AEMC

REVIEW

Australian Energy Market Commission

APPROACH PAPER

2014 Retail Competition Review

17 January 2014

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Approach Paper

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About the AEMC

The Council of Australian Governments (COAG), through its then Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. In June 2011, COAG established the Standing Council on Energy and Resources (SCER) to replace the MCE. The AEMC has two main functions. We make and amend the national electricity, gas and energy retail rules, and we conduct independent reviews of the energy markets for the SCER.

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1 Introduction

The Australian Energy Market Commission (AEMC) is responsible under the Australian Energy Market Agreement (AEMA) for assessing the state of competition in electricity and natural gas retail markets. The AEMC's reviews provide advice to governments to support a commitment made by all jurisdictions under the AEMA to remove retail energy price regulation where effective competition can be demonstrated. The AEMC completed competition reviews for Victoria in 2008, South Australia in 2008, the Australian Capital Territory in 2011 and New South Wales in 2013.

In December 2012, the Standing Council on Energy and Resources (SCER) and the Council of Australian Governments agreed the AEMC's future competition reviews should focus on the state of competition across all jurisdictions within the national electricity market (NEM). The reviews are to be conducted on an annual basis. The new approach is reflected in the AEMA, which was amended in December 2013. The terms of reference, which apply to this year's review and future annual reviews, were provided by the SCER to the AEMC on 13 January 2014.[1]

This 2014 review will be the first AEMC review of retail energy market competition that looks at all jurisdictions in the National Electricity Market (NEM) at the same time.

1.1 Purpose of this Approach Paper

This document sets out how the AEMC will conduct the 2014 retail competition review. It is intended to provide clarity to stakeholders on how we plan to gather and analyse evidence on the state of competition in NEM jurisdictions.

This document applies solely to the 2014 review. We intend to consult in the second half of 2014 to refine the approach for future annual competition reviews.

We are also using this document to seek stakeholder views on the current state of competition in each jurisdiction. Information on how to make a submission is provided in section 1.4.

1.2 Scope of this review

The scope of this review is set out in the terms of reference and in the amended AEMA. The AEMA requires the AEMC to assess the effectiveness of competition in accordance with guidance issued by SCER[2] for the purpose of jurisdictional decisions on the retention, removal or reintroduction of retail energy price controls.

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1 The terms of reference are available on the project page (project code "RPR0002") on the AEMC's website: www.aemc.gov.au.

2 The Standing Council on Energy and Resources has replaced the Ministerial Council on Energy (MCE). The MCE is still referred to in some legal documents, including the AEMA.

The terms of reference require the AEMC to report on the current state of retail competition and its possible future development. The annual reviews are to comment on issues affecting energy retail competition across NEM jurisdictions. Under the terms of reference, we are to focus on the small customer end of retail electricity and gas markets. The consumption thresholds used to define small customers vary across jurisdictions. We are permitted to use the relevant jurisdictional consumption thresholds or any other means the AEMC deems appropriate.

The reviews are to principally cover energy markets in jurisdictions that are subject to retail price regulation. For comparison purposes, the AEMC should also consider the effectiveness of competition in jurisdictions where prices have been deregulated.

The reviews will look at competition in all Australian states and territories with the exception of Western Australian and the Northern Territory, which are not part of the NEM. As part of this 2014 review, the AEMC will conduct more detailed analysis on South East Queensland. This is because the Queensland Government is currently considering removing price regulation in that market on 1 July 2015 subject to finding competition to be effective.[3] This is the first time the AEMC will review energy retail market competition in Queensland.

The terms of reference require the AEMC to consider a set of criteria in assessing the effectiveness of competition across and within NEM jurisdictions. This is subject to practicality, data availability and resourcing constraints. The 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
- customer switching behaviour.

These criteria were developed by the Ministerial Council on Energy (MCE) and have been factors in all AEMC retail reviews to date. Consistent with the AEMC's approach for the NSW competition review, we will use these criteria as a framework for our assessment of whether retail markets are providing outcomes reflective of effective competition. This is discussed further in section 3.3.

The terms of reference also require the AEMC to advise Energy Ministers whether there are any jurisdictions to which we could usefully provide further advice on possible ways to transition to price deregulation. Following the completion of this

3 Queensland Government, Queensland Government response to the Interdepartmental Committee on Electricity Sector Reform, 16 June 2013.

review, there may be scope for the AEMC to provide more detailed advice on possible pricing reform for specific jurisdictions, as required.

The scope of the review will also include consideration of competitive retail market costs in Victoria. The 2013 AEMC Residential Electricity Price Trends report found that the competitive market cost component of customer bills (which includes the retail and wholesale components) appears to be higher in Victoria than in other jurisdictions with market offers. Subject to data availability, this 2014 competition review will further consider this issue.

We may also consider other issues that are raised during the course of this review that are of relevance to retail energy market competition in NEM jurisdictions.

1.3 Process for this review

The standing terms of reference for annual competition reviews require the AEMC to publish a final report by 30 June each year.

The AEMC is required to consult with jurisdictions during the preparation of our report. The terms of reference state that the AEMC may also consider consultation with key stakeholders where practicable.

The AEMC considers stakeholder consultation important in conducting our work. We plan to meet with key stakeholders during the first quarter of 2014 to discuss the review and seek their input. This will include consumer groups, retailers, ombudsmen, pricing regulators and jurisdictional governments. In addition, we invite any stakeholders to contact the AEMC if interested in meeting to discuss any aspect of this review. Please contact Elisabeth Ross to arrange a discussion on (02) 8296 7800 or Elisabeth.Ross@aemc.gov.au.

The timeframe for this 2014 review does not provide sufficient time for the AEMC to consult with stakeholders on a draft report. However, we welcome submissions early in the review process to inform our assessment. The submission details are provided in the next section.

Additionally, energy customers and energy retailers will be involved in this review through work being undertaken by market research professionals that the AEMC plans to engage. This research will be conducted through customer surveys, customer forums and interviews with energy retailers.

We will also speak to stakeholders about opportunities to draw from any relevant research they have underway or have recently completed. This includes the work of consumer representatives and the Australian Energy Regulator on retail market performance.

1.4 Submissions

As part of this review, the AEMC is seeking stakeholder views on the state of competition in each jurisdiction. The AEMC is particularly interested in stakeholder responses to a series of questions set out in Attachment A. Stakeholders are invited to provide written submissions by **28 February 2013**.

In providing submissions to the review, stakeholders are encouraged to give evidence, data and any other information (such as case studies) to support issues raised. We recognise that this material might contain information that is confidential in nature. All information will be treated in accordance with the AEMC's submissions guidelines which can be viewed at www.aemc.gov.au.

Submissions should refer to AEMC project number "RPR0002" and be sent electronically through the AEMC's online lodgement facility at www.aemc.gov.au. All submissions received during the course of the review will be published on the AEMC's website, subject to any claims of confidentiality.

In order for the review to be completed within the timeframe provided the AEMC must adhere to strict deadlines. While we will have full regard to all submissions lodged within the specified time period, late submissions may not be afforded the same level of consideration. To ensure the AEMC is able to fully consider all submissions, we request that stakeholders lodge their submissions by no later than the due date.

2 Background to this review

The focus of this review is to assess the state of competition in the retail markets for electricity and gas in NEM jurisdictions. This recognises the importance of effective competition to promote the long-term interests of energy customers.

2.1 What is competition and why is it important?

Effective competition in energy retail markets promotes customer choice. Customers can choose from multiple energy contracts and energy retailers to find an offer that best meets their needs at a price they are willing to pay.

Retailers in competitive markets are incentivised to innovate and differentiate their offers from those of their competitors to better meet the needs of customers. This is due to the competitive tension created between rival firms to attract and retain customers. Competition also drives prices towards the efficient cost of supply. This is because retailers in a competitive market have an incentive to reduce prices in order to attract customers, and no single retailer has the power to control prices or earn excessive profits on an enduring basis.

The level of competition in a market falls on a spectrum. Markets are rarely competitive from the outset and tend to evolve over time into what is considered to be 'effective competition'. This is a level of competition that may not be 'perfect' but is sufficient to provide the right incentives for efficiency and protection of customers in terms of price and service quality.

2.2 Retail energy market competition in NEM jurisdictions

Government regulation may influence the level of competition in any market. Regulation of energy retail markets in jurisdictions has changed over time to promote greater competition. These markets traditionally involved vertically integrated, government-owned monopolies. Jurisdictional regulation prohibited new energy retailers from entering the market and customers did not have a choice of energy retailer.

A series of energy market reforms began in the 1990s in recognition of the benefits that competition can offer to customers. Australian jurisdictions have adopted a staged approach to promote competition. A critical first step was to introduce retail contestability where customers are free to choose their retailer.

Large and small customers are now permitted to choose their retailer of both electricity and gas in Victoria, New South Wales, South Australia, the Australian Capital Territory and Queensland. In Tasmania, large electricity customers, some small business electricity customers[4] and all gas customers are free to choose their retailer.

4 These customers are those small businesses that consume between 50 and 150 megawatt hours per annum.

The Tasmanian Government has indicated retail electricity competition will be permitted in Tasmania for households and small businesses from 1 July 2014.[5]

With the introduction of retail competition, jurisdictions sought to protect customers through regulatory mechanisms until competition was seen as effective. The regulatory mechanisms generally involved price regulation as well as imposing obligations governing retailers' interactions with customers (such as information requirements).

2.2.1 Price regulation

Regulated prices are currently available to small customers in the Australian Capital Territory, New South Wales, Queensland and Tasmania. Regulated prices ensure that, regardless of the level of competition, all customers can obtain prices for electricity and gas that are considered reasonable by the regulator. To do this, the regulator must estimate all the costs retailers will face in supplying electricity to their customers to determine a maximum price retailers can charge.

The two main rationales for price regulation are:

- to act as a proxy for competition – the regulator aims to set an efficient price in the absence of sufficient competition in the market; and
- to prevent abuse of market power through excessive pricing – where there is insufficient competition, customers may not be able to switch away from an unfavourable offer.

In the case of monopolies such as electricity distribution and transmission networks, price regulation has a vital role to play in protecting customers. However, in sectors where competition is feasible and has been introduced, price regulation should be considered to be temporary rather than permanent.

The AEMC considers that regulated prices will always be an imperfect substitute for prices determined by the competitive process of a market, and are likely to impose costs and distortions that would not otherwise be present. Specifically, since regulated businesses have better cost and market information than regulators, there is a risk that regulated prices will either be set:

- too low, deterring investment and innovation; or
- too high, to the detriment of customers.

Regulated pricing arrangements also lack the flexibility and timeliness of market prices.

As well as being concerned about prices, customers also have an interest in non-price factors such as quality of service. Regulators are not able to easily assess how

5 As of 1 January 2014, these customers are able to choose a market offer with the incumbent retailer, Aurora Energy.

customers value non-price factors. In contrast, many of these factors are more easily assessed by retailers themselves, since they can observe customer preferences within competitive markets by the choices customers make.[6]

In general, the more competitive the market, the more light-handed regulation can be. Jurisdictions have recognised that when competition reaches a sufficient level, price regulation becomes unnecessary and can be detrimental. In 2004 all jurisdictions signed the AEMA and committed to remove retail energy price regulation where effective competition can be demonstrated. Victoria and South Australia achieved this commitment in 2009 and 2013, respectively. New South Wales is considering the advice from the AEMC's 2013 review which found competition was effective.[7]The Queensland Government has indicated it will remove electricity price regulation in South East Queensland by 1 July 2015, subject to satisfactory customer protection and engagement.

Removal of price regulation does not mean the removal of all regulation. There are a series of customer protection measures that remain in place to provide support to small customers in jurisdictions where price regulation is removed. These include jurisdictional and national protection measures that together support customer choice, provide a mechanism for complaint resolution and provide assistance to those in hardship.

6 For further discussion of the costs of price regulation, refer to chapter 7 of the draft report for the NSW retail competition review or the AEMC retail price trends report. AEMC 2013, Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales, Draft Report, 23 May 2013, Sydney. AEMC 2013, Advice on best practice retail price methodology, Final Report, 27 September 2013, Sydney.

7 More information on the AEMC's Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales is available at: www.aemc.gov.au.

3 Assessment framework

This section sets out how we plan to assess the current state of energy retail competition in all NEM jurisdictions. It is important to note that NEM jurisdictions are at different stages in promoting competition in energy retail markets and it is therefore likely that their markets are at different stages along the competitive spectrum. While one market may be more competitive than another, they may both be considered effectively competitive. We will use a range of competitive market indicators to assess whether the retail electricity and gas markets are effectively competitive in each jurisdiction.

3.1 Data timeframes

It is important for any assessment of competition to look over a period of time. Competition is a process and conclusions on its effectiveness cannot be based on a single point in time. Markets are dynamic with changing customer preferences and technologies. Prices, products and profits fluctuate as businesses enter, innovate and exit a market, as well as when input costs change. We will look at a range of competitive indicators across the 2013 calendar year and will take historical data into account where possible.

It is also important to consider whether current conditions are likely to prevail in the future. As part of this assessment, we will ask whether there are likely to be any major changes in market conditions that could impact the level of competition in the future.

Our analysis of competition across the NEM will be subject to data availability. Much of the data we require will need to be sourced from retailers.

3.2 Market definition

The first stage in assessing the level of competition in a market is to define the relevant market(s). The terms of reference require the AEMC to focus on small electricity and natural gas customers in NEM jurisdictions. To provide a framework for analysis, we need to know whether the supply of electricity and gas to small customers in each jurisdiction involves a single market, is part of a larger market, or involves multiple markets.

We propose to consider each jurisdiction as a single geographic market with two product markets: an electricity retail market and a gas retail market. We will also treat all small customers as part of the same market. There is no distinction between small business and residential customers. This market definition was adopted for the NSW competition review, supported by our analysis of the available data.

A key exception to the above approach applies to Queensland. We will look at two geographic markets in Queensland. The first is South East Queensland, which is subject to retail competition where customers can choose their retailer. The second is the remainder of Queensland, where retail competition is currently permitted but there is only one retailer at present.

Our market definitions may be subject to change if the data gathered during the review supports an alternative approach. In particular, we will analyse regional areas separately in each state to determine whether there are any systemic differences from urban areas.

3.3 Competitive market indicators

The level of competition is affected by different factors and there is no single measure of effective competition. We will use a range of interrelated indicators to assess the current and expected future state of competition. These relate to the market structure, the conduct of its participants and the resulting market performance.

Consistent with the NSW review completed in 2013 and the terms of reference for this review, we will focus our assessment of retail competition on a series of competitive market indicators. These are:

- the level of customer activity in the market;
- barriers to retailers entering, expanding or exiting the market;
- the degree of independent rivalry, such that retailers are competing strongly with each other to attract and retain customers;
- customer satisfaction with market outcomes; and
- retailer outcomes with respect to prices and competitive retail market costs.

Analysis of the first three indicators will help to provide a picture of the market structure and market conduct for each jurisdiction. The last two indicators should provide information on the performance of the market. The methods we plan to use to analyse these indicators are outlined below. This is not an exhaustive list and we may take other information into consideration during the course of the review.

3.3.1 Customer activity in the market

A desirable outcome of a competitive market is that customers are aware of the choices available to them and are able to act on those choices. By shopping around to receive lower prices or better service, customers play an important role in maintaining downward pressure on prices and driving retailers to provide the quality of service customers demand. Customer activity is an important indicator of whether competition is effective. Our analysis of this market indicator will consider:

- *customer engagement in choosing market offers* to see what proportion of customers are on market offers and what proportion are on standing or regulated offers;

- *customer attitudes* obtained through surveys to understand how and why customers participate in the market and whether there are any issues preventing customers from shopping around;

- *customer churn* showing the number of people switching retailer. These will be carefully interpreted in conjunction with other indicators as we note that high or low churn rates are not necessarily a sign of a well-functioning market; and

- *customers changing plans with a retailer* to see whether customers are actively choosing new products or services offered by their existing retailer. This is to reflect customer switching activity that is not picked up in churn rates.

3.3.2 Barriers to entry, exit or expansion

Identifying any significant barriers to entry, expansion and exit is an important element of an assessment of competition. This involves analysing whether new retailers can freely enter the market and whether incumbent retailers can exit or expand within the market. Under these conditions, there are competitive pressures on existing retailers to charge prices commensurate with efficient costs and improve their offerings. An effectively competitive market will generally have no significant barriers to entry, exit or expansion. Our analysis of this market indicator will consider:

- *evidence of entry, exit or expansion* and whether this is indicative of low barriers to entry, exit or expansion for that market;

- *retailer interviews* to understand the difficulties that retailers may encounter in entering or expanding in a market. This could include economies of scope or scale, accessing and transporting gas, and regulatory barriers such as prudential requirements and state-based regulatory costs and obligations; and

- *measures of contract market liquidity* as a test of whether new entrant retailers are able to obtain hedging products to manage their risk exposure.

3.3.3 Independent rivalry

Independent rivalry reflects the extent to which retailers are competing to attract or retain customers. Rivalry between retailers helps to drive discounting and product innovation. An effectively competitive market will generally have a high level of independent rivalry. Our analysis of this market indicator will consider:

- *market share and concentration*, and how these have changed over time;

- *switching* between the big three retailers[8] or switching between the big three and smaller retailers. This is to test whether retailers are actively attracting new

8 The “big three retailers” refers to the three energy retailers with the highest market shares across the NEM jurisdictions, which are AGL, EnergyAustralia and Origin Energy.

customers and whether smaller retailers are able to gain or maintain market share; and

- *product differentiation and the number of market offers available* to test whether retailers are competing by offering different products and services that meet the needs of their customers.

3.3.4 Customer satisfaction

High levels of customer awareness and high switching rates by themselves do not provide a full picture of whether there is competition in a market. In effectively competitive markets, customers are generally satisfied with the range of products available to them and the choices that they make. Our analysis of this market indicator will consider:

- *customer complaints* to both retailers and ombudsman to test customer satisfaction with market outcomes; and

- *customer surveys* to test views on retailer services and value for money as well as the ease and speed with which they can switch.

3.3.5 Retailer outcomes

Profit margins can provide an indication of the level of competition in a market. If profit margins are persistently very high, retailers may be earning profits in excess of the efficient cost of supply and so the market may not be sufficiently competitive to maintain downward pressure on prices. On the other hand, if profit margins are persistently very low then new retailers may be deterred from entering the market if they cannot earn a reasonable return on their investment.

It is very difficult to accurately measure profit margins or identify an appropriate benchmark with which to compare profit margins in the retail market. Our analysis of this market indicator will consider:

- *competitive retail market costs* in all NEM jurisdictions, drawing on the AEMC's 2013 Residential Electricity Price Trends Report; and

- *Victorian competitive retail market costs*, which appeared higher than other jurisdictions in the analysis for the above price trends report. Differences in costs are expected between jurisdictions, however these differences appeared to be larger than expected and we will consider this issue as part of this review.

A Questions for stakeholder submissions

The AEMC is seeking stakeholder views on the state of competition in each NEM jurisdiction. Below is a list of questions highlighting the issues we are particularly interested in for stakeholder submissions. Details on how to provide a submission are in section 1.4.

A number of the questions below can be answered in terms of common issues across all NEM regions or issues applying solely to specific NEM regions. We are particularly interested in evidence of any trends over time (eg. data over multiple years).

Market definition

1. Is there evidence to support alternative market definitions to those that we are proposing to use for the review? We plan to base our analysis on separate markets for electricity and gas in each NEM region (ie two markets per region), except for Queensland where South East Queensland will be treated as a separate geographic market to the rest of Queensland.

Customer activity in the market

2. Are small customers able to access energy related information that is easy to understand, relevant and up to date, that supports their decision-making process to choose an energy offer?

3. What motivates small customers to switch from a standing (or regulated) offer to a market offer?

4. What motivates small customers to switch energy retailers?

5. What are the reasons behind some small customers remaining on a standing (or regulated) offer rather than shopping around for a market offer?

6. Are there any barriers preventing customers from switching energy plans within their current retailer or offered by an alternative retailer?

Barriers to entry, exit or expansion

7. Are there any current or expected barriers to entry, exit or expansion that impact on the development of effective competition in small customer electricity and natural gas retailing?

8. Have the barriers referred to above dissuaded retail businesses from entering, expanding within, or exiting the market?

9. Are the barriers referred to above likely to persist or abate in the future?

Independent rivalry

10. To what extent do energy retailers compete with each other in terms of price or product/service differentiation to acquire new, and retain existing, small customers?

11. What sort of product and/or service improvements have retailers delivered to small customers in electricity and natural gas retail markets?

12. In those jurisdictions where price regulation is in place, has retail price regulation encouraged, or impeded, tariff innovation or product/service innovation in small customer electricity and natural gas retail markets?

13. In those jurisdictions where price regulation has been removed, has retail price deregulation encouraged, or impeded, tariff innovation or product/service innovation in small customer electricity and natural gas retail markets?

14. What types of marketing practices, or business behaviours, have small customers experienced in different electricity and natural gas retail markets?

Customer satisfaction

15. Are customers satisfied with the service quality they receive from their energy retailer(s) and the value for money?

16. Are customers satisfied with the level of choice available in the market?

17. Are customers satisfied with the ease and speed with which they can switch retailers?

18. Is there evidence of any long term jurisdictional or cross-jurisdictional trends in the number and nature of customer complaints to retailers or ombudsman?

Retailer outcomes

19. How does the presence of price regulation affect retailer risk profiles and retailer risk management strategies?

20. Are energy retailers to small customers able to recover their efficient costs and an appropriate return at current standing (or regulated) offer contract tariffs or at current market offer contract tariffs?

21. Is there evidence of a material divergence in the level of competitive market costs between any of the jurisdictions where market offers are available?

22. Is there any evidence to explain the underlying cause(s) of any material inter-market divergence in retailer costs (ie the costs faced by the retailer)?