

Our ref: EOR008/Corro/15463

19 July 2006

Mr Drew Clarke  
Acting Chair  
MCE Standing Committee of Officials  
GPO Box 9839  
CANBERRA ACT 2601

Dear Mr Clarke

### **Draft Effective Competition Criteria**

I refer to your letter of 15<sup>th</sup> June 2006, inviting comment on the draft effective competition criteria being developed by the Ministerial Council on Energy (MCE), Standing Committee of Officials (SCO) as the basis for assessments of the effectiveness of the competition in electricity and natural gas retail markets by the Australian Energy Market Commission (the Commission).

The scope of the reviews to be undertaken will include:

- an assessment of the effectiveness of competition for the purpose of retention, removal or reintroduction of retail energy price controls; and
- provision of advice to each jurisdiction on compliance with the relevant clauses of the Australian Energy Market Agreement (AEMA) and on ways to phase out price controls (if competition is effective) and of promoting effective competition (if it is not).

The Commission agrees with the general approach to the assessment of the effectiveness of competition proposed in Attachment B of your letter. However, it has some more detailed comments and suggestions on aspects of the approach and the proposed criteria and indicators.

Regarding the specification of the criteria and indicators (section (4) of Attachment B), the Commission agrees with the observations that:

- the basic analytical framework for the assessments should involve consideration of the structural, conduct and performance features of the relevant market;
- in making its assessments, the Commission will need to consider a range of qualitative and quantitative indicators;
- high level principles and criteria will be appropriate (too much prescription will limit the flexibility to take account of different jurisdictional and market circumstances); and
- the criteria and assessment approach can be developed and elaborated through AEMC guidelines in consultation with stakeholders.

In relation to the possible weighting of the criteria and indicators, the Commission recommends adoption of Option 1. By placing no weightings on the criteria and indicators the option leaves it to the Commission to assign appropriate weightings to the criteria based on its analysis of the relevant jurisdictional and market circumstances.

Option 2 is not recommended for reasons given in Attachment B to your letter.

The Commission also recommends against adoption of the more limited guidance provided under Option 3. This option is based on what the Commission considers to be an artificial distinction between input (i.e. market structure) related indicators and output (i.e. market outcome) related indicators. As noted above and in Attachment B, an integrated assessment of the structure, conduct, performance and dynamic dimensions of a market is required to make an informed assessment of the effectiveness of competition. Those dimensions, and the weight relevantly attached to them, will vary across different markets at a point in time and for a particular market over time. Guidance which emphasises a particular dimension (e.g. market structure) is therefore likely to compromise the assessment process.

Turning to the proposed indicators and criteria (section (5) and Table 1 of Attachment B), the Commission agrees with the criteria described under the heading "Proposed Criteria" on page 5 of Attachment B. However, for completeness, you might consider including in the last dot point on market performance a reference to prices and profit margins that reflect efficient costs and competitive market conditions.

The Commission also considers that the higher level criteria under the heading "Proposed Criteria" on page 5 of Attachment B would provide sufficient policy guidance for the effective conduct of the reviews compared to the more prescriptive and detailed guidance contained in Table 1 of Attachment B. These high level criteria reflect the essential elements of a comprehensive analysis of the effectiveness of competition in energy retail markets and would therefore be most appropriate for strategic policy guidance on this matter. That approach would have the advantage of allowing the Commission the flexibility to develop the more detailed analytical framework having regard to the circumstances of retail markets in different jurisdictions and the information and views obtained through public consultation.

However, should the SCO decide to consult on a more detailed analytical framework, including criteria and indicators on the lines of Table 1, then, as noted above, the Commission would recommend not adopting the classification of indicators as either input or output related indicators and not requiring more weight to be placed on market structure indicators relative to market conduct or performance indicators.

For similar reasons, the Commission has reservations about the usefulness of the structure of Table 1 which classifies criteria and indicators in terms market structure and market outcome related indicators. This classification approach may appear to unduly underweight the market conduct of retailers and customers as a critical dimension of the competitive process. For example, Table 1 currently gives little or no emphasis to rivalrous behaviour on the part of retailers as an indicator of the competitive process in action<sup>1</sup>.

This concern could be addressed by adopting an alternative structure for Table 1 based on a structure, conduct, performance classification of indicators. A further useful modification would be the inclusion of an additional assessment category in relation to market definition. As a more general comment, you may care to consider whether the listing of numerous indicators for each assessment category in Table 1 has not been taken to a more detailed level than is appropriate for what is intended to be high level policy guidance. The Commission considers that the clarity and usefulness of Table 1 would be improved by sharpening the focus of the indicators and reducing their number. A modification of Table 1 incorporating these suggestions is attached for your consideration.

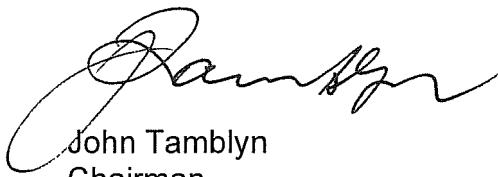
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<sup>1</sup> As noted by the Australian Competition Tribunal, "Competition expresses itself as rivalrous market behaviour – it is a process not a situation".

Thank you for the opportunity to comment on the draft effective competition criteria. I hope these comments will be of assistance in your further development of the criteria.

Please contact me on 02 8296 7801 if you wish to discuss our comments or any related issues.

Yours sincerely

A handwritten signature in black ink, appearing to read 'John Tamblyn', written in a cursive style.

John Tamblyn  
Chairman

c.c. Mr Robert Pullella, Economic Regulation Authority

## Suggested Effective Competition Criteria

ASSESSMENT CATEGORY	CRITERIA	PROPOSED ALTERNATIVE INDICATORS
Market definition	Scope and dimensions of the retail market	<p>Definition of the market in terms of the actual and potential transactions between the retailers and customers and the extent of actual or potential substitution of price/ service offerings between them.</p> <p>Review the market in each of the following four dimensions:</p> <ul style="list-style-type: none"> <li>• Product.</li> <li>• Functional.</li> <li>• Geographic.</li> <li>• Time.</li> </ul>
Market structure	Structural conditions of the market	<p>The structure of the relevant markets with reference to:</p> <ul style="list-style-type: none"> <li>• The degree of concentration, number and size of retailers.</li> <li>• Trends in market share and structure over time.</li> <li>• The extent of countervailing market power.</li> <li>• Technical and cost conditions of supply including the existence of economies of scale and scope.</li> </ul>
Market structure	Ability of suppliers to enter the market	<p>The ease of market entry and exit including:</p> <ul style="list-style-type: none"> <li>• The number and size of retailers entering and exiting the market over time.</li> <li>• The extent of any barriers to entry including economies of scale and scope and statutory, regulatory, economic or structural impediments.</li> <li>• The general structure, design and operation of the gas and electricity markets.</li> </ul>
Market conduct – customers	The exercise of market choice by customers	<p>The extent of participation, by customer segments, in the market including an assessment of:</p> <ul style="list-style-type: none"> <li>• Customer awareness of</li> </ul>

		<p>competition, choice of retailer and full retail contestability.</p> <ul style="list-style-type: none"> <li>• The degree of customer participation in the market and any impediments to effective market participation.</li> </ul>
	Customer switching behaviour	<ul style="list-style-type: none"> <li>• The ease with which customers can switch between retailers and/ or price service offering.</li> <li>• Incidence of switching.</li> <li>• Cost and convenience of switching.</li> <li>• Incentives to/ benefits from switching.</li> </ul>
Market conduct – retailers	Rivalrous or anti-competitive retailer conduct.	<p>Assessment of:</p> <ul style="list-style-type: none"> <li>• The degree of rivalry evident among retailers and the range of price/ service offerings to customers, marketing and customer service strategies.</li> <li>• Evidence of any anticompetitive behaviour.</li> </ul>
Market performance	Price, profit and service satisfaction outcomes	<p>A assessment of the performance of the market in terms of:</p> <ul style="list-style-type: none"> <li>• Extent to which the prices, products and services on offer reflect customer preferences.</li> <li>• The extent to which price for services reflect efficient costs and competitive market conditions.</li> <li>• The range of prices, products and services available to different customer segments (including size and location).</li> <li>• Customer satisfaction with the service received from their retailer.</li> </ul>