identified as confidential.

The Commission considers its established practice of omitting confidential or commercially sensitive information contained in a submission prior to publishing the submission on its website, offers adequate protection to parties making submissions in response to public consultation undertaken as part of the reviews.

A party who provides information to the Commission and considers that part or all of the information being provided is confidential or commercially sensitive, including a retail business, may request that such information be kept confidential. A request to maintain confidentiality should:

- be made in writing;
- clearly identify the information which is confidential and, where possible, separate that information from the other non-confidential information in the submission; and
- set out the basis upon which the information is confidential and/or commercially sensitive, including for example, a statement as to any detriment that is likely to result to the person or to any third party from the disclosure of the information.

The Commission notes that it may, from time to time, request information about customer usage patterns. As discussed in Chapter 3, this information may include statistics about switching data, usage patterns and consumer complaints. The Commission does not expect that it would require access to personal information<sup>38</sup> about specific energy customers for the purpose of conducting the retail competition reviews. In the event that personal information was available to the Commission, its position is that it would decline to receive the information in that form and request that it be aggregated or re-presented so as to remove all personal information.

The Commission may collect personal information from individuals who make submissions during the review or who attend public workshops, such as the

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<sup>37</sup> Section 24(1), *Australian Energy Market Commission Establishment Act 2004* (SA). This obligation extends to information that is obtained by the Commission by compulsion in the exercise of its powers, but the Commission is not empowered to compel the production of information for the purposes of this review.

<sup>38</sup> Personal information is “information or an opinion, whether true or not, relating to a natural person or the affairs of a natural person whose identity is apparent, or can reasonably be ascertained, from the information or opinion” (see section 3 of the Information Privacy Principles Instruction are set out in *Cabinet Administrative Instruction No 1 of 1989* (SA)).

individual's name or email address. The Commission is required to comply with an *Information Privacy Principles Instruction*.<sup>39</sup> While the Commission needs to identify individual authors of submissions, for example, on its website and in discussions in its reports, it will not otherwise disclose personal information unless permitted to do so by law.

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<sup>39</sup> The Information Privacy Principles Instruction are set out in *Cabinet Administrative Instruction No 1 of 1989*, which is an administrative instruction that the Commission, as a body established by legislation passed by the South Australian Parliament, is required to comply with. A copy of the Instruction is available at <http://www.premcab.sa.gov.au/pdf/circulars/Privacy.pdf>.

## Appendix A

### Retail Price Regulation

14.10 All Parties agree to phase out the exercise of retail price regulation for electricity and natural gas where effective retail competition can be demonstrated and that:

- (a) the AEMC will assess the effectiveness of competition for the purpose of retention, removal or reintroduction of retail energy price controls, whereby:
  - (i) the criteria for assessing the effectiveness of competition will be developed by the MCE in consultation with the AEMC and other interested parties based on the principles set out in Annexure 3;
  - (ii) the assessment process will commence from 1 January 2007 starting with those jurisdictions most likely to have effective competition; and
  - (iii) reviews will be conducted biennially, unless the AEMC recommends otherwise, until all retail energy price controls are phased out or at the request of a Party thereafter;
- (b) social welfare and equity objectives will be met through clearly specified and transparently funded State or Territory community service obligations that do not materially impede competition; and
- (c) the AEMC will publicly report on its assessments of effective competition in which it will provide advice to each jurisdiction on their compliance with clauses 14.10-14.14 and on:
  - (i) ways to phase out the exercise of retail price regulation if competition is determined to be effective and an appropriate timeframe; or
  - (ii) ways to promote the growth of effective competition for those users or areas of a jurisdiction which do not enjoy effective competition.