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### **Draft Criteria for Assessing the Effectiveness of Competition**

The Energy Supply Association of Australia (esaa) is pleased to provide the following comments on the MCE Standing Committee of Officials' proposed criteria for assessing effective competition in retail energy markets. esaa is the peak industry body for the stationary energy sector in Australia. It represents the policy positions of the Chief Executives of more than 40 electricity and downstream gas businesses in Australia. Over 25% of these businesses are active in the retail sector for gas and electricity.

#### **Background**

The energy sector in Australia is characterised by a high degree of competition which has resulted from concerted National Competition Policy reforms. However, despite the considerable progress to date the persistence of distortionary price regulation continues to be a significant impediment to fully achieving efficient and competitive market outcomes. Retail price caps were considered by governments to be a necessary transitional measure to provide a safety net for consumers following the disaggregation of the electricity sector and the introduction of competition. To date no timeframe has been agreed within jurisdictions for the removal of price regulation despite an expectation among market participants that it was only intended to serve as a transitional measure.

#### **Role of Prices and Implications of their Regulation**

Prices play an essential role in any market by efficiently signalling both the need for consumers to change their consumption patterns in response to the supply situation and for producers to consider new capacity investment. Retail price caps blunt these important price signals and ultimately prevent efficient market outcomes. Price regulation prevents the development of flexible and innovative pricing structures that could achieve more effective responses from demand side participants. As highlighted in the Council of Australian Governments Energy Market Review, the risks for the supply of electricity in suppressing retail prices are also significant. Retailers are exposed to substantial risk in the wholesale market but, as a result of price caps, are unable to pass through additional costs to consumers. Retaining price regulation puts much needed investment in the energy sector at risk.

Maintaining price regulation can also result in a decrease in competition and prevent the market from achieving efficient outcomes. This is because market forces, not government mandate, most effectively determine the competitive price for energy. In competitive markets free from distortions consumers face the full cost of producing energy which ensures that they consume the socially optimum amount. Government intervention to set prices at a politically determined level, for instance to protect certain classes of energy user, can artificially keep energy prices low and as a result prevents retailers from recovering full costs and creates barriers to entry for new suppliers, thereby preventing the achievement of a fully competitive retail market.

In New South Wales for example, IPART has set retail price caps demonstrably below the cost of recovery for electricity retailers for a number of years. In its Final Report and Determination on Electricity Regulated Retail Tariffs in June 2004, IPART acknowledged that “the presence of under-recovering tariffs may undermine the development of a competitive retail market” and that the terms of its review were “to ensure (as far as practicable) that tariffs are at cost reflective levels by 2007, or an appropriate date, and that a smooth transition is provided for customers.”<sup>1</sup>

Other jurisdictions have frequently highlighted the desire to maintain price regulation in order to protect vulnerable customers. esaa acknowledges the need to support vulnerable, low income consumers, but agrees with the conclusion of the Productivity Commission that this objective is more effectively delivered “through adequate, well targeted and transparent community service obligations”<sup>2</sup> rather than through inefficient regulation that prevents efficient market outcomes and internalises government social policy costs on companies and shareholders.

esaa considers that there is no sufficient public policy reason for maintaining distortionary and inefficient price regulation. With competitive market structures and competition and consumer protection law already in place, price regulation can safely be removed with flow on benefits to competitive outcomes.

### **Competition in Retail Markets**

With a competitive electricity generation sector and price regulated electricity networks, the retail market is by nature competitive and notorious for its narrow margins. Barriers for new retailers looking to enter the market are low as entry does not entail significant infrastructure investment. This is confirmed by the strong emergence of new, often niche, retailers especially in Victoria and South Australia. Full Retail Contestability also ensures consumers have the right to choose their supplier and has been introduced for all customers in all regions of the NEM with the exception of small customers in Queensland (2007) and Tasmania (2010).

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<sup>1</sup> IPART (June 2004) NSW Electricity Regulated Retail Tariffs 2004/05 to 2006/07 – Final Report and Determination

<sup>2</sup> Productivity Commission Inquiry Report (Feb 2005) Review of National Competition Policy Reforms

The Australian Energy Market Agreement (AEMA) sets out the States and Territories' commitment to phase out retail price regulation where effective competition can be demonstrated and places the responsibility on the Australian Energy Market Commission (AEMC) to carry out an assessment of effective competition.

esaa strongly supports the removal of retail price regulation in energy markets but has some concerns about the approach adopted in the AEMA. In particular, esaa notes that even if an assessment identifies that effective competition is in place this will not automatically result in the removal of retail price regulation. The recent amended AEMA pronounces that "States and Territories retain the right to maintain price regulation powers, obligation to supply arrangements and price monitoring to protect consumer interests provided these do not materially impede competition."<sup>3</sup> Notwithstanding the fact that the decision to retain price regulation will ultimately be taken at the relevant State or Territory Minister's discretion, there is no explanation of what "materially impede competition" means and how it is to be evaluated nor what scope the AEMC has to take any action should price regulation/monitoring be found to be a material impediment.

The Association also asserts that the AEMA should not start from an inherent assumption that energy markets are uncompetitive and need to be proved otherwise. The assumption should instead be that markets are competitive and the focus should be on identifying the structural impediments, such as retail price regulation, which impact on competition and distort efficient market outcomes. esaa acknowledges that the AEMA has now been agreed to by the relevant jurisdictions but suggests that the proposed approach is unlikely to lead to a satisfactory outcome.

### **Proposed competition test**

Presuming that the generation sector is competitive and access to networks is on a non-discriminatory basis, esaa contends that it is actually the threat of new entry which acts as the overriding test of a competitive retail market. As long as barriers to entry are low such that new retailers are easily able to enter the market and contest the market share of incumbents, firms will be motivated to behave in a competitive manner and costs and prices will be maintained at efficient levels.

Any test for competition therefore must start by first identifying what material structural impediments exist to prevent new retailers entering the market (including the presence of government imposed retail price regulation), and put in place a clear and enforceable process for their removal.

#### *Prescriptiveness of the criteria and indicators*

In terms of prescriptiveness, esaa agrees with the statement in the consultation paper that "a high level of prescription may reduce flexibility and potentially limit AEMC from adequately taking into account specific jurisdictional circumstances". The preferred approach should be to confine the indicator set to a number of high level indicators which focus on identifying barriers to entry.

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<sup>3</sup> Ministerial Council on Energy (June 2006) Energy Market Reform Bulletin No. 64

### *Weighting of the criteria and indicators*

The Association supports the third option proposed regarding the weighting of criteria and agrees with the statement in the consultation paper that “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.”

More importantly, these measures are not in themselves barriers to entry, which is the overriding factor in determining competitive market behaviour.

For these reasons, the sole or substantial focus of the assessment should be on the input (market structure related) indicators related to barriers to entry. Little or no weight should be given to the proposed outcome indicators that are not necessarily indicative of a competitive market, as many are arbitrary and too subjective to be applied consistently and meaningfully.

### *Assessment of proposed efficient competition criteria and indicators*

The two most important indicators proposed in the consultation paper are contained within the section on the “ability of suppliers to enter the market”:

- Existence of barriers to entry, including costs associated with entry or exit from the market and related regulatory arrangements; and
- The ease with which new firms may enter and secure a viable market.

Effectively these indicators are the same, as the ease with which new firms enter a market is determined by barriers to entry, so a focus on the first indicator would be sufficient. As already highlighted, *esaa* contends that the existence of barriers to entry is the most important indicator of competition, and should be the overriding consideration in any assessment of effective competition in retail markets.

Regarding the other criteria listed in the draft, *esaa* suggests that, where the criteria indicate potential impediments to a competitive market, this should be seen as a reason to remove the impediment, not a reason to maintain price regulation which is likely in itself to impede competition.

Most of the criteria listed are not necessary conditions for a competitive market. For example, a market may have few sellers but provided their prices are set competitively and barriers to new entry are few, then a limited number of sellers, of itself, does not suggest a lack of competition. Similarly, lack of customer ‘churn’ might indicate a general satisfaction of consumers with their current suppliers, rather than a lack of suitable alternative options.

Several of the indicators suffer from a lack of clarity. For many it is not clear how the information will be collected or what would represent an acceptable outcome. For example, it is unclear how “the technical and cost conditions of supply” would be measured and applied in practice, or how this might in some way indicate the presence of competition in a market.

There also seems to be a large degree of overlap between some of the proposed indicators. Criteria which look at the degree of concentration, vertical integration, other arrangements between firms, and economies of scale and scope are all subsets of the broader question of market structure. These criteria indicate an implicit assumption that concentration and vertical integration are indicators of a lack of competition. Such activity allows the energy industry to establish its most efficient cost structure, and the scope for companies to engage in anti-competitive behaviour is limited by the presence of competition law.

In addition, some of the criteria are too broad to be measured or applied in any meaningful sense, for example “the general operation of the gas and electricity markets”.

Finally, indicators which are backward looking, such as “history of entry and exit of retailers” and “trends in market share and the extent of industry rivalry over time”, may be useful when considering the evolution of the market over time, but are of limited value when assessing the current level of competition in a market.

## **Conclusion**

ESAA believes that the presumption that energy markets are not competitive and that evidence should be provided to prove competition is effectively in place is misguided. The energy market reform process over the past fifteen years has established observable competition, with the only exception being where States and Territories have prevented it by deliberate legislative action.

It is the threat of new entry that ultimately determines whether firms act in a competitive manner, and this should be the overriding consideration when assessing the competitiveness of energy retail markets.

The focus of the market assessment should therefore be on identifying and removing impediments to new entry rather than seeking reasons to maintain a distortionary and inefficient practice such as retail price regulation. The AEMC test should be developed on this basis.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Brad Page', with a stylized, cursive script.

**Brad Page**  
Chief Executive Officer