



Consultancy Terms of Reference

From: Australia Energy Market Commission
Date: 31 October 2007
Project No: EO0008/RS

Review of the Effectiveness of Competition in electricity and gas retail market- Report on impact of maintaining retail price regulation

Background

The Council of Australian Governments, through the Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (Commission) in July 2005. The Commission is a national body and is responsible to the MCE for the performance of its functions.

The Commission promotes the strategic longer-term design and development of energy markets through its functions of rule making, market reviews and policy advice. Its key responsibilities are to:

- consider rule change proposals that govern the energy market;
- conduct energy market reviews and inquiries for the MCE; and
- provide policy advice to the MCE as requested or on its own initiative.

The framework for the reforms leading to the establishment of the Commission is set down by the Commonwealth and State governments in the intergovernmental agreement known as the Australian Energy Market Agreement (AEMA).

Retail Competition Reviews

Under the AEMA, the Commission is required to review and publicly report on the effectiveness of retail competition in jurisdictions participating in the National Electricity Market (retail competition reviews).

The objective of the retail competition reviews is to assess the effectiveness of competition in the electricity and gas retail markets for the purpose of retaining, removing or reintroducing retail energy price controls. The assessment is required to be conducted on the basis of criteria developed by the MCE.

In addition to assessing the effectiveness of competition, the Commission must also provide advice to the relevant State or Territory Government as follows:

- *where the Commission finds competition is effective*: on ways to phase out retail price oversight in the jurisdiction; or
- *where the Commission finds competition is not effective*: on ways to promote competition in the relevant market.

The first retail competition review focuses on energy retailing in Victoria.

The Commission published its *First Draft Report into the Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria* (First Draft Report) on 4 October 2007. The First Draft Report sets out the Commission's analysis and preliminary conclusions about the effectiveness of competition in the retail supply of electricity and gas in Victoria. The Commission's preliminary conclusions are that competition in electricity and gas retailing in Victoria is effective. A copy of the First Draft Report is available from the Commission's website at www.aemc.gov.au. It is expected that a final report on the effectiveness of competition in the retail energy markets in Victoria will be published on 12 December 2007.

As stated above, where competition is found to be effective, the Commission is to provide advice to the State of Victoria on ways to phase out the exercise of retail price regulation. The Commission has commenced preparing that advice. It is anticipated that this advice will also be published on 12 December 2007.

Consideration of regulated prices as a reference point

While the MCE's direction to the AEMC is to provide advice on the removal of price regulation where competition is assessed as being effective, a number of community and consumer representative groups have argued in submissions that competition is effective *because* the regulated price provides a reference point or benchmark for discounting. They further argue that competition would be impeded in the absence of the regulated price; therefore, price regulation should be retained in Victoria.

Under this view a standard or regulated price / offer is necessary for the maintenance of effective price competition in the supply of essential services such as retail electricity and gas supply. In such markets it is held a standard or regulated price / offer assists small consumers compare competitive offers by providing a price benchmark or reference point. This view also holds that a standard or regulated price / offer facilitates competition by providing a benchmark price against which energy retailers make their market or competitive offers.

In providing advice on the case for the removal of price regulation, the Commission will have to address this proposition directly by reference to the theory of competitive markets and the practical experience in recently deregulated competitive markets. Consideration must be given to the cost of regulation; and the price distortions and behavioural incentives and inefficiencies price regulation can introduce into an otherwise competitive market. For example where the regulated price is a generous one, firms may be encouraged to price up towards or limit their discounts from the regulated price, compared to prices they may have charged in the absence of such a benchmark.

Objective of Consultancy

The objective of this consultancy is to provide a report (Report) to the Commission on the theoretical implications and practical experience in relevant countries of deregulated, competitive markets that have moved from the situation of having a regulated or standard offer price, particularly one which is higher than competitive prices are expected to be, to effectively or workably competitive markets where price is unregulated.

In particular, the Report should draw on both theoretical literature and experience in other countries and other industries to address the questions of whether the existence of a benchmark price is likely to result in:

- the distortion or enhancement of pricing, innovation, competitive behaviour and the efficiency of market outcomes compared to those that would occur in competitive markets where price is unregulated or no benchmark or reference price exists;
- retailers charging prices which are lower or higher than they would be in the absence of a benchmark or regulated price; and
- consumers making more or less informed and beneficial price /service decisions than they would have made in the absence of a benchmark or regulated priced.

Scope of the Consultancy

The Report should focus on the experience in markets:

- for goods or services provided to the mass market or small consumers and regarded as 'essential'; and
- which have moved from the situation of having a regulated or standard offer price, to the situation of effective or workable competition where price is unregulated.

In this regard, the Report should primarily reference the experience of deregulated retail energy markets in the United Kingdom and other deregulated energy markets in Europe and North America. The experience of deregulation of markets for other utilities and industries should be included where relevant.

The Report should reference existing relevant theoretical and empirical literature, including analysis and reports published by academic and other independent institutions and public agencies.

Timing of the Report

The Commission must provide its final report to the MCE on the case for removing or retaining price regulation in Victoria by 28 February 2008 and will publish a draft report on that matter on 14 December 2007 for public comment. Submissions on the draft report are due by 1 February 2008.

The Report is required by 16 January 2008 and would be published on the Commission's website by 18 January 2008 to inform public submissions and the Commission's preparation of its final report to the MCE.