

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

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## Executive Summary

Origin welcomes the MCE SCO's Consultation Paper *Phase out of Retail Price Regulation for Electricity and Natural Gas - Draft Effective Competition Criteria*.

Overall, we support the substance of the approach in the Consultation Paper, and we endorse Option 3, which is to weight, or prioritise, criteria/indicators based on whether they are input-related indicators or outcome-related indicators.

Based on this, and on an analysis of the criteria outlined by the SCO in its Consultation Paper, Origin has suggested a competition assessment decision-making framework that prioritises the range of data to be collected. This approach also incorporates the 'in principle' indicators under the Australian Energy Market Agreement.

This decision-making framework is based upon a view that the primary goal of a market assessment should be to evaluate whether there is market failure (caused by the market, not by existing regulation - 'regulatory failure' should be addressed separately). We suggest that market failure is where the market conditions allow for ongoing misuse of market power. This is likely to be enabled (and objectively observed) through the existence of barriers to entry. The absence of market failure means that the market is effective enough to regulate price efficiently without state intervention in price setting.

The second key element of the proposed approach is to differentiate between data that directly inform analysis of market failure and data that merely provide context. The ease of accessing objective information also needs to be assessed.

Based on the above, and a realistic assessment of the data sources generally available, Origin believes the primary indicators of effective competition in a defined retail energy market are as follows:

No evidence of sustained misuse of market power, as shown by:

- minimal or insignificant barriers to market participation for retailers; and
- minimal or insignificant barriers to market participation for customers.

The presence of customer participation reflects the fact that retail energy is seen as an essential service. It is also highly prioritised because more fundamental problems in the market are likely to be manifested as constraints on customers being able to access the market on what are generally held to be reasonable terms.

We suggest that these are the core matters to be assessed by the AEMC, with all other so-called indicators considered more as *data sources* than as indicators of an effective market per se.

Origin has included the full list of required data sources and what they might mean for both supply and demand in the market. A summarised version is shown in Table 1 on the following page. It is important to note that these data sources do not in themselves indicate the presence or otherwise of market failure, but should help the AEMC form a view about barriers to entry.

Table 1: Real or perceived barriers to participation: supply and demand data sources

		Possible interpretation
Retailers	Number and market shares of competing suppliers, including the presence of large suppliers.	To be understood as a result of the below.
	- <i>Customer level acquisitions through marketing and sales activity</i> : Extent and type of marketing activity, and the range of services provided.	General marketing activity and availability of contracts signifies an absence of market failure. Problems with marketing activity and contract availability likely to be manifested through customer elements below.
	- <i>Corporate changes, such as M&amp;A</i> : Existence of economies of scale and scope.	Helps inform an understanding of why the market structure is as it is.
	History of entry and exit of retailers.	Helps inform a dynamic view.
	Investment trends by new and incumbent firms.	Lack of solid investment might mean barriers to entry.
	Incentives for suppliers to enter the market having regard to sustainable retail margins.	Lack of desire to enter the market (in states with price regulation) for this reason might indicate a regulatory barrier.
	The technical and cost conditions of supply.	Relevant if some suppliers can control input costs for others.
Customers	Customer awareness of choice of energy retailer.	General awareness of choice is positive.
	Ease of obtaining meaningful information.	Incomprehensible information may act as a deterrent. A greater concern would be where information is not provided on request.
	Switching costs, including the time and requirements to switch.	Need to be scrutinised if there is perception they are used as barriers to transfer.
	Extent of offers being sought by customers, and corresponding retailer responses.	A significant lack of response by retailers to customers might indicate a problem.
	Number of customers accepting market offers and/or switching retailers, both as a result of unsolicited marketing activity and where customers have sought quotes.	If the numbers generally match requests for quotes and retailers' marketing expectations, the market is probably effective. A significant mismatch might indicate a problem.
	The degree to which these factors vary between region and customer type.	Key regions and customer types should be developed in consultation with the stakeholders in the relevant market.

## 1. Introduction

Origin is an energy retailer with over two million gas, electricity and LPG customers in Australia, and as such, is the second largest energy retailer in Australia. Origin is one of three incumbent, or 'host' retailers in Victoria, an incumbent gas supplier in South Australia and Queensland, and a second-tier retailer across all states with competitive retail energy markets. With this range of experience we believe we are well qualified to provide comment on issues related to retail energy in Australia.

Origin believes that as time progresses and the market develops, retail price regulation should be increasingly left to the market. The most important actions of government are to encourage the development of a competitive and sustainable market so that market forces can set efficient prices and protect consumers from price exploitation. In this context we note that regulators already have access to powerful statutory framework of anti-competitive conduct and unfair practice legislation.

With a national approach to retail and distribution market rules and to network pricing, there should be a national approach to the market itself and a commitment to the premise of the market, which is that it is there to *set prices and provide products that consumers want*. Any jurisdictional need to supplement this can be dealt with through jurisdictions' own CSO policies. There are always creative means for governments to achieve their social policy objectives that do not include direct interference in market price outcomes.

We are pleased to see the recent amendments to the Australian Energy Market Agreement (AEMA) which support this philosophy of relying on effective markets (rather than state regulation) to drive efficient consumer pricing, supplemented by transparent government CSOs to achieve relevant social objectives. In clearly distinguishing the issues of the removal of price regulation and achievement of social objectives, the AEMA represents a significant step forward that is strongly supported by Origin, and is a step that promises the optimal achievement of both objectives.

Clauses 14.10-14.16 of the AEMA sets out all parties' agreement on the phase out of retail price regulation for electricity and natural gas, and advises that the MCE will, in consultation with the AEMC and other stakeholders, develop criteria for assessing the effectiveness of competition. These are to be based on the following in-principle indicators:

1. Customer experiences
2. Customer switching
3. Price and non-price offers
4. Entry and exit of suppliers
5. Market share
6. Barriers to entry

The MCE SCO's Consultation Paper *Phase out of Retail Price Regulation for Electricity and Natural Gas - Draft Effective Competition Criteria* reflects the commencement of the MCE's consultation on the detail of the criteria underpinning these indicators.

We welcome this work programme of the SCO and are pleased to provide comment. Overall, we support the substance of the approach in the Consultation Paper, and have used the approach (under Option 3) to develop a framework for competition analysis.

Appendix A also includes Origin's commentary on the phase out of retail price regulation clauses of the AEMA.

## 2. Principles behind demonstrating effective competition

### 2.1 The need for a decision-making framework

The SCO has proposed a set of high level criteria to guide the AEMC's assessment, possibly supplemented by guidelines, which would be developed by the AEMC in consultation with interested parties.

Origin would certainly support an approach that provides the AEMC with clear guidance to the key objectives of its analysis, within which it can flexibly assess market circumstances. The key elements we would want to see addressed are discussed below.

#### *2.1.1 The need to prioritise data received*

The competition reviews carried out by jurisdictional regulators to this point in time have tended to be relatively ad hoc in their approach, with consultation asking open questions about a range of areas of the market and providing little or no discussion of how the various areas are prioritised and how inputs might be assessed. That is, there has been no apparent decision-making framework from which to interpret information and make decisions. Sometimes inputs might be categorised, but this is merely a labelling function; the relative weighting of one indicator against another is not stated, and no level of what might be 'adequate' activity on any one indicator is discussed. This approach therefore focuses on the information collection process itself, where stakeholder submissions and views are the sole resource.

This method of analysis increases the challenge for the market assessor, as there is no clear way to evaluate and trade off the (mostly predictable) variety of inputs and views received from stakeholders. For example, (and at the risk of being simplistic) how might any market assessor value the hypothetical market findings of 'low customer churn', 'insufficient marketing' and 'high customer awareness' to arrive at a robust view about the 'effectiveness of competition'? This will depend on the decision-maker's theoretical preconceptions about what constitutes an effective market, and their views on the day.

Overall, in past assessments there seems to be a lack of differentiation between information that is 'nice to have' and might be of help in certain circumstances if used in conjunction with other data, versus information that is a fundamental requirement, and which is likely to provide an unambiguous signal about the effectiveness of the market.

Origin believes that some indicators of an effective market *are* more meaningful than others, and should be prioritised accordingly, as discussed below. We are pleased to see the SCO address this matter, as the development of a meaningful framework for the evaluation of competition is paramount.

#### *2.1.2 Identifying the absence of market failure is easier than identifying success*

The recent development of retail markets and corresponding regulation in energy has been the opposite of most other sectors, in that in each jurisdiction retail energy price regulation has been present from market start, with competition needing to be demonstrably 'effective' (that is, seen to be 'working') for regulation to then be reduced. Other industries usually need to have serious market failure *before* regulation is then imposed, with the onus on policymakers or regulators to prove this failure before intervening.<sup>1</sup>

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<sup>1</sup> Indeed, the whole thrust of the general post-Hilmer reform process places the onus of proof on those who wish to regulate the market to clearly state the objective of the regulation, the 'harm'

We recognise the political and historical reasons why the approach to retail energy is different, but the fact is that the energy market's *presumption of failure*, with competition needing to be proved effective before governments can remove themselves from intervention in pricing, is not actually operationally meaningful or true to the premises of the market. 'Effective' market outcomes are impossible to define (and thus unambiguously observe) in practice, and even to define them in theory would presuppose that markets are static and predictable. The problems with focussing on outcomes are discussed in detail in Section 2.2 below.

Rather than looking for positive evidence of the outcomes of competition, the primary aim should be to identify any significant impediments to competition, where these may be linked to misuse of market power to make monopoly profits in some way. Misuse of this type of market power is the market failure which should prompt regulatory intervention, and already has legal precedent through the *Trade Practices Act 1974* and legal interpretation of the Competition Principles.

It would then be logical to allow the market to work by removing the impediments to competition, rather than intervening in the market to impose prices.

### *2.1.3 Understanding the effects of regulation on the market*

A further problem with the presumption of failure approach is the inherent difficulty it presents with separating the effect of regulatory intervention from the effect of the market alone, and the circular effect this can have on market assessments.

State price controls, if prices are set too low, can reflect a barrier to market participation for retailers; it is logical that if there is no profit potential, retailers will not seek to participate in the market. This has been a common issue across Australian jurisdictions, where some regulated prices to certain customer segments still do not even allow for basic cost recovery. Even where low margins do not stifle innovation across the board, price controls and interventionist approaches from regulators and governments to date have had a dampening effect on competition.

This relative lack of retailer participation can in turn be perceived by a competition assessor as a symptom of inadequate competition arising from an undeveloped market, where the market is then seen to require ongoing state price controls until it improves. The problem here is there may well have been no problem with the market per se and the need for state price controls has been misunderstood.

Fundamentally, a presumption of the need for state price regulation must be avoided, particularly where there is no evidence of this need. Making this presumption increases the risk of Type II regulatory errors (to regulate where state regulation is not warranted), and becomes a self-fulfilling prophecy where the resulting regulatory approach stifles competition. For example, if jurisdictional governments or regulators are waiting for competition in any one jurisdiction to significantly 'prove itself' through high churn rates before removing price controls, they may have created a vicious cycle (particularly if prices are set below cost of supply).

To summarise, we propose that there should be a clear theoretical framework that sets out concisely what the objective of a competition assessment is, in the sense of what can reasonably be expected to be observed by the assessor and how it demonstrates the 'effectiveness' of competition.

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that is to be addressed, the overall costs and benefits and, more specifically, the impact the regulation will have on the development of a competitive market.

We would suggest that the primary goal should be to evaluate whether there is market failure (caused by the market, not by existing regulation). The absence of market failure means that the market is effective enough to regulate price efficiently without state intervention in price setting.

The issue of any 'regulatory failure' arising from price controls and their negative effects on the market should be addressed separately, and clearly understood as not reflecting a failure of the market itself.

Building on this, we strongly suggest that a core principle for any development of FRC effectiveness indicators should be to have some understanding about what the results of any particular query are likely to tell us about the state of the market within the theoretical framework. There needs to be a way of differentiating 'nice to have' data that merely help contextualise the given situation, versus vital data that should demonstrate market failure (or the absence of market failure). The ease of accessing objective information also needs to be assessed.

## 2.2 Weighting of criteria: structure (input) versus outcomes

The SCO suggests three options relating to weighting FRC effectiveness criteria.

- Option 1 - place no weighting on the criteria/indicators specified.
- Option 2 - place weighting on all criteria/indicators specified.
- Option 3 - weighting criteria/indicators based on classes of indicators (i.e. place more weight on input related indicators compared to outcome related indicators).

As might be expected based on the previous argument, Origin strongly supports Option 3, where criteria/indicators are weighted according to classes of indicators, specifically whether they are input or outcome related. As the SCO notes, this will provide guidance to the AEMC in assessing which classes of indicators are highly relevant in its assessment, yet will provide sufficient flexibility in weighting indicators within a class to factor in the circumstances of the region in question.

Our further rationale for prioritising structure, or input related, indicators over outcome related indicators is explained below.

### 2.2.1 *The problem with identifying 'enough' competition*

In their reviews of competition, regulators have addressed, among other things, churn rates, pricing, customer awareness of retail brands, and the emergence of new tariff offerings. That is, they have asked questions about the outcomes of competition to that point. While this alone is not problematic, a problem arises when these factors are then apparently rated as equal in importance to other indicators of competition that are more input related (such as market structure).

As noted by SCO, while these outcome-related factors may be helpful in mapping the market and its characteristics, they are ultimately unhelpful as primary indicators of an effective market as *there is no clarity about what would adequately demonstrate an effective market*. There are no objective studies that demonstrate what is 'enough' churn, or what is the 'right' price or 'enough' offers, and there is no agreement in regulatory or academic circles about these matters even on general terms.

The competition evaluations of the Victorian Essential Service Commission and the UK regulator Ofgem show that even where competition has been decided to be effective, this decision is made 'on balance' and not a result of observing unambiguous indicators of competition. For example, to this point, no regulator has been able to identify what is a 'good' or 'efficient' price (or range of prices) and use this to determine how well

competition is working. Even if efficient prices are viewed as those that are close to cost inputs, regulators do not have access to true cost information in a dynamic environment. In any event, the presence of high profit does not itself reflect an ineffective market, or more particularly, that the remedy is price control. The issue is to show monopoly profits over a significant period of time.

Further to this, we have real concerns about regulators or policymakers continuing to believe that they *can* somehow determine the 'right' or efficient price for a good or service in place of market forces. Given that market prices are the most efficient because only the market can order all the necessary information, any price setting or estimation of 'efficient' prices by other means will naturally be inadequate. This approach also suggests that there is only one efficient price; however, there may be many efficient prices. For example, the efficient price for a long standing incumbent may be very different than the efficient price for a new entrant into the market.<sup>2</sup>

It should be recognised under the 'assessing for market failure' model suggested in Section 2.1.2, the ideal indicator would be outcome related, that is, there would be an assessment of whether a given market price reflects supernormal monopoly profits are being made (that is, the market has failed because it allowed for this situation). However, as can be seen from the preceding argument, the observation of (in)efficient prices is unlikely to be easy. This means that structural conditions need to be assessed as a priority, even if this is sometimes as a proxy for the fundamental issue, which is efficient pricing.

## 2.2.2 *The market is dynamic and unpredictable*

A further problem with using outcomes as key indicators of competition relates to the time-specific nature of this approach. Even if there was an agreed view on market outputs, real world outcomes by their nature are dynamic and uncertain, and thus cannot be predicted or assessed objectively in any long term sense. Markets drive innovation, where to innovate is to do something in a *new way*. Today's 'inadequate' churn level may well be tomorrow's high churn level as market conditions change and retailers innovate in their product offerings. Low customer churn only shows customers haven't felt the need to switch retailer yet; it does not of itself demonstrate inadequate competition.

Customer awareness of retailers is also time dependent. As a low engagement service, customer awareness of competing energy retailers will go up or down depending on such factors as the concentration of advertising at any point in time. Customer awareness will also naturally increase if prices rise to levels that are unsatisfactory - they will quickly seek out alternatives. In any case, brand awareness and promotion is only one factor in a complex mix of competitive marketing strategies that drive customer churn.

Assuming customers can actually change retailer, and competitive retail products are readily available, market forces swiftly assert themselves. All consumers need to know is that they can change retailer if they want to, and how to access the range of providers when they want to do so. To provide an example, most people probably cannot recall the names of the range of plumbing services available to them, but that does not mean that the market for plumbing needs regulation. It is commonly understood that if a person needs the service of a plumber they will know they have a choice and will access the range of options in the usual range of community and internet references.

It is unfortunate then if prices have been set by government for the next few years based upon a regulator's assessment that the market offers insufficient competitive offers, churn, or brand recall, based only on a brief period of time. Further, even a comprehensive

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<sup>2</sup> This distinction appears to be now recognised by the NSW Government and acknowledged by IPART in its recent deliberations about electricity retail price controls for 1 July 2007 - 30 June 2010. The efficient price could be higher or lower depending on such factors as billing systems and supply portfolio.

historical study will not be able to predict the future of the market.

These are indeed the reasons why markets are the preferred tool of many governments worldwide for resource allocation, with a market's efficiency due to it being the best means by which to order the ever changing range of complex information available (which is unknowable to any one entity).

We therefore suggest that the most meaningful indicators of competition are those related to market structure, particularly those that can inform a view about the degree of market power possessed by incumbents and specifically the degree to which this market power may be exercised in an ongoing way to charge monopoly rents or restrict entry.

### 2.2.3 *The principle of contestability, not observed competition*

It should be noted that the structural issues relate more to *contestability* than observed competition in itself. Needing to demonstrate actual competition, even through structural indicators, ends up looking suspiciously like an outcome based analysis, and the issues raised above of what is 'enough' of any one factor to prove competition arises again. For example, how many are 'enough' retailers? What does 'effective' competition actually look like even from a structural perspective?

It should be recognised, as the Courts have done in multiple test cases, that an effective competitive market does not necessarily require many sellers, merely the absence of demonstrable and ongoing market power. Highly concentrated markets can still be contestable if the structural features of the market, such as limited barriers to entry or exit, are in place. These limit the incumbent firm's ability to raise its price above competitive levels. The presence of potential competitors waiting to take advantage of any significant profits and unhappy customers is enough to keep incumbents attentive to pricing in a way that consumers find acceptable and mitigates misuse of market power.

This view has been supported by the frequently quoted Australian Trade Practices Tribunal (QCMA, 1976) observation: 'it is the threat of the entry of a new firm or a new plant into the market which operates as the ultimate regulator of competitive conduct'.<sup>3</sup> While retail energy markets are not perfectly contestable, as market entry and exit are not costless, there are still generally very few barriers to entry to a retail market with respect to traditional factors such as high upfront capital investment costs.

In summary, we believe the key matter is whether the market *structure* itself *provides for competition*, in particular the conditions for market entry. As noted, there is now a body of statutory law (e.g. s 46 of the TPA) and case law (e.g. Queensland Wire v BHP, Boral v ACCC) that define the requirements of a competitive market. These focus on market structure, and specifically, the presence or otherwise of barriers to entry.

Low retailer and customer participation do not demonstrate that forces are not present, or are not sufficiently capable of regulating prices. They may only mean that prices are not yet at the levels that encourage active market involvement by either competing retailers or disgruntled/eager consumers. This may well be a result of effective market forces.<sup>4</sup>

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<sup>3</sup> See Appendix B for the full reference, which also includes the quotation referenced by the SCO on page 3 of its Consultation Paper.

<sup>4</sup> It may also be the result of unsustainably low regulatory price setting, but the point here is that market structure issues are more important to contextualise and render meaningful any competitive 'outcomes' such as churn and offers available.

## 2.3 Defining the market

The SCO states that 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.*

Origin supports the need for a clear definition of the relevant market, and also endorses the development of a definition that has clear geographical, functional and time dimensions. However, we would strongly argue that stakeholders should be consulted with to arrive at a meaningful definition per market assessment, and in particular, to arrive at meaningful definitions of customer classes.

See Appendix A for further discussion on this issue as it relates to the AEMA.

## 2.4 The Structure, Conduct, Performance Model

The SCO also states that an assessment of the effectiveness of competition for the purposes of retention, removal or reintroduction of retail energy price controls, will require:

- *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.*

It is logical that the SCO would want to develop an overall framework for analysis, but we question the value of the 'structure, conduct, performance' model (SCP model) when combined with a weighting approach that favours inputs over outcomes.

While useful theoretically, categories of the SCP model are generally not well-defined and are somewhat artificial in a practical sense. Arguments can be circular about what drives different behaviour, and as a result the SCP model can categorise many indicators in multiple ways. This results in great confusion about what is actually a structural indicator versus a conduct or performance indicator. For example, the criterion of customer transfer rates can be seen to fit into any category, as follows:

- Customer transfer can be a **structural indicator**, as it shows the number of customers actively participating in the market. Given that the number of retailers participating in the market is generally seen as a structure indicator, it makes sense to have the other side of the supply-demand equation allocated to 'structure' as well.
- Customer transfer can be a **conduct indicator**, as churn is about customers' active behaviour in response to retailers' marketing behaviour. Retailers' marketing behaviour is generally seen as a conduct indicator.

- Customer transfer can be a **performance indicator**, as the overall outcome of the market is the price and what customers do in response to the market price. Transfer statistics are often quoted by regulators and governments as though they are the true evidence of a competitive market.

The act of categorising an indicator or criterion into one of the SCP model elements can thus be an extremely difficult process, and makes an already challenging task even more problematic. Given that the SCP model's value is only in categorisation and does not provide a decision-making framework, it would seem that for our purposes it is not particularly effective and merely absorbs effort better spent assessing what data collected *mean*.

Therefore, we suggest that while the basic elements of the SCP model might help contextualisation of the issues in a theoretical sense (as suggested by the SCO), it does not have a place in a more rigorous competition analysis. It certainly does not seem to add value to an approach that has already categorised FRC indicators into input or outcome.

### 3. The SCO's proposed indicators and criteria

As discussed in the previous section, the problem with most competition assessments in the past, both in Australian jurisdictions and overseas, is that there seems to be a lack of differentiation between information that is 'nice to have' and might be of help in certain circumstances if used with other data, versus information that is a fundamental requirement, and which is likely to be unambiguous. This is why we have suggested and supported the concept of a weighted, or prioritised, approach to competition assessments.

There is little point weighting or prioritising criteria, however, if the criteria themselves overlap across weightings or cover the same terrain even within weightings. Criteria used by the AEMC for retail energy market assessments should be as clear as possible, and not directly overlap.

Thus a higher set of principles seem warranted. As noted above, we strongly suggest that a core principle for any development of FRC effectiveness indicators should be to have some understanding about what the results of any particular query are likely to tell us about the state of the market. This in turn needs to sit within a theoretical framework that clearly sets out what might be seen as market failure and thus what is viewed as 'success' (that is, sufficient capacity for competition to negate the need for state price intervention). It will be a challenge to recognise an effective market if we have not established our expectations of what it may look like.

Thus answers to the following questions need to be understood:

1. What are the expected (observable) characteristics of an effective market?
2. How does the indicator in question demonstrate market effectiveness?
  - a. What data would demonstrate adequate competition that would show state price regulation to be unnecessary?
  - b. What data would demonstrate market failure?
  - c. How practical is the collection of the data? Are the data truly objectively observable?
3. How does this indicator interact with other indicators?
4. Are there secondary characteristics of this indicator that might assist assessment of data arising?

Some of these may be a little hard to answer definitively, but if there is no succinct way of showing an indicator can add value through this process, we suggest it is deleted, or perhaps delegated to being a secondary characteristic of another indicator.

Further, there is a need when answering these questions to be clear about the various possible interpretations of data. As noted earlier, state price intervention itself can create perceived or real barriers to retailers, which can then look like market failure. However, this is not a failure of the market, but of the state's intervention. There is thus a requirement to assess the effects of state price controls, separate from issues of market failure.

We have addressed the detail of the indicators provided in the Appendix to the SCO Consultation Paper according to this conceptual framework in Sections 3.1 (market structure) and 3.2 (market outcomes) below. Section 4 then outlines Origin's preferred approach based on this analysis.

### 3.1 Market structure indicators

#### 3.1.1 Independent rivalry in the market

The SCO has stated that independent rivalry in the market can be assessed 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.

Further, 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.

While many of these factors are useful to understand, it should be clear that market power in itself is not a bad thing. Problems arise when there is a non-transitional abuse or misuse of market power, such as the exploitation of the opportunity to make supernormal rents in a monopoly.

Therefore, while Origin agrees that these are relevant indicators, they do not necessarily point to any misuse of market power on their own. They are also difficult to identify; for example, what will be 'too much' supplier concentration?

Origin also agrees that all assessments of this nature must be dynamic, but this raises the questions of:

- over what period of time is the market assessed;
- how frequently is the 'pulse of the market' taken over this time; and
- how are the data aggregated to form a holistic view?

Overall most of these indicators would seem to be supplementary indicators or data sources, to be used to map the market and assist in the interpretation of the primary indicators. Detailed assessment of the indicators underpinning the assessment of independent rivalry in the market is provided in Table 2 below.

**Table 2: Independent rivalry in the market - competitive indicators**

INDICATORS	ORIGIN VIEW
Number and market shares of competing suppliers including the presence of large suppliers.	This is useful information but does not in itself indicate a problem. Even with the extreme example of only one supplier in the market, a market may still be efficient or 'effective'. The issue is contestability, where as long as other suppliers can enter the market and erode the incumbent's market share when prices rise high enough, there is no need for state price regulation.
The degree of concentration (the extent to which a small number of players account for a large share of the market).	This would appear to be a subset (or replication) of the previous indicator.
The technical and cost conditions of supply.	Potentially useful but requires clarification. Does this relate to the costs of competing in the market? This would be useful if the issue came up that there were barriers to entry that were argued to be because certain firms could affect input costs to advantage their own business. However, given this is not an industry that relies heavily on

INDICATORS	
	specific knowledge or infrastructure, this would seem unlikely. Suggest this is either deleted or clarified so there is clear guidance about what effort AEMC is expected to go to in ascertaining these costs, and under what circumstances it does this.
Number of competing consumers in the market.	It depends what this means. If it is a statement about the potential population who can choose, it is not an indicator of anything as such, it is merely a fact. If this refers to the numbers of customers actively choosing a retailer (whether the incumbent or to transfer), this is the same as the output indicator below 'The number of customers accepting market offers and/or switching retailers.' Suggest delete this indicator, or shift into a general statement to the AEMC that it must cover basic 'facts' in its reporting such as the population statistics for a particular market or sub-market. One might expect the assessor of the market to do this anyway.
Existence of economies of scale and scope.	Useful to understand how the market has evolved, however this does not in itself demonstrate whether competition is effective. Suggest it is a possible secondary characteristic of understanding an efficient market structure.
Trends in market share and the extent of industry rivalry over time.	Useful as a secondary characteristic only - helps establish the dynamic perspective.

### 3.1.2 Ability of suppliers to enter the market

This criterion captures patterns of market entry and exit of suppliers and the existence of barriers to entry.

In assessing this, the SCO has suggested 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.

Origin believes that this is the key group of indicators, and of these the primary indicators of effective competition (or otherwise) in the retail energy market are as follows:

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

Even so, the second of these is essentially another version of the first. Some of the other criteria are also a little concerning without there being some explanation of their purpose. Detailed assessment of the indicators underpinning assessment of ability of suppliers to enter the market is provided in Table 3 below.

Table 3: Ability of suppliers to enter the market - competitive indicators

Investment trends by new and incumbent firms.	Interesting in terms of mapping the market, but not of primary importance. A lack of solid investment might require an assessment of real or perceived barriers to entry. Suggest as a secondary characteristic of barriers to entry.
History of entry and exit of retailers.	Interesting in terms of mapping the market, but not of primary importance. The history of a market does not in any way determine its future. The history should be used solely to help inform a dynamic view of other important indicators. Suggest as a secondary characteristic of barriers to entry.
Existence of barriers to entry, including costs associated with entry or exit from the market and related regulatory arrangements.	The primary indicator that should be used to assess the effectiveness of the market.
The degree of vertical integration and the character of 'vertical relationships' with customers and with suppliers and the extent of vertical integration.	This is a similar indicator to the 'existence of economies of scale and scope' in the previous section, and we would agree it is thus redundant.  If the point of differentiation is to imply that vertical integration is undesirable, we would argue this is incorrect. In fact, vertical integration is a natural outcome of the environment leading to greater efficiencies, which ultimately leads to better outcomes for consumers in the form of: least cost energy prices; appropriate levels of investment in energy infrastructure; and reliability and security of energy supply. <sup>5</sup>
The ease with which new firms may enter and secure a viable market.	This is a key indicator, but is in fact a duplicate of the barriers to entry criterion. Barriers to entry will obviously impact the ease of new firms entering the market. If the point of the indicator is a 'viable' market, we suggest this is difficult to assess, and not actually the role of the AEMC to assess in any event. Businesses make decisions that may not be commercially wise (e.g. entering a market where there is no viable business if the operating strategy is at all inefficient) but this does not in itself point to a failure in the market.
Incentive for supplier to enter the market having regard to 'profit margin/headroom'.	We suggest a better term for this is 'sustainable retail margin'. While interesting, the absence of a sustainable retail margin is not in itself a sign of ineffective competition. If anything, where there are no barriers to entry, it shows that the market is keeping prices at their most efficient. In any event, the nature of the costs that define the margin and the question of what is 'enough' retail margin are both deeply subjective and statements about costs/margin will vary according to the particular business and its business/profit goals and the nature of its operating costs.  As intimated above, the only other reason there could be insufficient retail margin would be because there is price regulation - which should not be a feature of a competitive market. If this is raised as a problem then the issue is the perceived barrier - price regulation - which should then be addressed and preferably removed. Suggest this is either deleted or used as a secondary potential characteristic of identifying market barriers (although not technically a barrier to entry) where they are government/regulatory barriers.
The nature of any formal, stable and fundamental arrangements between firms which restrict their ability to function as independent entities.	This needs clarification. This appears to be a subset of the indicators above. Arrangements are only a problem if they present a barrier to entry. Suggest this is either deleted or used as a secondary potential characteristic of identifying market barriers.

<sup>5</sup> See Bushnell, J. B.; Mansur, E. T.; and Saravia, C. (2006) *Vertical Arrangements, Market Structure, and Competition: An Analysis of Restructured U.S. Electricity Markets*, Yale University, June, [http://www.som.yale.edu/faculty/etm7/papers/bushnell\\_mansur\\_saravia\\_3markets.pdf](http://www.som.yale.edu/faculty/etm7/papers/bushnell_mansur_saravia_3markets.pdf).

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The general operation of the gas and electricity markets.	Unless there is an un-stated point to this it seems somewhat redundant. Any assessment of competition will surely assess the general operation of the market as a result of using the range of other indicators. Suggest delete, or build into overall principle that sets out AEMC take a 'holistic view'.

### 3.2 Market outcome indicators

#### 3.2.1 *The exercise of market choice by customers*

This criterion addresses the conduct of market participants, including the degree of innovation and the degree of active exercise of market choice by consumers. SCO has suggested 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.

The above reflects a combination of fundamental information and secondary characteristics that are not actually indicators of competition. The key issues are:

- Customer awareness of competition of choice and Full Retail Contestability.
- Ease of obtaining meaningful information (this has been modified).
- Anticompetitive or misleading behaviour including the impact of unilateral and coordinated exercise of market power.

Detailed assessment of the indicators is provided in Table 4 below.

**Table 4: The exercise of market choice by customers - competitive indicators**

Customer awareness of competition of choice and Full Retail Contestability.	This is fundamental information that shows customers' capacity to engage with the market.
Ease of obtaining and comparing information.	The issue is more about obtaining information than it is in comparing information. The ease of obtaining information is more important. The ease of comparison is more a secondary characteristic, where it may be that the difficulty of comparison (if there is one) means that obtaining the <i>necessary</i> information to make a choice is not possible. The key issue here is to determine (a) what information customers deem necessary to exercise choice in this market, and (b) if they can access this information.
Extent and type of marketing activity.	Useful to map the market but it does not signify a problem with competition if there is little marketing activity. The issue also arises about what is 'enough' marketing activity. This indicator falls into the same category as how many retailers are in the market and it has significant overlaps with the range and quality of services provided, as discussed below.
Number of competing suppliers of which customers were aware.	This is misleading as an indicator. It is not efficient for customers of a low involvement service like energy to remember the range of retailers they <i>could</i> choose from if they ever decide to switch. The issue is if the customers (a) know they have a choice (that is, there is more than one retailer), and (b) know then how to access the

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	information they need to make that choice. Consider a range of other services - surely it would not be expected that the average person could list the range of plumbers they might use if they ever needed one, or even to know how many plumbers are out there.
Proportion of customers satisfied with the service they receive from their retailer.	This would not seem to be an indicator of competition in any sense. Satisfaction may arise because they have exercised choice, it may arise because they have not had to bother with making a proactive choice (that is, the customer has made a passive choice to stay with the incumbent on a deemed/standing contract). A dissatisfied customer today might be a satisfied one tomorrow if they have transferred to a different retailer. This is a useful indicator only where it has already been found that people (a) aren't switching and (b) don't know they can, or how. Where they are dissatisfied in these circumstances this would lead us to perhaps say there are problems with the market. It is therefore merely a secondary characteristic.
The range and quality of services provided.	Useful to map options only. The presence of limited offers does not, in itself show a problem with competition. This is the same as the issue above with limited suppliers. As long as there is capacity for more to be offered there is no need to regulate the market. Further, 'quality' is difficult to assess and any attempt at assessment ends up making this indicator the same as the previous indicator relating to customer satisfaction.
Anticompetitive or misleading behaviour including the impact of unilateral and coordinated exercise of market power.	This is the fundamental aspect of the entire competition assessment process. The presence of unilateral and coordinated exercise of market power would then need to be assessed to see if it is temporary (and thus will decline as others enter the market) or a more permanent or significant feature which requires regulatory intervention.

### 3.2.2 Differentiated products and services

SCO has suggested the following indicators:

- 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.

These indicators seem to be versions of one another, as the key point seems to be 'innovation to meet customer needs as reflected in a range of products and services, whether this is through pricing or non-price aspects'.

Even if the indicators are merged into one statement as above, the aspect of the products being 'in response to the preference of customers' will be almost impossible to determine. All retailers would argue their products have been developed to meet customer needs and preferences. This concept can be captured differently, as discussed in Section 4.

The issue of efficient price will also be impossible to determine and begs the question of efficiency from what perspective. Unless the AEMC plans to audit all internal company costs and compare internal service procurement strategies to determine each retailer's efficiency in their business, this will be impossible. (As noted in Section 2.2, we would argue it would be impossible even in those circumstances.) This is the point of the market - it alone determines efficient prices. All that can be known is that the market is, or is not, able to provide for these efficient outcomes.

These indicators also have significant overlap with other indicators. For example, the presence of differentiated products is much the same as the 'range of products and services' covered above in Table 4. For this reason we would suggest these specific indicators are redundant and should be deleted.

### 3.2.3 *Prices and profit margins*

The SCO has suggested that 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.

We believe that the profit margins of retailers will be difficult to determine for several reasons, the major reason being the increasing complexity of business structures, outsourcing, and use of third party providers (e.g. for billing). For example, the Victorian Essential Services Commission faced difficulty in its recent network price determination in exposing true costs and returns. These issues also faced the South Australian Essential Services Commission and the New South Wales Independent Pricing and Regulatory Tribunal in their most recent retail price determinations. For example, IPART was unable to establish with any confidence that all retailers undertook comparable cost to serve analyses. Establishing a consistent framework for accurate reporting on hedging books would be even more problematic.

More importantly, and as discussed in Section 2.2, we are not sure how the AEMC is to determine what a competitive price level would be in the (potential) absence of competition. Even if it did, and found prices to be 'above competitive levels', the issue is surely that they need to be *significantly* higher, and for a *significant* period of time. The presence of high profit does not itself reflect an ineffective market.

The only real means of assessing whether there could be sustained price increases over competitive levels - and which might be significant enough of concern - would be to assess whether market conditions provide for this, that is, the above arguments about structure.

### 3.2.4 *Customer switching behaviour*

The SCO has suggested customer transfer rates would be assessed, 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.

We believe these are useful indicators to map the market, but if transfers are low this does not mean that competition is necessarily ineffective.

Costs occurred when switching may be useful, as will be time requirements. If these are used as barriers to transfer they will need to be scrutinised. We would argue that this is in fact also a structure issue, but structure in the sense of how the demand side can participate in the market.

In Section 4, Origin synthesises this analysis into a suggested decision-making framework.

## 4. Origin's preferred approach

This section brings together the commentary from previous sections to outline Origin's preferred approach to the evaluation of market effectiveness.

### 4.1 Defining the objective

The first issue is to define what we would see as an effective market. As the SCO notes on page 2 of the Consultation Paper:

*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.*

While Origin agrees with these statements, we would suggest that this can be conceptually tightened a little. As noted in Section 2.1.2, it is easier to define an effective market by what it is *not*. An effective market for the purposes of the AEMA requirements is one that does not exhibit characteristics of market failure, thus it does not require ongoing state price regulation.

The next issue is to define market failure. Market failure is where the market conditions allow for ongoing<sup>6</sup> anticompetitive behaviour arising from the misuse of market power, which would generally be behaviour in pursuit of monopoly profits. This is likely to be enabled through the creation of barriers to entry. Further, this behaviour is also likely to be best *observed* through the presence of barriers to entry. Given the problems with accessing reliable and objective 'outcome' based information (such as finding the 'efficient' price), structural conditions such as barriers of entry are the most practical means of observing misuse of market power.

Supporting this, we note the SCO quotes the Australian Competition Tribunal<sup>7</sup> at page 3 of the Consultation Paper and replicates the Tribunal's list of market structure elements to be addressed in an assessment of market conditions. The next statements made by the Tribunal that are not reflected in the SCO paper are as follows:<sup>8</sup>

*Of all these elements of market structure, no doubt the most important is (2), the condition of entry. For it is the ease with which firms may enter which establishes the possibilities of market concentration over time; and it is the threat of the entry of a new firm or a new plant into a market which operates as the ultimate regulator of competitive conduct.*

Thus the conditions of entry provide the key information about the effectiveness of the market. Barriers to entry can indicate market failure, or alternatively, the absence of structural barriers to entry show that a market is probably effective.

A final issue is whether there are other matters that might impact market effectiveness. Origin believes that real or perceived barriers to market entry might result from existing regulatory arrangements, including where prices set unsustainably low by the state. This has been addressed separately as it does not generally qualify as a supply-side barrier that enables misuse of market power.

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<sup>6</sup> Market failure that warrants regulatory intervention is non-temporary by definition.

<sup>7</sup> From Australian Trade Practices Tribunal (now the Australian Competition Tribunal) in *Re Queensland Co-operative Milling Association Ltd; Re Defiance Holdings Ltd* (OCMA) (1976) 25 FLR 169.

<sup>8</sup> The full quote and preceding statements are replicated at Appendix B of this document.

The presence of market failure characteristics would indicate a need to assess and modify the market regulatory arrangements, whether this is to increase intervention where there is actual market failure, or decrease intervention to respond to a situation where regulated prices are too low.

## 4.2 The primary indicators of effective competition

Having established:

- an effective market is one with no market failure,
- market failure is where there is sustained misuse of market power, and
- sustained misuse of market power is generally made possible, and is generally only directly observable, through the presence of barriers to entry,

it is clear that the key indicator of effective competition is the absence of barriers to entry.

Given the nature of energy as an essential service, it would perhaps make sense to extend this to an absence of barriers to market participation on the customer side as well. Another reason why customer access should be highly prioritised is because more fundamental problems in the market are likely to be manifested as constraints on customers being able to access the market on what are generally held to be reasonable terms.

Indicators of effective competition in a defined retail energy market are thus:

No evidence of sustained misuse of market power, as shown by:

- minimal or insignificant barriers to market participation for retailers; and
- minimal or insignificant barriers to market participation for customers.

These are the core matters, with all other data sources used to inform a view of any observed barriers to entry as the misuse of market power.

## 4.3 Required data sources

While not seeking to limit the AEMC, the following data sources should be used as a minimum to inform the market assessment. It is important to note that these data sources do not in themselves indicate the presence or otherwise of market failure, but should help the AEMC form a view.

In each case we have provided further information about how data might be interpreted, and generally tried to capture more ephemeral matters (such as customer needs being met) through the market through what can be directly observed.

An easy conceptual approach that assists practical assessment of data is to further view an effective market as one that generally shows clear links between supply and demand, where activity on the demand side should stimulate the supply side, and vice versa. Significant activity<sup>9</sup> on one side that is not matched to some degree by activity on the other within a reasonable timeframe might signify a more serious problem with the market.<sup>10</sup>

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<sup>9</sup> Activity is defined here as customers requesting quotes and entering contracts and retailers providing quotes and contracts.

<sup>10</sup> This still depends on the circumstances. If customers were seeking contracts and generally not receiving responses from retailers, the market might have failed. However, while it would not be efficient or useful for retailers to offer 20 products when customers only want 2 products, this would probably be a temporary situation and not require regulatory intervention.

*Retail data sources - Looking for significant barriers to market participation for retailers:*

- **Number and market shares of competing suppliers, including the presence of large suppliers.** To be understood as a result of:
  - Customer level acquisitions through marketing and sales activity
    - **Extent and type of marketing activity, and the range of services provided.** It might be expected that general marketing activity and availability of contracts would signify an absence of market failure.<sup>11</sup> Problems with marketing activity and contract availability likely to be manifested through customer data below.
  - Corporate changes, such as mergers and acquisitions
    - **Existence of economies of scale and scope,** which will help inform an understanding of why the market structure is as it is.
- **History of entry and exit of retailers,** which can be used to help inform a dynamic view of real or perceived barriers to entry.
- **Investment trends by new and incumbent firms,** where a lack of solid investment might require an assessment of real or perceived barriers to entry.
- **Incentives for suppliers to enter the market having regard to sustainable retail margin,** where a lack of desire to enter the market for this reason might indicate a regulatory barrier (in states with price regulation).
- **The technical and cost conditions of supply,** which may help inform a view about barriers to entry if they are seen to be present.

*Customer data sources - Looking for significant barriers to market participation for customers, or a class of customers:*

- **Customer awareness of choice of energy retailer.** General awareness of choice would indicate customers are able to investigate further if they want to change retailer. Also a result of marketing and promotional activity, which in turn is a result of retailers' freedom to enter the market.
- **Ease of obtaining meaningful information,** where statements from customers that it is not easy will need further investigation. Incomprehensible information may act as a deterrent to customer involvement. A greater concern would be where information is not provided on request, which shows a de-linking of demand and supply drivers.
- **Switching costs,** including the time and requirements to switch from one service provider to another - if these are used as barriers to transfer they will need to be scrutinised.
- **The extent of offers being sought by customers and responses by retailers to requests.** A significant lack of response by retailers to customers in general or within specific customer classes might indicate a form of market failure (once again, a de-linking of demand and supply drivers).
- **The number of customers accepting market offers and/or switching retailers,** both as a result of unsolicited marketing activity and where customers have sought quotes. If the numbers generally match requests for quotes and retailers' marketing

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<sup>11</sup> Diversity of contracts might also indicate positive market effects, but we would caution against focussing too heavily on innovation without it being based on fact or precedent. The truth is that residential energy contracts do not tend to lend themselves to high degrees of innovation potential, and customers have not generally sought out offers that do much more than provide a basic energy service, or perhaps with a green component.

expectations the market is probably effective. A significant mismatch might indicate a problem.

- **The degree to which these factors vary between region and customer type,** where the key regions and customer types should be developed in consultation with the stakeholders in the relevant market. See Appendix A for the difficulties in targeting customers based on generally held conceptions about financial hardship.

Data on all the above should be collected over a six month period, with weekly assessments where this is relevant and practicable. This should thus commence at least six months prior to the end of an existing state regulatory arrangement, such as a price path.

Longer term trends should be assessed where this information is already available.

This approach is consistent with the six indicators stated in the AEMA and covers all key points made in that document.

## Appendix A: Comments on the AEMA

Origin would like to comment on two issues within the AEMA:

- jurisdictional powers and rationale for retention of price controls: this will affect jurisdictions' interpretation of the AEMA; and
- principles of remaining price regulation that Origin recommends should also be added to the AEMA.

### Jurisdictional powers

Origin notes that under section 14.4 of the AEMA, jurisdictions have agreed that phase out of the exercise of retail price regulation:

*(b) may involve a period of price monitoring and/or price agreements with retailers under appropriate oversight arrangements; and*  
*(c) does not prevent the exercise of a reserve price regulation power by the State or Territory where effective competition for categories of users ceases, provided that the power is only exercised in accordance with a regulatory methodology promulgated by the AEMC, and is subject to review by the AEMC of the effectiveness of competition.*

While Origin understands the likely rationale for the inclusion of these provisions in the AEMA, we seek clarification about how these clauses might be used in practice.

In particular, we ask the AEMC to be prepared to critically assess any arguments that might be made for the retention of price regulation to protect certain customer groups. The SCO has already highlighted the requirement for AEMC to evaluate customer experience by customer class.

The customer group that assessors of competition are often specifically asked to look at is those people who have difficulty paying their energy bills (for a range of reasons, but generally linked to low income). These are the 'hardship' or 'vulnerable' customers.<sup>12</sup> The political perception of the circumstances of this group, and what might happen if price regulation is removed, is generally behind the political decisions to retain price regulation. We note recent Ministerial media statements that support this view.<sup>13</sup>

Origin does not disagree with a potential need for a specific assessment of the effect of the market on customers who may be subject to financial hardship. Further, if there is found to be market failure according to the criteria outlined in this submission, ongoing regulation

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<sup>12</sup> The term 'hardship customer' is used frequently by those in the industry to denote those who are already within retailers' financial hardship processes or schemes (such as those in receipt of a Victorian Utility Relief Grant), or those who are mistakenly disconnected for reasons of non-payment. However, this definition is inadequate if we recognise that some customers may not have been captured by retailers' hardship schemes *or* have been disconnected for non-payment, but still might require assistance. These people may be currently experiencing financial hardship but are not (yet) recognised by the retailer as requiring assistance or disconnection, or they may have managed the current level of payment but would not be able to afford any price increase.

Thus the argument needs to recognise the *potential* for 'hardship' cases to be increased through either making a previously invisible group visible through changed work practices, or through creating new hardship cases through price increases. It is this group of customers that has been generally understood as those who are 'vulnerable', meaning they are more vulnerable than the norm to having problems with the affordability of their bills. However, defining this group in any operational sense is problematic. See Origin's submission to the Victorian Inquiry into Financial Hardship of Energy Consumers for a further discussion, at [http://www.doi.vic.gov.au/doi/doielect.nsf/2a6bd98dee287482ca256915001cff0c/db551bfa14e31633ca257030000c8860/\\$FILE/Origin%20Energy.pdf](http://www.doi.vic.gov.au/doi/doielect.nsf/2a6bd98dee287482ca256915001cff0c/db551bfa14e31633ca257030000c8860/$FILE/Origin%20Energy.pdf).

<sup>13</sup> See Bildstien, C. (2006) 'Scrapping price caps 'silliness'', *Adelaide Advertiser*, Business Journal, 22<sup>nd</sup> August, page 38.

may well be warranted. However, it needs to be clear: the market as 'effective' for this group is unrelated to whether market prices available to them are *affordable*. Efficient prices from effective markets do not guarantee affordability for all people irrespective of their financial outlook. This is where government and community support are important as a supplementary measure to the market. Government social programmes, community and industry initiatives have evolved considerably in recent years, and can be depended upon to provide the necessary support to those in hardship.

In advance of this becoming an issue under the AEMC's competition assessment we would like to have the following noted:

- The issue of the causes of financial hardship must be separated from the issue of retail competition. Retailers have always been faced with the problem of how to reveal the differences between customers who cannot pay and customers who will not pay, and how to deal appropriately with customers experiencing problems with affordability of energy use. This has nothing to do with competition.

There has also been no evidence to date that retail competition exacerbates customers' experiences of hardship. In fact, in Victoria the disconnection rates and assistance for customers in hardship have improved significantly since competitive reforms (and privatisation) were carried out.

- There has been no evidence to date to support an argument that any customer group will be left out of the market based on socio-economic characteristics. As found by ESC in Victoria and ESCOSA in South Australia, customers of all types are being offered and are taking up market contracts. There are also no apparent data to support the argument that customers are being disadvantaged through inappropriate contractual terms and conditions.

Further, this group is essentially unable to be defined and targeted effectively in an objective, or systems focussed, way. This means retailers could not leave 'vulnerable' customers out of the market or seek to disadvantage them *even if they wanted to*.

- The physical differences in geography between country and city customers is sometimes referred to when making arguments about the need for protections and subsidies, and is sometimes merged with the issue of financial hardship. However, any difference in city and country prices is a regulated network issue and not related to retail. Unlike the telecommunications and water industries, where the sale and the transportation of the service are combined, in energy the retail and network functions are separate. Energy retail services are not physical functions in any way, which means the only locational difference in prices arise from the pass-through of a network service provider, which in most cases is a separate company and is regulated by the state under a different regime.
- Finally, there should be greater focus on who ultimately has responsibility for customers in financial hardship. The primary responsibilities lie with the customers themselves (to manage budgets and advise retailers if they need support) and government/social welfare agencies (to provide financial and other assistance). Most retailers have hardship policies in effect, and provide assistance where this is possible, but retailers cannot be responsible for directly subsidising the energy accounts of customers who simply do not have enough money.

The fact remains that customers who the government wants to support can still be supported, as a matter of social policy delivered by government agencies. This has nothing to do with competition. If there are customers who need direct financial assistance outside of the extensions of time to pay or payment plans that can be

provided by retailers, this is the responsibility of government. This has also been provided for through CSO arrangement clauses in the AEMA.

While Origin welcomes AEMA Clause 14.11 (b) which states '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', we hope that the issue of support mechanisms for those in financial hardship (where the market is effective) is fully captured by this clause and does not become entangled in the methodology for competition assessments.

### **Principles underpinning remaining price regulation**

It is expected that an interim process will be required for the jurisdictions where full retail competition is not yet established (such as Queensland). It would also be used in the unlikely event that ongoing price controls are required in the states with retail markets that are generally held to be effective (such as Victoria).

We suggest that the regulatory approach to any remaining retail price regulation should also be based upon clear and agreed national pricing principles, similar in concept (if not in detail) to the pricing principles currently in Part IIIA of the TPA,<sup>14</sup> or in line with high level principles set out in the proposed amendments to Part IIIA, the Competition Principles Agreement (CPA) and the National Gas Law.

The importance of setting out consistent pricing principles in a regulated energy industry has been well documented with respect to distribution and transmission pricing. Origin sees no reason why regulated retail prices should not be similarly determined within a set of relevant, nationally agreed pricing principles.

The proposed principles that need to be applied to decisions about price regulation are shown in Figure 1 on the following page.

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<sup>14</sup> Part IIIA allows recovery of efficient costs and return on investment 'commensurate with the regulatory and commercial risks involved'.

**Figure 1: Principles for effective retail price regulation**

1. **Competition** is the preferred overall means of regulating the retail energy market. Any price regulation deemed necessary must support longer term evolution of the market toward cost-reflective tariffs, and perhaps provide retail margin to facilitate competition and innovation.  
  
We suggest that the state should bear the burden of proof to demonstrate how its decisions to continue with price regulation will promote the process of competition - regulators are already required under competition law to produce Regulatory Impact Statements that address the impact of their regulation on competition.
2. **Consistency** in approach across jurisdictions is vital. There should be a presumption of a national approach, with exceptions only to be managed by jurisdictions. Approaches should also be aligned with the rest of energy industry, such as appeals mechanisms and cost allocation (see principles 6 and 7).
3. **Cost recovery** must be provided for in tariffs, both across customer segments and within customer segments, thus eliminating cross-subsidies. Prices should also allow for a reasonable commercial margin to the retailer. For example, in a triangular relationship:  
  
*Final Price = Network [tariff pass through + retailer's cost of administration] + Retailer [costs + reasonable margin]*
4. **Competitive neutrality** principles must be upheld. The objective of competitive neutrality is to ensure government business activities do not have competitive advantages or disadvantages relative to their privately owned competitors simply as a result of their government ownership.
5. Regulation must be **'light-handed'** in the sense of not representing high regulatory or compliance costs.
6. **Accounting separation** should be monitored and enforced so retail businesses cannot be subsidised by their distribution arms (where these are present).
7. **Appeals processes** should be in place, where this is relevant.

These principles are neither new nor radical. They reflect principles that have been espoused in one form or another in multiple reviews of the energy industry over the last ten years of National Competition Policy. In Origin's view, they are essential if retail pricing (which drives customer behaviour) is to be aligned with the national reform agenda.

Regulatory approaches that follow these principles will enhance investment and innovation in the relevant market, as they will reduce market participants' perceptions of sovereign or regulatory risk. The forms of price regulation chosen are less of a concern while these principles are upheld.

Any necessary CSO agreements would then be negotiated between jurisdictions and energy businesses on a commercial basis.

## Appendix B: The Nature of Competition

From Australian Trade Practices Tribunal (now the Australian Competition Tribunal) in *Re Queensland Co-operative Milling Association Ltd; Re Defiance Holdings Ltd* (QCMA) (1976) 25 FLR 169.

Competition may be valued for many reasons as serving economic, social and political goals. But in identifying the existence of competition in particular industries or markets, we must focus upon its economic role as a device for controlling the disposition of society's resources. Thus we think of competition as a mechanism for discovery of market information and for enforcement of business decisions in the light of this information. It is a mechanism for firms discovering the kinds of goods and services the community wants and the manner in which these may be supplied in the cheapest possible way. Prices and profits are the signals which register the play of these forces of demand and supply. At the same time, competition is a mechanism of enforcement; firms disregard these signals at their peril, being fully aware that there are other firms, either currently in existence or as yet unborn, which would be only too willing to encroach upon their market share and ultimately supplant them.

This does not mean that we view competition as a series of passive, mechanical responses to 'impersonal market forces'. There is of course a creative role for firms in devising the new product, the new technology, the more effective service or improved cost efficiency. And there are opportunities and rewards as well as punishments. Competition is a dynamic process; but that process is generated by market pressure from alternative sources of supply and the desire to keep ahead.

As was said by the U.S. Attorney-General's National Committee to Study the Antitrust Laws in its Report in 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 choose its level of profits by giving less and charging more. Where there is workable competition, rival sellers, whether existing competitors or new potential entrants into the field, would keep this power in check by offering or threatening to offer effective inducements....'

Or again, as is often said in U.S. antitrust cases, the antithesis of competition is undue market power, in the sense of the power to raise price and exclude entry. That power may or may not be exercised. Rather, where there is significant market power the firm (or group of firms acting in concert) is sufficiently free from market pressures to 'administer' its own production and selling policies at its discretion. Firms may be public spirited in their motivation; but if their business conduct is not subject to severe market constraints this is not competition. In such a case there is substituted the values, incentives and penalties of management for the values, incentives and penalties of the market place.

Competition expresses itself as rivalrous market behaviour. In the course of these proceedings, two rather different emphases were placed upon the most useful form such rivalry can take. On the one hand it was put to us that price competition is the most valuable and desirable form of competition. On the other hand it was said that if there is rivalry in other dimensions of business conduct - in service, in technology, in quality and consistency of product - an absence of price competition need not be of great concern.

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.

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 market 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.

Of all these elements of market structure, no doubt the most important is (2), the condition of entry. For it is the ease with which firms may enter which establishes the possibilities of market concentration over time; and it is the threat of the entry of a new firm or a new plant into a market which operates as the ultimate regulator of competitive conduct.