Phase Out of Retail Price Regulation for Electricity and Natural Gas
- Draft Effective Competition Criteria

Consultation Paper

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Draft Effective Competition Criteria

This paper considers the criteria and indicators to be utilised by the Australian Energy Market Commission (AEMC) for determining whether competition is effective in jurisdictional retail energy markets.

This paper develops the draft criteria for consultation with the AEMC/ERA and interested parties. The final criteria will be brought back to MCE for decision in late 2006.

(1) Background

The Australian Energy Market Agreement (AEMA) (clauses 14.10-14.16) sets out all parties' agreement on the phase out of retail price regulation for electricity and natural gas where effective competition can be demonstrated. The AEMA states that the AEMC will assess the effectiveness of competition for the purpose of retention, removal or reintroduction of retail energy price controls (clause 14.11(a)). The AEMA notes that the AEMC will publicly report on its assessments of effective competition in which it will provide advice to each jurisdiction. (clause 14.11(c)).

The AEMA states that the AEMC assessment will be conducted in accordance with criteria for assessing the effectiveness of competition, which will be developed by the MCE in consultation with the AEMC and other interested parties based on the principles/indicators set out in Annexure 3 of the AEMA. (clause 14.11(a)(i)).

The criteria outlined for the AEMC's assessments are broad indicators which are relevant in the assessment of effective competition within the retail energy industry. It is intended that the specific circumstances of jurisdictions would be factored into the AEMC's assessment.

In undertaking assessments of the effectiveness of competition, 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; and the form and the existence of regulatory instruments and mechanisms which operate within the jurisdiction, including those that relate to meeting social and equity objectives.

(2) Effective competition

The starting place for developing criteria and indicators is to consider what is meant by the term "effective competition".

An effectively competitive market is one in which the ability of market participants to exercise market power to the detriment of competition and consumers is constrained due to the actions of other market participants. In an effectively competitive market, one or more firms may possess some degree of market power, yet pose no significant risk to present or future competition. There is no universal benchmark against which effective competition can be demonstrated or assessed. It will require the AEMC to exercise judgement having regard to a number of factors and indicators and recognising the differences that exist between jurisdictions.

The Australian Competition Tribunal has defined competition in terms of a process of rivalry:

> *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 there should be*

independent rivalry in all dimensions of the price-product-service packages offered to consumers and customers.

…

Competition is a process rather than a situation. Nevertheless whether firms compete is very much a matter of the structure of the markets in which they operate. The elements of market structure which we would stress as needing to be scanned in any case are these:

(1) *the number and size distribution of independent sellers, especially the degree of concentration;*

(2) *the height of barriers to entry, that is the ease with which new firms may enter and secure a viable market;*

(3) *the extent to which the products of the industry are characterised by extreme product differentiation and sales promotion;*

(4) *the character of 'vertical relationships' with customers and with suppliers and the extent of vertical integration; and*

(5) *the nature of any formal, stable and fundamental arrangements between firms which restrict their ability to function as independent entities.* [1].

It is not expected that effective competition will emulate a perfectly competitive market, yet an effectively competitive market may be expected to exhibit some of the fundamental characteristics of perfect competition. When competitive conditions do not exist or are sufficiently weak, suppliers may be able to exercise market power. This can include extracting monopoly rent or operating inefficiently in terms of the cost of supply or the range and quality of services, without losing market share to rivals. An aspect of effective competition is the freedom of competitors to imitate and improve upon the processes and products of others.

(3) Assessment of effective competition – domestic and international context

It is recognised that an assessment of effective competition requires analysis of quantitative and qualitative matters. In order to satisfy itself that the relevant market being assessed exhibits effective competition, the AEMC will need to consider a range of indicators using quantitative and qualitative tools.

The AEMC's assessment of effective competition for the purpose of retention, removal or reintroduction of energy price controls will not be the first time that effective competition has been assessed within the energy market. A number of regulators have assessed the effectiveness of competition in retail markets, including Ofgem (the UK regulator), the Victorian economic regulator the Essential Services Commission in Victoria, IPART in NSW and the South Australian Regulator, ESCOSA. Furthermore, in 2001 the Productivity Commission assessed the effectiveness of competition in the context of the telecommunication industry.

In general, the same basic analytical framework has been used – this involved consideration of market structure, conduct and economic performance to examine issues of effective competition. The indicators proposed and outlined in Annexure 3 of the AEMA are largely based upon these principles.

To determine the extent of competition within the relevant retail market, an analysis of the structural features of the market, behaviour of the market participants and market outcomes that have resulted from these structural and behavioural characteristics is required. These matters vary between and within the retail industry in jurisdictions.

The Australian Competition and Consumer Commission (ACCC) Merger Guidelines[2] outline the ACCC assessment process for proposed mergers or acquisitions in accordance with section 50 of

[1] Queensland Cooperative Milling Association Ltd and Defence Holdings Ltd (1976), ATPR 40-112, at p 17 246, quoted in AAPT sub. 7, p. 5.

the *Trade Practices Act 1974*. These Guidelines could be usefully adapted by the AEMC to undertake its effectiveness of competition assessments. However, the screen tests and screen considerations outlined in the ACCC's Guidelines are not relevant to the AEMC's considerations.

In addition, competition without regulated caps has been in place in the UK and New Zealand electricity market for a period of time. Observations of outcomes in these markets may assist in considering the effectiveness of competition within the Australian context. Furthermore, observation of outcomes in other energy markets and non-energy markets may provide objective evidence on which to base the existence of effective competition. In comparing these markets, care will need to be given to the unique circumstances and market structures that exist within other domestic and international markets.

(4) Specification of the criteria and indicators

There are two issues of relevance in considering the form of the criteria to guide the AEMC's assessment of effective competition within the context of the retail energy market. These are discussed below.

- *Prescriptiveness of the criteria/indicators* –should the criteria developed specify in detail the form of the measures and thresholds to be used?

Prescriptive criteria may aid the AEMC in its assessment of the effectiveness of competition and may promote stability and certainty in the framework implemented by the AEMC. Prescriptive criteria may also provide some form of consistency in the measures and thresholds used.

However, a high level of prescription may reduce flexibility and may potentially limit the AEMC from adequately taking into account specific jurisdictional circumstances. Specific thresholds may differ between jurisdictions and between customer classes within jurisdictions. Therefore, materiality and suitability of thresholds will differ depending on the features of the market in question.

It is proposed that a high level set of criteria to guide the AEMC's assessment appears to be an appropriate approach. The detailed elaboration of how the high level principles could be applied may be addressed, where relevant, through guidelines developed by the AEMC in consultation with interested parties to allow stakeholder input into the process.

- *Weighting of criteria* – should the criteria specify the weightings attributable to each of the indicators specified?

There are generally three options:

Option 1 - place no weighting on the criteria/indicators specified

This option involves placing equal weighting on all the criteria/indicators specified. Placing no weighting on the criteria provides limited guidance to the AEMC on which matters are considered more relevant in assessing effective competition. Such an approach may elevate certain indicators, such as customer churn rates, over other market structure indicators. This could result in outcomes where the market structure criteria may indicate that effective

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[2] Australian Competition and Consumer Commission, *Merger Guidelines*, June 1999.

competition is not present but indicators such as churn rates may be high. It would be an undesirable outcome if churn rates are weighted higher or equally to market structure indicators in this circumstance.

On the other hand, placing equal weighting on all criteria will allow the AEMC to make a balanced and informed judgement based on the circumstances of the jurisdiction in question. Each assessment is likely to depend on market context and be a dynamic process, thereby limiting the ability to prescribe the importance of a particular indicator in all cases.

Option 2 - place weighting on all criteria/indicators specified

This option involves placing a weighting on all the criteria (i.e. if there were 10 indicators, placing a 1-10 weighting). This approach limits the AEMC's flexibility in considering the unique circumstances of the jurisdiction in question. Therefore, it may skew results in an inappropriate fashion and limit the AEMC's ability to conduct a balanced assessment.

Option 3 - weighting criteria/indicators based on classes of indicators (i.e. place more weight on input related indicators compared to outcome related indicators)

This option falls between the first two options outlined above. It provides guidance to the AEMC in assessing which classes of indicators are highly relevant in its assessment, yet provides sufficient flexibility in weighting indicators within a class to factor in the circumstances of the region in question.

There are merits in this approach. However, it would be important to ensure that such an approach does not compromise the AEMC's holistic and balanced assessment.

For the purposes of this option, the two proposed classes of indicators include input (market structure related) indicators and output (outcome related) indicators which deal with the outcomes of introducing competition in the market. While outcome related indicators assist in mapping the market and its characteristics, there is no clarity about what would adequately demonstrate what is "enough churn" or what is "the right price" or "enough offers", and there is no general agreement on the benchmark for these matters.

Input related indicators can inform views about the degree of market power possessed by incumbents and the degree to which this market power may be exercised on an ongoing basis to charge monopoly rents, excess prices or restrict entry. As such it appears appropriate to place more weight on input related indicators compared to output related indicators. However, as noted above, it is important that a holistic assessment, considering input and outcomes related indicators are considered.

(5) Proposed indicators and criteria

Australian Energy Market Agreement

The AEMA sets out six indicators upon which the MCE criteria is to be based. The six indicators set out in Annexure 3 of the AEMA are:

1. *Customer experiences* – for competition to be effective, customers must be aware of different retailers and perceive that they can make price comparisons – data complied from customer surveys.
2. *Customer switching* – transfer rates can indicate customer interest and activity in the competitive market – available from market data.

3. *Price and non-price offers* – evidence that suppliers are actively competing by offering innovative products that meet customer needs – complied from retailer surveys and 'mystery shopper' surveys.
4. *Entry and exit of suppliers* – number of competing suppliers and changes in the number of suppliers can indicate the degree of competition – available from market data.
5. *Market share* – market share and changes in market shares are an indicator of market structure and dynamics – available from market data.
6. *Barriers to entry* – the threat of new entry creates pressures to reduce prices and improve services – to be ascertained by analysis.

Proposed criteria

An assessment of the effectiveness of competition for the purposes of retention, removal or reintroduction of retail energy price controls, will require:

- A definition of the relevant market with reference to the product (including the nature of any substitute to the product), geographic, functional and time dimensions. In defining the relevant market, the AEMC may have regard to the classes of customers/consumers which exist within the relevant market.[3]
- an examination of the relevant market structure with reference to the number and market shares of competing suppliers, the technical and cost conditions of supply and the presence of barrier to entry. In assessing the structure of the relevant market, a "dynamic" assessment of the market performance over time, rather than a simple assessment of "market share" at a single point in time, is preferable;
- an assessment of the conduct of market participants within the relevant market including the degree of rivalry or innovation, and the impact of anticompetitive conduct. Consideration should be given to the impact of unilateral and coordinated exercise of market power; and
- an assessment of the performance of the market and impact on customer awareness and choice including differentiation of products and services.

In assessing these matters, the AEMC is to have regard to and take into account legislative or regulatory instruments/initiatives introduced or in place at the time of the assessment. Including but not limited to the types of schemes available, institutional arrangements such as ombudsman, and regulatory issues in the effectiveness of competition assessment.

In assessing whether competition is effective, the high level criteria have been classified into two classes of indicators:

- input related indicators, which deals with market structure; and
- output/outcome related indicators, which deal with the outcomes of introducing competition in the market.

In undertaking the effective competition assessment, the AEMC may place more weight upon indicators considered input related without compromising its holistic assessment.

[3] This provision is to ensure that the AEMC's assessment considers effective competition for customer classes, specific areas of the jurisdiction or a region more broadly.

In assessing these two classes, the AEMC may consider the matters outlined in table 1 and any other factors the AEMC considers relevant in its considerations[4]. In considering the matters outlined in table 1, the AEMC may:

- where relevant, consider outcomes in other markets where price caps have been removed (including international energy markets) as well as similar domestic markets where comparisons can be drawn; and
- use various quantitative and qualitative methods.

[4] The purpose of this provision is ensure that the proposed indictors outlined in Table 1 are not considered to be an exhaustive list of matters the AEMC is to consider. The criteria is to guide the AEMC in its assessment, and allow other factors that may arise during an assessment process which have a material impact on the assessment to be factored into the AEMC's considerations.

Table 1 Effective Competition Criteria

ASSESSMENT CATEGORY	CRITERIA	INDICATORS
Market structure	*Independent rivalry in the market*	The structure of the relevant markets with reference to the following factors: • Number and market shares of competing suppliers including the presence of large suppliers. • The degree of concentration (the extent to which a small number of players account for a large share of the market). • The technical and cost conditions of supply. • Number of competing consumers in the market. • Existence of economies of scale and scope. • Trends in market share and the extent of industry rivalry over time. A "dynamic" assessment of the market performance over time should be undertaken, rather than a simple assessment of "market share" at a single point in time.
Market structure	*Ability of suppliers to enter the market*	Patterns, including "market dynamic" considerations, of market entry and exit of suppliers and the existence of barriers to entry. In assessing this, the AEMC may have regard to the following factors: • Investment trends by new and incumbent firms. • History of entry and exit of retailers. • Existence of barriers to entry, including costs associated with entry or exit from the market and related regulatory arrangements. • The degree of vertical integration and the character of 'vertical relationships' with customers and with suppliers and the extent of vertical integration. • The ease with which new firms may enter and secure a viable market. • Incentive for supplier to enter the market having regard to "profit margin/headroom" • The nature of any formal, stable and fundamental arrangements between firms which restrict their ability to function as independent entities. • The general operation of the gas and electricity markets.
Market outcome	*The exercise of market choice by*	The conduct of market participants including the degree of innovation and the degree of active

	customers	exercise of market choice by consumers. The following matters may be considered: • Customer awareness of competition of choice and Full Retail Contestability. • Ease of obtaining and comparing information. • Extent and type of marketing activity. • Number of competing suppliers of which customers were aware. • Proportion of customers satisfied with the service they receive from their retailer. • The range and quality of services provided. • Anticompetitive or misleading behaviour including the impact of unilateral and coordinated exercise of market power.
Market outcome	*Differentiated products and services*	• Differentiated products and services that reflect innovations on the part of sellers in response to the preference of customers, and prices that reflect the efficient costs of those products and services. • Price and non-price offers – evidence that suppliers are actively competing by offering innovative products that meet customer needs. The AEMC will need to consider the type and range of products and services offered.
Market outcome	*Prices and profit margins*	• The AEMC is to assess the prices and profit margins of retailers over time by using annual reporting information. Such considerations would include an assessment of whether there could be sustained price increases over competitive levels.
Market outcome	*Customer switching behaviour*	Customer transfer rates including: • The extent of offers being sought and made. • The number of customers accepting market offers and/or switching retailers. • The costs incurred when switching and the time and requirements to switch from one service provider to another. • The degree to which these factors vary between region and customer type. • The degree to which this has changed over time becomes relevant.