



REVIEW

Australian Energy Market Commission

APPROACH PAPER

2016 Retail Competition Review

22 October 2015

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About the AEMC

The AEMC reports to the Council of Australian Governments (COAG) through the COAG Energy Council. We have two functions. We make and amend the national electricity, gas and energy retail rules and conduct independent reviews for the COAG Energy Council.

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1 Introduction

The Australian Energy Market Commission (AEMC) is conducting its third annual assessment of competition in electricity and gas retail markets across all jurisdictions within the national electricity market (NEM). These reviews are conducted under standing terms of reference set by the Council of Australian Governments (COAG) Energy Council in January 2014¹ and must be completed by 30 June each year.

We (the AEMC) are seeking stakeholder input on how we can further develop our approach to the 2016 Retail Competition Review (2016 review), building on our approach to the 2015 Retail Competition Review (2015 review) and the 2014 Retail Competition Review (2014 review).

In conducting the 2016 review we intend to draw from a range of information sources to form an evidence base to assess the state of competition against the following five competitive market indicators:

- customer activity in the market;
- customer satisfaction with market outcomes;
- barriers to retailers entering, expanding or exiting the market;
- the degree of independent rivalry; and
- whether retail energy prices are consistent with a competitive market.

As has been our approach in previous reviews, no one indicator will be determinative of the effectiveness of competition in a market.

An assessment of competition cannot be based on observing one indicator at one point in time. Multiple indicators are required to form a more complete picture of the state of competition. There are also no 'critical thresholds' for these indicators that tell us when competition is operating effectively. Information on a range of indicators needs to be considered collectively before judgement can be formed on the overall state of competition.

A range of information sources will be used to assess the competitive indicators in each market. These include stakeholder submissions, quantitative customer research, retailer surveys and data provided by ombudsmen, retailers, jurisdictional regulators, the Australian Energy Regulator and Australian Energy Market Operator.

We invite submissions from stakeholders on our approach to this review and the state of competition in NEM jurisdictions by 4 December 2015.

¹ A copy of the terms of reference is provided at Appendix B.

1.1 Purpose of this approach paper

This approach paper sets out how we intend to conduct the 2016 review.

We are seeking stakeholder views on our approach to this review and on the current state of competition in each jurisdiction. Our proposed approach set out in this document has taken account of feedback received to date from stakeholders on the 2015 review.

Information on how to make a submission is set out in section 1.4. We ask that submissions address the key questions set out in Appendix A.

1.2 Scope of this review

The scope of this review is set out in the standing terms of reference provided by the COAG Energy Council in January 2014 (Appendix B). The AEMC's annual reviews are to assess the current status (and possible future development) of competition in retail energy markets across NEM jurisdictions, as well as comment on issues affecting competition in those jurisdictions. NEM jurisdictions are Queensland, New South Wales, the Australian Capital Territory, Victoria, South Australia and Tasmania.

We are required to focus on small customers in retail energy markets, which includes residential and small business customers and excludes larger industrial and commercial energy users. Small customers are defined by reference to consumption levels which vary across jurisdictions.²

The terms of reference require us 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 resource constraints. Consistent with our approach for the 2015 review, we will use these criteria as a framework for our assessment of the effectiveness of competition in retail markets. This framework is discussed further in Chapter 3.

The terms of reference also require us to advise Energy Ministers on whether we could usefully provide further advice to any jurisdictions on possible ways to transition to price deregulation.

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.

² For most jurisdictions the consumption threshold for small electricity consumers is 100 MWh per annum. This varies in Victoria and South Australia which have thresholds of 40 and 160 MWh per annum respectively. The threshold for small gas consumers is 1 TJ per annum.

1.3 Stakeholder consultation

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

We will continue to meet with stakeholders throughout this review to seek their comments and request information on competition in NEM jurisdictions. Stakeholders are also encouraged to contact us directly to discuss any aspect of this review.

This approach paper requests submissions from stakeholders on our approach to this review and the state of competition in NEM jurisdictions. Submissions are requested by **4 December 2015**.

The relevant AEMC contact for this review is Dominic Adams. He can be reached by phone on (02) 8296 7800 or by email at dominic.adams@aemc.gov.au.

1.4 Submissions

We are requesting written submissions particularly focussed on the series of questions set out in Attachment A. Stakeholders are invited to provide their submissions by **4 December 2015**.

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 "RPR0004" 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 time frame provided we 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.

2 Background to this review

Under the Australian Energy Market Agreement (AEMA), all jurisdictions have committed to remove retail energy price regulation where effective competition can be demonstrated. We are required to undertake competition reviews to provide advice to governments to support this commitment.

2.1 Retail energy market competition in NEM jurisdictions

This is the third NEM-wide review of retail market competition to be undertaken by the AEMC. The first review was completed on 22 August 2014 and the second review was completed on 30 June 2015.

The 2014 review found that the state of competition in energy markets for small customers varies across the NEM reflecting the different pace of market reforms across jurisdictions. The state of competition also varies between electricity and gas markets due to differences in size, structure and market design features.

The findings of the 2015 review were largely consistent with the findings of the 2014 review. The 2015 review also found that new retailer entry and declines in market concentration suggest markets are continuing to evolve and mature and that further developments are expected over time as this evolution continues and new technologies are taken up.

For electricity, competition has led to greater choice of retailers and plans in Victoria, South Australia, New South Wales and South East Queensland. At the time of the review, effective competition was yet to emerge in electricity markets in the Australian Capital Territory, Tasmania and regional Queensland.

For gas, competition has been more tempered as gas is a secondary consideration for most customers and a less attractive value proposition for some retailers. Structural and market design features have led to significant differences in market outcomes between and within states.

Based on the findings of our 2015 review, the Commission recommended that jurisdictions should:

- consider options for raising awareness of the tools available for comparing energy offers to improve customer confidence in the market, for instance, through tailored communications to different audiences as set out in the AEMC's consumer engagement blueprint;
- ensure concession schemes are delivering on their intended purpose in an efficient and targeted way;
- continue to harmonise regulatory arrangements to reduce the long term costs of competing across jurisdictions;

- implement the recommendations of the AEMC's review of electricity customer switching to improve the accuracy and timeliness of the customer transfer process;³ and
- remove energy retail price regulation where competition is effective.

These recommendations were consistent with the recommendations in the 2014 review, with the addition of the recommendation regarding the review of electricity customer switching.

The 2016 review provides an opportunity to check whether there have been any significant changes in the competitiveness of the energy retail markets since the last review. It also provides an opportunity to incorporate relevant issues raised by stakeholders into the review.

As set out in section 1.4, we are now seeking submissions on our approach to this review and on the state of competition in NEM jurisdictions to provide evidence to inform our assessment.

2.2 Relevant external projects

As part of this review, we plan to engage with other organisations undertaking work relevant to monitoring aspects of retail energy markets.

A number of organisations are assessing various indicators of competition in NEM jurisdictions. This includes work by government and regulatory bodies, as well as consumer groups and ombudsmen. Some of these projects are repeated on an annual basis and cover similar issues to the AEMC's competition reviews.

The Australian Energy Regulator (AER) publishes a number of reports that include information relevant to the assessment of retail competition across a number of jurisdictions. Firstly the AER publishes quarterly updates monitoring retailer performance in jurisdictions that have implemented the National Energy Customer Framework (NECF).⁴ The AER also publishes annually its State of the Energy Market Report in December. These reports both present and analyse data relating to retail market competition such as customer numbers, contract types, complaints made to retailers, energy debt, payment plans, hardship programs, disconnections and reconnections.

The Queensland Productivity Commission (QPC) has been tasked by the Queensland Government to examine electricity pricing in Queensland and provide the Government

³ Australian Energy Market Commission, Review of Electricity Customer Switching, AEMC, April 2014.

⁴ The NECF was developed to promote national consistency in the regulation of retail energy markets. The NECF commenced operation in the ACT and Tasmania on 1 July 2012, followed by South Australia on 1 February 2013, New South Wales on 1 July 2013 and Queensland on 1 July 2015. Victoria has retained Victorian-specific legislation to regulate its retail energy markets.

with options that improve outcomes for consumers.⁵ The QPC is tasked with examining a number of specific matters that are relevant to retail market competition in Queensland, including retail price regulation, the ownership structure of government owned assets in networks and generation, options to increase competition in regional Queensland, energy concessions frameworks, consumer behaviour and emerging technologies.

The QPC published an issues paper in October 2015 setting out a broad range of issues they are seeking stakeholder views on.⁶ It is required to complete an interim report by the end of January 2016 and a final report within 10 months of the start of the inquiry.

The NSW Independent Pricing and Regulatory Tribunal (IPART) is required under legislation implementing the NECF to report annually to the Minister for Resources and Energy on the performance and competitiveness of the retail electricity market in NSW.⁷ IPART is required to have regard to information provided by the AEMC, the AER, retailers, and any publicly available information. IPART published its first draft report in July 2015 and intends to publish its first final report by the end of 2015 and annually thereafter.

The Victorian Essential Services Commission (ESC) annually reports on standing and market offer prices in Victoria. The ESC is also undertaking two significant reviews relevant to competition in retail energy markets in Victoria:

- *Energy Hardship Review* - this review is designed to inquire into best practice financial hardship programs of energy retailers.⁸ The ESC published its draft findings for this review setting out its views on the current regulatory framework for customers having difficulty paying their energy bills and proposing a new framework that the ESC considers will deliver better outcomes for these customers.
- *Energy Licence Framework Review* - this review is designed to investigate the efficiency and effectiveness of Victoria's licence framework relating to the supply of electricity and gas, and has produced an issues paper detailing options for the modernisation of the framework.⁹ This includes consideration of the flexibility and proportionality of the licence framework to respond to new technologies. The ESC notes that responses to that issues paper will inform whether the Commission proceeds to a draft decision by the end of 2015.

⁵ The terms of reference for this inquiry are available at:
http://www.qpc.qld.gov.au/files/uploads/2015/06/Terms-of-Reference_Electricity-Inquiry.pdf.

⁶ Queensland Productivity Commission, *Electricity Pricing in Queensland: Issues Paper*, October 2015.

⁷ The project page for this work can be found at:
http://www.ipart.nsw.gov.au/Home/Industries/Electricity/Reviews/Retail_Pricing/Retail_electricity_market_monitoring_2015.

⁸ The project page for this work can be found at:
<http://www.esc.vic.gov.au/Energy/Energy-Hardship-Review>.

⁹ The project page for this work can be found at:
<http://www.esc.vic.gov.au/Energy/Modernising-Victoria-s-Energy-Licence-Framework>.

The Essential Services Commission of South Australia (ESCOSA) reports to the Minister for Mineral Resources and Energy on electricity and gas standing and market offer prices that were generally available to small customers in the previous financial year.¹⁰ The reports are provided to the Minister annually, with the latest report published in August 2015.

ESCOSA is also tasked with reviewing whether the overall operation of NECF has furthered the interests of South Australian energy consumers.¹¹ ESCOSA published an issues paper in February 2015 calling for stakeholder submissions, which were published in July 2015. ESCOSA intends to publish a draft report in October 2015 and a final report in February 2016.

These projects undertaken by jurisdictional governments and regulatory bodies provide helpful insights into competition. There is scope for us to work with jurisdictional governments and regulatory bodies to minimise duplication of effort and to leverage existing work, and we will continue to engage with them to this end.

¹⁰ A copy of the most recent report to the Minister on electricity and gas prices can be found at: <http://www.escosa.sa.gov.au/library/20150828-Energy-RetailOfferPricesMinisterialReport2015.pdf>.

¹¹ The project page for this work can be found at: <http://www.escosa.sa.gov.au/projects/222/review-of-necf-in-south-australia.aspx>.

3 Assessment framework

This section sets out how we plan to conduct our assessment of competition in each NEM jurisdiction for the 2016 review.

We intend to approach the 2016 review in a similar way to our approach to the 2014 and 2015 reviews.

Most stakeholders have been supportive of our approach to the 2015 review. Some stakeholders have made suggestions for refinements and additions to the information we collect and areas for further analysis, and we have taken these into account in forming our approach to the 2016 review.

3.1 Data and time frames

We aim to produce the most up to date assessment of competition possible. We intend to conduct consumer surveys in late 2015 and further consumer research in early 2016. We intend to conduct retailer surveys in early 2016. We will look at a range of competitive indicators across the 2015 calendar year and will take historical data into account where possible. Where data is not available for the calendar year, we will consider data for the 2014-15 financial year. Some data on retail energy products and prices will be collected in early 2016.

We will also consider whether current conditions are likely to prevail in the future and whether there are likely to be any major changes in market conditions.

Our analysis of competition across the NEM will be subject to data availability. Much of the data we require will be sourced from the AER, jurisdictional regulators, Ombudsmen and the Australian Energy Market Operator (AEMO). We will also be collecting primary data through our consumer survey, qualitative consumer research, and our retailer survey.

We note that we do not have powers to compel market participants or others to produce information. This inevitably impacts the kinds of data that we can collect and consequently the type of analysis we can undertake.

3.2 Market definition

The first stage in assessing the level of competition is to define the relevant markets to be assessed. 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.

Subject to stakeholder input we intend to adopt the same market definition for this review as for the 2015 review, which was supported by the available data. This would

involve considering each jurisdiction as a single geographic market with two product markets: an electricity retail market and a gas retail market. A key exception to this approach applies to Queensland, where we would look at two geographic markets; South East Queensland, where customers can choose their retailer, and the rest of Queensland, where retail competition is currently permitted but there is presently only one active electricity retailer.

We will analyse regional areas separately in each state to determine whether there are any material differences from urban areas. This approach was taken for the 2014 and 2015 reviews.

We plan to consider small business and residential customers as part of the same market, but we will identify where specific findings differ between these two types of customers. For example, our assessment of retailer rivalry and our consumer research results will highlight any materially different outcomes.

Retailer submissions to the consultation paper for the 2015 review suggested the AEMC should broaden the market definition to include all parties who are authorised retailers or who receive an individual exemption, including solar energy suppliers and other embedded non-network suppliers (also known as "alternative energy sellers").¹² The submissions suggested that electricity provided by alternative energy sellers is acting as a substitute for electricity sourced from licenced retailers. Some submissions also noted that the barriers to entry for these businesses were lower than for traditional retailers. These issues were also raised by some retailers during informal engagement following the publication of the 2015 review.

The AEMC has been tasked with assessing the current state of retail competition in electricity and gas markets. While alternative energy sellers sell energy in these markets for use at customers' premises (that is, the usual trigger to attract regulation as a retailer) they have been exempted by the AER from the full range of obligations on retailers operating in such markets. The AER currently grants these exemptions where it considers such sellers have a 'lesser' involvement in the market.¹³

This year we intend to consider the current and potential impact of new products and services on competition in retail energy markets in greater detail than in previous reviews. The focus of this investigation will be on a broad range of new products and services. The investigation will therefore be broader than the suggested consideration of alternative energy sellers. We intend to collect information on this issue through our consumer research and retailer survey and by considering publicly available information. Section 3.4.2 provides further details of our approach to this issue.

¹² See the submissions to the consultation paper for the 2015 Retail Competition Review of AGL, Energy Retailers Association of Australia (ERAA), Lumo, Red Energy, Simply Energy and Origin Energy.

¹³ AER Statement of Approach: Regulation of alternative energy sellers under the National Energy Retail Law, June 2014. We note that this document is currently under review as discussed in section 3.4.2.

Although we will be considering the impact of new products and services in greater detail, we do not intend to consider alternative energy sellers as part of the market definition for this review for the following reasons:

- Alternative energy sellers only represent a small proportion of businesses that provide customers with products that compete with the traditional retail energy business model; for example, those that sell energy under solar power purchase agreements. Many businesses are not captured because they do not sell energy for use at customers' premises, however they still sell products that compete with the energy retailers. Those businesses include those that sell or lease products that reduce the energy needed from a retailer, such as solar panels, batteries, and energy efficiency or home energy management systems.
- There is very little data available on the activities of alternative energy sellers. This is principally because alternative energy sellers are not obliged to report on their performance to the AER as other retailers are required to do. They are also not obliged to be a part of energy ombudsman schemes in most states and so there is also little data available on customer complaints.
- It is not necessary to include alternative energy sellers in the market definition in order to assess the impact of new products and services on retail energy markets. Indeed, doing so may distract from considering the aggregate impact of new products and services, which we intend to consider in this review as noted above.

3.3 Competitive market indicators

We have drawn on the criteria in the terms of reference and refined them to focus our assessment of whether outcomes in retail markets in NEM jurisdictions are consistent with effective competition. The competitive market indicators we will use for our assessment are:

- customer activity in the market;
- customer satisfaction with market outcomes;
- barriers to retailers entering, expanding or exiting the market;
- the degree of independent rivalry in the market; and
- whether retail energy prices are consistent with a competitive market.

Analysis of the first two indicators will help to provide a picture of what the market is delivering and what the outcomes are for customers. The last three indicators should provide more detail on the market structure and the performance of the market against a number of identifiable metrics, such as the level of product differentiation and range of prices available for customers to choose from.

As has been our approach in previous reviews, no one indicator will be determinative of the effectiveness of competition in a market. An assessment of competition cannot be based on observing one indicator at one point in time. Multiple indicators are required to form a more complete picture of the state of competition. There are also no 'critical thresholds' for these indicators that tell us when competition is operating effectively. Information on a range of indicators needs to be considered collectively before judgement can be formed on the overall state of competition.

The methods we plan to use to analyse each of the indicators of competition are outlined below. This is not exhaustive 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 new products and a quality of service that customers demand. Customer activity is therefore an important indicator of whether competition is effective. Our analysis of this market indicator will consider the following:

- *Customer engagement in choosing energy offers* - obtained through AER data and customer surveys to explore the extent to which customers are shopping around for better energy deals, what they understand about retail energy markets and what kinds of information they use to make their decisions.
- *Customer attitudes* - obtained through customer surveys to understand the key drivers for consumers to shop around and whether there are any issues inhibiting their ability to do so.
- *Customer switching* - obtained through customer survey and AEMO data showing the number of people switching from one retailer to another and customer survey data on people switching plans with the same retailer. This data will be carefully interpreted in conjunction with other evidence on customer activity, as well as other competitive indicators.

We note that a focus on switching rates alone is unhelpful because high or low switching rates in isolation are not a sign of a well-functioning market. For example, customer switching data should be considered with data showing the motivations for switching, and the levels of satisfaction with the results of switching, in order to build up a more comprehensive picture of whether or not the switching activity is consistent with a competitive market. Similarly, information on the number of customers on a particular offer type, such as the proportion of customers on standing offers, should not be considered in isolation.

To gather information on customer engagement and attitudes, a consumer research firm will conduct a survey of customers across NEM jurisdictions. The survey and the associated methodology will be similar to that conducted for the 2015 review.¹⁴

We intend to build on the 2015 customer survey to extend the time series of the core questions that provide important data that feeds into the assessment of customer activity and engagement. We also intend to use the customer survey to investigate key issues identified by stakeholders.

As with the 2015 customer survey, in the 2016 survey we will segment the data to identify any differences in trends for small business and residential customers, urban and rural customers, younger and older customers, low income and high income customers and customers with or without solar panels. We intend to further segment the results for vulnerable customer groups to build a more detailed picture of market activity and outcomes for these groups. For more details on our approach to considering vulnerable customers see section 3.4.1.

In the 2015 customer survey we considered whether having solar panels affected customer perception of their ability to switch retailer or plan. We intend to consider this issue again and also to consider customer awareness and understanding of other new products and services, which will help inform a more detailed discussion of such emerging trends in this review. For more details on this discussion see section 3.4.2.

3.3.2 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 the following:

- *Customer surveys* to test views on the products the market is delivering for customers as well as testing retailer services and value for money and the ease and speed of switching.
- *Customer complaints* to both retailers and ombudsman to test customer satisfaction with market outcomes.

As discussed in section 3.3.1, we will engage a consumer research consultant to undertake a customer survey in NEM jurisdictions. We will use this survey to gather information on market outcomes for customers. As with the results for customer activity, we plan to segment the result by different customer characteristics to better understand customer satisfaction with the retail energy market and whether satisfaction may differ depending on these characteristics.

¹⁴ Details on the survey and methodology are available in Newgate Research's report on the 2015 review project page at:
<http://www.aemc.gov.au/Markets-Reviews-Advice/2015-retail-competition-review>.

3.3.3 Barriers to entry, exit or expansion

Analysing whether new retailers can freely enter the market, and whether incumbent retailers can expand or exit, is an important element of a competition assessment. Where there are low barriers to entry, exit and expansion there are competitive pressures on existing retailers to charge prices that reflect efficient costs and improve their offers. An effectively competitive market will generally have no significant barriers to entry, exit or expansion. Our analysis of this market indicator will consider the following:

- *Evidence of entry, exit or expansion* of retailers and whether this is indicative of low barriers to entry, exit or expansion for that market. This includes identifying which retailers have entered or exited a market since the 2015 review and how the market share of retailers may have changed during the same period.
- *Retailer surveys* 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 jurisdictional regulatory costs and obligations.
- *Measures of contract market liquidity* as a test of whether new entrant retailers are able to obtain hedging products to manage their risk exposure.

During informal consultation since the release of the 2015 review a number of retailers questioned the value provided by the retailer survey, in particular questioning whether all retailers consider the survey in sufficient detail and at a sufficiently senior level within the organisation. We note that the retailer survey is particularly important for assessing this indicator of competition. We will work with the consultant that is engaged to conduct the retailer survey to incrementally improve the retailer survey and to address stakeholder concerns regarding the survey. We also intend to work with the consultant to include new questions that may improve our understanding of the vulnerable customer experience in retail energy markets and the impact of new products and services on competition.

3.3.4 Independent rivalry

Independent rivalry describes the extent to which retailers compete to attract customers away from their rivals and retain existing 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 the following:

- *Market share and concentration* in each jurisdiction and how these have changed over time.

- *Switching between retailers, including switching between the big three retailers¹⁵ and switching between the big three and smaller retailers.*
- *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. This may include differences in branding, tariff structure, contract terms and conditions, GreenPower, solar services or other characteristics that customers value.*

In this review we will discuss the role of innovation in competitive retail energy markets, including its role in increasing product differentiation. This is likely to include a review of literature and a discussion of the ways retailers may compete by developing innovations in the products and services they offer. We will also consider evidence of product innovation in the offers available in energy markets in NEM jurisdictions.

The role of innovation in competitive retail energy markets will also be considered as part of an investigation of the current and potential impact of new products and services on competition. This is discussed further in section 3.4.2.

3.3.5 Competitive retail prices

One of the key ways energy retailers compete is through price. Retail prices can be expected to fluctuate with changes in underlying costs, changes in the behaviour of competitors and in response to customer behaviour. Over time retailers may be able to reduce underlying costs and manage supply of services in a cost-effective way enabling these savings to be passed on to customers through competitive retail prices. Trends in retail prices over time can provide an indication of the level of competition in a market. Our analysis of this market indicator will consider the following:

- *Prices offered by retailers in NEM jurisdictions.*
- *The composition of retail prices.*
- *The range of prices available in different product categories.*

As with previous years, we plan to draw from a range of information to assess this competitive market indicator, including our own pricing analysis, the work of consumer representatives, regulators and other government bodies.

As part of our assessment of competition across NEM jurisdictions we will consider publicly available information on the margins earned by energy retailers. We do not intend to conduct a detailed assessment of the levels of retail margins in NEM jurisdictions for the reasons outlined below.

¹⁵ 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.

Net margins, meaning the amount that a supplier makes per customer after all its operating and other costs are considered, can be an indicator of the level of competition in a market. Where net margins are high there are incentives for new entry. New entrants should seek to obtain market share by driving down prices and incumbents should seek to maintain their market share by following prices down. In an efficient market with low barriers to entry this process should see net margins trending to an efficient level.

There are limitations to what an analysis of net margins can indicate regarding the level of competition in a market and as a result net margins should not be considered in isolation. Net margins vary over time and high or low margins can occur for a variety of reasons:

- Net margins may temporarily vary as part of the competitive process where suppliers discount to attract customers or protect against new entry. Net margins may increase as suppliers reduce the costs of supply through innovation or developing and marketing higher value products.
- Energy retailers have a range of business models and strategies. Many retailers own some generation, but the amount and generation type varies. Some retailers sell energy alongside other products, such as telecoms products. These different business models will affect their cost structures and levels, and how their profits or losses are shown in their accounts, which makes understanding actual net margins for retailers particularly challenging, and increases the likelihood they will vary over time. The net margin earned from different customers may also vary as customers that are active in the market may be able to find better priced offers, while customers that are inactive could remain on higher priced standing offers.
- Net margins may also vary for reasons that are outside of the control of suppliers, such as changes in the underlying costs of supply and changes in customers' consumption and switching behaviours.

There is no clear indication of what net margins should be in competitive retail energy markets. There is even less information on what they should be at various stages of the transition toward effectively competitive markets, as would be required to reflect the different competitive and market conditions in different NEM jurisdictions.

There are also significant problems with accurately assessing net margins. To assess net margins in a meaningful way would require a detailed assessment of the capital, risks, revenue and costs of energy retailers by jurisdiction.¹⁶ Without information gathering powers this assessment would be extremely difficult and costly for the AEMC to undertake. It would inevitably involve making a range of assumptions, particularly regarding average prices paid by customers, wholesale energy costs and retailers' operational costs and the risks involved in market participation. The results of any

¹⁶ The evidentiary and other difficulties of reviewing profit margins are described in detail in Australian Energy Market Commission, 2014 Retail Competition Review, AEMC, August 2014, pp15-16 and pp173-183.

assessment conducted on this basis would be highly sensitive to these assumptions, significantly limiting the value of the results.

Due to the difficulties in estimating net margins noted above, most recent assessments of margins in Australian retail energy markets have instead assessed gross margins. That is, the amount a supplier makes per customer before its operating and other costs are considered. Such assessments should only be used to draw limited conclusions on the state of competition because they do not incorporate retailers' underlying costs. Without assessing retailers' actual costs it cannot be accurately determined whether prices are trending toward efficient costs over time.

Regardless, it is not necessary to undertake a detailed investigation of net or gross margins to consider the state of competition in retail energy markets in NEM jurisdictions. The assessment framework outlined in this Chapter is sufficient to provide a reasonably clear assessment of the level of competition.

3.4 Issues for further investigation

Discussions with stakeholders have highlighted the need to further investigate a number of important issues concerning the effectiveness of competition in retail energy markets. This year we will consider the two issues outlined below.

3.4.1 Vulnerable customers

Not all customers are willing or able to engage in competitive markets. For some customers this is a rational decision because they may value their time more highly than the rewards of investigating and choosing a new energy deal. However some customers may be having difficulty paying their energy bills, but may not be investigating their options and choosing energy deals that better suit their needs.

The survey results for the 2015 review suggested that customers who were then receiving a rebate or concession, had a special payment arrangement with their retailer as a result of financial hardship or were experiencing difficulty paying their energy bills were:

- more likely to have investigated their options;
- more interested in seeking out a better deal;
- more likely to have switched energy retailer or plan;
- more concerned about hidden fees and charges; and
- less trusting of energy companies who promise a better deal.¹⁷

¹⁷ Australian Energy Market Commission, 2015 Retail Competition Review, AEMC, 30 June 2015, p30.

The results from the 2015 customer survey suggests the experience of vulnerable customers differs from other customers. It suggests that although some vulnerable customers are more active, many vulnerable customers have difficulty engaging in retail energy markets due to concerns about the potential for poor outcomes.

We would like to further investigate the experiences of and outcomes for vulnerable customers in retail energy markets. In particular we intend to consider in greater detail:

- the differences in experiences and outcomes for vulnerable customers compared with other customers;
- the causes of the disengagement of some vulnerable customers from retail energy markets, such that they do not investigate their options;
- the reasons why some vulnerable customers may investigate their options or consider investigating their options but fail to change to a deal that better suits their needs; and
- the changes in the experiences of vulnerable customers that may assist them to participate more effectively in competitive retail energy markets and access the best available offers.

We will investigate these matters by considering changing or adding to the customer survey as well as considering conducting qualitative research on the vulnerable customer experience. We will consult with interested stakeholders on the approach to this research and would value input from consumer groups, retailers and jurisdictional governments and regulators.

3.4.2 New products and services

The traditional, centralised energy supply model is being challenged by new products and services, particularly for electricity. Many of these new products and services allow customers greater control over how their electricity is delivered and consumed. Some of these products and services may allow customers to cede control over how their electricity is delivered and consumed to third parties. These developments are likely to be transformative for retail energy markets.

We would like to investigate the current and potential impact of new products and services on competition in retail energy markets. Such emerging products and services include:

- distributed generation technologies such as solar panels, fuel cell and small scale gas generation and battery storage;
- innovative financing options for distributed generation (such as power purchase agreements or solar equipment leases);
- off-grid options both for individuals and groups of customers;

- demand management services, such as direct load control and home energy management systems, including aggregated services; and
- innovative retail energy products, such as time-of-use and other innovative tariff structures.

New technologies, methods and processes allow retailers to innovate in the ways that they deliver energy services and the ways customers use energy, in order to reduce costs or improve their customers' experience. While considering the impact of new products and services we also intend to discuss the role of innovation in competitive retail energy markets.

To explore the current and potential impact of new products and services on competition we will consider options to examine:

- current customer awareness and understanding of new and emerging energy products and services;
- current customer engagement and uptake of new and emerging energy products and services;
- potential short and medium term engagement and uptake of new and emerging energy products and services;
- customer motivations for current and potential uptake of new and emerging energy products and services (including motivations for not taking up such products and services); and
- customer expectations and views regarding the level of consumer protection they might expect from their purchase of various new and emerging technologies, compared with the protections they receive for traditional purchases of energy.

We will draw from a range of sources to investigate these issues, including by considering changing or adding to the customer survey as well as considering conducting qualitative research. We also intend to draw from work already done by other jurisdictional governments and regulators.

We do not intend for this review to duplicate the AER's work on the regulation of innovative energy selling business models under the National Energy Retail Law, which they are currently consulting on.¹⁸ Nor do we intend to duplicate the relevant work of the COAG Energy Council's Energy Working Group (EWG), which recently considered whether the regulatory frameworks in the NEM are appropriate in the context of new products and services being offered to small electricity customers.¹⁹

¹⁸ Further information is available at:
<http://www.aer.gov.au/retail-markets/retail-guidelines/review-of-retail-exempt-selling-guidelin-e-2015>.

¹⁹ Further information is available at:
<http://www.scer.gov.au/workstreams/energy-market-reform/demand-side-participation/new-products-and-services-in-the-electricity-market/>.

The EWG published its advice to the COAG Energy Council in July 2015, recommending that the Council initiate a range of new workstreams to investigate the appropriateness of various regulatory frameworks in light of the potential impacts of new products and services.

A Questions for stakeholder submissions

We are seeking stakeholder views on our approach to this review and 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 make a submission are in section 1.4.

A number of the questions below can be answered in terms of common issues across all NEM jurisdictions or issues applying solely to specific jurisdictions or regions within jurisdictions. We are particularly interested in new evidence not considered in the 2015 review and in evidence of any trends over time (eg. data over multiple years).

Questions on the approach

1. Is the approach described above appropriate for this year's review of competition and why?

Questions on the competitive market indicators

2. Is there any new evidence about how customers are behaving in retail energy markets and what does that evidence tell us about the level of competition in those markets?
3. What are the barriers to some customers (such as, customers that remain on standing offers) seeking out a new market offer that better suits their needs?
4. Is there any new evidence about what the outcomes are for customers in retail energy markets (such as their level of satisfaction with their experiences) and what does that evidence tell us about the level of competition in those markets?
5. What is the nature of any current or expected barriers to entering, exiting or expanding in any NEM jurisdictions for electricity or natural gas retailers?
6. Is there any new evidence that retailers are competing in retail energy markets on price, product and service differentiation to acquire new, and retain existing, small customers, and what does this evidence tell us about the level of competition in those markets?

Questions on the key issues for this year's review

7. What are the differences between the experiences of vulnerable customers in retail energy markets and other customers; and what do these tell us about how effectively vulnerable customers are able to participate in retail energy markets?
8. Is there any evidence that new products and services are currently impacting competition in retail energy markets and if so, what is that impact?

B Terms of reference

09 JAN 2014



THE HON IAN MACFARLANE MP

MINISTER FOR INDUSTRY

PO BOX 6022
PARLIAMENT HOUSE
CANBERRA ACT 2600

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

RECEIVED 15 JAN 2014

Dear Mr Pierce *Sohn*

As you are aware, Australian governments have committed under the Australian Energy Market Agreement (AEMA) to remove retail energy price regulation where effective competition can be demonstrated. The Australian Energy Market Commission (AEMC) is tasked under the AEMA with responsibility for assessing the state of retail competition across jurisdictions within the National Electricity Market (NEM).

In December 2012, the Standing Council on Energy and Resources (SCER) and the Council of Australian Governments agreed to revise the AEMC's existing approach to competition reviews. As such, the attached revised Terms of Reference were developed by SCER to underpin a revised focus of the reviews on the state of competition across jurisdictions within the NEM with scope for more detailed jurisdiction-specific advice, if agreed, by the AEMC.

To support this approach the AEMA was amended in December 2013 to remove prescriptive elements associated with the existing approach which are focused on individual jurisdictional reviews.

This revised approach to competition reviews is to be applied annually from 2014 onwards. To guide the AEMC in this approach in future competition reviews, please find attached the Terms of Reference that supersede the Statement of Approach for the AEMC's reviews. The Terms of Reference will remain in place for the AEMC's reporting on an ongoing basis from 2014 until such time as directed otherwise by SCER.

Yours sincerely,

Ian Macfarlane
Ian Macfarlane

Phone: (02) 6277 7070 Fax: (02) 6273 3662

TERMS OF REFERENCE

AUSTRALIAN ENERGY MARKET COMMISSION (AEMC) REPORTING ON THE STATE OF RETAIL ENERGY MARKET COMPETITION ACROSS THE NATIONAL ELECTRICITY MARKET

BACKGROUND

Australian governments have committed under the Australian Energy Market Agreement (AEMA) to remove retail energy price regulation where effective competition can be demonstrated. The Australian Energy Market Commission (AEMC) is tasked under the AEMA with responsibility for assessing the state of retail competition across jurisdictions within the National Electricity Market (NEM).

From 2007 to 2013 the AEMC, as requested by the Ministerial Council on Energy (MCE), the predecessor to the Standing Council on Energy and Resources (SCER), conducted reviews of retail energy market competition in individual jurisdictions. These reviews were guided by prescription contained within the AEMA and a Statement of Approach approved by the MCE. The AEMC reviewed Victoria over 2007 and 2008, South Australia in 2008, the Australian Capital Territory over 2010 and 2011, and New South Wales over 2012 and 2013. During this period, Victoria and South Australia deregulated retail energy prices from January 2009 and February 2013 respectively and the Australian Capital Territory did not deregulate retail pricing as effective competition could not be demonstrated.

In December 2012, SCER and the Council of Australian Governments agreed to revise the AEMC's existing approach to competition reviews. Accordingly, these Terms of Reference have been developed by SCER to underpin a revised focus on the state of competition across jurisdictions within the NEM, with scope for further more detailed jurisdiction-specific advice on pricing reform by the AEMC, as required.

To support this approach, the AEMA was amended in December 2013 to remove those prescriptive parts of Section 14 and Annexure 3 which were associated with previous methodologies. Also, these Terms of Reference supersede the previous Statement of Approach.

OUTLINE

These Terms of Reference are intended to guide the AEMC's assessment of the state of retail energy market competition across and within jurisdictions in the NEM.

The task entails annual reporting by the AEMC on the state of competition in retail electricity and gas markets across NEM jurisdictions, with scope for more detailed jurisdiction-specific advice on pricing reform as required.

SCER requests this reporting by the AEMC pursuant to section 41 of the National Electricity Law and section 79 of the National Gas Law.

Terms of Reference – AEMC reviews of retail energy market competition

The AEMC's reporting is to be carried out in accordance with the assessment framework and processes outlined below.

SCOPE

The AEMC is required to publish an annual report assessing the current status (and possible future development) of retail competition in electricity and gas markets across all the NEM jurisdictions. This assessment is to be based upon objective measures and analysis. The AEMC's reports should also comment on NEM-wide issues that are affecting retail competition. More details on the assessment framework are provided below.

The AEMC's reporting will focus on the small customer end of retail electricity and gas markets as defined by the relevant jurisdictional consumption threshold(s) or any other means the AEMC deems appropriate.

The competition monitoring that occurs as part of the AEMC's annual NEM-wide reviews will principally cover energy markets in jurisdictions that are subject to retail price regulation, but also markets in jurisdictions where prices have been deregulated - mainly for comparison purposes.

As part of this annual reporting, the AEMC is required to advise Energy Ministers whether there are any jurisdictions to which it could usefully provide further advice on how they may transition to price deregulation. SCER would use this advice to inform their potential further directions to the AEMC on the provision of such advice.

ASSESSMENT FRAMEWORK

The AEMC should have regard to the following criteria where practicable, and subject to data availability and resourcing constraints, in assessing the effectiveness of retail competition in energy markets across and within NEM jurisdictions (i.e. they apply for both NEM-wide and any jurisdiction-specific reports).

CRITERIA

1. Independent rivalry within the market.
2. The ability of suppliers to enter the market.
3. The exercise of market choice by customers.
4. Differentiated products and services.
5. Price and profit margins.
6. Customer switching behaviour.

CONSULTATION

The AEMC must consult with jurisdictions during the preparation of its report including on methodology, data collection processes and timelines, with a view to maintaining a consistent approach on assessing competition across jurisdictions.

The AEMC must release its draft report to jurisdictions for their review and comment.

Terms of Reference – AEMC reviews of retail energy market competition

The AEMC may also consider where practicable consultation with key stakeholders in the preparation of its report including energy retailers, consumer groups, energy ombudsman and pricing regulators.

TIMING

The AEMC must publicly release its NEM-wide report by 30 June each year and provide embargoed copies of the report to Energy Ministers (through SCER) at least ten days before publication.

The second half of each year is intended to allow the AEMC sufficient time to provide individual jurisdictions with supplementary advice where the need is identified by the AEMC and agreed by SCER. This advice would also be made public with timing and other parameters to be agreed by SCER as part of its request to the AEMC.

These Terms of Reference will remain in place for the AEMC's reporting on an ongoing basis from 2014 until such time as directed otherwise by SCER.

7 JANUARY 2014