

Australian Energy Market Commission

ISSUES PAPER

Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales

13 December 2012

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About the AEMC

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

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Executive Summary

The Australian Energy Market Commission (AEMC) has commenced its review of competition in the New South Wales (NSW) small customer electricity and natural gas retail markets (NSW Review). For the purpose of informing our work, stakeholders are invited to submit written responses to the questions contained in this Issues Paper **by no later than 5pm, Friday 8 February 2013**.

A decade on from the introduction of retail competition in NSW, this review commences at a time of considerable change in both the retail and wholesale energy markets. The sale of the previously NSW Government-owned retailers has altered retailer market shares in NSW. Similarly, selling the trading rights to two NSW Government-owned generators has changed the dynamic of the NSW wholesale market, increasing the prevalence of vertical integration (or the so-called "gentailer" model). These changes are set to continue with the announced sale of the NSW Government's generation asset portfolio.

This review also occurs following a period of significant electricity price rises which may have had an impact on customers' interest and willingness to engage in the electricity and natural gas retail markets. Further, a number of recommendations have recently been made as part of the AEMC's Power of choice review.¹ The proposed package of reforms provides households, businesses and industry with more opportunities to make informed choices about the way they use electricity and manage expenditure.

Our work on the NSW Review is in response to a notification from the Standing Council on Energy and Resources (SCER), through the Ministerial Council on Energy (MCE), providing the AEMC with a request to undertake a review and provide advice on the state of competition in the NSW electricity and natural gas retail markets for small customers (Appendix A). This work must be completed and provided to the MCE by no later than 30 September 2013.

It will include:

- an assessment of the state of competition and the extent to which it is deemed effective for small electricity customers (i.e. customers consuming less than 160 megawatt hours per annum, noting that from 1 July 2013 regulated prices in NSW will only apply to those consuming less than 100 megawatt hours per annum) and small natural gas customers (i.e. customers consuming less than 1 terajoule per annum);
- the availability and take up of time of use tariffs and the impact of time of use tariffs on competition; and

¹ See AEMC website, www.aemc.gov.au, "Power of choice review - giving consumers options in the way they use electricity - Final Report", AEMC, 30 November 2012.

- based on that assessment, advice on the ways in which the effectiveness of competition can be improved (where competition is found to be not effective) as well as possible implementation strategies for the removal of retail price regulation for small electricity customers and small natural gas customers in NSW, regardless of the state of competition. This is to include advice for an option to gradually roll back retail price regulation through a reducing eligible consumption threshold.

NSW small customers include both residential and small business consumers of energy. This review will explore how these customers have fared in terms of competitively priced energy and choice of supplier after approximately one decade of access to Full Retail Contestability (FRC) in electricity and natural gas, including:

- small customers' experiences of FRC in NSW's electricity and natural gas retail markets, such as the types of marketing practices used and the prices offered under market contracts;
- stakeholders' experiences with, and views on, time of use tariffs, including their availability, take up and impact on competition; and
- stakeholders' views on the best path to removing retail price regulation in NSW's small customer electricity and natural gas retail markets, including views on the appropriateness of gradually rolling back the threshold for access to regulated prices.

This Issues Paper contains a series of questions that focus on the specific matters that are pertinent to the NSW Review. Stakeholders are also encouraged to include any other relevant information and comments in their submissions.

Electricity and natural gas retail prices for small customers in NSW are regulated by the Independent Pricing and Regulatory Tribunal (IPART), at the direction of the NSW Government, although lighter-handed regulation applies for natural gas. This contrasts with Victoria where retail price regulation for small customers was removed following the AEMC's 2007 competition review of Victoria's electricity and natural gas retail markets. The AEMC has also previously reviewed retail competition in South Australia's small customer electricity and natural gas retail markets in 2008, and the Australian Capital Territory's small customer electricity retail market only in 2010 (as no natural gas retail price controls exist), however energy retail price controls remain unchanged in those jurisdictions.

Retail competition reviews are conducted in accordance with the framework set out in the Australian Energy Market Agreement (AEMA), which represents the commitment of the Commonwealth, States and Territories to the ongoing reform process of energy markets. One of the commitments made by each of the jurisdictional signatories to the AEMA is for the AEMC to assess competition in the retail markets for electricity and natural gas for the purpose of retaining, removing or reintroducing retail price regulation.

The AEMC considers that in situations where competition is found not to be effective, and some form of regulation is seen to be required, it is important that retail price regulation is designed and applied in a way that promotes the most efficient outcomes.

The NSW Review goes beyond the traditional format of previous retail competition reviews in that the MCE has requested specific advice on possible implementation strategies for the removal of retail price regulation, regardless of the state of competition in NSW's retail electricity and natural gas retail markets. Such strategies cannot be developed in isolation from other broader energy market reviews and developments. In addition, the extent of regulation in NSW's energy retail markets needs to be assessed and balanced against the level of small customer protections currently in place and anticipated to be adopted in future. This includes measures implemented to facilitate a smooth transition to the adoption of the National Energy Customer Framework (NECF) on 1 July 2013.

The AEMA requires the AEMC to base its assessment of the effectiveness of competition on criteria originally developed by the MCE (MCE criteria) and use a methodology and approach that is to be formalised in a Statement of Approach and approved by the MCE (Appendix B).

In addition to welcoming feedback in response to the questions raised in this paper, stakeholders will have a further opportunity to submit comments to the AEMC when it publishes a Draft Report in mid-2013 containing the AEMC's draft findings and recommendations in respect of the NSW Review. After consideration of stakeholders' submissions, the AEMC will then move to finalise its competition assessment and advice before providing it to the MCE by 30 September 2013. The NSW Government will then have up to six months to provide a public response to the AEMC's final advice, in accordance with the AEMA.²

Submissions should refer to project number "RPR0001" and be sent electronically through the AEMC's online lodgement facility at www.aemc.gov.au.

² See SCER's website, www.scer.gov.au, "AEMA (as amended, 2 October 2011)", clause 14.15.

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1 Introduction

The Australian Energy Market Commission (AEMC) has commenced its review of competition in the New South Wales (NSW) small customer electricity and natural gas retail markets (NSW Review)³. In NSW, the category of small customers generally comprises residential and small business energy customers.⁴ This group of customers has access to regulated retail energy prices, although they may enter into a negotiated contract with their retailer of choice, paying prices that are not regulated.

1.1 Request to undertake review

Our work on the NSW Review is in response to a notification from the Standing Council on Energy and Resources (SCER), through the Ministerial Council on Energy (MCE), requesting the AEMC to undertake a review of, and provide advice to the MCE on, the state of competition in the NSW electricity and natural gas retail markets for small customers.⁵

The request to undertake the review (Appendix A) requires the AEMC to conduct its assessment and provide its advice to the MCE by no later than 30 September 2013.

This Issues Paper, which signals the commencement of our work on the NSW Review and on which submissions are invited, will be followed by two other key reports:

- a Draft Report - to be prepared after consideration of stakeholders' submissions in response to the Issues Paper and AEMC-collated data and analysis, this report will present the AEMC's draft competition assessment and, based on that assessment, draft advice to the MCE on how to remove retail price regulation or improve retail competition, and invite stakeholders to make written submissions in response; and
- a Final Report - this report will contain the AEMC's finalised competition assessment and final advice to the MCE.

In addition to these papers, the AEMC will host several stakeholder forums and meetings at which it will seek to engage, and discuss its preliminary findings, with stakeholders.

³ Review of competition in the retail electricity and natural gas markets in New South Wales (NSW Review).

⁴ NSW small customers are currently those residential and small business energy customers that consume less than 160 megawatt hours (MWh) per annum of electricity or less than 1 terajoule (TJ) of natural gas. The NSW Government notified the Independent Pricing and Regulatory Tribunal on 27 September 2012 that, from 1 July 2013, the definition of a "small retail customer" for the purposes of price regulation will be reduced from customers using less than 160 MWh of electricity per annum to customers using less than 100 MWh of electricity per annum.

⁵ See Appendix A. This notification was issued in a letter from the Chair of the SCER, the Hon. Martin Ferguson AM MP, to the Chairman of the AEMC, John Pierce, 10 October 2012.

For the purpose of informing our work, stakeholders are invited to submit written responses to the questions contained in this Issues Paper **by no later than 5pm, Friday 8 February 2013**.

1.2 Purpose of Issues Paper

The purpose of this paper is to invite and obtain observations from stakeholders concerning their experience of competition in NSW's small customer electricity and natural gas retail markets since the introduction of Full Retail Contestability (FRC) in January 2002.

The AEMC would like to obtain information that will further its understanding of changes in the nature and extent of competition that has occurred in these markets over time. The AEMC is particularly interested in:

- small customers' experiences of FRC in NSW's electricity and natural gas retail markets, such as the types of marketing practices used and the prices offered under market contracts;
- stakeholders' experiences with, and views on, time of use tariffs, including their availability, take up and impact on competition;
- stakeholders' views on the best path to removing retail price regulation in NSW's small customer electricity and natural gas retail markets, including views on the appropriateness of gradually rolling back the threshold for access to regulated prices.

To assist stakeholders, this paper provides background information on NSW's electricity and natural gas retail markets and sets out the specific matters that are pertinent to the NSW Review. Stakeholders are invited to make submissions on the questions raised in the paper and any other issues they consider relevant to the NSW Review.

1.3 Lodging submissions

Written submissions from stakeholders and interested parties in response to this Issues Paper must be lodged with the AEMC **by no later than 5pm, Friday 8 February 2013**.

Submissions should refer to AEMC project number "RPR0001" and be sent electronically through the AEMC's online lodgement facility at www.aemc.gov.au.

All submissions received during the course of the NSW Review will be published on the AEMC's website, subject to any claims for confidentiality. The AEMC's approach to confidentiality is set out in Chapter 5.

In order for the NSW Review to be completed by no later than 30 September 2013, the AEMC must adhere to strict deadlines. While the AEMC will have full regard to all submissions lodged within the specified time period, late submissions may not be

afforded the same level of consideration. To ensure the AEMC is able to fully consider all submissions, we request that stakeholders lodge their submissions by no later than the due date.

1.4 Structure of Issues Paper

The remainder of this paper is structured as follows:

- Chapter 2 - presents the policy and legislative framework for the NSW Review;
- Chapter 3 - provides background information on NSW's small customer electricity and natural gas retail markets, including an overview of the regulatory frameworks and customer protections currently in place;
- Chapters 4 and 5 - identify the specific issues that the AEMC is seeking stakeholders' written comments on for the purpose of informing our work in relation to assessing the state of competition in NSW and identifying a path to removing retail price regulation, respectively; and
- Chapter 6 - sets out an indicative timetable for the NSW Review, the process for public consultation and our approach to confidentiality.

The following appendices have also been included for the information of stakeholders and interested parties:

- Appendix A - presents the SCER's notification letter to the AEMC, which includes the MCE's request for advice;
- Appendix B - presents the AEMC's Statement of Approach to the NSW Review, as approved by the MCE; and
- Appendix C - reproduces an extract from the Australian Energy Market Agreement (AEMA), outlining the framework for AEMC retail competition reviews.

2 Policy and legislative framework for the NSW Review

This chapter presents a description of the policy and legislative framework for the NSW Review, including the matters which are to be considered by the AEMC.

2.1 Policy and legislative framework

Pursuant to section 41 of the National Electricity Law (NEL) and section 79 of the National Gas Law (NGL), the MCE may request the AEMC to undertake reviews and provide advice to the MCE on the effectiveness of competition in a jurisdiction's retail energy markets.

In September 2011, the Council of Australian Governments (COAG) created the SCER, which includes the Ministers responsible for Energy. These Ministers comprise the membership of the legally enduring MCE and are entitled to make requests under the NEL and the NGL (Appendix A).

The commitment of the Commonwealth, States and Territories to the ongoing energy market reform process is reflected in the terms of the AEMA.⁶ One of the commitments made by each of the jurisdictional signatories to the AEMA is for the AEMC to assess the effectiveness of competition in the retail markets for electricity and natural gas for the purpose of retaining, removing or reintroducing retail price regulation.⁷ 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.

Retail competition reviews follow the framework provided in clauses 14.10 to 14.17 of the AEMA (Appendix C). This requires, among other things, the AEMC to base its assessment of the effectiveness of competition on criteria originally developed by the MCE (MCE criteria).⁸

The MCE criteria require an assessment of the following characteristics of the energy market under review:

- independent rivalry within the market;
- the ability of suppliers to enter the market;
- the exercise of market choice by customers;
- differentiated products and services;
- price and profit margins; and

⁶ See SCER's website, www.scer.gov.au, "AEMA (as amended, 2 October 2011)".

⁷ See SCER's website, www.scer.gov.au, "AEMA (as amended, 2 October 2011)", clause 14.11(a).

⁸ See SCER's website, www.scer.gov.au, "AEMA (as amended, 2 October 2011)", clause 14.11(a)(i).

- customer switching behaviour.

In April 2007, the MCE advised the AEMC that retail competition reviews would be conducted sequentially, commencing with those jurisdictions most likely to have effective competition.⁹

To date, the AEMC has conducted retail competition reviews of:

- Victoria's electricity and natural gas retail markets in 2007 (VIC Review) - where competition was found to be effective in those markets at that time;¹⁰
- South Australia's electricity and natural gas retail markets in 2008 (SA Review) - where competition was found to be effective in those markets at that time;¹¹ and
- Australian Capital Territory's electricity retail market in 2010 (ACT Review) (n.b. no retail price controls exist for natural gas) - where competition was found not to be effective in that market at that time.¹²

Since the completion of these previous reviews, retail price regulation no longer applies in Victoria's electricity and natural gas retail markets, continues to apply in South Australia's electricity and natural gas retail markets and continues to apply in the Australian Capital Territory's electricity retail market.

In June 2011, Energy Ministers agreed the following forward schedule of retail competition reviews to be undertaken by the AEMC:¹³

- NSW is to be reviewed in 2012 (i.e. the subject of this paper);
- Queensland is to be reviewed in 2013;
- no review is to be conducted in 2014;
- South Australia is to be reviewed in 2015 (i.e. as electricity and natural gas retail price regulation remains in place);

⁹ This notification was issued in a letter from the then-Chair of the MCE, the Hon. Ian Macfarlane MP, to the then-Chairman of the AEMC, Dr John Tamblyn, 19 April 2007.

¹⁰ See AEMC's website, www.aemc.gov.au, for VIC Review papers, including stakeholders' submissions and the AEMC's findings and recommendations in respect of the Review of the effectiveness of competition in the electricity and gas retail markets in Victoria (VIC Review).

¹¹ See AEMC's website, www.aemc.gov.au, for SA Review papers, including stakeholders' submissions and the AEMC's findings and recommendations in respect of the Review of the effectiveness of competition in electricity and gas retail markets in South Australia (SA Review).

¹² See AEMC's website, www.aemc.gov.au, for ACT Review papers, including stakeholders' submissions and the AEMC findings and recommendations in respect of the Review of the effectiveness of competition in the electricity retail market in the Australian Capital Territory (ACT Review).

¹³ See SCER website, www.scer.gov.au, Energy and Resources Ministers' meeting communique, 10 June 2011.

- Australian Capital Territory is to be reviewed in 2016 (i.e. as electricity retail price regulation remains in place); and
- Tasmania is to be reviewed no sooner than 18 months after the implementation of FRC in that jurisdiction.

Notwithstanding the above timetable, the commencement of each retail competition review is subject to specific approval by the MCE of a request for advice and timetable for the individual jurisdiction prior to commencement of the review.

2.2 Matters to be considered

In accordance with the SCER's notification letter of 10 October 2012, the MCE has determined the scope of the NSW Review.¹⁴

The scope (Appendix A) requires the AEMC to undertake a review of, and provide advice to the MCE on, the state of competition in the NSW electricity and natural gas retail markets for small customers. In particular:

- an assessment of the state of competition and the extent to which it is deemed effective for small electricity customers (i.e. customers consuming less than 160 megawatt hours per annum, noting that from 1 July 2013 regulated prices in NSW will apply to those consuming less than 100 megawatt hours per annum¹⁵) and small natural gas customers (i.e. customers consuming less than 1 terajoule per annum);¹⁶
- the availability and take up of time of use tariffs and the impact of time of use tariffs on competition; and
- based on that assessment, advice on the ways in which the effectiveness of competition can be improved (where competition is found not to be effective) as well as possible implementation strategies for the removal of retail price regulation for small electricity customers and small natural gas customers in NSW, regardless of the state of competition. This is to include advice for an option to gradually roll back retail price regulation through a reducing eligible consumption threshold.

¹⁴ See Appendix A. This notification was issued in a letter from the Chair of the SCER, the Hon. Martin Ferguson AM MP, to the Chairman of the AEMC, John Pierce, 10 October 2012.

¹⁵ See IPART's report, "Review of regulated retail prices and charges for electricity 2013 to 2016: Electricity - Issues Paper", November 2012, p3.

¹⁶ n.b. IPART regulates both retail electricity and natural gas prices for NSW small customers. IPART's most recent electricity and natural gas standing offer price determinations cover the period from 1 July 2010 to 30 June 2013. See IPART's website, www.ipart.nsw.gov.au.

2.2.1 Competition assessment and formulation of advice

In assessing the state of competition, and the extent to which it is deemed effective, for small customers in NSW's electricity and natural gas retail markets, the AEMA requires the AEMC to apply the MCE criteria and use a methodology and approach that is to be formalised in a Statement of Approach and approved by the MCE (Appendix B).¹⁷

In formulating its advice on the state of competition in the energy retail markets under review, the AEMC will have regard to clause 14.14 of the AEMA which notes jurisdictional signatories' agreement that the phase out of the exercise of retail price regulation:

- need not include the removal of "obligation to supply" arrangements;
- may involve a further period of price monitoring and/or price agreements with retailers under appropriate oversight arrangements; and
- does not prevent the exercise of a reserve price regulation power where effective competition for categories of users ceases, provided that the power is only exercised in accordance with a regulatory methodology promulgated by the AEMC, and is subject to review by the AEMC of the effectiveness of competition in accordance with the AEMA.

2.2.2 Consultation and reporting

During the course of the NSW Review, the AEMC will consult and meet with NSW Government and relevant stakeholder groups in NSW who have an interest in the oversight, regulation or other control of retail prices and retail competition in the electricity and natural gas markets of NSW.

In terms of AEMC reporting, the MCE has streamlined the AEMC's reporting process compared with the previous retail competition reviews (Appendix A). This is expected to deliver administrative benefits both to stakeholders and the AEMC with no compromise to consultation opportunities or report quality and analysis.

Following publication of this paper, the AEMC will adhere to the following MCE-approved reporting and advice process:

- stage one - this stage requires the publication of, and consultation on, a Draft Report setting out the AEMC's draft competition assessment and draft advice to the MCE; and

¹⁷ For the NSW Review, the methodology and approach is detailed in Chapters 2 and 3 of the Statement of Approach. The AEMC has previously prepared and published versions of its Statement of Approach and has applied them to the VIC Review (2007), SA Review (2008) and the ACT Review (2010). The MCE, in consultation with the AEMC, periodically approves revisions and updates to the Statement of Approach to reflect developments and reforms in energy markets and revised timings for the remaining jurisdictional retail competition reviews.

- stage two - after considering all stakeholder submissions received in response to the Draft Report, the AEMC will publish a Final Report setting out its finalised competition assessment and final advice to the MCE, which is due by no later than 30 September 2013. The NSW Government will then have up to six months to provide a public response to the AEMC's final advice, in accordance with the AEMA.¹⁸

In previous retail competition reviews, the AEMC had published draft and final reports both for stages one (i.e. the competition assessment) and two (i.e. the advice to the MCE), whereby the competition assessment was published first and separate to the MCE advice. For the NSW Review, in publishing its draft competition assessment and draft advice to the MCE in a consolidated Draft Report, stakeholders will benefit from being able to assess and comment on the AEMC's draft findings and draft recommendations in an holistic manner and prior to finalisation of the Final Report.

The AEMC's process for public consultation and an indicative timetable for the NSW Review are set out in Chapter 5.

¹⁸ See SCER's website, www.scer.gov.au , "AEMA (as amended, 2 October 2011)", clause 14.15.

3 Overview of the NSW small customer electricity and natural gas retail markets

This chapter presents an overview of the NSW small customer electricity and natural gas retail markets. It also provides a summary of the retail pricing and customer protection frameworks that currently apply to these markets.

3.1 The NSW small customer electricity retail market

The National Electricity Market (NEM) commenced operations in 1998 and facilitates the sale of wholesale electricity to retailers and end-users in NSW, Queensland, Victoria, South Australia and Tasmania. All electricity that is generated by power stations and consumed by NSW small customers is traded through this market. The operation of the NEM is governed by the NEL and the National Electricity Rules (NER). The Australian Energy Market Operator (AEMO) is responsible for ensuring that electricity demand and supply are constantly balanced by dispatching electricity generation (supply) to meet varying demand on a real-time basis. AEMO also financially settles the wholesale market by collecting payments from retailers and end-users for electricity purchased and, in turn, distributing payments to generators for electricity produced.¹⁹ The electricity supply chain is summarised in Figure 3.1.

The NSW small customer electricity retail market includes:

- Retailers - energy retailers purchase electricity from the NEM and sell it to their small customers. In NSW, around 32 companies are licensed to retail electricity, of which around 13 currently retail electricity to small customers.²⁰ In 2011, the NSW Government privatised its three energy retail businesses, EnergyAustralia (acquired by TRUenergy who, in turn, has rebranded its retail operations as EnergyAustralia), Integral Energy (acquired by Origin Energy) and Country Energy (acquired by Origin Energy); and
- Customers - small customers, such as households and small businesses, purchase electricity from their retailer of choice for consumption purposes, such as powering household appliances and office equipment.

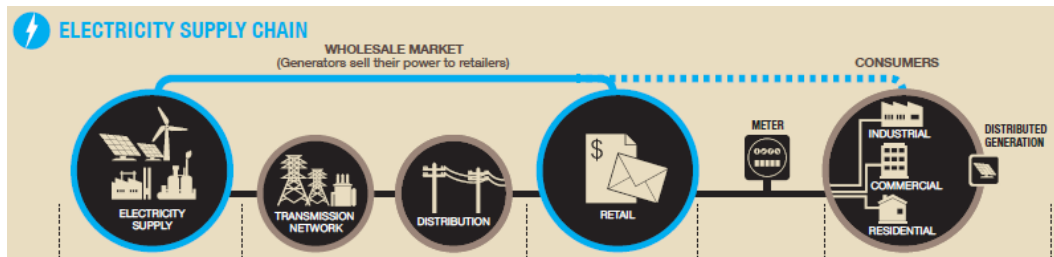
Since FRC commencement in electricity in January 2002, all NSW electricity small customers have been able to choose their retailer by entering into a negotiated (or "market offer") retail supply contract with a licensed retailer. However, small customers who have chosen to not take up a market offer, or who have not been offered a market contract, can remain on a standard form (or "standard offer")

¹⁹ See AEMO's website, www.aemo.com.au, "An introduction to Australia's National Electricity Market", July 2010.

²⁰ See IPART's website, www.ipart.nsw.gov.au, "Review of regulated retail prices and charges for electricity 2013 to 2016: Electricity - Issues Paper", November 2012, p.88.

customer supply contract with their standard retail supplier²¹ and are charged a regulated retail price for their energy consumption. Customers can move from a standard offer contract to a market offer contract, and vice versa.

Figure 3.1 The electricity supply chain



The Independent Pricing and Regulatory Tribunal (IPART) recently reported that around 50 per cent of NSW small customers were on unregulated electricity prices (i.e. market offer contracts), up from around 34 per cent at the start of the 2010 determination period.²²

3.2 The NSW small customer natural gas retail market

The NSW natural gas retail market is characterised as a "contract carriage" model, whereby natural gas is generally supplied through long term bilateral natural gas supply contracts between gas producers and retailers. The operation of the NSW natural gas retail market is governed by the NGL, the National Gas Rules (NGR) and jurisdictional Retail Market Procedures made under the NGR. AEMO facilitates the operation of the NSW natural gas retail market, which includes facilitating customer switching between natural gas retailers and managing the daily allocation of natural gas usage to retailers to enable settlement of natural gas supply and pipeline use of system contracts.

The NSW small customer natural gas retail market includes:

- Retailers - energy retailers generally purchase natural gas directly from natural gas wholesalers (shippers), have arrangements in place to have the natural gas transported on the NSW distribution system and sell the natural gas to its small customers. In NSW, around 20 companies are authorised (or licensed) to retail natural gas, of which around five currently retail natural gas to small customers;²³ and
- Customers - small customers, such as households and small businesses, purchase natural gas from their retailer of choice for consumption purposes, such as

²¹ Standard retailers are required to offer small customers in their respective supply areas a regulated retail price that is approved by IPART. This is described further in section 3.3.

²² See IPART's website, www.ipart.nsw.gov.au, "Review of regulated retail prices and charges for electricity 2013 to 2016: Electricity - Issues Paper", November 2012, p.27.

²³ See IPART's website, www.ipart.nsw.gov.au, under "Gas / Licensing".

powering cooking and heating appliances. As at 30 June 2011, there were around 1.1 million natural gas small customers in NSW.²⁴

Since FRC commencement in natural gas in January 2002, all NSW small natural gas retail customers have been able to choose their retailer. Natural gas customers can also choose to remain on regulated retail prices with the standard natural gas retailer in their area.²⁵ As part of this review, it is important to ascertain whether small customers are actively choosing their natural gas retailer based on the customer's own assessment of their supply needs and perception of value, or whether the decision to choose a natural gas retailer (and a natural gas product offering) is a secondary consideration for the customer after the supply of electricity.

IPART recently reported that around 70 per cent of NSW small customers were on unregulated gas prices (i.e. market offer contracts) as at 30 June 2012, up from under 50 per cent in June 2009, although this trend was not uniform across the supply areas.²⁶

3.3 Energy retail price setting in NSW

IPART is the independent regulator that determines the maximum prices that can be charged for certain retail energy, water and transport services in NSW. IPART also monitors service delivery, audits suppliers and oversees license compliance by certain water utilities and retail energy suppliers.²⁷

Regulated electricity retail prices determined by IPART are the prices that NSW standard retailers²⁸ - namely, EnergyAustralia²⁹, Integral Energy (acquired by Origin Energy) and Country Energy (acquired by Origin Energy) - charge customers who have not entered into a market offer contract. In March 2010, IPART made a determination on the amount by which these retailers could increase their regulated prices on 1 July 2010 and also set out its approach and process for conducting annual

24 See IPART's website, www.ipart.nsw.gov.au, "Gas retail businesses' performance against customer service indicators in NSW", January 2012, p29. The figure of 1.1 million natural gas small customers is based on total residential customers of 1,048,534 and total non-residential customers of 29,019, as at 30 June 2011.

25 See IPART's website, www.ipart.nsw.gov.au, "Changes in regulated retail gas prices in NSW from 1 July 2012", June 2012.

26 See IPART's website, www.ipart.nsw.gov.au, "Review of regulated retail prices and charges for gas 2013 to 2016: Gas - Issues Paper", November 2012, p.15.

27 See IPART's website, www.ipart.nsw.gov.au, under "About us".

28 A standard retailer, or a "standard retail supplier", is a retail supplier to whose retail supplier's licence is attached a standard retail supplier's endorsement. Standard retailers must offer a regulated price to small customers in their supply areas. A standard retail supplier must impose tariffs and charges for, or in relation to, supplying electricity under a standard form customer supply contract in accordance with any relevant determination of IPART under Division 5 of the *Electricity Supply Act 1995* (NSW). See IPART report, "Changes in regulated electricity retail prices from 1 July 2012", p100.

29 Note that, since acquiring EnergyAustralia's retail business in March 2011, TRUenergy has rebranded its retail operations as EnergyAustralia.

reviews to determine how these retailers could increase these prices in the two subsequent financial years.³⁰

On 27 September 2012, the NSW Minister for Resources and Energy requested that IPART undertake a review and make a new determination for regulated electricity retail prices from 1 July 2013 to 30 June 2016.³¹

IPART also regulates retail natural gas prices for NSW small customers, although to date it has used lighter-handed voluntary pricing agreements with each of the NSW standard suppliers to establish natural gas retail prices. NSW small customers are eligible for natural gas supply at regulated retail prices under a standard form customer supply contract with standard natural gas retailers in their supply areas. There are four gas standard retailers in NSW:

- AGL supplies gas to most of the small regulated retail customers in NSW, covering Sydney, Wollongong, Newcastle, Dubbo, Orange, Parkes, and parts of the Riverina region;
- ActewAGL supplies the regions around the NSW/ACT border (including Young, Goulburn, and Yass) and South East NSW (including Shoalhaven);
- Origin Energy, trading as Country Energy, supplies the South Western regions of NSW including Wagga Wagga and Gundagai and inland cities such as Tamworth; and
- Origin Energy also supplies customers on the NSW/Victorian border, including the Albury and the Murray Valley Towns.

On 27 September 2012, the NSW Minister for Resources and Energy requested that IPART continue to regulate default tariffs and charges for small retail natural gas customers via new Voluntary Transitional Pricing Agreements or a gas pricing order that will apply from 1 July 2013 to 30 June 2016.³²

3.4 Principles for efficient retail price regulation

As noted previously, one of the commitments made by each of the jurisdictional signatories to the AEMA is for the AEMC to assess the effectiveness of competition in the retail markets for electricity and natural gas for the purpose of retaining, removing or reintroducing retail price regulation. 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.

³⁰ See IPART's report, "Changes in regulated electricity retail prices from 1 July 2012", p1.

³¹ See IPART's website, www.ipart.nsw.gov.au, "Terms of reference - Review of regulated electricity retail tariffs and charges 2013 to 2016", 27 September 2012.

³² See IPART's website, www.ipart.nsw.gov.au, "Terms of reference - Review of regulated gas retail tariffs and charges 2013 to 2016", 27 September 2012.

In advising on ways to improve competition, the AEMC considers that taking account of the following principles will lead to the best outcomes for consumers:

- the benefits of removing or retaining regulation should outweigh the costs of the market power it is designed to protect against;
- the removal or retention of regulation should not stifle competition, but promote it where possible;
- maintenance of a degree of regulation, where required, should be an interim step on the way to facilitating improvements in competition;
- maintenance of a degree of regulation, where required, should be targeted at specific areas or sectors of the market, rather than applied more broadly; and
- in general, the more competitive the market, the lighter-handed should be the regulation.

3.5 Customer protections

There are a series of customer protection measures that currently exist and would remain in place to provide support to small customers even if price regulation was removed. These include a combination of NSW and national measures that together support customer choice, provide a mechanism for complaint resolution and provide assistance to those in hardship. These measures are discussed below.

3.5.1 NSW legislative customer protections

The *Electricity Supply Act 1995* (NSW) (ESA) and *Gas Supply Act 1996* (NSW) (GSA) provide important small customer protections in the NSW electricity and natural gas retail markets. They also provide a framework under which customers can be supplied under standard form or negotiated supply contracts. This includes setting out the matters that must be covered in standard form contracts.

The objectives of the ESA include:³³

- to establish a competitive retail market in electricity so as to promote efficient and environmentally responsible production and use of electricity and to deliver a safe and reliable supply of electricity; and
- to regulate network operations and electricity supply in the retail market in a manner that ensures open access to electricity distribution systems, promotes customer choice and creates customer rights in relation to electricity connections and electricity supply.

³³ See section 3 of the ESA.

Similarly, the objectives of the GSA include:³⁴

- to encourage the development of a competitive market in gas, so as to promote the thermally efficient use of gas and to deliver a safe and reliable supply of gas in compliance with the principles of ecologically sustainable development contained in section 6(2) of the *Protection of the Environment Administration Act 1991* (NSW); and
- to regulate gas reticulation and gas supply, so as to protect the interests of customers and to promote customer choice in relation to gas supply.

3.5.2 Australian Consumer Law

The Australian Consumer Law (ACL) commenced on 1 January 2011. It establishes a national legal framework for fair trading and consumer protection. The ACL is enforced and administered by the Australian Competition and Consumer Commission (ACCC), each State and Territory's consumer agency and, in respect of financial services, the Australian Securities and Investments Commission (ASIC).

The ACL, which replaced consumer protection provisions in at least 20 different Commonwealth, State and Territory laws, includes:³⁵

- a national unfair contract terms law covering standard form consumer contracts;
- a national law providing consumer guarantees relating to the supply of goods and services;
- a national law for unsolicited consumer agreements covering door-to-door sales and telephone sales; and
- new penalties, enforcement powers and consumer redress options.

In recent times, door-to-door energy selling has fallen under increased scrutiny by regulators, industry and consumer groups. According to research commissioned by the ACCC, around 55 per cent of the energy industry's total residential sales in 2011, or at least 791,719 residential sales, were derived from door-to-door sales activities. This compares to sales of around 50 per cent for fixed line telephony, 20 per cent for solar panels and 10 per cent for pay television.³⁶

Online sales are another marketing growth area for energy retailers that warrants further investigation, especially in light of easier access to the internet by small customers. For example, the widespread use of smart-phones by small customers has made it easier for energy customers and retailers to interact.

³⁴ See section 3 of the GSA.

³⁵ See ACL website, www.consumerlaw.gov.au.

³⁶ See ACCC's website, www.accc.gov.au, for a report commissioned by the ACCC and prepared by Frost & Sullivan Pty Ltd, "Research into the door to door sales industry in Australia", pp26-32, July 2012.

3.5.3 Energy & Water Ombudsman NSW

The Energy & Water Ombudsman NSW (EWON) was established in 1998 and provides a free and independent complaint resolution service for all electricity and natural gas customers throughout NSW and some water providers.³⁷ Created under the ESA³⁸ and GSA³⁹, EWON handles small retail customer disputes and complaints concerning energy accounts, disconnection or restriction of supply, connection or transfer issues, debts and arrears and marketing practices to name a few.

As an industry-based complaints scheme, EWON is funded by its members, in accordance with their licensing conditions, who are electricity and natural gas retailers and distributors.⁴⁰ EWON's decision-making process is independent of members and stakeholders and, if necessary, the Ombudsman can make a binding decision to resolve a complaint.

A breakdown of EWON's complaints statistics for the 2011-12 financial year is provided below.⁴¹

- 25,162 complaints were finalised by EWON (up 43 per cent over the previous year), of which 79 per cent related to the electricity industry, 13 per cent related to the natural gas industry, 3 per cent related to the water industry and 4 per cent related to the "dual fuel" energy industry;
- 18,001 complaints related to electricity retailers (up 50 per cent over the previous year);
- 3,217 complaints related to natural gas retailers (up 20 per cent over the previous year);
- 919 complaints related to "dual fuel" energy retailers (up 54 per cent over the previous year);
- 95 per cent of complaints received were from residential customers;
- 26 per cent of complaints received were from regional, rural and remote areas of NSW; and
- Of all electricity- and natural gas-related complaints raised by customers, respectively, the matters related to billing (38 and 49 per cent), credit (20 and 19

³⁷ EWON was originally established as the Energy Industry Ombudsman NSW (EION) in 1998 and renamed as EWON in 1999 after Sydney Water joined the scheme. For further information on EWON's establishment, see EWON's website, www.ewon.com.au, under "About us / Our history".

³⁸ See section 96B of the ESA.

³⁹ See section 33G of the GSA.

⁴⁰ EWON's membership include around 19 electricity retailers, 3 electricity distributors, 8 gas retailers, 6 gas distributors and 11 water retailers/distributors. See EWON's website, www.ewon.com.au.

⁴¹ See EWON's website, www.ewon.com.au, Annual Report 2011-12, pages 14-17.

per cent), customer service (15 and 21 per cent), transfer (14 and 9 per cent) and marketing (6 and 1 per cent).

3.5.4 NSW Government customer assistance measures

A component of the AEMC's retail competition reviews is to investigate whether social welfare and equity objectives are met through clearly specified and transparently funded State or Territory community service obligations that do not materially impede competition.⁴²

The NSW Government provides financial assistance and support programs to NSW residential customers to help them manage their energy costs. Rebates and support programs that are available include:⁴³

- Low Income Household Rebate - provides eligible customers with a rebate on their energy bills (\$215 per year);
- Family Energy Rebate - designed to assist families manage their energy costs (\$35-\$75 per year, subject to whether customer is a recipient of the Low Income Household Rebate);
- Medical Energy Rebate - provides assistance to eligible customers who have an inability to self-regulate body temperature (\$215 per year);
- Life Support Rebate - assists people who are required to use energy-intensive life support machines at home in paying their electricity bills (\$20-\$600 per year, subject to equipment and usage);
- Energy Accounts Payments Assistance Scheme - a voucher-based system, administered by community welfare organisations on behalf of the NSW Government, designed to assist financially disadvantaged customers in crisis or an emergency situation to pay their energy bills (\$30 vouchers); and
- Home Power Savings Program - helps households save on their energy use by offering free expert energy assessments, power savings kits (including efficient light bulbs) and power savings action plans.⁴⁴

In addition, eligible Commonwealth Seniors Health Card holders may have access to the Senior's Supplement payment, which helps older Australians pay regular bills such as energy, rates, phone and motor vehicle registration.⁴⁵

⁴² See SCER's website, www.scer.gov.au, "AEMA (as amended, 2 October 2011)", clause 14.11(b).

⁴³ See NSW Trade and Investment's website, www.trade.nsw.gov.au, under "Energy / Information for energy customers / Rebates".

⁴⁴ See www.savepower.nsw.gov.au, under "Households / Home Power Savings Program".

⁴⁵ See Commonwealth Department of Human Services website, www.humanservices.gov.au under "Older Australians".

3.5.5 National Energy Customer Framework

The National Energy Customer Framework (NECF) involves the harmonisation of state-based regulatory frameworks (excluding retail price regulation and community service obligations) for the retail energy market and energy distribution sector into a single set of national rules. The focus of the NECF is on providing a regulatory framework for the relationship between energy customers and the energy retailers and distributors that supply them, and includes a range of energy-specific consumer protections.⁴⁶

On 1 July 2012, Tasmania, the Australian Capital Territory and the Commonwealth became the first jurisdictions to apply and implement the NECF. Other jurisdictions are expected to follow in accordance with their own implementation plans.

The NSW Parliament passed legislation on 13 June 2012 to implement the NECF at a future date. The NSW Government is aiming to commence the NECF on 1 July 2013.⁴⁷

The aim of the National Energy Retail Law (NERL) and the National Energy Retail Rules (NERR) is national consistency in the medium to long term for all stakeholders in the energy market, including:

- customers - ensuring an efficient level of consumer protection over and above the general law (e.g. ACL);
- business - clarifying roles between retailers, distributors and customers; and
- governments - assuring a smooth transition from jurisdictional arrangements to a national approach.

The NECF package of reforms includes a number of important customer protections, including:

- rules relating to retailers collecting security deposits from new customers as a risk management measure, including their level and application;
- rules relating to retailers imposing late payment fees on small customers' bills, which must be waived for hardship customers; and
- the requirement that each authorised (or licensed) energy retailer must develop, maintain and implement a customer hardship policy for their residential customers.⁴⁸

⁴⁶ See NSW Trade and Investment's website, www.trade.nsw.gov.au, under "Energy / Information for energy customers / National Energy Customer Framework", and the AEMC's website, www.aemc.gov.au, under "Retail".

⁴⁷ The NSW Minister for Resources and Energy, the Hon Chris Hartcher, announced in a media release, dated 17 September 2012, that the NSW Government is aiming for a NECF start date of 1 July 2013.

The NERL defines a "hardship customer" as a residential customer of a retailer who is identified as a customer experiencing financial payment difficulties due to hardship in accordance with the retailer's customer hardship policy.⁴⁹

There are minimum requirements for a retailer's customer hardship policy, which includes processes to identify residential customers experiencing payment difficulties due to hardship, processes for the early response by the retailer in the case of residential customers identified as experiencing payment difficulties due to hardship, and flexible payment options (including a payment plan and Centrepay) for the payment of energy bills by hardship customers.⁵⁰

The Australian Energy Regulator (AER) has responsibility for approving (and varying) retailers' customer hardship policies where it is satisfied that the policy contains the minimum requirements for such a policy, and will or is likely to contribute to the achievement of the purpose of a retailer's hardship policy as defined in the NERL.⁵¹

Energy retailers in NSW will be required to comply with the NERL provisions relating to retailers' customer hardship policies at such time that the NECF commences in NSW.

48 See AER's website, www.aer.gov.au, under "Retail markets / Hardship policies" for information on energy retailers' customer hardship policies.

49 See *National Energy Retail Law (South Australia) Act 2011*, Schedule 1 - NERL, section 2.

50 See *National Energy Retail Law (South Australia) Act 2011*, Schedule 1 - NERL, section 44.

51 See *National Energy Retail Law (South Australia) Act 2011*, Schedule 1 - NERL, section 45.

4 Assessing the state of competition

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, the AEMC 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 characteristics of effective competition as per the AEMC's Statement of Approach to the NSW Review (Appendix B).

In this context, there are a number of matters that are likely to impact on the potential for effective competition to develop in NSW's electricity and natural gas retail markets.

This chapter presents such matters and invites stakeholders to make written submissions in response to the matters raised by addressing their relevance to, and effect on, small customer electricity and natural gas retail competition in NSW.

4.1 Market definition

The first stage in assessing the level of competition in a market is to define the relevant market(s). This is necessary so that products and factors that make up the scope of the assessment can be identified.

The MCE request for advice sets out the scope of the customer segments to be assessed - that being small customers in the electricity and natural gas retail markets of NSW.

While this establishes the scope of the NSW Review, it will be important to assess the levels of competition for all customers within the identified segments. In order to do so, it will be helpful to identify whether there are sub-markets within those two broad small customer segments, as there may be different levels of competition for different groups of small customers. Or it may be that parts, or all, of the two broad small customer segments fall within the same market.

While the AEMC does not consider it necessary to formally and precisely define the relevant markets for the purposes of the NSW Review, we will consider broadly where the competitive constraints and interactions lie by considering the extent of substitution between different products, areas and time periods.

As a result, we will have regard to the following four dimensions of market definition:

- **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;
- **Functional** - as a market typically involves multiple stages of production (e.g. production, wholesale and retail), it is necessary to determine which functional level(s) is to be included in the analysis when defining the market;

- Geographic - this is the area(s) over which the relevant product is supplied and to which consumers can practically turn; and
- Temporal - it is necessary to determine the time over which the substitution possibilities should be considered.

It is appropriate for the AEMC to consider the question of market definition afresh at the commencement of each jurisdictional retail competition review. While we propose to adopt the same framework as applied in previous reviews for our analysis of NSW's small customer electricity and natural gas retail markets, we recognise that each review will focus on the competitive market experience of a specific class of energy customers in a jurisdiction and that each jurisdiction may have unique characteristics that must be taken into consideration.

We invite stakeholders to make written submissions on the following questions relating to market definition for the NSW Review.

Question 1 Market definition

- (a) To what extent can other fuels or products be substituted for the supply of electricity or natural gas to small customers in NSW's electricity and natural gas retail markets (including the extent to which they are substitutes for each other)?

Question 2 Market definition

- (a) Are there barriers to single-fuel energy retailers (i.e. suppliers of either electricity or natural gas only) supplying both electricity and natural gas to small customers in NSW's electricity and natural gas retail markets?
- (b) Do energy retailers of both fuels (i.e. suppliers of both electricity and natural gas) enjoy cost or other advantages over single-fuel energy retailers?

Question 3 Market definition

- (a) Are there different costs to serve electricity small customers, and/or natural gas small customers, at different energy consumption levels in NSW's electricity and natural gas retail markets?
- (b) Are there barriers to energy retailers supplying electricity, and/or natural gas, to small customers at different energy consumption levels in NSW's electricity and natural gas retail markets?

Question 4 Market definition

- (a) Are there different costs of supplying electricity, and/or natural gas, to small customers located in different geographical areas or distribution networks of NSW? For example, the cost(s) of supplying energy to small customers residing in rural or remote areas of NSW compared to the cost(s) of supplying energy to small customers residing in urban areas.

Question 5 Market definition

- (a) What other characteristics of NSW's small customer electricity and natural gas retail markets should the AEMC take into consideration when defining the market for the NSW Review?

4.2 Market structure

The opportunity for competition to develop may be influenced by a range of structural, behavioural and regulatory characteristics and conditions that affect energy retailers' decisions to enter, expand within, or exit from small customer retailing in NSW.

This section notes some features of NSW's small customer electricity and natural gas retail markets that may be relevant to an assessment of the effectiveness of competition.

4.2.1 Market concentration

The number of energy retailers, and the size of their respective small customer bases, can affect the competitiveness of electricity and natural gas retailing in NSW.

Understanding the effect of these structural conditions on competition is important because the unilateral market power of individual energy retailers, and the collective or coordinated market power of a group of energy retailers, tends to increase as their customer share increases.

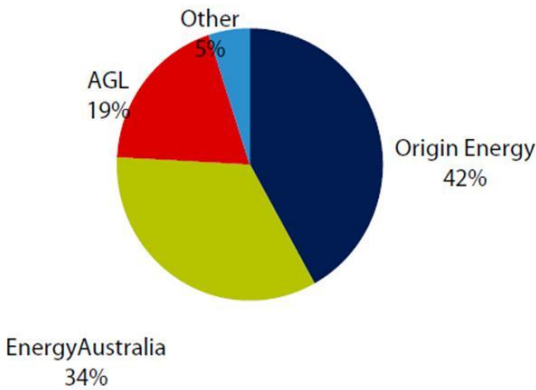
Privatisation of the three former state-owned NSW energy retailers on 1 March 2011⁵² has resulted in NSW residential electricity customer market shares of approximately 42 per cent, 34 per cent and 19 per cent for Origin Energy, EnergyAustralia (including TRUenergy and EnergyAustralia customers) and AGL, respectively (i.e. a three-firm concentration ratio of 95 per cent).⁵³

⁵² The NSW Government privatised energy retailers, EnergyAustralia (acquired by TRUenergy), Country Energy (acquired by Origin Energy) and Integral Energy (acquired by Origin Energy) on 1 March 2011.

⁵³ See IPART's website, www.ipart.nsw.gov.au, "Review of regulated retail prices and charges for electricity 2013 to 2016: Electricity - Issues Paper", November 2012, p25. "Other" retailers in Figure

Figure 4.1 provides a breakdown of market share by electricity retailer for NSW small customers.

Figure 4.1 Electricity market shares of small customers in NSW (as at 30 June 2012)



Note: Market shares are based on small customers with up to 160MWh of consumption per annum. Origin Energy's market share includes the 2 Standard Retailers it owns; Integral Energy and Country Energy. AGL's market share includes its wholly-owned Powerdirect business.

Data source: IPART's calculation based on individual energy licensees' reported operating statistics for 2011/12.

Source: IPART, "Review of regulated retail prices and charges for electricity 2013 to 2016: Electricity - Issues Paper", November 2012, p25.

In terms of NSW residential natural gas small customers, as at 30 June 2011, AGL held a market share of around 66 per cent, EnergyAustralia (including TRUenergy and EnergyAustralia customers) held a market share of around 24 per cent, and Origin Energy (including acquired Essential Energy / Country Energy customers) held a market share of around 8 per cent (i.e. a three-firm concentration ratio of 98 per cent).⁵⁴

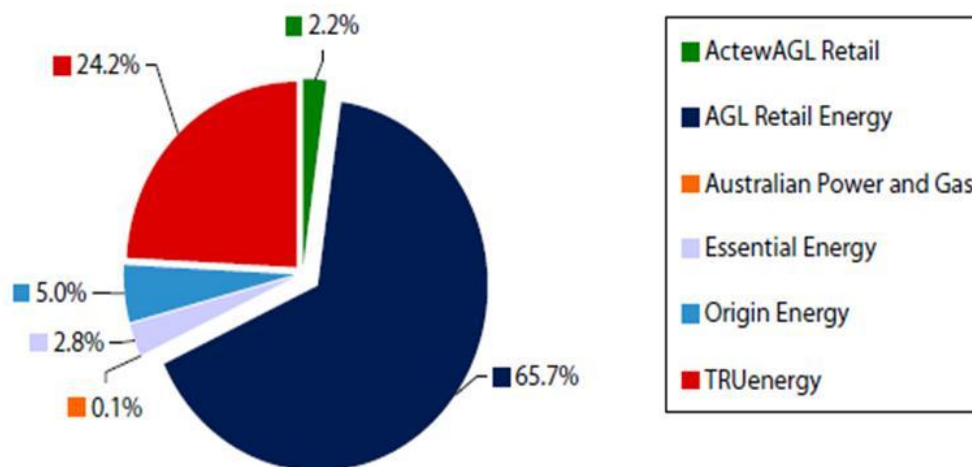
Figure 4.2 provides a breakdown of market share by natural gas retailer for NSW residential customers.⁵⁵

4.1 includes small customers attributed to ActewAGL Retail, Australian Power & Gas, Dodo Power & Gas, Lumo Energy, Red Energy and Sanctuary Energy.

⁵⁴ See IPART's website, www.ipart.nsw.gov.au, "Gas retail businesses' performance against customer service indicators in NSW", January 2012, p6.

⁵⁵ Note that ActewAGL's share includes only its NSW customers. The Australian Capital Territory is excluded.

Figure 4.2 **Natural gas market shares of residential customers in NSW (as at 30 June 2011)**



Source: IPART, "Gas retail businesses' performance against customer service indicators in NSW", January 2012, p7.

4.2.2 Conditions for entry

The threat that a new energy retailer(s) will enter a market and erode any excess profits can constrain the pricing and output decisions of retailers already in the market. However, the effectiveness of potential new entry as a competitive constraint on incumbent retailers 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 retailer such that effective entry will be deterred. It does not include a cost or other impediment that applies more or less to any party, whether new or established, participating in energy retailing.

Barriers to entry are an important element of an assessment of the effectiveness of competition because where barriers are high, potential new entrants will experience difficulty in entering a market and, as such, existing market participants may continue to operate free from any competitive discipline.

For example, a potential new entrant retailer may face a barrier to entry if:

- the retailer cannot secure access to wholesale energy supplies at prices that will enable it to compete profitably with existing market participants;
- there are insufficient financial contracts available to allow the energy retailer to mitigate its price and volume risks; or
- legislative licensing requirements impose entry costs.

Difficulties in securing access to wholesale energy supplies and risk mitigation tools may also affect existing market participants that are seeking to expand their respective energy retail business.

4.2.3 Expansion and exit

Once an energy retailer has entered a market, it may also face costs or impediments that prevent or limit its expansion, or exit, from the industry relative to established competitors. These restrictions are known, respectively, as barriers to expansion and exit.

Barriers to expansion exist where fringe or niche market entry may be possible, but there are obstacles to expanding to a size that would allow more effective competition against larger, more established competitors. In such circumstances, the larger, more established competitors may still not be constrained by the threat of effective competitors.

Barriers to exit can affect market 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 market entry requires substantial capital investment by an entity that cannot be recovered on exit (i.e. there are sunk costs), entry may be discouraged. In some situations, market exit itself may involve further sunk costs where, for example, a firm must incur costs to render a site or premise suitable for alternative uses.

Some retailers, for example, may seek to exit a market where margins are low and may partially offset its establishment (sunk) costs by selling its existing customer base to a competitor at the expense of competition in that market. Note, however, that such acquisitions may require clearance from the ACCC.

4.2.4 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 market 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 energy retailing, economies of scale may arise by virtue of the size of a retailer's customer base. A larger customer base enables a retailer to reduce average fixed costs, improve the utilisation of fixed assets and potentially contribute to a higher profit margin (e.g. utilising an existing billing system to manage and service a greater number of retail customers). Lower average costs can lead to improvements in competition because it allows a 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 (or more) 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 market entry requires a prospective energy retailer to offer multiple products or services to customers or to operate at multiple functional levels of the market. When combined with sunk costs, economies of scope increase the risks of market entry and may deter potential new entrants.

Economies of scope may arise where an energy retailer is vertically integrated with a business operating at another functional level in the industry. An example in the electricity context is owning both generation and retail assets. Vertical integration can have a positive impact on the competitiveness of electricity and natural gas retailing if it allows efficiency gains achieved to be passed on to customers in the form of reduced energy retail prices. However, it can also be detrimental where prospective new energy retailers cannot gain access to wholesale markets, distribution networks or financial hedging instruments under the same terms and conditions that are afforded to the incumbent retailer. As a result, prospective new retailers may be deterred from entering the market.

The opportunity for energy retailers to offer customers "dual fuel" products or services in electricity and natural gas, or "multi utility" products or services across a number of different utility industries (e.g. across energy, water and telecommunications industries), potentially facilitates economies of scope. "Dual fuel" and "multi utility" products and services potentially lower the average cost to serve customers by spreading a retailer's fixed costs over a larger number of supplied customers.

4.2.5 Regulatory constraints

Energy retailers operating in NSW's small customer electricity and natural gas retail markets 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.

In terms of NSW's small customer electricity and natural gas retail markets, the regulatory obligation that is the principal focus of this NSW Review is the regulated retail price for electricity and natural gas. That is, the price at which electricity and natural gas is sold to NSW small customers pursuant to a non-negotiated (or "standard") customer contract.

The regulated retail price of electricity and natural gas provides important signals to suppliers and end-users about how scarce resources should be allocated (e.g. whether additional investment in infrastructure is required, or whether new market entry is likely to be profitable). Accordingly, the level at which the NSW regulated electricity

and natural gas retail price is set by IPART may have important implications for the development of competition.

For instance, if energy retailers are exposed to material volatility in wholesale electricity or natural gas prices and the regulated retail price is set at a level that does not provide retailers sufficient opportunity to recover input costs, then prospective retailers may be discouraged from entering, or existing retailers from expanding within, NSW's electricity and natural gas retail markets. Further, material volatility could result in existing retailers exiting the market.

4.2.6 Climate change policies

In the context of regulators setting electricity and natural gas retail prices, it is also worth noting the impact of the implementation of climate change policies. In the AEMC's Review of Energy Market Frameworks in light of Climate Change Policies (2009), the AEMC noted that the effective regulation of retail prices will become more challenging as a price on carbon would introduce increased uncertainty and volatility into the wholesale energy purchase costs of retailers.⁵⁶

On 1 July 2012, the Commonwealth Government introduced its carbon pricing mechanism, which imposes direct costs on around 500 entities in Australia by requiring them to pay for their carbon emissions under the *Clean Energy Act 2011*. A carbon price of \$23 per tonne of carbon pollution was introduced.⁵⁷ As electricity generation is a carbon intensive activity through the burning of fossil fuels, an increase in the wholesale electricity cost has occurred. This means that purchasers of wholesale electricity (i.e. retailers) are likely to seek to pass through the higher cost of electricity to energy customers. Similarly, for natural gas, upstream entities are liable for the cost of their carbon emissions associated with natural gas production, transportation, distribution and consumption by their end-users. In turn, this may flow through to higher retail natural gas prices.

In July 2009, the AEMA was amended to include a new clause 14.17 which stipulates that in relation to regulated retail prices, increases to energy costs associated with climate change policies shall be passed through to end-use customers.

The NSW Government has also introduced environmental schemes in recent years to increase energy efficiency and reduce carbon emissions. The NSW Energy Savings Scheme, which aims to reduce electricity consumption in NSW by creating financial incentives for energy savings activities, requires electricity retailers to surrender certificates in order to meet legislated annual energy savings targets. The NSW Climate

⁵⁶ AEMC, September 2009, *Final Report on the Review of Energy Market Frameworks in light of Climate Change Policies*, p.54.

⁵⁷ AEMO found that the increase in NEM spot prices was around \$21 per megawatt hour in the first three months of carbon pricing, however notes that the time period is short and quarterly seasonal factors may need to be taken into account. AEMO also found no noticeable change in wholesale gas markets after the start of carbon pricing. See AEMO's website, www.aemo.com.au, "Carbon Price - Market Review", 8 November 2012, p.3.

Change Fund levy, which is charged to electricity distributors to provide financial support to the fund, is used to finance projects to help businesses, households, schools, communities and government save water, energy and greenhouse gas emissions and, from 1 July 2012, to recover the costs of the Solar Bonus Scheme. IPART has estimated that, from 1 July 2012 to 30 June 2013, the cost of complying with NSW Government and Commonwealth Government environmental (or "green") schemes will contribute around \$316, on average, to an indicative NSW regulated electricity customer's bill, that being: \$34 and \$13 for NSW's Climate Change Fund levy and Energy Savings Scheme, respectively; and \$168, \$64 and \$38 for the Commonwealth's Carbon pricing mechanism, Small scale Renewable Energy Scheme and Large scale Renewable Energy Target, respectively.⁵⁸

Question 6 Market structure

- (a) Have the structural conditions for small customer electricity and natural gas retailing in different geographical areas or distribution networks of NSW supported or hindered the development of effective competition?
- (b) Are the structural conditions referred to in (a) likely to support or impede improvements in competition in the future?

Question 7 Market structure

- (a) Are there barriers to entry that impact on the development of effective competition in small customer electricity and natural gas retailing in different geographical areas or distribution networks of NSW?
- (b) Have the barriers to entry referred to in (a) dissuaded prospective energy retailers from entering NSW's small customer electricity and natural gas retail markets, or can they be overcome?
- (c) Are the barriers to entry referred to in (a) likely to persist or abate in the future?

Question 8 Market structure

- (a) Are there barriers to expansion, or exit, that impact on the development of effective competition in small customer electricity and natural gas retailing in different geographical areas or distribution networks of NSW?

⁵⁸ See IPART's website, www.ipart.nsw.gov.au, "The impact of green schemes on regulated electricity retail prices from 1 July 2012", fact sheet, 13 June 2012.

- (b) Have the barriers to expansion, or exit, referred to in (a) dissuaded prospective energy retailers from entering NSW's small customer electricity and natural gas retail markets, or can they be overcome?
- (c) Are the barriers to expansion, or exit, referred to in (a) likely to persist or abate in the future?

Question 9 Market structure

- (a) Are there unique or specific features of the small customer electricity and natural gas retailing environment in different geographical areas or distribution networks of NSW that support, or impede, the development of competition? For example, energy retailers offering small customers "multi utility" products and services (e.g. across energy, water and telecommunications industries) or "dual fuel" products and services (i.e. in electricity and natural gas).

4.3 Market conduct

The consideration of market conduct focuses on the behaviour of participants in the defined market. This includes both the supply side (that is, electricity and natural gas retailers) and the demand side (that is, small customers of electricity and natural gas) of the market. There are a number of factors that will be considered in relation to market conduct in NSW's small customer electricity and natural gas retail markets.

4.3.1 Rivalry

Independent rivalry between energy retailers is an important driver of effective competition in small customer energy retail markets. An effectively competitive market is more likely to exist where retailers compete (and/or there is the threat of credible market entry) to offer the products, services, prices and other conditions of energy supply which are most attractive to small customers. In a competitive market, retailers also respond to changes in customer preferences by offering new, differentiated or superior products in a timely manner. This may include the development of time of use product offerings, where the price charged by an electricity retailer varies throughout the day, with the price being the highest in the peak period and lowest in the off-peak period.

In assessing the extent to which retailers are engaging in, and are likely to continue to engage in, rivalrous behaviour, it is necessary to investigate a range of factors, including marketing and customer participation and experience, as identified below.

4.3.2 Marketing

The extent to which energy retailers are actively competing may also be reflected in their marketing activities. Where small customers demonstrate low levels of interest in energy products and services, energy retailers (especially retailers who are looking to expand) face incentives to reduce small 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 small customers, such as direct marketing.

Direct marketing presents small customers with information and product comparisons, allowing them to exercise some choice with minimum sacrifice of time and effort. However, the choices offered may not be comprehensive or represent the best alternatives for the customer. Periods of intense energy retailer rivalry are likely to be characterised by vigorous marketing activity and, as the number of small customers participating in the competitive market increases, there would be an increase in the overall competitiveness of energy retailing. Where retailers are able to select the small 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. However, it may also be argued that such situations present as ideal opportunities for new or niche energy retailers to enter the market with innovative products and services that cater to the needs of under- or un-served small customers which, in turn, may influence existing product and service offerings available to mass market small customers.

The contribution of energy retailers' marketing activities to 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. Many of these types of activities are regulated by the Commonwealth's *Competition and Consumer Act 2010* and ACL. More recently, the conduct of door-to-door selling in Australian energy retailing has become the focus of efforts by energy retailers⁵⁹, regulators⁶⁰, energy ombudsmen and small energy customer representatives in response to an increasing number of small customer complaints.

An indication of the prevalence of mis-selling and other anti-competitive conduct in NSW's small customer electricity and natural gas retail markets may be available from data contained in energy retailers' complaints and dispute resolution systems, or from statistics published by the AER, IPART or EWON.

⁵⁹ See Energy Assured Limited's website, www.energyassured.com.au, for information on the energy industry's self-regulated scheme which seeks to monitor and improve door-to-door marketing standards of energy retailers and energy marketing companies.

⁶⁰ See ACCC's website, www.accc.gov.au, for a report commissioned by the ACCC and prepared by Frost & Sullivan Pty Ltd, "Research into the door to door sales industry in Australia", July 2012.

4.3.3 Small customer participation and experience

Informed customer choice and a willingness to switch also places competitive pressure on energy retailers to provide electricity and natural gas products and services at prices and on terms and conditions that meet customers' needs. However, necessary pre-conditions for informed and effective customer participation in electricity and natural gas retail markets is that customers are aware that FRC exists, they understand the consequences of being able to choose their retailer, and they have the tools to assess or compare offers so as to facilitate customer engagement.

In assessing the effectiveness of competition in NSW's small customer electricity and natural gas retail markets, it is appropriate to have regard to the proportion of small customers who have switched energy retailer or who have switched from a standing (or "regulated") offer customer contract to a market offer customer contract.

It is important to consider small customer switching rates in light of the reasons for small customers' decisions to switch energy retailers. For example, switching prompted by the opportunity to realise a cost saving may reflect a small customer's preference for a particular energy retailer's relatively lower priced offering and reinforces the pro-competitive effects of rivalrous conduct between retailers. It may also signal to the outgoing retailer that its product or service offerings are considered less attractive to some small customers compared to the offerings of other retailers.

It is also relevant to understand why some small customers elect not to switch energy retailer. In some instances, the decision may be underpinned by a perception that the time and effort to gather and compare multiple retailers' energy offers is outweighed by the likely savings that could be realised by switching to a lower energy tariff. Customers may also believe that they have little or no control over the stability of prices they pay over the energy contract period, reducing their confidence to participate in the market. Switching may also involve actual financial costs to the customer, such as exit fees payable for terminating a market offer contract early, or the loss of the opportunity to recover new energy account establishment fees through lower energy tariffs over a given time period.⁶¹ Finally, customers may also hold a belief (whether real or not) that they must stay with their retailer due to their electricity feed-in tariff arrangement.⁶²

Energy retailers play an important role in educating small customers about FRC in electricity and natural gas retail markets, particularly in relation to energy product and

⁶¹ The NSW Government recently announced its intention to ban electricity retailers from charging an early termination or exit fee to small customers wanting to exit their electricity contract due to a change in the contract terms and conditions, as a complement to the start of NECF in NSW in the near future. The NSW Minister for Resources and Energy, the Hon Chris Hartcher, announced in a media release, dated 17 September 2012, that the NSW Government is aiming for a NECF start date of 1 July 2013.

⁶² Note that the feed-in tariff is set by the NSW Government and therefore does not differ between retailers. However, some customers may have a leasing arrangement with their retailer for their solar panels. This may create difficulties for a customer seeking to switch retailer if they must first pay any remaining costs associated with the solar panels.

service offerings under development or already available in the retail marketplace. This may include time of use product offerings, which to date have not been an active consideration for many participants in the retail end of the market, but in future may lead to an increasing number of small customers being offered retail tariffs that reflect the changing marginal cost of supply and rewards for shifting their energy consumption away from peak times. This information may be provided to small customers in a variety of ways. For example, retailers who use direct sales channels, like door-to-door or telephone selling, may communicate this information verbally as well as through written documentation. This approach may enable retailers to overcome small customers' search and switching costs and increase customer participation in the competitive market. However, information about energy product and service offerings is likely to promote competition only if it is easy to obtain, understand, relevant, up to date and enables competing energy offers to be compared. It may also be the case that even though the information meets these objectives, small customers may choose to disregard 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 and motivations of small customers in NSW's electricity and natural gas retail markets. Further, the AEMC would like to understand the changes in switching behaviour since FRC introduction in January 2002 and what switching patterns are likely to be observed in the near to medium term.

Question 10 Market conduct

- (a) To what extent do energy retailers compete with each other to acquire new, and retain existing, small customers in NSW's electricity and natural gas retail markets?
- (b) What sort of product and/or service improvements have retailers delivered to small customers in NSW's electricity and natural gas retail markets?

Question 11 Market conduct

- (a) Has retail price regulation of electricity and natural gas encouraged, or impeded, tariff innovation in NSW's small customer electricity and natural gas retail markets?
- (b) Has retail price regulation of electricity and natural gas encouraged, or impeded, product differentiation in NSW's small customer electricity and natural gas retail markets?
- (c) Has retail price regulation of electricity and natural gas encouraged, or impeded, service competition in NSW's small customer electricity and natural gas retail markets?

Question 12 Market conduct

- (a) On what basis, and to what extent, might energy retailers be expected to compete in NSW's small customer electricity and natural gas retail markets in the future?
- (b) Describe the availability and take up of time of use tariffs in NSW's small customer electricity and natural gas retail markets?
- (c) What impact may time of use tariffs have on competition in NSW's small customer electricity and natural gas retail markets in the future?

Question 13 Market conduct

- (a) What does the nature, and extent, of marketing activity indicate about the level of competition in NSW's small customer electricity and natural gas retail markets?
- (b) What do the types of marketing activities undertaken by energy retailers indicate about the level of competition in NSW's small customer electricity and natural gas retail markets?

Question 14 Market conduct

- (a) What types of marketing practices, or business behaviours, have small customers experienced in NSW's small customer electricity and natural gas retail markets?

Question 15 Market conduct

- (a) What effect, if any, does energy retailer exposure to fluctuations in wholesale electricity and natural gas prices have on energy retailers' abilities to offer competitive product and service offerings to small customers in NSW's electricity and natural gas retail markets?

Question 16 Market conduct

- (a) What motivates small customers to switch from a standing (or regulated) offer contract to a market offer contract in NSW's electricity and natural

gas retail markets?

- (b) What motivates small customers to switch energy retailers in NSW's electricity and natural gas retail markets?
- (c) With respect to electricity feed-in tariffs, have small customers experienced any difficulties in terms of switching retailer due to a leasing agreement for their solar panels?

Question 17 Market conduct

- (a) Are small customers in NSW's electricity and natural gas retail markets able to access energy related information that is easy to understand, relevant and up to date?
- (b) Are small customers in NSW's electricity and natural gas retail markets able to access energy related information that enables competing energy offers from energy retailers to be compared?
- (c) To what extent do small customers in NSW's electricity and natural gas retail markets rely on the energy related information referred to in (a) and (b) when deciding whether to switch energy retailers?
- (d) What information are small customers presented with by their energy supplier at, or near, expiry of their existing energy supply contract? What action(s) must small customers undertake to ensure a continuation of energy supply?

4.4 Market performance

The outcomes, or performance, of a 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 a market – include profit margins earned, price and non-price competition between energy suppliers and evidence of differentiated and innovative product and service offerings.

4.4.1 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 energy retailing. The profit margin available to energy retailers is a critical condition for market entry and expansion. A significant profit margin above all relevant retail costs will provide an incentive for retailers to enter a market. The pursuit of profit is the main impetus that drives competition, providing incentives to retailers to minimise costs and offer products and services that small customers are willing to pay for. However, evidence of a retailer (or a small number of retailers)

achieving high profit margins over a sustained period(s) of time can be indicative of a lack of retail market competition and may indicate the presence of barriers to market entry.

Profit analysis can only provide a broad, indicative view of retail margins because it is difficult to ascertain the exact cost structure of retail businesses and, therefore, it is difficult to deduce what an appropriate retailer margin is. These issues are further complicated by uncertainty of the time period over which a retailer expects to make an acceptable profit. Sensitivity analysis around a range of scenarios is one way to address some of these uncertainties.

4.4.2 Price

Competition between energy retailers to secure small customers for relatively homogenous products, such as electricity or natural gas, often focuses on price. Accordingly, the price at which retailers offer to supply electricity and natural gas pursuant to a market offer contract may provide some indication of the extent of competition. In competitive markets, prices offered by individual firms normally reflect each firm's assessment of prevailing prices, supply and demand conditions and of the future competitive environment. However, in energy retail markets that are in transition to an effectively competitive market, market prices may be set by reference to a regulated retail price (for example, a percentage discount off the regulated retail price) or determined independently.

Market 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 energy retail price provides a focal point around which energy retailers compete and may increase the risk of tacit price collusion. A recent report published by St Vincent de Paul notes that "none of the electricity and gas market offers contain published rates (prior to discounts) below the regulated offers".⁶³ Product differentiation instead appears to occur through discount offers and non-price offers.⁶⁴

On the other hand, during the AEMC's VIC Review, energy customer representatives submitted that the regulated retail price facilitated price-based competition and provided customers with a benchmark against which to assess competitive market offers.⁶⁵

Energy retail price regulation may also cause some detriment to small customers as they may be misled into thinking that the regulated retail price represents what the jurisdictional regulator considers to be a fair and reasonable price and that a

⁶³ St Vincent de Paul Society and Alvis Consulting Pty Ltd, NSW Energy Prices July 2011 - July 2012, August 2012, p5.

⁶⁴ St Vincent de Paul Society, Victoria and Alvis Consulting Pty Ltd, The National Energy Market - in a bit of a state?, November 2012, p11.

⁶⁵ See, for example, submissions to the AEMC's *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).

percentage discount off this price must necessarily be a good deal for the customer. Based on these assumptions, small customers may limit their search for alternative, better offers and, as a result, may pay more.⁶⁶ The effect of focal points, combined with reduced customer participation, can jeopardise differentiation and innovation in product and service offerings, energy tariff levels and energy tariff structures offered to customers.

Some evidence from energy markets overseas also indicates that the removal of retail price regulation can result in greater innovation in both tariff structures and the level at which the tariff is set.⁶⁷

4.4.3 Products and services

While electricity or natural gas may be fairly homogenous products, the products offered by retailers can differ significantly due to non-price related products and services. The availability of differentiated product and service offerings, including increasing customer service levels, may be indicative of the extent of competition between energy retailers. Product differentiation may be reflected in non-price small customer benefits, such as magazine subscriptions, or discounts for paying on time and/or via direct debit. Non-price retailer rivalry may also exist in the form of offers to small customers for accredited "green" (or renewable) energy products or superior levels of customer service, such as faster call centre response times, payment methods, length of contract, and "dual fuel" offers. A broad range of products that meet a variety of customers' needs may be evidence of effective competition.

Question 18 Market performance

- (a) Are energy retailers to small customers in NSW's electricity and natural gas retail markets able to recover their efficient costs at current standing (or regulated) offer contract tariffs?**
- (b) Are energy retailers to small customers in NSW's electricity and natural gas retail markets able to recover their efficient costs at current market offer contract tariffs?**

⁶⁶ Professor George Yarrow, January 2008, *Report on the Impact of Maintaining Price Regulation*, p.71.

⁶⁷ In 2007, Ofgem found that United Kingdom energy retailers offered a greater range of tariff products that proved popular in the United Kingdom energy 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 that offer customers options to reduce or offset their carbon footprint. Ofgem also estimated that competition between United Kingdom energy retailers had saved all domestic customers more than £100 (\$150) on average by protecting them from the full impact of rising wholesale energy prices over the four years to June 2007. Ofgem, June 2007, *Domestic Retail Market Report*, pp.1-8. We note that Ofgem has since moved to reduce the complexity of electricity tariffs and is consulting on plans to limit the number of tariffs each supplier is allowed to offer. See Ofgem, October 2012, *The Retail Market Review - Updated domestic proposals: Consultation*, 26 October 2012, p.61.

- (c) Are future expected profit margins for energy retailers in NSW's small customer electricity and natural gas retail markets likely to be sufficient to encourage new market entry and increase competition, or will new market entry be deterred?

Question 19 Market performance

- (a) To what extent do energy retailers actively compete to offer the products, services, prices and other conditions of energy supply which are most attractive to small customers in NSW's electricity and natural gas retail markets? For example, retailers offering small customers tailored advice on ways to lower their household energy usage.
- (b) To what extent do energy retailers respond to changes in small customer preferences in NSW's electricity and natural gas retail markets?
- (c) Do energy retailers currently issue NSW small customers a single bill for their electricity and natural gas usage?

Question 20 Market performance

- (a) To what extent do energy retailers in different geographical areas or distribution networks of NSW compete with each other in terms of price to acquire new, and retain existing, small customers in NSW's electricity and natural gas retail markets?

4.5 Other considerations

4.5.1 Customer access to the benefits of competition

Energy services are essential for all sectors of the social and economic community. Electricity and natural gas are "derived demand" goods, in that their essential nature is derived from the services they enable — such as space heating, lighting, cooking and refrigeration. There are important implications for the standard of living that is achievable by small customers who are unable to access energy services.

In assessing the state and effectiveness of competition in NSW's small customer electricity and natural gas retail markets and, based on that assessment, the development of possible implementation strategies for the removal of retail price regulation in respect of such customers, it is appropriate to have regard to small customers' actual experience of retail competition and to gauge the experiences that are likely in future.

There may be certain small customers that, for example, due to a range of individual and/or broader social circumstances, are not able to experience all of the benefits of retail competition. This may include small customers in the following situations:

- those who require an uninterrupted electricity supply, for example due to a specific medical need, which may limit their capacity to benefit from innovative tariff structures;
- those who find it challenging to understand information about energy market offers or contract terms and conditions, for example due to language, literacy and/or numeracy difficulties; or
- customers who are facing temporary or permanent financial hardship, meaning they may be unable to participate more effectively in the market through the exercise of choice of retailer or products.

When assessing competition, it is important to distinguish clearly between any failure of retail competition versus issues of customer hardship and affordability, although it is noted that some individuals may still experience financial hardship even when energy retail prices are determined by market competition. While it is not within the scope of the MCE's request for advice to the AEMC to assess the causes of financial hardship or to make policy recommendations to address them, where retail markets are effectively competitive, the maintenance of energy retail price regulation - which distorts the efficient operation of the market to the detriment of all customers - is not the appropriate means to deal with financial hardship issues related to energy products.

Noting the arrangements that are currently in place in NSW's electricity and natural gas retail markets, the AEMC wishes to understand any energy specific and non-energy specific factors that limit the ability of small customers, or certain groups of small customers, to access the benefits of energy retail competition.

Question 21 Other considerations

- (a) Are there classes of small customers who are unable to access the benefits of competition in NSW's electricity and natural gas retail markets?
- (b) What factors contribute to the difficulties experienced by the classes of small customers referred to in (a)?

Question 22 Other considerations

- (a) What initiatives do energy retailers undertake to assist small customers experiencing difficulties in participating in NSW's electricity and natural gas retail markets?

(b) How effective are the energy retailer initiatives referred to in (a) in assisting small customers?

5 Identifying a path to removing retail price regulation

As part of assessing the effectiveness of competition for small electricity customers and small natural gas customers in New South Wales, the SCER has asked the Commission to provide advice on implementation strategies for the removal of retail price regulation. The terms of reference also state that this advice should consider the option to gradually roll back retail price regulation through reducing the eligible consumption thresholds.

5.1 Options for removing price regulation

There are two broad methods for removing retail price regulation: a gradual roll-back of the eligibility for remaining on a regulated tariff; and the immediate implementation of price deregulation for all customers. Each of these options has benefits and drawbacks, and the appropriate path will depend on the specific circumstances of the jurisdiction under consideration. Further, both approaches should be accompanied by customer protection measures and information awareness to smooth the transition. These measures could be transitional or could remain in place as a permanent feature of the new arrangements. The Commission has already noted the importance of effective communication and education strategies for customers as part of its Power of choice review.⁶⁸

We note that IPART has proposed an “opt-in” regulatory pricing model where all existing regulated retail prices would become unregulated and a limited number of new cost-reflective regulated prices would be established for each standard retailer.⁶⁹ IPART states that customers that are currently on an existing regulated retail price could choose to:⁷⁰

- “ • do nothing and remain on their current price which would be unregulated in terms of price (but may retain non-price protections);
- 'opt in' to regulated prices by electing to move onto a new regulated price offered by their standard retailer; or
- sign a market contract with either their standard retailer or 1 of the '2nd tier retailer's operating in their area.”

The Commission has previously reviewed the effectiveness of retail price regulation for Victoria, South Australia and the Australian Capital Territory. For each of these reviews, the Commission recommended ways in which retail price regulation should be removed. While the path to removing retail price regulation in each jurisdiction

⁶⁸ See AEMC website, www.aemc.gov.au, "Power of choice review - giving consumers options in the way they use electricity - Final Report", AEMC, 30 November 2012.

⁶⁹ IPART, Review of regulated retail prices and charges for electricity 2013 to 2016, Electricity – Issues Paper, November 2012, p. 33

⁷⁰ Ibid.

was, to some extent, dependent on the individual market characteristics and regulatory arrangements that were unique to that particular jurisdiction, there are nonetheless some common approaches that the Commission has recommended. These include:

- maintaining the obligation to supply to residential customers;
- establishing a price monitoring framework;
- greater consumer awareness and education campaigns; and
- providing the jurisdiction with the reserve powers to re-introduce retail price regulation if competition is found no longer to be effective.

Below is a summary the Commission's recommendations from previous reviews.

5.1.1 Victoria

In the Victorian retail competition review, the Commission recommended the removal of retail price regulation following its finding that effective competition was effective. The Commission did not recommend a gradual roll back of the eligible consumption threshold, but proposed the removal of regulation for all customers on 1 January 2009, with a number of customer protection measures to remain in place.

In addition to the four broad recommendations above, the Commission provided recommendations around:

- identifying which retailer has responsibility for supplying customers under different circumstances, such as for existing connections versus new connections;
- the public availability and format of standing offer prices, including the ability of the Essential Services Commission of Victoria to gather and publish on its website current details of all retailers' standing offer tariffs; and
- providing the Victorian Government the ability to request a review of competition at either short notice or according to an accelerated time frame.

The Victorian Government subsequently decided to remove price regulation for all customers, consistent with Commission's recommendations. In addition to the measures recommended by the Commission, the Victorian Government required each of the electricity retailers to widely publish the retail prices that they offer. The Victorian Government also stipulated that prices could not change more frequently than once every six months.

5.1.2 South Australia

The Commission also found retail competition to be effective in the South Australian market and again recommended the removal of regulated tariffs for all customers.

The Commission made similar recommendations for the transition to price deregulation as it made for the Victorian review, including obligations on retailers regarding new and existing connections and the publication of standing contracts and default contract prices. The Commission also recommended that the Essential Services Commission of South Australia maintain and update a central database on its website of the standing contract prices of all South Australian retailers.

Ultimately the South Australian Government decided against removing price regulation at that stage.

5.1.3 Australian Capital Territory

In contrast to the Victorian and South Australian reviews, the Commission found that competition in the Australian Capital Territory was not effective. The Commission considered that the most appropriate way to promote competition in the market was to establish a path towards price deregulation. Consequently, the Commission recommended a number of mechanisms similar to the earlier reviews to smooth the path to deregulation. Some of these recommendations were updated to reflect changes in the policy environment, such as adopting the NECF as soon as practicable to improve the harmonisation of regulatory requirements between the ACT and other jurisdictions.

In addition, due to the nature of the ACT market, the Commission made stronger recommendations around the customer awareness campaigns, including:

- establishing a consumer education program for small electricity users that provides information on the electricity market; and
- setting up a marketing campaign to inform customers of contractual details and obligations and a website containing baseline information relating to the ACT market.

As with South Australia, the ACT Government ultimately decided not to remove price regulation.

5.2 Roll back retail price regulation

The request for advice asks the AEMC to consider the state of competition in the electricity and gas markets for small customers. Small customers are defined as consuming less than 160MWh per annum for electricity and less than 1 TJ per annum for natural gas customers. However, we note IPART has been asked to recommend regulated tariffs for electricity customers that have an annual consumption of less than 100 MWh. IPART states that “This lower consumption threshold still captures almost all households, but excludes some small businesses.”⁷¹

⁷¹ IPART, Review of regulated retail prices and charges for electricity 2013 to 2016, Electricity – Issues Paper, November 2012, p. 3.

This eligibility threshold could be gradually reduced further such that fewer customers have access to regulated tariffs until, ultimately, all customers are on a market contract.

Question 23 Identifying a path to removing retail price regulation:

- (a) Are the approaches in past reviews useful as a basis for NSW? Should the path to deregulation be gradual or should price regulation be removed for all customers at the same time?
- (b) What are the benefits of a gradual approach? If a gradual approach is preferred, what increments i.e. how many stages should there be and what should be the applicable level of eligible consumption? Over what time frame? Should businesses be deregulated first?
- (c) What types of small customers fall within the current 160MWh electricity threshold and the 1TJ natural gas threshold? What are the annual consumption ranges for residential customers and small businesses customers?
- (d) What information should be provided to customers to establish awareness of price deregulation? What customer protections are required?

5.3 Ways to improve competition

If the Commission finds that competition is not effective in NSW, or in parts of NSW, we are required to provide advice on ways in which competition can be improved. Generally, areas in which this could be improved upon include:

- changing consumer behaviour and attitudes in relation to the purchase of energy products and services, for example through information and awareness campaigns; and
- improving the ease of entry into energy retailing by removing barriers to entry where possible.

Question 24 Improving the effectiveness of competition

- (a) Where effective competition does not exist, in the context of improving competition, should similar options to addressing full deregulation of retail prices apply? If yes, which one? If no, what options should apply?
- (b) Are there any other areas that should be considered for improvement if competition is found to be ineffective? If so, what options should apply to address these particular areas?

6 Timetable and consultation process

This chapter identifies the reports that the AEMC will publish as part of the NSW Review, including indicative dates for their publication. It also sets out the AEMC's process for public consultation and approach to confidential information.

6.1 Reporting

The MCE's request for advice formalises a two stage reporting and advice process that the AEMC must follow post publication of this Issues Paper.

This includes preparation of a:

- Draft Report (i.e. draft competition assessment and draft advice to the MCE) for stakeholder consultation; and
- Final Report (i.e. finalised competition assessment and final advice to the MCE), which the AEMC must provide to the MCE by no later than 30 September 2013. The NSW Government will then have up to six months to provide a public response to the AEMC's final advice, in accordance with the AEMA.⁷²

An indicative timetable for publication of AEMC reports and stakeholder consultations is set out in Table 5.1.

Table 6.1 Indicative timetable for the NSW Review

Indicative date	Milestone
13 December 2012	AEMC publishes Issues Paper for stakeholder consultation
8 February 2013	Due date for stakeholder submissions in response to the Issues Paper
March 2013	AEMC hosts a public forum on the findings from its consumer surveys
Mid-2013	AEMC publishes Draft Report for stakeholder consultation
Mid-2013	AEMC hosts public forum on the Draft Report
Mid-2013	Due date for stakeholder submissions on the Draft Report
30 September 2013	AEMC provides its Final Report to the MCE and publishes the report

⁷² See SCER's website, www.scer.gov.au, "AEMA (as amended, 2 October 2011)", clause 14.15.

6.2 Public consultation

The AEMC will issue a public notice at the same time it publishes this Issues Paper. The public notice will announce the commencement of the NSW Review, together with a proposed timetable for the publication of future AEMC reports and stakeholder consultations, including provision of the final advice to the MCE by no later than 30 September 2013.

The AEMC commits to consulting and meeting with the NSW Government and relevant stakeholder groups who have an interest in the oversight, regulation and other control of retail prices and retail competition in NSW.

6.3 Consultants' reports

During the course of the NSW Review, the AEMC intends to engage consultants to provide expert advice and commits to publishing on its website all resulting reports. This includes publishing reports setting out the results of a survey of NSW electricity and natural gas small customers and the non-confidential results of interviews with electricity and natural gas retail businesses.

The findings from the reports will be incorporated into the AEMC's Draft Report. Stakeholders will be invited to examine and comment on the results of the consultants' reports, including any other reports prepared at the request of the AEMC, during the consultation period on the AEMC's Draft Report.

6.4 Confidentiality

The AEMC's approach to confidentiality is set out in full in its Statement of Approach (see Appendix B).⁷³

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. This includes submissions received from stakeholders in response to this Issues Paper.

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 the information be kept confidential. A request to maintain confidentiality should:

- be made in writing;

⁷³ The AEMC's approach to confidentiality is set out in its Statement of Approach at clause 4.4, "Management of confidential information".

- 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 NSW Review and in accordance with its relevant procedures.

Abbreviations

ACCC	Australian Competition and Consumer Commission
ACL	Australian Consumer Law
ACT Review	Review of the effectiveness of competition in the electricity retail market in the Australian Capital Territory
AEMA	Australian Energy Market Agreement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASIC	Australian Securities and Investments Commission
COAG	Council of Australian Governments
ESA	<i>Electricity Supply Act 1995 (NSW)</i>
EWON	Energy & Water Ombudsman NSW
FRC	Full Retail Contestability
GSA	<i>Gas Supply Act 1996 (NSW)</i>
IPART	Independent Pricing and Regulatory Tribunal
MCE	Ministerial Council on Energy
NECF	National Energy Customer Framework
NEL	National Electricity Law
NEM	National Electricity Market
NER	National Electricity Rules
NERL	National Energy Retail Law
NERR	National Energy Retail Rules
NGL	National Gas Law

NGR	National Gas Rules
NSW	New South Wales
NSW Review	Review of competition in the retail electricity and natural gas markets in New South Wales
SA Review	Review of the effectiveness of competition in electricity and gas retail markets in South Australia
SCER	Standing Council on Energy and Resources
VIC Review	Review of the effectiveness of competition in the electricity and gas retail markets in Victoria

A Request for Advice

The Ministerial Council on Energy's (MCE) request for advice to the AEMC on the state of competition in the electricity and natural gas retail markets for small customers in NSW has been prepared as a separate document and may be downloaded from the NSW Review project page (i.e. project "RPR0001") on the AEMC website, www.aemc.gov.au .

B Statement of Approach

The AEMC's Statement of Approach to the NSW Review, which has been approved by the Ministerial Council on Energy (MCE), has been prepared as a separate document and may be downloaded from the NSW Review project page (i.e. project "RPR0001") on the AEMC website, www.aemc.gov.au .

C Australian Energy Market Agreement

The following extract from the Australian Energy Market Agreement (AEMA) outlines the framework for the AEMC's retail competition reviews.

Retail Price Regulation

14.10 The Parties⁷⁴ reaffirm their commitment to full retail contestability in accordance with the National Competition Policy Agreements.

14.11 All Parties agree to phase out the exercise of retail price regulation for electricity and natural gas where effective retail competition can be demonstrated and that:

- (a) the AEMC will assess the effectiveness of competition for the purpose of retention, removal or reintroduction of retail energy price controls, whereby:
 - (i) the criteria for assessing the effectiveness of competition will be developed by the Ministerial Council on Energy (MCE) in consultation with the AEMC and other interested parties based on the principles set out in Annexure 3⁷⁵ and will be formalised in a Statement of Approach to be approved by the MCE;
 - (ii) the assessment process will commence from 1 January 2007 starting with those jurisdictions most likely to have effective competition;
 - (iii) reviews will be conducted according to a schedule determined by the MCE, which must be published and may be amended by the MCE;
 - (iv) reviews will be repeated, except in respect of Parties which have phased out retail price regulation, according to the schedule determined by the MCE and until all retail energy price controls are phased out; and
 - (v) the AEMC may conduct a review within a jurisdiction that has phased out retail price regulation at the request of the relevant Party;

⁷⁴ "Parties" means the parties to the AEMA, namely the Commonwealth of Australia, the states of New South Wales, Victoria, Queensland, Western Australia, South Australia and Tasmania and the territories of the Australian Capital Territory and the Northern Territory.

⁷⁵ Annexure 3 of the Australian Energy Market Agreement presents indicators of competition in retail energy markets, which include: (1) customer experiences (e.g. customer awareness of retailers); (2) customer switching (e.g. customer transfer rates); (3) price and non-price offers (e.g. evidence of retailers offering innovative products that meet customer needs); (4) entry and exit of suppliers (e.g. number of competing retailers and changes over time); (5) market shares (e.g. retailer market shares and changes over time); and (6) barriers to entry (e.g. the threat of market entry by potential new retailers creates pressures to reduce prices and improve service).

- (b) social welfare and equity objectives will be met through clearly specified and transparently funded State or Territory community service obligations that do not materially impede competition; and
- (c) the AEMC will publicly report on its assessments of effective competition in which it will provide advice to each jurisdiction on their compliance with clauses 14.10 - 14.14 and on:
 - (i) ways to phase out the exercise of retail price regulation if competition is determined to be effective and an appropriate timeframe; or
 - (ii) ways to promote the growth of effective competition for those users or areas of a jurisdiction which do not enjoy effective competition.

14.12 The Parties agree that where competition is not yet effective for a market, group of users or a region:

- (a) retail energy controls (including those furthering social welfare and regional equity objectives) can be imposed by the relevant State or Territory but should, to the extent possible, not hinder further development of competition and ensure that the benefits outweigh the costs, and costs are minimised; and
- (b) retail energy price control will be retained under the existing arrangements or be transferred to the AER⁷⁶ and the AEMC at the discretion of each jurisdiction (such a transfer would not include the funding of community services obligations).

14.13 Where competition has been found to be effective under clause 14.11, the Parties agree to implement the phase out of the exercise of retail price regulation in accordance with clauses 14.14 and 14.15.

14.14 The Parties agree that the phase out of the exercise of retail price regulation under clause 14.13:

- (a) need not include the removal of 'obligation to supply' arrangements;
- (b) may involve a period of price monitoring and/or price agreements with retailers under appropriate oversight arrangements; and
- (c) does not prevent the exercise of a reserve price regulation power by the State or Territory where effective competition for categories of users ceases, provided that the power is only exercised in accordance with a regulatory methodology promulgated by the AEMC, and is subject to review by the AEMC of the effectiveness of competition in accordance with clause 14.11.

14.15 The Parties further agree that, for the purposes of the phase out of the exercise of retail price regulation under clause 14.13, Parties are to provide a public response

⁷⁶ Australian Energy Regulator.

to advice from the AEMC under clause 14.11(c)(i) within 6 months of receiving the advice.

14.16 The functions and powers conferred on the AEMC by clauses 14.11, 14.14 and 14.15 are taken to be conferred on the Economic Regulation Authority for the State of Western Australia until such time as Western Australia elects to join the NEM⁷⁷ or the Economic Regulation Authority is disestablished. The Economic Regulation Authority will conduct these functions and powers in consultation with the AEMC and in accordance with the national consistent methodology developed by the AEMC.

14.17 The Parties agree that, where retail prices are regulated, energy cost increases associated with the Carbon Pollution Reduction Scheme and the Renewable Energy Target shall be passed through to end-use consumers.

⁷⁷ "NEM" means the National Electricity Market governed by the National Electricity Law and the National Electricity Rules.