



Australian Energy Market Commission

**Review of the Effectiveness of Competition in
Electricity and Gas Retail Markets in South
Australia**

Issues Paper

14 March 2008

Commissioners

Tamblyn
Carver
Woodward

Inquiries

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

E: aemc@aemc.gov.au

T: (02) 8296 7800

F: (02) 8296 7899

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About the AEMC

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy markets. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market. It is a statutory authority. Our key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council as requested, or on AEMC initiative.

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Abbreviations and Glossary

AEMC	see Commission
COAG	Council of Australian Governments
Commission	Australian Energy Market Commission
Electricity Act	<i>Electricity Act 1996 (SA)</i>
ESCOSA	Essential Services Commission of South Australia
FRC	Full retail competition
Gas Act	<i>Gas Act 1997 (SA)</i>
MCE	Ministerial Council on Energy
MWh	Megawatt hours
NEL	National Electricity Law
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company
NERA	NERA Economic Consulting
Ofgem	Office of Gas and Electricity Markets (UK)
Rules	National Electricity Rules
Statement of Approach	<i>Review of the Effectiveness of Competition in Gas and Electricity Retail Markets – Statement of Approach (April 2007)</i>
TPA	Trade Practices Act 1974 (Commonwealth)
TJ	Terajoules
Victorian Review	Review of the Effectiveness of Competition in Gas and Electricity Retail Markets in Victoria

Executive Summary

The Australian Energy Market Commission (Commission), in accordance with the terms of the Australian Energy Market Agreement (AEMA) and the request for advice from the Ministerial Council on Energy (MCE), is reviewing whether competition in electricity and gas retailing in South Australia is effective (South Australian Review). If competition is found to be effective, the Commission is required to provide advice to the MCE on ways to phase out retail price regulation. Where competition is found not to be effective, the Commission's advice is required to identify ways to develop competition.

Full retail competition (FRC) was introduced in South Australia in January 2003 for electricity customers and, in practical terms, in July 2004 for gas customers. The objective of FRC is to deliver efficient prices and services to energy customers and the opportunity for customers to exercise choice among competing retailers and their price and service offerings. Rivalry between retailers and the exercise of choice by customers maintains competitive pressure on retailers to manage their input costs effectively, to offer more cost-reflective prices and to improve and diversify the retail services they offer in order to better meet the preferences of customers.

Where competition is effective in promoting efficient prices and services, there is generally no need for price regulation. Regulation is costly, in terms of both administration and compliance costs and possible distortions to competitive market processes. It is only justified where markets are not effectively competitive, regulation can improve market outcomes and the benefits of regulation exceed the costs.^a This view is reflected in clause 14.11(a) of the AEMA, which requires jurisdictions to phase out retail price regulation where competition is determined to be effective.

The publication of the Issues Paper marks the formal commencement of the South Australian Review. The findings made and the advice given during the South Australian Review and the reviews to be conducted in each of the other jurisdictions will have a direct influence on policy decision making for the regulatory frameworks that will apply to electricity and gas retailing in the future. The Commission is required to finalise the South Australian Review by 31 December 2008.

Input from stakeholders is vital to ensure that the Commission's assessment of the effectiveness of competition is robust. In this regard, the Commission is seeking informed comment, supported by evidence, from stakeholders about the effectiveness of retail competition in South Australia. The Commission is also inviting detailed submissions on a number of issues that it considers are important to address. In particular, the Commission is seeking specific comment in relation to the following matters:

^a This is not to say, however, that other regulatory frameworks are not required in order to overcome other market failures and thereby support competitive market processes and outcomes, e.g. prudential regulation and consumer protection provisions.

- Are there features of the South Australian electricity or gas retailing environments that have a bearing on the development of competition? For example, are there barriers facing potential new retailers that affect their decision to enter the market? Are there barriers facing existing retailers who intend to expand their retail business that affect their ability to do so?
- Are retailers competing vigorously to acquire new customers and retain existing customers? For example, are retailers seeking to differentiate their product and service offerings in an effort to produce at least cost the products that customers want and value most? Do retailers respond to changes in consumer taste by offering new, different and better products in a timely manner? What marketing strategies are retailers using to communicate and engage with customers?
- Are customers participating in the competitive market? For example, are customers prepared to switch retailers or not, and what are the reasons behind their choice? Are customers able to make an informed choice to switch energy retailer or enter into a market contract, or are there obstacles to customers effectively participating in the competitive market? Is there sufficient information available to customers about their options and is this information easily accessible and able to be understood? Is the information conveyed by retailers through their marketing activities accurate or are some retailers engaging in mis-selling practices?
- Are the price outcomes and service offerings consistent with what may be expected in an effectively competitive market? For example, are the market contract prices reflective of the efficient cost of supply and are the offers made to customers consistent with their needs and expectations?
- What roles do retail price regulation and the associated energy-specific safety net arrangements currently play in assisting energy customers and what impact have they had on competitive market outcomes?
- Are the benefits of full retail competition equally accessible by all classes of customers, or are there some customers who face more limited opportunities to participate in the competitive market? For example, are there customers who, because of personal or social circumstances, or as the result of the structure of the market, do not have the same opportunity to access competitive energy offers as other customers?

Submissions made in response to the Issues Paper will be an important input to the Commission’s analysis during the South Australian Review. To assist stakeholders in the preparation of submissions, Chapter 3 of the Issues Paper expressly identifies a series of “Issues for comment”. These issues focus on specific matters which the Commission invites stakeholders to address in submissions.

The Commission notes that interested parties may wish to raise other matters that may be relevant to the South Australian Review, for example, the Commission’s approach to public consultation or its framework for analysis. The Commission encourages interested parties to address these matters in submissions made in response to the Issues Paper.

Given the important contribution that the South Australian Review will make to the debate about the future of energy policy, the Commission encourages all interested parties to make submissions to the Issues Paper and to participate in the opportunities for public consultation. Informed contributions from stakeholders will assist in ensuring that the Commission's findings and advice concerning the future of retail price regulation are informed by stakeholder views and experience, relevant factual market information and rigorous, evidence-based analysis.

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1 Introduction

1.1 Purpose of the Issues Paper

The purpose of the Issues Paper is to invite and obtain informed observations from stakeholders and other interested parties about the experience of competition in electricity and gas retailing in South Australia. In particular, the Australian Energy Market Commission (Commission) wishes to obtain information that will further its understanding of:

- changes in the nature and extent of competition that have occurred since the introduction of full retail competition (FRC), particularly the experience of residential and small business customers of FRC to date;
- the current competitive environment for electricity and gas retailing; and
- the likely effectiveness of competition in electricity and gas retailing in South Australia in the future.

To assist stakeholders, the Issues Paper sets out specific matters that the Commission is interested to receive submissions on. However, it is not the Commission's intention to limit submissions to issues directly raised in the Issues Paper. Accordingly, interested parties are encouraged to raise other issues they consider relevant to the conduct of the South Australian Review.

1.2 Lodging submissions

The Commission invites written submissions from interested parties in response to the Issues Paper by **5pm, Friday 11 April 2008**. Submissions may be sent electronically or by mail in accordance with the following requirements.

Lodging a submission electronically

- The submissions must be sent by email to submissions@aemc.gov.au.
- The email must contain the phrase "SA Retail Review - Response to Issues Paper" in the subject line or heading.
- The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.
- If submitted on behalf of an organisation, the submission must be in PDF format.
- The submission must also be forwarded to the Commission via ordinary mail.

Upon receipt of the electronic version of the submission, the Commission will issue a confirmation email. If this confirmation email is not received within 3 business days, it is the submitter's responsibility to ensure successful delivery of the submission has occurred.

Lodging a submission by mail

- The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.
- The submission should be sent by ordinary mail to:

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

- The envelope must be clearly marked "SA Retail Review - Response to Issues Paper".

Except in circumstances where the submission has also been submitted electronically, upon receipt of the hardcopy submission the Commission will issue a confirmation letter. If this confirmation letter is not received within 3 business days, it is the submitter's responsibility to ensure successful delivery of the submission has occurred.

The Commission intends to publish all submissions it receives on its website, subject to any claims for confidentiality. The Commission's approach to confidentiality is set out in Chapter 4 of the Issues Paper and further at 4.4 of the Statement of Approach.

In order that the South Australian Review can be completed by December 2008 (as required by the MCE), the Commission is subject to strict deadlines. Accordingly, the Commission will have full regard to all submissions lodged within the specified time period but regrets that it may not be able to afford late submissions the same level of consideration. To ensure it is able to fully consider all submissions, the Commission strongly urges interested parties to provide their submissions by 11 April 2008.

1.3 Structure of the Issues Paper

The remainder of the Issues Paper is structured as follows:

- **Chapter 2** summarises the policy and legislative framework that underpins the South Australian Review and the reviews to be undertaken in the other jurisdictions;
- **Chapter 3** identifies the specific matters the Commission invites stakeholders to comment on in written submissions;
- **Chapter 4** sets out the timetable for the South Australian Review and the process for public consultation, and outlines the Commission's approach to confidentiality;
- **Appendix A** contains the Request for Advice from the MCE;
- **Appendix B** reproduces clauses 14.10-14.16 of the AEMA; and

- **Appendix C** provides background information about electricity and gas retailing in South Australia.

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2 Framework for the Review

This chapter summarises the policy and legislative framework that underpins the South Australian Review, and sets out four key questions that the Commission must answer in conducting the Review.

2.1 Policy and legislative framework

The ongoing energy market reforms continue to introduce important changes to the structure and operation of Australian energy markets. The commitment of the Commonwealth and the States and Territories to these reforms is reflected in the terms of the AEMA. One of the commitments made by each of the signatories is to review the effectiveness of competition in the retail markets for electricity and gas for the purpose of retaining, removing or reintroducing retail price regulation.¹

The AEMA requires the Commission to review and publicly report on the effectiveness of competition in the retail energy markets of the jurisdictions that are signatories to the AEMA. Where competition is found to be effective, the Commission is to provide advice on ways to phase out retail price regulation. Where competition is found not to be effective, the Commission's advice must suggest ways to improve competition.

On 19 April 2007, the MCE advised the Commission that the reviews would be conducted sequentially. The MCE confirmed that the first jurisdiction to be reviewed would be Victoria in 2007, followed by South Australia in 2008.² The Commission completed its review of Victoria (Victorian Review) on 29 February 2008. The South Australian Review formally commences with the publication of this Issues Paper.

In conducting each review, the Commission is required to follow the framework provided for in clauses 14.10 to 14.16 of the AEMA. This requires, amongst other things, the Commission to base its assessment of the effectiveness of competition on criteria developed by the MCE in consultation with the Commission and other interested parties (MCE criteria).³ The MCE criteria are:

- independent rivalry within the market;
- the ability of suppliers to enter the market;
- the exercise of market choice by customers;
- differentiated products and services;
- price and profit margins; and

¹ Clause 14.11(a), AEMA.

² Letter dated 19 April 2007 from the Chair of the MCE, the Hon Ian Macfarlane MP to the Chairman of the Australian Energy Market Commission, John Tamblyn.

³ Clause 14.11(a)(i), AEMA.

- customer switching behaviour.

On 13 December 2007, the MCE formally requested the Commission to provide advice on the state of competition in, and retail price oversight for, electricity and natural gas retailing in South Australia (Request for Advice). Consistent with the AEMA, the Request for Advice requires the Commission to apply the MCE criteria in providing its advice. The Request for Advice is reproduced at Appendix A.

The Request for Advice also requires the Commission to use the methodology and approach detailed in Parts 2 and 3 of the Statement of Approach.⁴ The Statement of Approach outlines the Commission's approach to conducting the retail reviews, including the method of applying the MCE criteria and the Commission's consultation process.

The Request for Advice requires that the South Australian Review focus on "small customers"; that is, customers who consume less than 160MWh of electricity per annum or less than 1TJ of gas per annum. Accordingly, the Commission's role in the South Australian Review is to assess and publicly report on whether competition is effective for small customers and, based on this assessment, provide advice to the MCE about the future of retail price regulation in South Australia.

2.2 Matters to be addressed by the Commission

In providing its advice to the MCE, the Commission is required to address four key questions. These questions, which substantially reflect the obligations contained in the AEMA and the Request for Advice, are:

- Is competition in electricity retailing to small customers in South Australia effective?
- Is competition in natural gas retailing to small customers in South Australia effective?
- If competition in electricity and/or gas retailing is effective for some or all small customers, how should retail price regulation be removed?
- If competition in electricity and/or gas retailing is not effective for some small customers, how can the growth of effective competition be promoted for those customers?

The first two questions go directly to the Commission's assessment of the effectiveness of retail competition, and will be answered in the first phase of the South Australian Review. The last two questions will be answered during the second and final stage of the Review when the Commission provides its advice to the MCE about the future of retail price regulation in South Australia. The advice the

⁴ The Statement of Approach can be downloaded from the Commission's website at www.aemc.gov.au.

Commission provides to the MCE will be based on the Commission's assessment of the effectiveness of retail competition.

As noted in Chapter 1, the Commission encourages stakeholders to respond to these questions in submissions.

2.3 What is effective competition?

The central notion underpinning the South Australian Review is the concept of competition and the circumstances in which competition is considered to be effective. The Commission's views about what constitutes "effective competition" are set out in detail in Chapter 2 of the Statement of Approach, however, for the ease of stakeholders, this section includes a summary of the Commission's views.

Competition is a process of rivalry between sellers to win the business of customers (or between buyers to obtain supplies). Businesses supplying in competitive markets attempt to improve their offers to consumers – in terms of prices, products and service delivery – relative to other sellers in the market. Competition implies independence of action and the absence of collusion or coordination between suppliers. Each supplier is constrained in its price and output decisions by the market activity and competitive responses of rival businesses. The exercise of informed customer choice among competing suppliers and their products and services also constrains the behaviour of their competitors as they strive to retain customer patronage and increase their share of the total number of customers. In these ways, effective competition ensures that the price mechanism works effectively to allocate resources in accordance with consumer preferences. Resources move freely in response to price signals, both between and within markets, and no supplier or group of suppliers is able to raise prices, restrict output and earn sustainable excess profits.

By constraining businesses and directing resources in this way, competition promotes economic efficiency.⁵ Competition encourages businesses to produce at least cost the goods and services that consumers want and value most, and to respond to changes in consumer tastes by offering new, different or better goods and services in a timely manner.⁶

Where competition is effective in promoting economic efficiency, there is generally no need for price regulation. Regulation is costly, in terms of both administration and compliance costs and possible distortions to competitive market processes. It is only justified where markets are not effectively competitive, there is evidence that regulation can improve market outcomes and the benefits of regulation exceed the costs. This view is reflected in clause 14.11(a) of the AEMA, which requires jurisdictions to phase out retail price regulation where competition is determined to

⁵ The Hilmer Committee observed "[the] promotion of effective competition and the protection of the competitive process are generally consistent with maximising economic efficiency": Hilmer Committee, *National Competition Policy: Report by the Independent Committee of Inquiry*, August 1993, pp. 4-5.

⁶ Economists often refer to these as allocative, cost and dynamic efficiencies.

be effective. This is not to say, however, that other regulatory frameworks are not required in order to overcome other market failures and thereby support competitive market processes and outcomes, e.g. prudential regulation and consumer protection provisions.

In the Statement of Approach, the Commission observed that different levels of competition may exist within a single market over time as it evolves and moves toward a perfectly competitive market. Figure 2.1 below illustrates the movement of a market away from, at one extreme, a monopoly towards, at the other extreme, a perfectly competitive market.

Figure 2.1 Progression of competition



Monopoly → Oligopoly → Monopolistic competition → Perfect competition

Source: AEMC, *Review of the Effectiveness of Competition the Gas and Electricity Retail Markets – Statement of Approach*, April 2007, p. 6.

There is no single point that, once reached, signals that a market is effectively (or workably) competitive. It is therefore extremely difficult to develop a set of criteria that, if satisfied, will give rise to an uncontroversial finding that a market is effectively competitive. Rather, there will exist different combinations of the structural conditions and the behavioural and performance-based characteristics which may, in combination, correspond to the existence of effective competition. While economic models of competition establish certain abstract formal conditions that underpin efficient market outcomes and these models can help inform our understanding of real world markets, the Commission's approach to evaluating effective (or workable) competition draws on the approach adopted in relation to the development and application of competition law and policy. That is, for any given market, an assessment of whether competition is effective will be a fact-based exercise, which assesses all of the relevant structural, behavioural and performance characteristics and their interaction.

In evaluating the effectiveness of competition, it is important to take a forward rather than backward looking approach. Clearly, regard must be had to evidence of what has actually been happening in a market but the most important question is: what is likely to happen going forward? The past is only relevant to the extent that it is a guide to the future. It is in the future that any regulatory changes consequent to the Commission's findings will be implemented. It is therefore necessary (and appropriate) to consider the likely state of competition with and without such regulation and whether past trends are likely to continue. The Commission will be guided in its analysis by the forward-looking approach of the High and Federal

Courts of Australia and the Australian Competition Tribunal (and its predecessors) in competition law analysis.⁷

The Commission's analysis of the effectiveness of competition will be guided by the characteristics of effective or workable competition identified above and the factors which are most likely to combine to deliver those outcomes. The Commission invites stakeholders and interested parties to identify those characteristics and features of energy retailing in South Australia that are combining to deliver, or are restricting the ability to achieve, effective competition.

⁷ See, for example, *Re Tooth & Co Ltd and Tooheys Ltd* (1979) 38 FLR 1 at 38-39 where the Trade Practices Tribunal observed (emphasis added):

"In our judgment, given the policy objectives of the legislation [the Trade Practices Act], it serves no useful purpose to focus attention upon a short-run, transitory situation... This does not mean we seek to prophecy the shape of the future - to speculate upon how community tastes, or institutions, or technology might change. Rather, we ask of the evidence what is likely to happen to patterns of consumption and production were existing suppliers to raise price or, more generally, offer a poorer deal. *For the market is a field of actual or potential rivalry between firms.*"

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3 Issues for Consultation

As noted in Chapter 2, there is no definitive set of criteria that, if met, will give rise to an uncontroversial finding that a market is effectively competitive. Rather, the Commission must undertake a dynamic analysis of the various factors that, when viewed collectively, are likely to result in effective competition. By considering these factors in conjunction with the MCE criteria and the characteristics of effective competition outlined in Chapter 2 and in the Statement of Approach, the Commission has developed three analytical strands that will inform its approach to assessing the effectiveness of competition in energy retailing in South Australia:

- the ease of entry into energy retailing in South Australia;
- the nature and extent of rivalrous behaviour between retailers; and
- customer behaviour, attitudes and information requirements in relation to the purchase of energy products and services.

Within these three strands, the Commission has identified a number of matters that it considers are likely to impact on the potential for effective competition to develop in energy retailing in South Australia. These matters are raised in this chapter, and stakeholders are invited to provide written submissions addressing their relevance to, and effect on, energy retail competition in the state.

3.1 Market structure and conditions for entry, expansion and exit

The opportunity for competition to develop may be influenced by a range of structural, behavioural and regulatory characteristics and conditions that affect decisions by retailers to enter, expand within or exit from energy retailing in South Australia. In this section, the Commission notes some of the features of the South Australian market that may be relevant to its assessment of the effectiveness of energy retail competition.

The number of retailers and the size of their respective customer bases can affect the competitiveness of energy retailing. Understanding the effect of these structural conditions on competition is important because the unilateral market power of individual retailers and the collective or coordinated market power of a group of retailers tends to increase as their customer share increases⁸ In South Australia, the privatisation of the electricity and gas industries resulted in the creation of a single electricity host retailer (now AGL Energy) and a single gas host retailer (now Origin Energy), who each supply energy to a substantial proportion of the small customer base. The presence of structural conditions such as these may make it difficult for new entrant retailers to compete effectively.

⁸ LECG, "Concentration Indexes", contained in Australian Energy Market Commission, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria – First Final Report*, December 2007, p. 167.

The actual or potential threat that a new retailer will enter the market and erode any excess profits can constrain the pricing and output decisions of retailers already in the market. However, the effectiveness of new entry as a competitive constraint may be lower where barriers to entry are present. A barrier to entry is a structural characteristic or condition that places an efficient potential new entrant retailer at a disadvantage relative to an established business. A barrier to entry does not properly include a cost or other impediment that applies more or less to any party wanting to participate in energy retailing, irrespective of whether it is an established retailer or a new retailer. Barriers to entry are an important element of an assessment of the effectiveness of competition because, where barriers are high, new entrants will not be encouraged to enter the market and, as such, existing market participants may be freed from competitive discipline.

Once a retailer has begun trading, it may also face costs or impediments that prevent it from expanding, or limit its ability to expand within or exit from the industry relative to its established competitors. These restrictions are known respectively as barriers to expansion and exit. Barriers to expansion exist where fringe or niche entry may be possible but there are obstacles to expanding to a size that would allow a new entrant to compete effectively against larger, more established businesses. In such circumstances, established large retailers may still not be constrained by the threat of entry. Barriers to exit can affect entry decisions if the costs of exiting the market are so prohibitive that the incentive to enter is reduced or removed altogether. For example, where entry requires substantial capital investment which cannot be recovered on exit (i.e. there are sunk costs) entry may be discouraged. In some situations, exit itself may involve further sunk costs, e.g. costs associated with rendering a site or premises suitable for alternative uses.

Barriers to entry, expansion or exit in energy retailing in South Australia may take a variety of forms. A retailer may face a barrier to entry if it cannot secure access to wholesale energy supplies at prices that enable it to compete profitably with existing market participants, or if there are insufficient financial contracts available to allow the retailer to mitigate its price and volume risks. In the case of gas, retailers may require access to smaller, additional supplies of gas - "swing gas" - to balance discrepancies between system injections and withdrawals. Questions of access to wholesale energy and risk mitigation tools may also affect existing retailers seeking to expand their energy retail businesses.

The recent report prepared by NERA Economic Consulting (NERA) as part of the review of the effectiveness of energy retail market competition conducted by the Essential Services Commission of South Australia (ESCOSA) (NERA Report) found that retailers considered access to adequate gas transmission and distribution services was a significant barrier to entry.⁹ Because South Australia operates a contract carriage market for gas¹⁰, retailers wishing to deliver gas to South Australia

⁹ NERA, *Review of the Effectiveness of Energy Retail Competition in South Australia – Phase 2 Report for ESCOSA*, June 2007, p. 32.

¹⁰ Under a contract carriage model, the pipeline owner manages the pipeline and users enter into bilateral contracts with the pipeline owner. These contracts set out the service requirements of the user including, where relevant, the firm capacity reservation which is expressed as a maximum daily quantity: NERA Report, p. 45.

for sale to small customers must contract for firm pipeline capacity on either the SEAgas pipeline system or the Moomba to Adelaide Pipeline System (MAPS). The Commission understands that haulage constraints on MAPS may have eased recently following the expiration of several haulage contracts but that the only capacity currently available on the SEAgas pipeline is interruptible.¹¹ The NERA Report also identified difficulties in obtaining adequate access to the gas distribution network and to laterals off the MAPS.¹² The Commission wishes to understand the current issues concerning the ease or difficulty associated with obtaining access to gas transmission and distribution networks in South Australia and invites stakeholders to comment on these matters.

The NERA Report also revealed that regulatory barriers (including regulatory differences between jurisdictions, the extent of state regulation, regulatory uncertainty and standing offer price regulation) was another significant barrier to entry facing South Australian energy retailers.¹³ Other barriers to entry may include sunk costs (such as the costs of marketing required to grow customer share) and the costs associated with overcoming customer loyalty to established retailer brands.

In some markets, economies of scale and scope may provide a business with a competitive advantage over its rivals. Economies of scale exist if the long-run average cost of production declines as the rate of output increases.¹⁴ Economies of scope are present where the unit costs of a business producing two different products is lower for a given level of output than if those products were produced by two separate businesses.¹⁵ Economies of scale may deter entry if entry on an efficient scale requires significant sunk costs and/or would be likely to result in post-entry prices that depress expected profits below an acceptable level. Economies of scope may also affect competition if competitive entry requires the business to offer multiple products, or to operate at multiple functional levels of the market. When combined with sunk costs, economies of scope increase the risks of entry.

In energy retailing, economies of scale may arise by virtue of the size of the retailer's customer base. A large customer base enables a retailer to reduce average fixed costs, improve the utilisation of fixed assets and potentially contribute to a higher margin. Lower average costs can improve competition because it allows the retailer to charge a lower price to customers. The Commission invites stakeholders to comment on whether there is a minimum scale of operation necessary for retailers to achieve in order to compete effectively in electricity and/or gas retailing, or whether equivalent scale economies can be achieved by using flexible and adaptable business models and cost structures. For example, a smaller retailer may outsource the customer billing and call centre functions of its retail business to third party

¹¹ NERA Report, p. 35.

¹² NERA Report, pp. 35-37.

¹³ NERA Report, p. 32.

¹⁴ Jeffrey Church and Roger Ware, *Industrial Organization: A Strategic Approach*, McGraw Hill, Boston 2000, p. 54.

¹⁵ Robert S. Pindyck and Daniel L. Rubinfeld, *Microeconomics*, 5th ed, Prentice Hall, New Jersey, 1995, p. 231.

contractors, thereby rendering these otherwise “fixed” costs scalable and enabling its average fixed costs to be lowered.

Economies of scope may arise where the retail energy business is vertically integrated with a business operating at another functional level in the industry. In the case of electricity, vertical integration is most likely to occur between a retail business and a generation business, resulting in the creation of a “gentailer”. In the case of gas, the retail business is most likely to be vertical integrated with a business that has interests in gas fields, production facilities or network transportation assets. Vertical integration can have a positive impact on the competitiveness of energy retailing if it allows efficiency gains achieved by the retail business to be passed on to customers in the form of reduced retail energy prices. However, its effect can be detrimental if there is insufficient access to independent providers of wholesale energy. This is a relevant consideration in the electricity sector. Alternatively, vertical integration may have a negligible impact on competition (as was found to be the case in Victoria¹⁶). The Commission invites submissions to comment on whether vertical integration, particularly the increase in the number of gentailers, is affecting the competitiveness of energy retailing in South Australia.

The opportunity for retailers to offer dual fuel products has provided retailers with the potential to benefit from economies of scope, as dual fuel products lower the average cost to serve by spreading the retailer’s fixed costs over a larger number of customer connections. Noting that only four retailers currently offer to supply electricity and gas products to small customers in South Australia, the Commission encourages stakeholders to comment on the benefits and disadvantages of dual fuel products in achieving economies of scope.

Electricity and gas retailers operating in South Australia are required to comply with specific requirements prescribed by legislation and a range of subordinate instruments, such as regulations, licences, codes and guidelines. Regulatory obligations exist in relation a variety of matters, including licensing, prudential requirements, service standards, customer transfer and consent, and consumer protection. The Commission notes the work being undertaken by the Department of Climate Change to finalise a detailed design for a national emissions trading scheme by the end of 2008, for commencement no later than 2010.¹⁷ While not the primary focus of the South Australian Review, stakeholders may wish to comment on whether any aspect of these or other regulatory obligations, including the costs of compliance, have an impact on competition.

¹⁶ Australian Energy Market Commission, *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria – First Final Report*, December 2007, p. 116.

¹⁷ <http://www.greenhouse.gov.au/emissionstrading/index.html>. The Commission also notes that the MCE, as part of the national energy reform agenda, is examining the costs and benefits of rolling out advanced metering technology in each jurisdiction, including South Australia. On 5 March 2008, the MCE released for public consultation the reports it commissioned on the case for a roll-out of smart meter in each jurisdiction (including South Australia). The Commission notes that these reports have not been endorsed and do not represent a policy position of the MCE, participating jurisdictions, the Standing Committee of Officials, or any jurisdictional supporting officers.

The regulatory obligation that is the principal focus of the South Australian Review is the standing offer tariff; that is, the price at which energy is sold to small customers pursuant to a standing offer contract. The retail price of energy provides important signals about how resources should be allocated, whether additional investment is required, or whether new entry is likely to be profitable. Accordingly, the level at which the standing offer tariff is set may have important implications for the development of competition. For instance, electricity retailers may be exposed to material volatility in the wholesale price for electricity, which is a key cost in electricity retailing. Where the standing offer tariff is set at a level that does not permit retailers sufficient opportunity to recover their input costs, new entrants may be discouraged from commencing, or existing retailers from expanding, an energy retailing business.

The Commission is interested to receive submissions, supported by evidence, that address the effect that structural characteristics and barriers to entry, expansion and exit identified above may have, or may have had, on the development of competition in electricity and gas retailing in South Australia. Submissions are also invited to address other factors that stakeholders consider are relevant to the ease of entry into energy retailing in South Australia.

Issues for comment

In relation to each of electricity and gas retailing:

1. Have the structural conditions for energy retailing in South Australia supported or hindered the development of effective competition? Are these structures likely to support or impede further improvements in competition in the future?
2. Are there barriers to entry that impact on the development of effective competition? Have these barriers dissuaded prospective energy retailers from entering or can they be overcome? Are these barriers likely to persist or abate?
3. Are there barriers to expansion or exit that impact on the development of effective competition? Have these barriers dissuaded prospective energy retailers from entering or can they be overcome? Are these barriers likely to persist or abate?
4. Are there unique or specific features of the South Australian electricity or gas retailing environments that may support or impede the development of competition?

3.2 Retailer rivalry

Independent rivalry between retailers is an important driver of effective competition. An effectively competitive market is more likely to exist where retailers compete (and/or there is the threat of entry by new retailers) to offer the products, services, prices and other conditions of supply which are most attractive to customers, and retailers respond to changes in consumer taste by offering new, different or better products in a timely manner. In assessing the extent to which retailers are engaging

in and are likely to continue to engage in rivalrous behaviour, it is necessary to consider a range of factors.

Competition between suppliers to secure customers for a relatively homogeneous product like energy often focuses on price. Accordingly, the price at which retailers offer to supply energy pursuant to a market contract may provide some indication of the extent of competition. In competitive goods and services markets, prices offered by individual businesses are normally determined by reference to the business' assessment of prevailing prices and supply and demand conditions, and of the future competitive environment. However, in energy retail markets in transition to effective competition, prices may be set by reference to the standing offer tariff (e.g. a percentage discount on the standing offer tariff) or determined independently.

The opportunity for retailers to price by reference to the regulated retail price may affect the nature and extent of retailer rivalry. Some commentators submit that the presence of a published, regulated price provides a focal point around which retailers compete and may increase the risk of tacit price collusion. Retail price regulation may also cause detriment to consumers, who may be misled into thinking that the regulated price represents what the regulator considers a fair and reasonable price, and that a discount on this price must necessarily be a good deal. Based on these assumptions, consumers may limit their search for alternative, better offers and may end up paying more.¹⁸ The effect of focal points, combined with reduced customer participation, can jeopardise diversity and innovation in the product offerings, energy tariffs and tariff structures offered to customers.

While evidence from energy markets overseas indicates that removing retail price regulation can result in greater innovation in both tariff structures and the level at which the tariff is set,¹⁹ retail price regulation is also credited with delivering a range of pro-competitive benefits. During the Victorian Review, consumer groups submitted that the regulated retail price facilitated price-based competition and provided customers with a benchmark against which to assess competitive market offers.²⁰ The Commission encourages submissions to address the effects of retail price regulation in South Australia, including its effect on retailer rivalry.

The availability of differentiated products and services may also be indicative of the extent of rivalry between retailers. Product differentiation may be reflected in non-price benefits (e.g. free gifts such as magazine subscriptions, movie tickets or household appliances) or discounts such as for paying on time or paying via direct

¹⁸ Professor George Yarrow, *Report on the Impact of Maintaining Price Regulation*, Oxford, January 2008, p. 71.

¹⁹ For example, Ofgem found that retailers now offer a greater range of tariff products that have proved popular in the market, such as price guarantee deals (including fixed price, capped price and tracker deals), online tariffs that offer customers savings for managing their account online, and green tariffs which offer customers options to reduce or offset their carbon footprint. Ofgem also estimates that competition between British energy retailers has saved each customer more than £100 on average by protecting them from the impact of rising wholesale prices over the past four years: Ofgem, *Domestic Retail Market Report*, June 2007, pp. 1-8.

²⁰ See, for example, submissions to the *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria – First Draft Report*, (October 2007) from the Alternative Technology Association (p. 2), Consumer Action Law Centre (p. 8), and St. Vincent de Paul (p. 3).

debit. Non-price rivalry may also exist in the form of offers for accredited GreenPower and other “green energy” products. Further, retailers may seek to differentiate their service offerings from those offered by other retailers, for example, by providing superior customer service. This may be delivered through accurate and timely billing, call centre response times that meet or exceed the standards set by ESCOSA, or the provision of advice about future energy developments, e.g. energy efficiency targets and demand side opportunities to reduce energy consumption.

The extent to which retailers are actively competing may also be reflected in their marketing activities. Where small customers are characterised by low levels of interest in energy products and services, retailers face incentives to reduce customers’ search costs and overcome any actual or perceived switching costs. One way for retailers do this is to adopt marketing campaigns that focus more heavily on personal contact with customers, for example, by using direct marketing to present customers with relevant information and product comparisons which allow them to exercise choice at a low cost with minimum sacrifice of time and effort. Periods of intense retailer rivalry are likely to be characterised by vigorous marketing activity and, as the number of customers participating in the competitive market increases, an increase in the overall competitiveness of energy retailing. However, if retailers are able to select the customers to whom they market their products and services or are able to withhold offers from particular customers or classes of customers, there may be limitations on the effectiveness of competition.

The effectiveness of retailers’ marketing activities in increasing competition, particularly through direct sales techniques such as door-to-door sales or telesales, must be considered in light of any behaviour that may undermine competition. Examples of such conduct include providing misleading information, engaging in deceptive behaviour or exerting coercive pressure on prospective customers. At the extreme, mis-selling may extend to transferring customers without consent. Such conduct is regulated by the *Trade Practices Act 1974* (Cth) and the *Fair Trading Act 1987* (SA), and by energy-specific instruments including the Energy Marketing Code and the Energy Customer Transfer and Consent Code.

The Commission notes that some indication of the prevalence of mis-selling and other anti-competitive conduct may be available from data contained in retailers’ complaints and dispute resolution systems, or from statistics published by the Energy Industry Ombudsman of South Australia. In addition to having regard to data from these sources, the Commission invites submissions to provide evidence about the incidence of such practices. The Commission also notes its intention to collect its own evidence of mis-selling through a statistically significant survey of small energy customers in South Australia.

Another factor influencing retailer rivalry is the ability for retailers to recover their efficient economic costs²¹, including a return on capital employed. For example, a retailer may suspend activities aimed at acquiring new customers where the costs of

²¹ “Economic costs” refers to all costs that are necessary to incur in supplying a good or service, including opportunity costs, such as a return on investments made and compensation for risks borne.

supplying the additional customers is unprofitable.²² Therefore, one indicator of effective competition is whether the profit margins that can be achieved under standing offer tariffs and market contract tariffs are each consistent with a competitive return commensurate with the risks of energy retailing. The Commission acknowledges the difficulties that are inherent in analysing retail profit margins, and invites stakeholders to provide evidence of the adequacy or otherwise of the profit margins that retailers are currently able to achieve, and information about historic margins. The Commission notes the work undertaken by ESCOSA in estimating profit margins as part of the retail price path reviews in electricity and gas, and invites stakeholders to refer the Commission to other robust studies undertaken in this area.

The Commission is interested to receive submissions, supported by evidence, that address the effect that the indicators of retailer rivalry identified above may have, or may have had, on the development of competition in electricity and gas retailing in South Australia. Submissions are also invited to address other factors that stakeholders consider are relevant to the nature and extent of rivalrous behaviour between retailers.

Issues for comment

In relation to each of electricity and gas retailing:

5. To what extent do retailers compete with each other to acquire new customers and retain existing customers? What does the current level of rivalry between retailers indicate about energy retailing in South Australia?
6. Has retail price regulation encouraged or impeded tariff innovation, product differentiation and service competition?
7. On what basis, and to what extent, might retailers be expected to compete in the future?
8. What does the nature and extent of marketing activity indicate about the level of competition? What do the types of marketing activities undertaken by retailers indicate about the level of competition?
9. Is there evidence of retailers engaging in mis-selling and other anti-competitive marketing practices?
10. Are retailers able to recover their efficient costs at current standing and market offer contract tariffs? Are future expected profit margins likely to be sufficient so

²² In 2007, Simply Energy suspended active marketing of its energy products for a period commencing 1 July 2007 (although it maintained a single fixed-rate offer which was available to residential customers during the period of suspension) because increases in the wholesale cost of electricity meant that market offers priced at a discount to the standing offer were unprofitable: Simply Energy, submission to the *Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria – First Draft Report*, p. 1.

as to encourage new entry and increase competition or insufficient such that new entry is deterred?

11. What effect, if any, does retailer exposure to fluctuations in wholesale electricity and gas price have on retailers' ability to offer competitive product and service offerings?

3.3 Customer participation and experience

Informed customer choice and a willingness to switch also places competitive pressure on retailers to provide customers with energy products at prices and on other terms and conditions that meet their needs. However, a necessary precondition for informed customer participation in energy retailing is that customers are aware that full retail competition exists and understand the consequences of being able to choose their energy retailer.

In assessing the effectiveness of retail competition, it is appropriate to have regard to the proportion of customers who have switched retailer or who have switched from a standing offer contract to a market contract. As at 31 December 2007, approximately 68 per cent of residential electricity customers and 45 per cent of small business electricity customers had entered into market contracts, and approximately 60 per cent of residential and 16 per cent of small business gas customers.²³ A recent report by the First Data Utilities and VaasaETT Utility Customer Switching Research Project ranked South Australia as the third hottest switching market in the world, and one of only three markets with a gross annual switching rate in excess of 15 per cent.²⁴

It is important to consider switching rates in light of the reasons for customers' decisions to switch. For example, switching prompted by the opportunity to realise a cost saving reflects the customer's preference for the product offered by that retailer and reinforces the pro-competitive effects of rivalrous conduct between retailers. It also signals to the losing retailer that its products or service offerings are considered by some customers as less attractive than those offered by its competitors.

It is also relevant to understand why some customers elect not to switch. In some instances, the decision may be underpinned by a perception that the time and effort taken to obtain and compare offers is outweighed by the likely savings that could be realised by switching to a lower tariff. Switching may also involve actual costs, for example, exit fees payable for terminating a market contract early or the loss of the opportunity to recover account establishment fees through reduced tariffs. In failing to overcome these costs, retailers receive a clear signal that their product and service offerings do not accord with consumer taste and that improvements are required.

²³ Essential Services Commission of South Australia, data collected through *Guideline 2: Reporting*, unpublished.

²⁴ First Data Utilities and VaasaETT Utility Customer Switching Research Project, *World Energy Retail Ranking*, 3rd edition, July 2007, p. 2.

Retailers perform an important role in educating customers about energy retailing and competition, particularly in relation to the product and service offerings that are available. This information may be provided to customers in a variety of ways. For example, retailers who use direct channels like door-to-door sales and telesales may communicate this information verbally, as well as through written publications. This approach may enable retailers to overcome customers' search and switching costs and increase customer participation in the competitive market. However, information about energy product and service offerings is likely to promote competition only if it is easy to obtain and understand, relevant and up to date, and enables competing offers to be compared. It may also be the case that, even though the information meets these objectives, customers choose not to have regard to it when deciding whether or not to participate in the competitive market.

While the Commission intends to test issues about customer participation with end use customers through its survey, the Commission invites stakeholders to make submissions, supported by evidence, about the switching behaviour of small energy customers in South Australia and the motivation for switching. Further, the Commission is interested to understand any changes in switching behaviour since the introduction of FRC, and whether similar switching patterns are likely to be observed in the near to medium term.

Issues for comment

In relation to each of electricity and gas retailing:

12. What motivates customers to switch from a standing offer to a market contract or to switch retailer? For those customers who are not willing to participate in the competitive market, what underpins their decision to remain on a standing offer?
13. Do retailers actively compete to offer the products, services, prices and other conditions of supply which are most attractive to customers? Do retailers respond to changes in consumer taste by offering new, different or better products in a timely manner?
14. Are customers able to access information that is easy to understand, relevant and up to date, and enables competing offers to be compared? Do customers rely on this information when deciding whether to switch? If not, why not?

3.4 Equitable access to the benefits of competition

Energy services are essential for all sectors of the community. Electricity is a derived demand good, in that its essential nature derives from the services it enables, such as space heating, lighting, cooking and refrigeration. There are important implications for the standard of living achievable by those consumers who are unable to access electricity. In assessing whether competition is effective and, going forward, whether retail price regulation should be phased out for some or all small customers in South Australia, it is appropriate to have regard to customers' experience of energy retail competition and to gauge the experiences that are likely in the future.

There may be certain customers that, due to a range of individual and broader social circumstances, are not able to experience all the benefits of competition. For instance, customers that have specific medical needs that require uninterrupted energy supply may be limited in their capacity to exercise choice and participate in the competitive market. Similarly, consumers with literacy and numeracy difficulties, or from non-English speaking backgrounds (NESB)²⁵, while not necessarily suffering financial hardship or physical or cognitive disability, may have difficulty understanding information about market offers or contract terms and conditions.

Some customers may also have limited opportunity to participate in the competitive market because of the structural characteristics of the South Australian energy market. For example, the NERA Report observed that competition for all small gas customers in regional areas of South Australia did not appear to be effective. NERA suggested that this may be because of capacity constraints on the laterals connecting MAPS with Envestra's distribution network.²⁶ The Commission invites submissions to address this issue, and to identify other structural or infrastructure-related matters that may affect the ability for customers to participate in the competitive market.

The principal explanation for why certain customers may be unable to participate effectively in the competitive retail energy market is because they are experiencing temporary or permanent financial hardship. The Commission notes the South Australian Government's initiatives and the financial hardship programs implemented by retailers to address this issue. However, it is important to distinguish clearly between any failure of competition and issues of hardship and affordability. Retail energy prices may be determined by competition but still cause financial hardship for some individuals. While it is not within the scope of the Request for Advice to assess the causes of financial hardship or to make policy recommendations to address them, where markets are effectively competitive, price regulation, which distorts the efficient operation of the market to the detriment of all consumers, is not the appropriate means to deal with financial hardship in relation to energy products.

Noting the arrangements that are currently in place in South Australia, the Commission wishes to understand the energy-specific and non-energy specific factors that limit the ability of customers to access the benefits of competition. To this end, the Commission invites stakeholders to identify those classes of customers who experience limited opportunities to participate in the competitive market, and provide material evidencing the causes of those limitations.

²⁵ It should not be assumed that consumers from non-English speaking backgrounds necessarily experience difficulty with English.

²⁶ NERA Report, p. ii.

Issues for comment

In relation to each of electricity and gas retailing:

15. Are there classes of customers who are unable to access the benefits of competition? If so, what factors contribute to the difficulties experienced by these customers?
16. What steps, if any, do retailers take to assist customers experiencing difficulties in participating in the competitive market? Are these initiatives effective in assisting these customers?

4 Timetable and Consultation

This chapter identifies the reports that the Commission is required to publish during the South Australian Review and the prospective dates for publication. It also sets out the process for public consultation during the Review, the opportunity for stakeholders to comment on independent reports and research commissioned by the Commission, and the Commission's approach to confidential information.

4.1 Reports to the MCE

The Request for Advice (at paragraph 10) requires the Commission to provide advice to the MCE using a four stage reporting process. In accordance with paragraph 12, the final report is to be provided by 31 December 2008.

The first report is to be a draft report of the Commission's assessment of the effectiveness of retail competition in electricity and gas (First Draft Report). The First Draft Report is to invite public comment on its findings.

At the conclusion of the public consultation process, the Commission will consider the submissions made and the results of any other consultation undertaken. It will then publish a final report setting out its assessment of the effectiveness of competition (First Final Report).

The Commission must also publish a draft of its advice to the MCE on ways to phase out retail price regulation where competition is found to be effective, or on ways to promote competition where it is not effective (Second Draft Report). The Second Draft Report is also to include advice on South Australia's compliance with clauses 14.10-14.14 of the AEMA.²⁷

Following consultation on the Second Draft Report, the Commission will consider the submissions made and the results of any other consultation undertaken. It will then publish its final advice on ways to phase out retail price regulation where competition is effective, or to promote competition where it is not (Second Final Report).

Based on the requirement that the Second Final Report be provided by 31 December 2008, the Commission has developed a timetable for the South Australian Review. The timetable is set out in the table below.

Indicative Time	Milestone
14 March 2008	Issues Paper published
11 April 2008	Submissions in response to the Issues Paper due

²⁷ As the South Australian Review is the first such review to be conducted in the jurisdiction, the Commission is limited in its ability to assess compliance with certain clauses of the AEMA. Accordingly, the Commission's advice will focus on South Australia's compliance with clauses 14.10 and 14.11(b) of the AEMA.

Indicative Time	Milestone
June 2008	First Draft Report published
July 2008	Submissions in response to the First Draft Report due
September 2008	First Final Report published
October 2008	Second Draft Report published
November 2008	Submissions in response to the Second Draft Report due
December 2008	Second Final Report

4.2 Public consultation

Paragraph 8 of the Request for Advice requires the Commission to issue a public notice announcing the commencement of the South Australian Review together with a proposed timetable for its completion, including the provision of advice. The notice must also call for public submissions on the effectiveness of competition in South Australian energy retailing.

On 14 March 2008, the Commission published on its website a notice in accordance with the requirements of the Request for Advice. This notice is also to be published in *The Australian* and *The Advertiser* newspapers on 15 March 2008.

The Commission has also published this Issues Paper, which calls for submissions on issues relevant to the South Australian Review, including on the effectiveness of competition. Submissions are to be lodged by 5pm, Friday 11 April 2008.

The Request for Advice requires (at paragraph 9) the Commission to consult with the South Australian Government at each step in the advice process, and to consult and meet with relevant stakeholder groups in South Australia who have interest in the oversight, regulation or other control of retail prices. In the lead up to the First Draft Report, the Commission intends to undertake a range of activities to gather quantitative and qualitative data relevant to the South Australian Review. These will include:

- a survey of South Australian residential and small business consumers;
- a survey of electricity and gas retailers operating retail energy businesses in South Australia;
- issuing a data template to electricity and gas retailers to collect quantitative data;
- meetings with retail energy businesses and with consumer groups; and
- reviewing and considering submissions made in response to this Issues Paper.

The Commission will also engage in ongoing consultation with the South Australian Government and ESCOSA.

4.3 Consultants' reports

The Commission intends to retain consultants to provide expert advice in the context of the South Australian Review. It is the Commission's intention to publish the reports it commissions, insofar as they provide information that is relevant to the Review.

Shortly, the Commission will release two reports commissioned from NERA. One of the reports outlines the structure of the upstream gas market, its competitive environment and potential implications for competition at the retail level, and the other outlines these issues in relation to the wholesale electricity market. These reports were originally commissioned as part of the Victorian Review and have been updated to reflect recent developments in the energy industry. Interested parties are invited to refer to these reports and to provide any relevant observations in relation to their contents.

Prior to the release of the First Draft Report, the Commission also expects to publish reports from its consultants setting out the results of a survey of residential and small business customers, and the non-confidential results of a survey of energy retail businesses. Interested stakeholders will also be given the opportunity to comment on these reports, and any other reports prepared at the request of the Commission.

4.4 Confidentiality

The Commission's approach to confidentiality is set out in full at 4.4 of the Statement of Approach. However, the Commission wishes to remind parties making submissions on the Issues Paper that information relied upon by the Commission should be published, commented upon and tested in open debate.

The Commission considers that its established practice of omitting confidential or commercially sensitive information contained in a submission prior to publishing the submission on its website offers adequate protection to parties making submissions in response to the Issues Paper. A party who provides information to the Commission and considers that part or all of the information being provided is confidential or commercially sensitive may request that that information be kept confidential. A request to maintain confidentiality should:

- be made in writing;
- clearly identify the information which is confidential and, where possible, separate that information from the other non-confidential information in the submission; and
- set out the basis upon which the information is confidential and/or commercially sensitive, including, for example, a statement as to any detriment that is likely to result to the person or any third party from the disclosure of that information.

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