

Our Ref: D13/92474  
Your Ref:  
Contact Officer: Gavin Fox  
Contact Phone: 02 6243 1249

4 July 2013

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

Dear Mr Pierce

**Draft Report: Review of Competition in the Retail Electricity and Natural Gas Markets in NSW**

The Australian Energy Regulator (AER) welcomes the opportunity to provide this submission to the Australian Energy Market Commission's (AEMC) draft report on the review of competition in the electricity and natural gas retail markets in NSW (Draft Report).<sup>1</sup> As the regulator for retail markets under the National Energy Customer Framework (Customer Framework), the AER is responsible for monitoring and enforcing compliance under the National Energy Retail Law and reporting on the performance of the retail market and energy businesses. Given these responsibilities and NSW's scheduled transition to the Customer Framework in July 2013, the issues covered in the AEMC's Draft Report are of particular interest to the AER.

While the AEMC's Draft Report covers a broad range of issues, our submission focuses on issues of direct relevance to the AER. In particular, our submission focuses on the AEMC's proposed expanded market monitoring role for the AER. The submission also comments on some of the metrics used to assess the effectiveness of competition.

*Market and price monitoring*

Effective retail competition provides strong incentives for suppliers to operate efficiently and be price competitive. This can deliver significant benefits to consumers, both in terms of competitive prices and more innovative products.

In its Draft Report, the AEMC concludes that energy retail competition is currently effective in NSW and on this basis recommends that retail price caps be removed.<sup>2</sup> The AEMC suggests that if NSW agrees to deregulate prices, a mechanism should be put in place to monitor the market, including the

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<sup>1</sup> AEMC 2013, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales*, Draft Report, 23 May 2013, Sydney

<sup>2</sup> *ibid*, p.92

prices that customers pay.<sup>3</sup> The purpose of these monitoring arrangements would be to provide relevant stakeholders with information regarding the development of the market and the effectiveness of competition.<sup>4</sup> This information includes market shares, gross and net (excluding move in and move outs) switching rates and the range of tariffs on offer. The AER or IPART are considered as possible entities for this role.<sup>5</sup>

The AER agrees with the AEMC that monitoring arrangements should be established for the NSW energy retail market if price caps are removed. We believe that these monitoring arrangements should capture information such as market shares, available tariffs and retailer revenue/margins, and provide commentary on the level of competition more generally. This information would provide useful insight into the effectiveness of competition in the NSW energy retail market. We also note the Essential Services Commission of Victoria "Energy Retailer Comparative Performance Report–Pricing", which captures similar information and has become a useful tool for assessing the performance of the Victorian energy retail market.<sup>6</sup>

The AEMC recommends that the monitoring arrangements should be undertaken by the AER or Independent Pricing and Regulatory Tribunal (IPART). As acknowledged by the AEMC, the Customer Framework already requires the AER to publish a retail market performance report. This report captures information including customer numbers per retailer and customer transfers. It also provides information on customer service and complaints. However, it does not capture customer tariffs, gross and net switching rates, retailer revenue/margins or provide a broader perspective on the level of competition.

It would appear efficient for the AER to expand its performance reporting arrangements to capture the broader competition analysis. The AER already has skills and experience relating to the wholesale market and network costs, which would assist in assessing retailer revenue/margins. It may also create efficiencies for retail businesses by reducing the number of entities they provide information to and would also make it easier for stakeholders, by having a single entity commenting on the performance of the NSW energy retail market.

However, the AER does not underestimate the task of assessing retailer revenue/margins on a regular basis. While we believe that we could undertake this role, the AER's funding arrangements would need to be adjusted to reflect this new responsibility. We would also require additional information gathering powers to collect pricing information. This may be facilitated by extending the AER's functions and powers under the National Energy Retail Law.

We consider that if the AER were to undertake the monitoring role, it would be appropriate to draw on IPART's existing expertise in setting NSW retail prices. Arrangements would need to be developed, but could potentially involve close consultation and liaison with IPART or the secondment of staff to the AER.

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<sup>3</sup> *ibid*, p.110

<sup>4</sup> *ibid*

<sup>5</sup> *ibid*, p.111

<sup>6</sup> Essential Services Commission 2012, *Energy retailers comparative performance report–pricing 2011-2012*, September

### *Competition metrics*

The AEMC is required to base its assessment of the effectiveness of competition upon criteria outlined in the Australian Energy Market Agreement.<sup>7</sup> These criteria, which include customer switching behaviour, provide some measure of the level of competition. However, they also have their own limitations.

As acknowledged by the AEMC, customer switching rates are not a perfect measure of customers that are active in the market.<sup>8</sup> The figures only capture the amount of transfers that occur. This means if one customer has switched four times, that would be counted as four transfers in the market. Customer switching rates also do not capture the basis upon which a customer transfers. For example, they do not inform us whether the customer switched after making an assessment of available energy offers. Gross switching rates are also problematic, since they capture move-in/move-out customers. In these instances, the customers are forced to engage with the market since they are moving house. While any use of switching rates as a measure of the effectiveness of competition will have its limitations, more meaningful trends will be provided by considering net switching rates (net of move-in/move-out customers). The AER notes that the AEMC is proposing the inclusion of net switching rates as part of its additional market monitoring measures.

The AER notes the approach used by the AEMC to assess independent rivalry. In the Draft Report, the AEMC concluded that independent rivalry exists. In the assessment of this metric, the AEMC considered measures such as market structure and product differentiation.

The AEMC reported that market concentration is high, with the major three retailers having a 95 per cent share of the electricity retail market.<sup>9</sup> While not a definitive metric for assessing competition, highly concentrated markets can lead to prices being set above efficient levels. The Herfindahl-Hirschman Index (HHI), a measure of market concentration, is 3,200 for the NSW electricity retail market and 4,500 for the gas retail market.<sup>10</sup> The ACCC uses a HHI of below 2,000 as a guide for when a merger is unlikely to raise competition concerns.<sup>11</sup> The United States of America's Department of Justice considers a HHI in excess of 2,500 as demonstrating a highly concentrated market.<sup>12</sup>

The AEMC also reported that product differentiation was somewhat limited, particularly when it was compared to Victoria.<sup>13</sup> From the survey conducted by Roy Morgan for the AEMC, only 34 per of electricity customer respondents and 25 per of natural gas respondents stated there was greater variety of offers than a year ago.<sup>14</sup> Retailers acknowledged limited innovation in the types of products and services they offered.<sup>15</sup> However, retailers did note ongoing price regulation as a factor for stifling product differentiation and innovation.

The AER considers that the AEMC's analysis appears to raise some issues with existing retail markets in NSW. Therefore, if the AEMC concludes in its final report that energy retail competition is effective in NSW and that prices should be deregulated, we consider that the market monitoring measures proposed by the AEMC would be an important feature of this deregulation.

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<sup>7</sup> Australian Energy Market Agreement 2011, *Indicators of competition in retail energy markets*, Annexure 3

<sup>8</sup> AEMC, *Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales*, Draft Report, 23 May 2013, p.36

<sup>9</sup> AEMC 2013, *op cit*, p.188

<sup>10</sup> AEMC 2013, *op cit*, p.188

<sup>11</sup> ACCC 2008, *Merger Guidelines*, p.37

<sup>12</sup> US Department of Justice, Herfindahl-Hirschman Index, <http://www.justice.gov/atr/public/guidelines/hhi.html>

<sup>13</sup> AEMC 2013, *op cit*, p.50

<sup>14</sup> AEMC, *op cit*, p.199

<sup>15</sup> *ibid*, p.201

If you have any queries relating to this submission please contact Gavin Fox, Director, on 02 6243 1249.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Andrew Reeves', with a long horizontal flourish extending to the right.

Andrew Reeves  
Chairman  
AER