



### **Submission to the Ministerial Council on Energy Standing Committee of Officials, September 2006**

The Consumer Utilities Advocacy Centre Ltd (**CUAC**) and Consumer Law Centre Victoria (**CLCV**) welcome the opportunity to comment on the Ministerial Council on Energy Standing Committee of Officials' (**MCE SCO**) Consultation Paper *Phase out of Retail Price Regulation for Electricity and Natural Gas – Draft Effective Competition Criteria* (the **Consultation Paper**). The following organisations have endorsed the views presented in this submission:

- Centre for Consumer and Credit Law, Griffith Univeristy (**CCCL**);
- Australian Council of Social Service (**ACOSS**);
- Victorian Council of Social Service (**VCOSS**);
- Tenants' Union of Victoria (**TUV**);
- UnitingCare Wesley Adelaide; and
- Alternative Technology Association (**ATA**).

CUAC is an independent consumer advocacy organisation, established to ensure the interests of Victorian electricity, gas and water consumers, particularly low-income, disadvantaged and rural consumers, are effectively represented in the policy and regulatory debate.

The CLCV is one of Australia's leading consumer and public interest organisations. A not-for-profit, independent organisation, we undertake research, policy development, advocacy and education. The CLCV's work is focussed on advancing the interests of consumers, particularly low-income and vulnerable consumers. The CLCV is currently working on a range of issues, including utilities, competition and consumer protection policies, financial services, telecommunications, exploitative credit and access to justice. The CLCV also operates a large consumer legal practice assisting over one thousand low-income consumers each year with free legal advice and representation.

#### **A. Introduction**

In light of the commitment made within the Australian Energy Market Agreement (**AEMA**) to remove price regulation of gas and electricity if competition is effective, the criteria for assessing the effectiveness are crucial to energy consumers, and in particular those who are unlikely to be 'winners' in a market with sub-optimal competition levels. As such, we recommend that the detailed assessment criteria be developed by the Australian Energy Market Commission (**AEMC**) in consultation with stakeholders and that the MCE restricts itself to a statement of broad principles in line with Clause 4.4(a) in the AEMA.

This submission comments on alternative and/or additional assessment criteria and indicators, the availability of market information and the importance of including sub-markets in competition assessments. Although we believe the AEMC is better placed to undertake the necessary consultation and research to develop a balanced and flexible assessment methodology, we also provide some comments on the issue of weighting the competition indicators.

**B. Overview of criteria in MCE paper**

The Consultation Paper proposes six criteria to be used by the AEMC to assess the effectiveness of competition in energy markets. The MCE divides its criteria into two ‘assessment categories’:

**Table 1: MCE draft criteria for assessing effectiveness of competition**

| <b>Assessment category</b> | <b>Criteria</b>                            |
|----------------------------|--|
| Market structure           | Independent rivalry in the market          |
|                            | Ability of suppliers to enter the market   |
| Market outcome             | The exercise of market choice by customers |
|                            | Differentiated product and services        |
|                            | Prices and profit margins                  |
|                            | Customer switching behaviour               |

While these criteria do comprise a range of important indicators which assist in assessing the effectiveness of competition in the market, we believe that there are important criteria missing. Issues relating to market concentration, information asymmetry and customers’ switching and search costs have not been adequately considered by the draft criteria, an oversight that will restrict the ability of the AEMC to make a sufficiently informed decision on the effectiveness of competition in any jurisdiction.

The UK Office of Fair Trading (OFT) has released a publication discussing how it selects particular markets for competition effectiveness references.<sup>1</sup> Under the UK Enterprise Act, the OFT can select particular markets for further investigation by the Competition Commission where it has reasonable grounds for suspecting that any feature, or combination of features, of a market for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or part of the UK.<sup>2</sup> The OFT’s publication, *Market investigation references*, provides a concise and clear overview of the criteria it uses to assess the effectiveness of competition in a market. In our view, these criteria offer a more useful framework to assess the effectiveness of competition.

**Table 2: OFT criteria for market investigation references**

| <b>Assessment category</b>      | <b>Criteria</b>                         |
|---------------------------------|---|
| Structural features of a market | Market concentration                    |
|                                 | Vertical integration                    |
|                                 | Conditions of entry, exit and expansion |
|                                 | Regulations and government policies     |
|                                 | Information asymmetries                 |
|                                 | Switching costs                         |
|                                 | Countervailing power                    |
| Firms’ conduct                  | Conduct of oligopolies                  |

<sup>1</sup> UK Office of Fair Trading, *Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act*, March 2006, available at: <http://www.offt.gov.uk/NR/rdonlyres/57C2BA34-81E8-4560-93CC-4BC4BBFC6DAF/0/oft511.pdf>.

<sup>2</sup> Enterprise Act, section 131.

| Assessment category  | Criteria                       |
|----------------------|--------------------------------|
|                      | Facilitating practices         |
|                      | Custom and practice            |
|                      | Networks of vertical agreement |
| Conduct of customers | Search costs                   |

Other indicators about the conduct of consumers in the market would include disconnection numbers and complaint numbers.

In the AEMC submission to the MCE dated 19 July 2006, it also provides alternative suggested criteria (the **AEMC criteria**). The AEMC criteria are clearly broader than the MCE draft criteria and consider the following assessment categories: market definition, market structure, market conduct and market performance. These assessment categories (and the criteria) are likely to provide a more complete picture of the effectiveness of competition in energy markets. We broadly support the AEMC criteria, but and would like to comment on the following criteria which we believe are specifically missing from the MCE criteria.

The OFT and AEMC criteria raise a number of important features that are worth considering in the context of the Australian energy markets. The first of these is **market concentration**. While market shares are not conclusive indicators of a firm’s market power, it is generally accepted that, other things being equal, the larger the market share of a firm, the greater its market power is likely to be, particularly if its market share has persisted over a period of time and is relatively stable. This is particularly relevant to the Victorian energy market which has three incumbent retail providers that have generally maintained large, stable market shares. While new entrants have gained some market share in Victoria, market concentration should be a separate criterion by which the effectiveness of competition can be assessed.

Secondly, the OFT paper highlights the importance of **information asymmetries**. As stated by the OFT:

*Where customers are well informed, they can make efficient choices and their purchases will provide useful information to sellers about customers’ preferences. Sellers then have the incentive to provide the goods and services that customers most value. Without such information, the incentives to compete on price, quality and other terms are likely to be diminished.<sup>3</sup>*

While the Consultation Paper proposes that the ease of obtaining and comparing information is an indicator relevant to the criterion ‘the exercise of market choice by customers’, in our view, information asymmetries are so important in energy markets as to warrant its own criterion. Energy is an essential service necessary for all, including society’s most vulnerable. For an effective competitive market, all consumers, including the vulnerable, must have access to the information necessary to enable them to participate in the market. In particular, all consumers must be sufficiently cognisant of the fundamental terms and conditions of market contracting, including understanding pricing structures and contractual terms being offered in the market place. Furthermore, consumers need to be sufficiently informed of their options for redress should something go wrong. It is acknowledged that for many consumers, energy is a complex product. The difficulty consumers experience understanding what is being offered by an energy retailer should be a relevant criterion in assessing the effectiveness of competition.

Thirdly, the notion of **search** or **switching costs** has been under-emphasised in the Consultation Paper, and is limited to an indicator for the criterion ‘customer switching behaviour’. As stated by the OFT:

*For competition to work effectively, it is often necessary that customers are readily able to switch their patronage if a competing supplier is found to offer better value for money.*

<sup>3</sup> UK Office of Fair Trading, above n 1, p 32.

*Where customers face difficulties in switching between suppliers, whether because of the monetary costs, administrative hurdles or inconvenience, competition can be affected.*<sup>4</sup>

In energy markets which are newly opened up to competition, switching costs may be high and a significant inhibitor to effective competition. The current criterion ‘customer switching behaviour’ focuses primarily on switching or ‘churn’ rates. While high churn rates may be indicative of competitive behaviour, it will not be conclusive. In particular, without qualitative research into the experience of consumers who switch suppliers, churn rates alone may be misleading. Such research, obtained from customers directly, should consider:

- the types of deals taken up by customers who have switched (i.e. whether they have been given a ‘better’ deal);
- the numbers of consumers who switch back to their original retailers; and
- whether certain sales approaches (e.g. door-to-door sales) are generating switches, and if so why.

Relevant information from international experiences indicates that ‘churn rates’ alone may be misleading as to the state of competition in energy markets.<sup>5</sup> An additional criterion which considers the switching costs of consumers will help balance the focus of the current criterion and provide more rigorous information about the effectiveness of competition in energy markets.

### **C. Availability and quality of market data**

Information about the working of the energy market needs to be consistently collected over time. All NEM jurisdictions should aim to collect and analyse the same type of information to assist future market assessments by the AEMC.

It is our understanding that the market data collected from NEMMCO varies to some degree between jurisdictions. In Victoria, for example, NEMMCO has not to date recorded information about customers transferring from a deemed/standing offer to a market offer with their existing retailers. In South Australia, on the other hand, this information has been collected. In an Issues Paper released in 2003, the Essential Services Commission (ESC) argued that effective competition can be observed through “consumers switching between retailers, from market contracts being accepted with the existing (standing offer) retailer, active marketing by retailers and an absence of misleading or deceptive marketing by retailers”.<sup>6</sup> We are thus surprised (and concerned) to learn that the market data collected in Victoria three years later does not record consumers taking up a market offer with their existing retailer.

Furthermore, it is evident that customer transfer data does not distinguish between customers actively seeking and switching to a different type of contract and those who do so because they are moving home. As switching rates are supposed to indicate levels of customer awareness and response to market signals, their reliability as an indicator is compromised when the data does not distinguish between ‘active shopping’ by the customer and ‘passive transfers’ by energy consumers. By ‘passive transfers’ we mean consumers that do not demonstrate any awareness of choice (i.e. signs up with the dominant retailer in the area) or seek to compare offers. In order to avoid diluting the indicator, the counting of customer transfers that are not clearly prompted by market activity must be minimised. As customers moving homes make up a large and identifiable group of such potentially ‘passive transfers’ they should not be included in this data.

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<sup>4</sup> Ibid, p 33.

<sup>5</sup>; Timothy J Brennan, *Consumer preference not to choose: Methodological and policy implications*, Discussion Paper, Resources for the Future (2005); Kevin Jewell, *Manipulated, misled, ignored, abused: Residential consumer experience with electric deregulation in the United Kingdom*, Consumers Union Program for Economic Justice and Public Services International Research Unit, University of Greenwich (2003).

<sup>6</sup> ESC, ‘*Issues Paper – Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity*, (December 2003) p 11.

The reliability of the switching data has been an on-going concern amongst consumer representatives. CUAC, for example, made the following argument in its submission to the Essential Services Commission (ESC) in 2004:

*In its previous FRC Review, the ESC cited switching levels as a major indicator as to the effectiveness of competition in the retail market. In his press release of 23 December 2003, the Hon Theo Theophanus, Minister for Energy Industries and Energy cited switching levels at around 13% and 11% respectively for electricity and gas. The statistics cited have to be treated carefully, given that they refer not only to consumers switching from a market to a standing contract, but also to consumers who have moved residence and may have remained on the standing contract but with a different host retailer. As the CSPPA study notes, around 29% of Victorians moved residence between 1997-2000, and it is likely that much of the switching has been driven by that rather than as a conscious effort to enter the market.<sup>7</sup>*

It is clear from the ESC's Effectiveness of Full Retail Competition reviews in 2002 and 2004 that there is a lack of systematically collected market data available. The ESC sought to address the problem of distinguishing between 'active' and 'passive' transfers in their Survey of Domestic and Small Business Customers in 2004. Although we supported the ESC's approach to base its assessment on various types of information (from market data provided by NEMMCO and VENCORP to Retailer Survey to Customer Survey), we believe that enhanced on-going collection of market data would form a more robust basis for a reliable and comparable analysis.

#### **D. Performance over time**

We agree with the Consultation Paper that market performance must be assessed 'over time'. However, we recommend the MCE investigate and clarify exactly what type of market data it expects the AEMC to be able to retrieve to produce an analysis with sufficient historical data. We remain concerned that the market data available to the AEMC might be less consistent and comparable than assumed in the Consultation Paper.

The customer switching indicator effectively demonstrates why it is important to be able to read and analyse trends over time. The assumption that switching rates continue to climb as the market matures (i.e. years since introduction of FRC) is present in both ESC reports on the effectiveness of full retail competition,<sup>8</sup> however data from other jurisdictions demonstrates that switching rates both increase and decrease substantially over time.<sup>9</sup>

We believe accurate switching data overlapped with data on price variations would produce a much more interesting and valuable indicator. An indication of an effective market would be one in which a high level of price variation coincides with a high level of switching. Price variations without customer response (through switching) on the other hand should, if consistent over time, cause concern.

The ESC has recognised the problem with poor indicators in Victoria and is therefore:

*developing a framework to measure developments arising from competition in the retail energy sector. The indicators will enable monitoring of performance on an annual basis and*

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<sup>7</sup> CUAC submission to ESC's Full Retail Competition Review, February 2004. The 'CSPPA study' refers to a report by the Centre for Study of Privatisation and Public Accountability at Monash University, *Protecting Utility Consumers From Market Failure* (2004), which CUAC attached to its submission.

<sup>8</sup> See ESC, *Special Investigation: Review of the Effectiveness of Full Retail Competition for Electricity*, Final Report, (September 2002) p 58 and ESC, *Review of Effectiveness of Retail Competition and Consumer Safety Net in Gas and Electricity*, Final Report, (June 2004) p 70-72.

<sup>9</sup> See, for example, The Norwegian Water Resources and Energy Directorate, Supplier switching in the Norwegian end user market – 4<sup>th</sup> quarter 2005, available at: [http://www.nve.no/FileArchive/339/Supplier%20switching4%20\\_05.pdf](http://www.nve.no/FileArchive/339/Supplier%20switching4%20_05.pdf)

*assist in further reviews of the effectiveness of full retail competition. Consequently, future retail energy performance reports will be more comprehensive in monitoring the competitive market, particularly with respect to price and service offers.<sup>10</sup>*

We agree with the ESC that it is necessary to enhance the reporting framework in order to utilise market data when assessing the effectiveness of competition. However, this will not improve the data collected to date and we remain concerned that the MCE is overestimating the information available from historical market data. As the Consultation Paper (rightly) stresses the importance of the time dimension in a market assessment, we recommend the MCE investigate this issue prior to deciding on indicators of effective competition.

## **E. Classes of customers**

In assessing the effectiveness of competition, it is important for the AEMC to consider competition within various sub-markets, not only geographical, but also segmented by class of consumers. Such sub-markets may separate residential customers from small business customers (i.e. by energy usage). Within these sub-markets, vulnerable customers such as tenants, customers with low incomes or customers residing in rural and remote areas may have varying experiences with competition.

In the report jointly authored by the Consumer Law Centre Victoria and Monash University's Centre for Privatisation and Accountability, *Electricity Reform in Victoria: Outcomes for Consumers*, it was concluded that while reforms in Victorian energy markets, including the introduction of full retail contestability, has produced some significant benefits for consumers, these benefits have not accrued equally among consumers. Benefits have accrued to industry, commercial users and metropolitan customers while low-income and disadvantaged consumers (including rural and regional consumers) have seen mixed impacts from reforms. A market delivering unequal distribution of benefits may seriously impinge upon the effectiveness of competition.

The ESC, in its *Review of the Effectiveness of Retail Competition in Gas and Electricity*, was particularly interested in the experiences of different classes of consumers in the market place.<sup>11</sup> The ESC examined the attractiveness of various classes of customers to retailers by their consumption, by their energy type (whether they consumed both electricity and gas so as to be appropriate for dual fuel retail offers) and the experiences of low-income consumers, including concession card holders.<sup>12</sup>

In our view, any criteria for assessing the effectiveness of competition should specifically consider the experiences of a range of consumer groups in participating in the market.

The Consultation Paper recognises the issue of jurisdictional differences and states that:

*the AEMC will need to be cognisant of the differences which exist between jurisdictions, including but not limited to: jurisdictional market structures within the retail and energy markets more generally...<sup>13</sup>*

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<sup>10</sup> ESC, *Energy Retail Business Comparative Performance Report for 2004-05 Financial Year* (December 2005), p 22-23.

<sup>11</sup> ESC, *Review of Effectiveness of Retail Competition in Gas and Electricity – Public Draft Report*, (October 2004) p 32-3.

<sup>12</sup> The Report found that while competition increased, it was not fully effective for around 60 percent of residential and small business customers. Within that group, customer classes perceived to have low consumption, poor credit or subject to off-peak tariffs were unlikely to be targeted by retailers. Another class of consumers having difficulty accessing any benefits from competition were tenants. Consumers within low income metropolitan areas and regional centres were also unlikely to be offered market contracts.

<sup>13</sup> MCE SCO, *Phase out of Retail Price Regulation for Electricity and Natural Gas – Draft Effective Competition Criteria*, (July 2006) p 2.

We would argue that the AEMC also needs to be cognisant of geographic differences within a jurisdiction as well as geographic differences in general. As noted in previous reviews by the ESC, consumers in rural and regional Victoria attracted fewer offers than metropolitan customers.<sup>14</sup> Additionally, consumers without access to natural gas are naturally excluded from 'dual fuel' contracts which have become a popular product to offer by retailers. Furthermore, the lack of fuel substitution in many non-metropolitan areas impacts on the conduct and performance of the energy market in those areas.

It is difficult to draw the exact boundaries of a market but from a consumer perspective it would seem logical to start with the product suite and define the geographic area where they are available. As such, the Victorian energy market would have to comprise of at least one sub-market as a key product (gas) is not (and is unlikely ever to be) offered in certain areas.<sup>15</sup>

We thus recommend that the MCE directs the AEMC to consider geographic differences, both in terms of market structure and market conduct, when assessing the effectiveness of competition.

## F. Weighting of criteria

The MCE draft criteria are divided into input related indicators, which deal with market structure, and output/outcome related indicators, which deal with the outcomes of introducing competition in the market. Furthermore, the MCE states that '[i]n undertaking the effective competition assessment, the AEMC may place more weight upon indicators considered input related without compromising its holistic assessment'.<sup>16</sup>

We do not agree with this distinction or the proposal to put more weight on input related indicators. We support the AEMC when it states that what is required is

*an integrated assessment of the structure, conduct, performance and dynamic dimensions of the market .... 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.*<sup>17</sup>

We support flexibility in the application of the criteria by the AEMC and do not see any reason to focus primarily on the input related indicators. While the input related indicators may be easier to benchmark, drawing primarily upon qualitative analysis about the structure of the market (how many players, ownership structures, market shares, and so on), the outcome related indicators are also fundamental to a rigorous assessment of the effectiveness of competition in energy markets. The outcome related indicators largely require more qualitative, consumer-based research so as to provide robust indications of the existence of effective market competition. Such research is discussed in Part B of this submission and we think it incumbent on the AEMC, when analysing the effectiveness of competition, to undertake such research.

In our view, the MCE criteria should enable the AEMC to paint an accurate picture of the state of energy markets. This will sometimes require nuance by examining the interplay between the criteria, rather than a strict analysis of each criterion separately.

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<sup>14</sup> ESC, above n 11, p 92.

<sup>15</sup> We are aware of the argument that electricity and gas are not perfect substitutes and thus should be treated as two separate markets. However, as the two products have been bundled by retailers, it impacts on the market conduct and can thus not be ignored in an assessment of effective competition.

<sup>16</sup> MCE SCO, above n 12, p 6.

<sup>17</sup> AEMC, *Submission to MCE SCO on Draft Effective Competition Criteria*, (19 July 2006), p 2.

If you have any questions about the submission, please contact May Mauseth Johnston, CUAC Senior Policy Officer on 03 9639 7600 or Gerard Brody, CLCV Solicitor, on 03 9629 6300.

Yours sincerely

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