



Australian Energy Market Commission

ISSUES PAPER

Review of the effectiveness of competition in the electricity market in the ACT

Commissioners

Tamblyn
Henderson
Woodward

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REVIEW

Inquiries

The 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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Contents

Contents	iii
Abbreviations	iv
Summary	v
1 Introduction	1
1.1 Purpose of the Issues Paper	1
1.2 Lodging submissions	1
1.3 Structure of the Issues Paper	2
2 Framework for the Review	3
2.1 Policy and legislative framework	3
2.2 Matters to be addressed in this Review	4
2.3 What is effective competition?	4
3 Issues for consultation	7
3.1 Market definition	7
3.2 Market structure	8
3.3 Market conduct	12
3.4 Market performance	16
3.5 Other considerations	18
4 Timetable and consultation	21
4.1 Reports to the MCE	21
4.2 Public consultation	21
4.3 Consultants' reports	22
4.4 Confidentiality	22
A Background information on electricity retailing in the ACT	23
B Request for Advice	
C Extract of AEMA	

Abbreviations

ACAT	ACT Civil and Administrative Tribunal
ACT Review	Review of the effectiveness of competition in the electricity retail market in the ACT
AEMA	Australian Energy Market Agreement
AEMC	Australian Energy Market Commission
COAG	Council of Australian Governments
Commission	see AEMC
CPRS	Carbon Pollution Reduction Scheme
DECCEW	Department of the Environment, Climate Change, Energy and Water (ACT)
FRC	Full Retail Competition
GWh	Gigawatt hours
ICRC	Independent Competition and Regulatory Commission (ACT)
MCE	Ministerial Council on Energy
MWh/year	Megawatt hours per year
NEL	National Electricity Law
NEM	National Electricity Market
Ofgem	Office of Gas and Electricity Markets (UK)
Rules	National Electricity Rules
Revised Statement of Approach	<i>Review of the effectiveness of competition in the ACT electricity retail market – Revised Statement of Approach, December 2009</i>
South Australian Review	Review of the effectiveness of competition in gas and electricity retail markets in South Australia
TPA	<i>Trade Practices Act 1974</i> (Commonwealth)
Victorian Review	Review of the effectiveness of competition in gas and electricity retail markets in Victoria

Summary

The Australian Energy Market Commission (AEMC), 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 retailing in the Australian Capital Territory is effective (ACT Review). If competition is found to be effective, the AEMC 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 advice is required to identify ways to develop competition.

Full retail competition (FRC) was introduced in the Australian Capital Territory (ACT) in July 2003 for electricity customers. 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 may also distort competitive market processes. It is only justified where markets are not effectively competitive, where regulation can improve market outcomes, and where the benefits of regulation exceed the costs.¹ This view is reflected in clause 14.11 of the AEMA, which states that all jurisdictions will phase out retail price regulation of electricity and gas where competition is determined to be effective.

The publication of this Issues Paper marks the formal commencement of the ACT Review. The findings made and the advice given during the ACT 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 retailing in the future. The AEMC is required to finalise the ACT Review by 31 December 2010.

Engagement with stakeholders is vital to ensure that the AEMC assessment of the effectiveness of competition is robust. In this regard, the AEMC is seeking informed comment, supported by evidence, from stakeholders about the effectiveness of retail competition in the ACT. In particular, the AEMC is seeking specific comment in relation to the following matters:

- Are there features of the ACT electricity retailing environment that have a bearing on the development of competition? For example, are there barriers to entry for potential new retailers, or barriers to potential expansion for existing retailers?

¹ This is not to say, however, that other regulatory frameworks are not required in order to overcome other market failures.

- 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 preferences 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 and why? Are customers able to make an informed choice to switch electricity retailer or enter into a market contract, or are there obstacles to their effective participation in the market? Is there sufficient and accurate information available to customers about their options and is this information easily accessible and able to be understood?
- 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? Are the offers made to customers consistent with their needs and expectations?
- What roles do the regulated retail price and electricity-specific concessions currently play? What impact do they have on competition and market outcomes?
- Are the benefits of FRC equally accessible by all classes of customers? 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 electricity offers as other customers?

Submissions made in response to the Issues Paper will be an important contribution to the analysis of competition in the retail electricity market. To assist stakeholders in the preparation of submissions, Chapter 3 of the Issues Paper expressly identifies a series of issues that focus on specific matters that the AEMC is interested in. Stakeholders are also encouraged to include any other relevant information and comment in their submission.

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

Submissions should refer to project number 'EPR0017' and be sent electronically through the AEMC's online lodgement facility at www.aemc.gov.au.

1 Introduction

As requested by the Ministerial Council on Energy (MCE), the Australian Energy Market Commission (AEMC) is conducting a review into the effectiveness of competition in electricity retailing in the Australian Capital Territory (ACT Review).² The Review is to be completed by 31 December 2010.

1.1 Purpose of the Issues Paper

The purpose of this Issues Paper is to invite and obtain informed observations from stakeholders and other interested parties about the experience of competition in electricity retailing in the Australian Capital Territory (ACT).³ In particular, the AEMC 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
- the likely effectiveness of competition in electricity retailing in the ACT in the future.

To assist stakeholders, the Issues Paper sets out specific matters that the AEMC is interested to receive submissions on. However, interested parties are encouraged to raise any other issues they consider relevant.

1.2 Lodging submissions

Written submissions from interested parties in response to this Issues Paper are requested by **5pm, Friday 9 April 2010**.

Submissions should refer to project number 'EPR0017' and be sent electronically through the AEMC's online lodgement facility at www.aemc.gov.au.

All submissions received during the course of this Review will be published on the AEMC website, subject to any claims for confidentiality. The AEMC's approach to confidentiality is set out in Chapter 4 of the Issues Paper and at section 4.4 of the Revised Statement of Approach.

In order that the ACT Review can be completed by 31 December 2010 (as required by the MCE) we are subject to strict deadlines. Accordingly, we will have full regard to

² Appendix B contains the Request for Advice from the MCE

³ The Revised Statement of Approach states that the 'aim of the competition reviews is to assess the effectiveness of competition in electricity and natural gas retail markets for the purpose of the retention, removal or reintroduction of retail energy price controls' (p. 1). As there are no retail price controls for natural gas in the ACT, this Review will focus on the electricity retail market.

all submissions lodged within the specified time period, however late submissions may not be afforded the same level of consideration. To ensure we are able to fully consider all submissions, we request that submissions be lodged by 9 April 2010.

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 ACT Review and the reviews still to be undertaken in other jurisdictions;
- **Chapter 3** identifies the specific matters that stakeholders are invited to comment on in written submissions;
- **Chapter 4** sets out the timetable for the ACT Review and the process for public consultation, and outlines the AEMC's approach to confidentiality;
- **Appendix A** provides background information about electricity retailing in the ACT;
- **Appendix B** contains the Request for Advice from the MCE; and
- **Appendix C** reproduces clauses 14.10-14.17 of the Australian Energy Market Agreement (AEMA).⁴

⁴ The Australian Energy Market Agreement as amended July 2009.

2 Framework for the Review

This chapter summarises the policy and legislative framework that underpins the ACT Review. It also sets out the three key questions that the AEMC must answer in conducting the Review.

2.1 Policy and legislative framework

Ongoing energy market reforms continue to introduce important changes to the structure and operation of Australian energy markets. The commitment of the Commonwealth, states and territories to these reforms is reflected in the terms of the AEMA.

One of the commitments made by each of the signatories to the AEMA is for the AEMC to assess the effectiveness of competition in the retail markets for electricity and gas for the purpose of retaining, removing or reintroducing retail price regulation.⁵ Where competition is found to be effective, the AEMC is to provide advice on ways to phase out retail price regulation. Where competition is found not to be effective, the advice must suggest ways to improve competition.

On 19 April 2007, the MCE advised the AEMC that the reviews would be conducted sequentially.⁶ The reviews for Victoria (Victorian Review) and South Australia (South Australian Review) were completed on 29 February 2008 and 18 December 2008 respectively. On 10 July 2009, the MCE directed the AEMC to continue its program of reviews of the effectiveness of competition in the retail energy sectors by considering the ACT in 2010, followed by New South Wales in 2011, Queensland in 2012 and then Tasmania in 2013 (if FRC has been implemented in that jurisdiction at that time).⁷

Each review is to follow the framework provided for in clauses 14.10 to 14.16 of the AEMA. This requires, among other things, the AEMC to base its assessment of the effectiveness of competition on criteria developed by the MCE (MCE criteria).⁸ 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;

⁵ Clause 14.11(a), AEMA.

⁶ Letter dated 19 April 2007 from the Chair of the MCE, the Hon Ian Macfarlane MP to the Chairman of the AEMC, John Tamblyn.

⁷ MCE Communiqué 10 July 2009.

⁸ Clause 14.11(a)(i), AEMA.

- price and profit margins; and
- customer switching behaviour.

On 16 December 2009, the MCE formally requested the AEMC to provide advice on the state of competition in, and retail price oversight for, electricity retailing in the ACT (Request for Advice). Consistent with the AEMA, the Request for Advice requires the AEMC to apply the MCE criteria in providing its advice. The Request for Advice is reproduced at Appendix B.

The Request for Advice also requires the AEMC to use the methodology and approach detailed in Parts 2 and 3 of the Revised Statement of Approach⁹ in conducting the retail competition reviews. The Request for Advice also requires that the ACT Review focus on 'small customers'; that is, customers who consume less than 100 MWh/year of electricity.

2.2 Matters to be addressed in this Review

Three key questions are the focus of this Review. Substantially reflecting the obligations contained in the AEMA and the Request for Advice, the questions are:

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

The first question goes directly to the assessment of the effectiveness of retail competition and will be answered in the first phase of the Review. The last two questions will be answered during the second phase of the Review in the advice to the MCE on the future of retail electricity price regulation in the ACT. The advice provided to the MCE will be based on the assessment of the effectiveness of retail competition.

As noted in Chapter 1, stakeholders are encouraged to respond to these questions in submissions.

2.3 What is effective competition?

The central notion underpinning the ACT Review is the concept of competition and the circumstances in which competition is considered to be effective. The AEMC's

⁹ The AEMC prepared and published a Statement of Approach (April 2007) which was adopted for the reviews undertaken in Victoria in 2007 and South Australia in 2008. Given the passage of time and developments that have since occurred, the Statement of Approach has been updated for the forthcoming reviews. The Revised Statement of Approach (December 2009) is available from the AEMC's website.

views about what constitutes 'effective competition' are set out in detail in Chapter 2 of the Revised Statement of Approach.

In summary, Chapter 2 of the Revised Statement of Approach highlights the following points in relation to effective competition:

- Competition is a process of rivalry between sellers to win the business of customers.
- In effectively competitive markets each supplier is constrained in its price and output decisions by the market activity and competitive responses of rival businesses and the exercise of informed customer choice.
- Competition promotes economic efficiency by encouraging businesses to produce at least cost the goods and services that consumers want and value most, and to respond to changes in consumer preferences by offering new, different or better goods and services in a timely manner.
- Different levels of competition may exist within a single market over time as it evolves and moves toward an effectively competitive market.
- An assessment of whether competition is effective should 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. The past is only relevant to the extent that it is a guide to the future.

In brief, the AEMC's analysis of the effectiveness of competition will be guided by the characteristics of effective or workable competition summarised above (and elaborated in the Revised Statement of Approach) and the factors which are most likely to combine to deliver those outcomes. Stakeholders are requested to identify those characteristics and features of electricity retailing in the ACT that are combining to deliver, or are restricting the ability to achieve, effective competition.

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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 unambiguous finding that a market is effectively competitive. Once the relevant market is defined, we will undertake a dynamic analysis of the various factors that, when viewed collectively, are likely to result in effective competition. We will consider these factors in conjunction with the MCE criteria and the characteristics of effective competition outlined in Chapter 2 and in the Revised Statement of Approach.

In this context, there are a number of matters that are likely to impact on the potential for effective competition to develop in electricity retailing in the ACT. These matters are raised in this chapter, and stakeholders are invited to provide written submissions addressing their relevance to, and effect on, electricity retail competition in the ACT.

3.1 Market definition

An important first step in analysing the competitiveness of a market is to define the relevant market. This sets the boundaries of the firms and the products that will be the focus of the review. We plan to define the market by having regard to the following four dimensions:

- **Product:** a market will include buyers and sellers of the same or similar products, and includes all actual and potential products that serve as a close substitute in the event that the price of the original product increases.
- **Geographic:** this is the area or areas over which the relevant product is supplied and to which consumers can practically turn.
- **Functional:** a market typically involves multiple stages of production, for example, production, wholesale and retail. As part of the market definition process, it is necessary to determine which functional level (or levels) is to be included in the analysis.
- **Temporal:** it is necessary to determine the time over which the substitution possibilities should be considered.

As outlined in the Revised Statement of Approach, it is appropriate to approach the question of market definition afresh at the commencement of the review of each jurisdiction. While we propose to adopt the same framework for our analysis, we are aware that each review will be focused on the competitive market experience of small energy users in a specific jurisdiction and that each jurisdiction may have unique characteristics that must be taken into consideration.

Issue for comment

1. What characteristics of the ACT electricity retail market should the AEMC take into consideration when defining the market for this review?

3.2 Market structure

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) electricity retailing in the ACT. This section notes some of the features of the ACT market that may be relevant to an assessment of the effectiveness of electricity retail competition.

3.2.1 Structure

The number of retailers and the size of their respective customer bases can affect the competitiveness of electricity 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 customer share increases.

Prior to the introduction of FRC in the ACT in 2003, 99 per cent of end use electricity customers were customers of the incumbent supplier ActewAGL, and had no choice about which licensed retailer of electricity would supply them.¹⁰ Following the introduction of FRC all small customers continue to have access to a regulated retail price but may opt for a negotiated price. ActewAGL remains the predominant electricity retailer despite 18 other entities holding licences to supply electricity in the ACT.

3.2.2 Conditions for entry

The 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 for incumbents may be lower where barriers to entry are present. A barrier to entry is a condition that places an efficient potential new entrant retailer at a disadvantage relative to an established business such that effective entry will be deterred. It does not include a cost or other impediment that applies more or less to any party (new or established) participating in electricity retailing. Barriers to entry are an important element of an assessment of the effectiveness of competition because where barriers are high new entrants will have difficulty in entering the market and, as such, existing market participants may be freed from competitive discipline.

For example, a retailer may face a barrier to entry if (a) it cannot secure access to wholesale energy supplies at prices that enable it to compete profitably with existing market participants, or (b) there are insufficient financial contracts available to allow

¹⁰ ICRC, July 2002, *Final Report: Full retail contestability in electricity in the ACT*, pp. 5-6.

the retailer to mitigate its price and volume risks. Difficulties in securing access to wholesale energy and risk mitigation tools may also affect existing retailers seeking to expand their energy retail business.

3.2.3 Expansion and exit

Once a retailer has begun trading, it may also face costs or impediments that prevent or limit its expansion 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 more effective competition against larger, more established retailers. In such circumstances, established large retailers may still not be constrained by the threat of effective competitors.

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 (that is, there are sunk costs) entry may be discouraged. In some situations, exit itself may involve further sunk costs such as costs to render a site or premises suitable for alternative uses.

3.2.4 Economies of scope and scale

In some markets, economies of scale and scope may provide a business with a competitive advantage over its rivals.

Economies of scale

Economies of scale exist if the long-run average cost of production declines as the rate of output increases. 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.

In electricity 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 per unit price to customers.

Economies of scope

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. Economies of scope may affect competition if competitive entry requires the new 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 and may deter potential new entrants.

Economies of scope may arise where the electricity retailer is vertically integrated with a business operating at another functional level in the industry. In the ACT vertical integration is present between the incumbent retailer and distributor. Vertical integration can have a positive impact on the competitiveness of electricity retailing if it allows efficiency gains achieved to be passed on to customers in the form of reduced retail electricity prices. However, it can be detrimental. For example, in the ACT if other retailers cannot gain access to the distribution network under the same terms and conditions experienced by the incumbent retailer then potential new entrants may be deterred.

The opportunity for retailers to offer products across a number of different utility services (so called 'multi-utility' services) and dual fuel products has provided retailers with the potential to benefit from economies of scope. Multi-utility and dual fuel products lower the average cost to serve by spreading the retailer's fixed costs over a larger number of customer connections. ActewAGL offers dual fuel and multi-utility products as well as its electricity retail service. It is the sole licensed provider of electricity and gas distribution and connection services and of water and sewerage services. ActewAGL is also a provider of retail gas, internet, broadband, phone and subscription TV services in the ACT. Of the 18 licensed retailers, eight are currently licensed to provide dual fuel products to small customers in the ACT.

3.2.5 Regulatory constraints

Electricity retailers operating in the ACT must comply with specific requirements as prescribed by legislation and a range of subordinate instruments (such as regulations, licences, codes and guidelines). Regulatory obligations exist in relation to a variety of matters including licensing, prudential requirements, service standards, customer transfer and consent, and consumer protection.

The regulatory obligation that is the principal focus of the ACT Review is the regulated retail price. That is, the price at which electricity is sold to small customers pursuant to a non-negotiated (or 'standard') customer contract. The regulated retail price of electricity 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 regulated retail price is set by the Independent Competition and Regulatory Commission (ICRC) may have important implications for the development of competition. For instance, if electricity retailers are exposed to material volatility in the wholesale electricity price and the regulated retail price is set at a level that does not provide retailers sufficient opportunity to recover input costs, then new entrants may be discouraged from commencing, or existing retailers from expanding, an electricity retailing business.

The introduction of FRC in the ACT opened the market for customers of all sizes to new retailers. Certain transitional arrangements were maintained to ensure that customers consuming less than 100 MWh/year were able to remain on non-negotiated contracts with the incumbent retailer, ActewAGL Retail. Transitional arrangements include a regulated price for the supply of electricity to those customers choosing not to negotiate a market contract.

The ICRC has addressed the issue of price regulation in the ACT retail electricity market since recommending the introduction of FRC. The ICRC concluded that there is sufficient competition to allow for the removal of the regulated retail price in preference for a monitoring scheme.¹¹ In its 2009 decision the ICRC noted that there is no continuing role for regulation of prices in a market that it believes is competitive. The ICRC also noted that there is an inherent contradiction between maintaining lower prices and therefore potentially limiting competition and raising prices with the intention of fostering competition.¹²

The issue of retail price regulation is also currently being considered by the ACT Government in a report prepared by the Department of the Environment, Climate Change, Energy and Water (DECCEW). The *Draft Sustainable Energy Policy 2010-2020* report suggests that the removal of retail price regulation would encourage retailers to develop new products (such as time-of-use tariffs) for residential users.¹³ Accordingly, the ACT Government intends to consider the removal of existing regulated electricity prices during the first half of 2010 and its possible replacement by a price monitoring arrangement (as adopted in Victoria).¹⁴

The focus of the ACT Government's policy in considering the removal of retail price regulation is to improve energy customer choice. The AEMC's review is focusing on the effectiveness of competition in the retail electricity market. Throughout the review we will communicate regularly with DECCEW on progress with the ACT Government's energy policy and consider any implications for this review.

3.2.6 Climate change policies

In the context of regulators setting retail prices it is also worth noting the potential impact of the implementation of the Carbon Pollution Reduction Scheme (CPRS). In its Review of Energy Market Frameworks in light of Climate Change Policies the AEMC noted that the effective regulation of retail prices will become significantly more challenging as the CPRS introduces increased uncertainty and volatility into the wholesale energy purchase costs of retailers.¹⁵ In July 2009, the AEMA was amended to include new clause 14.17 which stipulates that in relation to regulated retail prices, increases to energy costs associated with the CPRS shall be passed through to end-use customers. While the timing and policy details of a future CPRS remain uncertain, if a CPRS is introduced in the next year or two, there would be a greater risk of error in forecasting energy costs when setting future regulated retail tariffs for small customers. This has the potential to impact negatively on the development and maintenance of effective competition in the retail electricity market.

¹¹ ICRC, July 2009, *Final Decision on Retail Prices for non-contestable electricity customers, 2009-2010*, p. 56.

¹² ICRC, July 2009, *Final Decision on Retail Prices for non-contestable electricity customers, 2009-2010*, pp. 56-57.

¹³ DECCEW, December 2009, *Draft Sustainable Energy Policy 2010-2020*, p. 17.

¹⁴ This policy approach is currently open for comment.

¹⁵ AEMC, September 2009, *Final Report on Review of Energy Market Frameworks in light of Climate Change Policies*, p. 54.

Issues for comment

The AEMC is interested to receive submissions, supported by evidence, which 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 retailing in the ACT. Submissions are also invited to address other factors that stakeholders consider are relevant to the ease of entry into electricity retailing in the ACT.

In relation to electricity retailing:

2. Have the structural conditions for electricity retailing in the ACT supported or hindered the development of effective competition? Are these structures likely to support or impede further improvements in competition in the future?
3. Are there barriers to entry that impact on the development of effective competition? Have these barriers dissuaded prospective electricity retailers from entering or can they be overcome? Are these barriers likely to persist or abate?
4. Are there barriers to expansion or exit that impact on the development of effective competition? Have these barriers dissuaded prospective electricity retailers from entering or can they be overcome? Are these barriers likely to persist or abate?
5. Are there unique or specific features of the ACT electricity retailing environment that may support or impede the development of competition? For example, retailers offering multi utility and dual fuel products.

3.3 Market conduct

The consideration of market conduct focuses on the behaviour of participants in the defined market. This includes both the supply (in this case, electricity retailers) and demand (users of electricity). There are a number of factors that will be considered in relation to market conduct in the ACT electricity retail market.

3.3.1 Rivalry

Independent rivalry between retailers is an important driver of effective competition in the electricity retail market. An effectively competitive market is more likely to exist where retailers compete (and/or there is the threat of credible entry) to offer the products, services, prices and other conditions of supply which are most attractive to customers. In a competitive market retailers also respond to changes in consumer preferences 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 as identified below.

3.3.2 Marketing

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 electricity products and services, retailers face incentives to reduce customers' search costs and overcome any actual or perceived switching costs. One way for retailers to do this is to adopt marketing campaigns that focus more heavily on personal contact with customers, such as direct marketing. Direct marketing presents customers with relevant information and product comparisons, allowing them to exercise choice 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, there would be an increase in the overall competitiveness of electricity 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, this may impact adversely on the effectiveness of competition.

The effectiveness of retailers' marketing activities in increasing competition, particularly through direct sales techniques, must be considered in light of any behaviour that may undermine competition. This includes 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 *Consumer Protection Code 2007* under the *Utilities Act 2000* (ACT), and by electricity-specific instruments including the *Electricity Marketing Code* and the *Electricity Customer Transfer and Consent Code*.

The AEMC 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 ICRC or recorded by the ACT Civil and Administrative Tribunal (ACAT).

3.3.3 Customer participation and experience

Informed customer choice and a willingness to switch also places competitive pressure on retailers to provide electricity products at prices and on terms and conditions that meet customers' needs. However, a necessary precondition for informed customer participation in electricity retailing is that customers are aware that FRC exists and understand the consequences of being able to choose their electricity 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 customer contract to a market contract. With the exception of a short period in 2006, the number of ACT customers switching retailers in response to competitive supply offers has generally followed an increasing trend.¹⁶ However, following a period of strong switching behaviour in 2006–07, there was a noticeable

¹⁶ ICRC, September 2008, *Annual Report 2007–08*, pp. xx-xxi.

reduction in switching patterns in 2007-08.¹⁷ In 2007-08, about a quarter of total residential customers in the ACT were on negotiated customer contracts. This figure is a 12 percent reduction from the previous year. According to the ICRC, this reduction indicates that residential customers took the opportunity to return to the regulated retail price over the twelve-month period.¹⁸

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 satisfy customers and that improvements to their offers are required.

The ICRC has suggested several possible reasons for the market-wide easing in contestable activity. One is the high volatility and increased level of wholesale energy (generation) costs in late 2007. This may have pushed the level of the regulated retail price close to the possible market based levels. This, in turn, would reduce the opportunity for retailers to attract customers away from the regulated retail price with price discounts and additional service features. Alternatively, wholesale price volatility might also have deterred risk-averse retailers from competing in the ACT. ICRC reports that at least one retailer in the ACT decided not to accept new residential customers in 2007-08. In addition, another retailer was forced to withdraw from the market, requiring retailer-of-last-resort measures to be activated (although only one customer in the ACT was affected by this action).¹⁹

Although the impact of rising wholesale energy costs on energy retail competition is not specific to the ACT, ICRC considers that the reduction in market activity was more pronounced in the ACT than elsewhere. During the ICRC's review of electricity franchise tariffs in May-June 2008, some retailers suggested that the lower activity in the ACT market was due to the comparatively low retail margins embedded in the regulated retail price in the ACT compared to other jurisdictions. The ICRC noted that ActewAGL has continued to offer tariffs (particularly those included as part of a

¹⁷ ICRC, June 2009, *Licensed Electricity, Gas and Water and Sewerage Utilities Compliance and Performance Report for 2007-08*, p. 9.

¹⁸ ICRC, June 2009, *Licensed Electricity, Gas and Water and Sewerage Utilities Compliance and Performance Report for 2007-08*, p. 9.

¹⁹ ICRC, September 2008, *Annual Report 2007-08*, pp. xxi - xxii.

'bundled' service) at a discount to the regulated retail price, suggesting that the threat of competition has continued to promote contestable market behaviour.²⁰

Retailers perform an important role in educating customers about electricity 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 electricity 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.

The AEMC invites stakeholders to make submissions, supported by evidence, about the switching behaviour of small electricity customers in the ACT and the motivation for switching. Further, the AEMC is interested to understand the changes in switching behaviour since the introduction of FRC, and what switching patterns are likely to be observed in the near to medium term.

Issues for comment

In relation to electricity retailing:

5. To what extent do retailers compete with each other to acquire new customers and retain existing customers?
6. What does the current level of rivalry between retailers indicate about electricity retailing in the ACT?
7. Has retail price regulation encouraged or impeded tariff innovation, product differentiation and service competition?
8. On what basis, and to what extent, might retailers be expected to compete in the future?
9. 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?
10. Is there evidence of retailers engaging in mis-selling and other anti-competitive marketing practices?
11. What effect, if any, does retailer exposure to fluctuations in wholesale electricity price have on retailers' ability to offer competitive product and service offerings?

²⁰ ICRC, September 2008, *Annual Report 2007–08*, p. xxii.

13. 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?
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 Market performance

The outcomes or performance of the market is a reflection of both its structure and the collective conduct of market participants. Key indicators of market performance – and therefore of the effectiveness of competition in that market – include profit margins earned, price and non price competition between suppliers, and evidence of differentiated and innovative product and service offers.

3.4.1 Profit margin

One key indicator of effective competition is whether the profit margins that can be achieved under regulated retail prices are consistent with a return commensurate with the risks of electricity retailing. The margin available to retailers is a critical condition for entry and expansion in the market. For example, a significant margin above all relevant retail costs will provide an incentive for firms to enter the market.

3.4.2 Price

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

Pricing by reference to the regulated retail price may affect the nature and extent of retailer rivalry. It has been suggested 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 some detriment to consumers as they 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, as a result, may pay more.²¹ The effect of focal points, combined with reduced customer participation, can jeopardise

²¹ Professor George Yarrow, January 2008, *Report on the Impact of Maintaining Price Regulation*, p. 71.

diversity and innovation in the product offerings, electricity tariffs and tariff structures offered to customers.

Evidence from electricity 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.²² However, retail price regulation is also credited with delivering a range of pro-competitive benefits. For example, 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.²³ We encourage submissions to address the effects of retail price regulation in the ACT, including its effect on retailer rivalry.

3.4.3 Product

The availability of differentiated products and services may also be indicative of the extent of competition between retailers. Product differentiation may be reflected in non-price benefits (for example, free gifts such as magazine subscriptions, movie tickets or household appliances) or discounts for paying on time or paying via direct debit. Non-price rivalry may also exist in the form of offers for accredited GreenPower and other 'green electricity' products or by providing superior customer service (such as accurate and timely billing, call centre response times).

Issue for comment

15. 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 to encourage new entry and increase competition or will new entry be deterred?
16. 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 preferences?
17. To what extent do retailers compete with each other in terms of price to acquire new customers and retain existing customers?

²² 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 UK 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, June 2007, *Domestic Retail Market Report*, pp. 1-8.

²³ 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).

3.5 Other considerations

3.5.1 Consumer access to the benefits of competition

Electricity services are essential for all sectors of the community. Electricity is a derived demand good, in that its essential nature is derived 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 the ACT, it is appropriate to have regard to customers' experience of electricity 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 electricity 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 culturally and linguistically diverse backgrounds (CALD), 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 ACT electricity market. The AEMC 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 electricity market is because they are experiencing temporary or permanent financial hardship. The AEMC notes the ACT 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 electricity 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 electricity products.

Noting the arrangements that are currently in place in the ACT, the AEMC wishes to understand any electricity-specific and non-electricity specific factors that limit the ability of customers to access the benefits of competition. To this end, the AEMC 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.

Issues for comment

In relation to electricity retailing:

18. 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?
19. 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?

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4 Timetable and consultation

This chapter identifies the reports that the AEMC is required to publish during the ACT Review and the prospective dates for publication. It also sets out the process for public consultation during the Review, and the AEMC's approach to confidential information.

4.1 Reports to the MCE

The Request for Advice (at paragraph 10) requires the AEMC 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 2010. The timetable is set out in the table below:

Indicative Time	Milestone
4 March 2010	Issues Paper published
9 April 2010	Submissions in response to the Issues Paper due
July 2010	First Draft Report published
August 2010	Submissions in response to the First Draft Report due
October 2010	First Final Report published
	Second Draft Report published
November 2010	Submissions in response to the Second Draft Report due
December 2010	Second Final Report

4.2 Public consultation

Paragraph 8 of the Request for Advice requires the AEMC to issue a public notice announcing the commencement of the ACT 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 ACT electricity retailing.

On 4 March 2010, a notice was published on the AEMC website in accordance with the requirements of the Request for Advice. This notice was also published in *The Australian*.

The AEMC has also published this Issues Paper, which calls for submissions on issues relevant to the ACT Review, including on the effectiveness of competition. Submissions are to be lodged by 5pm, Friday 9 April 2010.

Prior to the publication of the First Draft Report, a range of activities will be undertaken to gather quantitative and qualitative data relevant to the ACT Review. These will include:

- a survey of ACT residential and small business consumers;

- interviews with licensed electricity retailers in the ACT;
- meetings with consumer groups;
- reviewing and considering submissions made in response to this Issues Paper; and
- ongoing consultation with the ACT Government and the ICRC.

4.3 Consultants' reports

The AEMC intends to procure consultants to provide expert advice in the context of the ACT Review and publish the resulting reports. Prior to the release of the First Draft Report, reports from consultants setting out the results of a survey of residential and small business customers, and the non-confidential results of interviews with electricity retail businesses will be released. Interested stakeholders will be given the opportunity to comment on these reports, and any other reports prepared at the request of the AEMC.

4.4 Confidentiality

The AEMC's approach to confidentiality is set out in full at section 4.4 of the Revised Statement of Approach. In general, information that is relied upon by the AEMC in its reports should be published to allow it to be commented upon and tested in open debate.

The AEMC 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 stakeholders. Where certain information is considered to be (in all or in part) confidential or commercially sensitive, the party 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.

The AEMC will consider each request for confidentiality in the context of the Review and in accordance with its relevant procedures.

A Background information on electricity retailing in the ACT

The retail market for electricity in the ACT is partially regulated. Any customer may elect to enter into a negotiated contract with a licensed electricity supplier. Customers are able to access a regulated retail price if they do not wish to enter into a negotiated market contract with a licensed retailer. The retail price for customers on market contracts is not regulated.

A.1 History of electricity retail in the ACT

In the ACT, the retailing of electricity to customers consuming more than 160 megawatt hours (MWh) per year (that is, predominantly large businesses) was made contestable from 1998. The electricity supply industry in the ACT was opened for retail competition to customers consuming more than 100 MWh/year, mainly medium sized businesses, from 1 July 2001. The market for customers using less than 100 MWh/year, largely small businesses and households, was opened to competition from 1 July 2003.

While the ACT Government decided to open the market to all customers, certain transitional arrangements were maintained to ensure that small customers were able to remain on non-negotiated contracts with the incumbent retailer, ActewAGL Retail. In December 2002, the ICRC was instructed to provide a price direction for the supply of electricity to these customers for a three year transitional period. At the beginning of that price direction all small customers were on the regulated retail tariff.

During the first transitional period, the ACT Treasurer sought advice from the ICRC on the need for the transitional arrangements to continue and, if so, the form of price protection that should apply to standing contracts (that is, non-negotiated contract) in the future and the duration of such protection. The ICRC recommended that retail price regulation should cease to exist, on the basis that there was evidence that the retail market in the ACT was sufficiently competitive to support its removal. However, the ICRC determined that retail price regulation should continue for a further year to allow the ACT Government to make any necessary legislative changes to preserve the conditions of the standard customer contract.²⁴

The ICRC was then instructed to provide a price direction for the supply of electricity to customers on a standing contract for a further transitional period from 1 July 2007 to 30 June 2008. The ICRC noted its concern that short reference periods meant it was unable to transition any price changes over a longer period, as was the case in other jurisdictions. Since this time, a further two references were received to determine any change to the regulated retail price to 30 June 2009 and, most recently, to 30 June 2010.²⁵

²⁴ ICRC, April 2006, *Final Report: Retail Prices for Non-contestable Electricity Customers*, p. 3.

²⁵ ICRC, February 2009, *Issues Paper: Retail Prices for Non-contestable Electricity Customers – 2009-2010*, pp. 1-2.

A.2 Size and structure of the ACT retail electricity market

Most of the electricity sold in the ACT is sourced from National Electricity Market generators elsewhere in Australia. Less than two per cent of the ACT's total electricity is generated in the ACT.²⁶

The ACT electricity retail market comprises mainly residential customers, who totalled just over 137,000 at the end of June 2007, accounting for 92.2 per cent of total customer numbers. Customers consuming less than 100 MWh/year accounted for 99 per cent of total customer numbers; only 710 customers consumed over 160 MWh/year. Non-residential customers, however, accounted for a greater share of electricity consumption with 59.1 per cent of the total sales. In 2006–07, the average electricity consumption in the ACT was 18.8 MWh/year per customer, down slightly from the previous year. For residential customers, the average was 8.4 MWh during the year; also down slightly on the previous year.²⁷

The number of residential customers who have entered into negotiated market contracts with either the incumbent or an alternative retailer increased steadily in the initial years following the introduction of retail contestability. Approximately 27,000 customers had entered into negotiated market contracts by 30 June 2006 and 34,000 by 30 June 2007. However, the number of customers on negotiated market contracts fell to approximately 30,000 by 30 June 2008 indicating that a number of customers have taken the opportunity to return to the regulated retail price.²⁸

In 2006–07, seven retailers supplied more than 100 customers, up from four retailers in the previous two years and just one retailer in both 2002–03 and 2003–04. Between 1 July 2003 and 30 June 2006, around 7,700 small customers elected to change retailers. In 2006–07, the rate of switching increased substantially when a further 11,040 customers, or 7.6 per cent of the base, opted for a change in retailer. In total, 18,700 customers—over ten per cent of the market—switched retailers. These numbers do not include ActewAGL customers switching from standard to negotiated customer contracts.²⁹

Electricity suppliers reported sales of 2,824 GWh in 2006–07, a slight increase over the preceding year.³⁰ Total revenue from electricity sales in the ACT rose by 10.7 per cent in 2006–07 to reach \$324 million, with the non-residential sector contributing nearly \$193 million, or 60 per cent of the total. The main contributing factor to the

²⁶ There are two small generators fired by reclaimed gas at the Mugga Way landfill tips and a mini hydro-generation plant at the Mount Stromlo Water Treatment Plant.

²⁷ ICRC, June 2009, *Licensed Electricity, Gas and Water and Sewerage Utilities Compliance and Performance Report for 2006–07*, pp. xi-xii.

²⁸ ICRC, February 2009, *Issues Paper: Retail Prices for Non-contestable Electricity Customers – 2009-2010*, p. 4.

²⁹ ICRC, June 2009, *Licensed Electricity, Gas and Water and Sewerage Utilities Compliance and Performance Report for 2006–07*, p. 12.

³⁰ ICRC, June 2009, *Licensed Electricity, Gas and Water and Sewerage Utilities Compliance and Performance Report for 2006–07*, p. xii.

sharp increase in overall revenue was that the average cost of power for non-residential customers rose by 15.8 per cent.³¹

ACT electricity supply customer numbers increased by 1.4 per cent over the 12 months to June 2007, to 148,667, with a 1.5 per cent increase in the residential sector and a 0.3 per cent increase in the non-residential sector. There is no indication that total size of the ACT retail electricity market will change in the near term as a result of economic factors. Growth in the ACT economy is expected to slow very significantly, business investment is forecast to fall sharply and consumption expenditure growth is expected to weaken significantly in the 2008-09 to 2010-11 period. The ACT's weak underlying growth rate is supported by relatively weak population growth and an even weaker employment growth.³²

³¹ ICRC, June 2009, *Licensed Electricity, Gas and Water and Sewerage Utilities Compliance and Performance Report for 2006-07*, p. 35.

³² National Institute of Economic and Industry Research, May 2009, *Natural gas projections for ActewAGL*, p. 21.

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