Review of the Effectiveness of Competition in Gas and Electricity Retail Markets: Issues Paper

Submission of Origin Energy

June 2007

Origin energy

Contents

Origin energy

Executive Summary

Origin Energy (Origin) welcomes the opportunity to comment on the Australian Energy Market Commission's (the Commission) *Review of the effectiveness of competition in gas and electricity markets: Issues Paper.*

As a leading energy retailer in the Victorian market, Origin is well placed to comment on the effectiveness of competition in Victoria. It is Origin's view that competition in the Victorian energy market is very effective. Since the commencement of FRC in Victoria, more than 2 million electricity transfers and 1.2 million gas transfers have been recorded through the NEMMCo and VENCorp transfer systems respectively. Origin also estimates that more than 60% of small Victorian customers are currently on market contracts. Coupled with annualised churn rates of 25% - 30% in electricity and 20% - 25% in gas, it is Origin's view that these statistics provide compelling evidence that consumers are aware of their right to choose an energy retailer.

Origin also believes that there are no significant barriers to entry to the Victorian energy market. The emergence of 'new entrant' retailers in both electricity and gas over the past five years has contributed significantly to the high level of customer switching seen in the market. With the emergence of these retailers, the combined market share for incumbent retailers has declined. Indeed, Origin estimates that new entrant retailers command towards 20% market share in electricity and around 10% in gas.

The emergence of new retailers across the sector and the heightened level of competition within Victoria have resulted in a wide range of products being available to consumers. Retailers have taken different approaches to positioning their products within the marketplace. Consumers can choose between products which are price focussed, such as discount products, and non price products offering benefits such as magazine subscriptions and discounted club memberships are also available in the market. Other product features such as pay on time benefits, and the application of termination fees in return for greater consumer benefit have been introduced by some retailers. Origin, for example, has developed a range of products which support our leading position around environmental sustainability. We would welcome the opportunity to provide the Commission with the full range of our product portfolio and marketing collateral on a confidential basis.

Origin notes that in its Issues Paper the Commission has sought to understand the impact of competition on vulnerable customers. We have some concern that the current questions around customer vulnerability could take the review outside its terms of reference. Moreover, these are issues that have already been discussed at length in Victoria, specifically through the recent Victorian Committee of Inquiry into Financial Hardship of Energy Consumers.[1] A range of effective measures to assist customers experiencing hardship (an issue unrelated to energy competition) have been introduced by energy retailers and supported by government. It is Origin's view that there is no evidence which suggests that any part of the market has been disadvantaged in the competitive market.

We also note that the Commission's task is not only to form a view about the effectiveness of competition in the Victorian market but also to provide recommendations about the phasing out of price regulation. Our experience in the Victorian market (and other jurisdictions) is that regulated prices form the benchmark or 'price to beat' in a competitive market. This is largely due to a customer's right to revert to a price-regulated standing offer.

Given our view of the effectiveness of competition in Victoria, Origin is concerned that any form of ongoing price regulation may only serve to undermine the competitive nature of the

[1] See http://www.dpi.vic.gov.au/dpi/dpinenergy.nsf/childdocs/-844e6406280eb3d5ca25729d00101732-1ac2510a81322843ca2572b10014f827?open for the papers released and government response.

Victorian market. The recent dramatic increases in wholesale electricity price demonstrate this risk. Retail margins have been eroded significantly over the past six months yet the 'ceiling' created by regulated prices provides no framework for reflecting such changes.

We have structured our response to the Issues Paper in two sections. The first section examines some general issues regarding the competition review which we would like to draw to the Commission's attention. Section 2 provides our response to the specific issues raised in the Issues Paper.

Origin would welcome the opportunity to discuss our submission with the Commission in greater detail. We are particularly interested in better understanding the decision making framework which the Commission will use to assess the effectiveness of competition in Victoria.

1. Introduction and general comments

Origin Energy (Origin) welcomes the opportunity to comment on the Australian Energy Market Commission's (the Commission) *Review of the effectiveness of competition in gas and electricity markets: Issues Paper.*

Origin suggests that competition in the Victorian energy market is effective, as there are no significant barriers to entry, consumers are aware they have choice of retailer, and they have access to contracts. We estimate that over 60% of all small Victorian customers are on market contracts. There is no evidence of market failure, of a customer group being systematically left out of the market, or of customers being disadvantaged by the market to date.

There are also effective supplementary measures to assist customers experiencing hardship (an issue unrelated to energy competition), with increased government support and retailers' own hardship programmes. Price regulation as a means of 'protecting' these customers from market prices would seem an unnecessary and inefficient measure, and, in fact, is more likely to stifle the competition that would keep prices at their most efficient.

Evidence for these views is presented throughout our submission.

We note that the Commission's task is not only to form a view about the effectiveness of competition in the Victorian retail energy market, but also to provide recommendations about phasing out price regulation. Our general view is that in the unlikely event that competition is found to not be effective, the key is to then act to remove the impediment to competition, rather than just continuing price regulation. However, if some form of price regulation is seen to be necessary, we suggest that it is retained only if there is a clear means by which it can facilitate its own timely removal.

Moreover, we believe Origin's view is the most consistent with the principles in the AEMA, where the focus is on assessing competition and, if found wanting, recommending non-price means to address this.

Overall, Origin has noted that there is less of a focus on the Structure, Conduct, Performance approach in the Commission's Issues Paper, which is a positive outcome, as it potentially allows for prioritisation of data received and less of a focus on output data. However, as noted in our previous submission to the Commission on its Draft Statement of Approach, there is still an absence of a robust decision-making framework and an explicit prioritisation of issues that would allow the Commission to arrive at a solid conclusion. Moreover, the effect of price regulation (or specifically, the price path) itself on the competitive market is not adequately investigated. We have discussed the issues relating to this in detail, and ask the Commission to review our prior submission to the Draft Statement of Approach.[2] We have also attached an extract from the submission at Appendix A.

We have commented on the Commission's consultation questions in detail in Section 2. However, there are also some specific issues that we would like to draw to the Commission's attention, as follows:

- the focus on efficient end prices and profit margins rather than more observable indicators;
- the focus on vulnerable customers;
- the use of the term 'safety net arrangements' instead of 'price regulation'; and
- Origin's suggested approach about how the obligation to offer could be enhanced.

[2] See http://www.aemc.gov.au/pdfs/reviews/Review%20of%20the%20effectiveness%20of%20competition%20in%20the%20gas%20and%20electricity%20retail%20markets/submissions1/006Origin%20Energy.pdf.

1.1 Focus on end prices and profit margins

On page 1, the Commission states that it seeks stakeholder input on several issues. The third of the issues raised is:

> *Are the outcomes in the market in terms of prices and service offerings consistent with what may be expected in an effectively competitive market? For example, are the market contract prices reflective of the efficient cost of supply and are the price and service offerings made to customers consistent with their needs and expectations?*

While we understand that theoretically the best test of effective competition is the degree to which prices are efficient, we argue that the reality of markets and how they operate makes this a near impossible task.[3] This is why the 'invisible hand' of the market is said to be the only way ensure efficient prices - it alone can organise the diverse range of information to arrive at efficient outcomes.

As per Origin's earlier submission to the Commission on this issue, we believe that to this point, regulators have struggled to effectively identify what is a 'good' or 'efficient' price (or range of prices), particularly as this price (if it is truly reflective of supply/demand in the market) will fluctuate over time in a way that is not captured in the regulatory context. For instance, as Frontier Economics illustrated in its analysis of wholesale prices for NSW regulated price path, there are multiple efficient prices on a risk/reward frontier and no one of these can be usefully described as more 'efficient' than another. Another example, with the recent dramatic increases in wholesale prices, is that a retail price that would seem to be supporting a high retail margin six months ago is now unprofitable.

We have only to witness the different ways regulators have attempted to address the current wholesale market increases to know the limitations of this as a measure of how well competition is working.

In any event, the presence of high profit does not itself reflect an ineffective market, or more particularly, that the remedy is price control. What is required in order to conclude that a market is not effective is the observation of monopoly profits over a significant period of time.

1.2 Impact of competition on vulnerable customers

Origin notes that in its Issues Paper the Commission has chosen to specifically focus on this customer group only, and has not sought to explicitly determine the market experiences of other customer types or groups. While we understand the political reasons for this approach, we would have preferred that the Commission took the more objective approach of first asking '*has the market failed for <u>any</u> customer group?*' and then using responses to further investigate the experiences of particular customer groups.

Further, we are concerned that some of the questions asked within the Issues Paper:

1. Cover issues that have recently been discussed at length in Victoria, specifically through the recent Victorian Committee of Inquiry into Financial Hardship of Energy Consumers.[4] The outcome of the Committee's findings was a report to government, where the government then released a package of changes, including new legislation to ensure Victorian retailers have hardship programmes. The findings of

[3] We also note that NERA's recent work for ESCOSA in South Australia has confirmed this view, where NERA's consultants decided that the difficulty of a margin analysis outweighed the potential benefits. See NERA (2007) *Review of the Effectiveness of Energy Retail Market Competition in South Australia, Phase 2 Report for ESCOSA*, June.

[4] See <u>http://www.dpi.vic.gov.au/dpi/dpinenergy.nsf/childdocs/-844e6406280eb3d5ca25729d00101732-1ac2510a81322843ca2572b10014f827?open</u> for the papers released and government response.

the Committee were generally positive and did not find that competition negatively impacted vulnerable customers.

2. Potentially take the review outside its terms of reference. We note that the clause 14.11(b) of the AEMA that: 'Social welfare and equity objectives will be through clearly specified and transparently funded State and Territory community service obligations that do not materially impede competition'. It is not clear from the Issues Paper that recommendations regarding social policy objectives will refer to CSOs rather than price regulation.
3. Take the review into an area of policy that remains ill-defined and rife with rhetoric; for example, if stakeholders put forward an argument that competition is not effective for 'vulnerable' consumers, and the Commission believes this to be true, what can the Commission do to provide a meaningful recommendation to government? This customer group has not been defined and remains unable to be defined (as we discuss further below).

Given the focus on vulnerable customers is already present, in our view the key issues to be investigated by the Commission should relate to how the hardship or vulnerable customer groups are experiencing competition generally (as we note the Commission is addressing), and should specifically focus on any evidence to suggest these customers stand the risk of material disadvantage if price regulation is removed, *for reasons of ineffective competition or market failure*. By not requesting this evidence the Commission is leaving the key questions unasked.

We suggest that if competition is effective, but some people still find energy unaffordable, this is an issue for the government to address through CSOs. In the unlikely event that competition is found to be ineffective, the Commission is then under a clear obligation to:

- describe the market failure involved and promote a means of managing this that does not see price regulation as the default option; and
- clarify the parameters of the customer group involved to ensure appropriate targeting of measures to improve market access or competitive outcomes.

1.3 The safety net versus price regulation

Origin notes that the Issues Paper discusses the role of the Victorian safety net, which, as outlined on page 11, covers the obligation to make a standing offer, minimum contractual standards, standing offer tariffs, and a right to reversion to the standing offer.

Origin has some concern about the use of the term 'consumer safety net arrangements' or 'safety net' throughout the Issues Paper, and specifically in the issues for comment. The Commission has not been asked to review the consumer safety net arrangements, it has been asked to review the effectiveness of competition and provide recommendations about price regulation. The consumer safety net arrangements do cover price regulation, but also extend far further.

We are concerned that while the safety net is referred to instead of price regulation, some stakeholders might believe that the purpose of the Commission's review is to determine whether the entire suite of safety net arrangements is to be phased out. This may cause some stakeholders to be more concerned about the nature of the review than they otherwise would be.

While Origin does not agree with price regulation, we support the principles behind the rest of the safety net arrangements (that is, the obligation to make a standing offer, minimum contractual standards, and a right to reversion to the standing offer) and do not wish to see them phased out.[5] In fact, and as outlined below, we would see maintenance of safety net

[5] Although we would prefer the contractual minimum standards under the Retail Code were modified. We note this is under consideration by the Retail Policy Working Group under the Ministerial Council

provisions around the obligation to offer and the basic Retail Code provisions as *essential* to governments and stakeholders ever feeling comfortable with the removal of price controls.

1.4 The enhanced obligation to offer: Origin's suggested approach

Origin has suggested to policymakers across various Australian jurisdictions that a number of their concerns about how vulnerable customers are dealt with by retailers could be addressed through an enhanced access approach.[6] This would *replace* price regulation, and depends heavily on competition in the market being effective (thus keeping prices efficient) and effective hardship policies from both government and industry (thus keeping bills affordable and sustainable).

Origin's proposal supports a shift from the notion of only the incumbent retailers being obliged to provide access to standing offer contracts to customers, to all retailers within a region having this obligation,[7] with the offers extended to all residential customers. This may be modified slightly if governments have concerns about smaller retailers' capacity to carry out this requirement,[8] or if there needs to be basic residential customer thresholds established. Each retailer could choose the extent to which they disaggregated this offer (for example having different basic offers for different distribution regions, or only one for a state).

Currently Origin will provide an offer to anyone who requests it, regardless of whether Origin is the designated provider of the basic standing offer contract. We would be comfortable to continue doing this, and to even guarantee this, if we had more comfort about the nature of the offer itself, and that there would be no explicit price controls.

The contract would have all the basic options, such as a range of payment methods. We would also publish prices for this offer, and would commit to publishing by set periods, so that prices across all retailers for the standing offer contract can be accessed easily and transparently via an external reporting mechanism.

As per the approach used in the UK, where price regulation was removed several years ago, this type of published basic offer will ensure customer access to supply, at terms and conditions which are unlikely to be able to lead to any disadvantage. If it is also offered by all retailers, each residential customer will then have a 'right' to a range of published basic offers, which is an enhancement to the current regime.

Origin's approach therefore ensures universal access - but goes beyond the current host retailer/regulated price obligation because it:

- provides a parallel competitive market in basic offers (as all retailers operating in the region will have to make a basic offer);
- removes the regulatory risk associated with regulators second guessing wholesale market trends; and
- provides all consumers with a real choice.

However, this approach will only be meaningful in a policy sense, and also be consistent with the national market and regulatory objectives, if prices are not regulated by the state, in line with the AEMA.

---

on Energy.

[6] This is detailed in our submission to recent Ministerial Council on Energy consultation processes about national rules for the retail and distribution of energy. See http://www.mce.gov.au/index.cfm?event=object.showSubmissionList&objectID=79BFB95D-C62B-0857-F6609BE926327F67.

[7] Note that we are not suggesting this in the separate context of deemed contracts. We support deemed contracts as reverting to the retailer financially responsible for the site.

[8] Although most retailers across the jurisdictions *do* have this capacity.

2. Responses to specific issues for consultation

2.1 Market structure and conditions of entry, exit and expansion

1. Are the structural conditions sufficient to support an effectively competitive market?

Origin believes that the structural conditions of the market are sufficient to support effective competition. We have not observed any significant barriers to market participation or customer transfer.

However, it might be said that the perception of regulation is a limiting factor to competition, both in the sense of it limiting competitive outcomes and in the risk it presents to investors seeking certainty from the policy and regulatory environment. We discuss this further in our response to Question 24, and in Appendix B. The presence of price regulation affects retailers' choices regarding market entry and innovation, specifically creating a problem with the right of reversion to the standing offer tariff, which necessarily becomes the price and offer to 'beat'.

2. Is there any evidence that incumbent retailers are not constrained by participants? 3. Are there barriers to entry that impact on effective competition? 4. Are there barriers to expansion or exit that impact on effective competition? 5. Are the barriers such that retailers are not influenced by the threat of new entry?

Overall, second-tier retailers represent a real competitive constraint and we believe there are no barriers to entry that might impact on effective competition.

As the AEMC will find in its research, the number of second-tier retailers has increased from zero prior to competition opening in the market to ten second-tier retailers actively participating in the residential and small business energy market.[9] Of these, a review of recent market entrants shows at least three new entrant retailers have been active for the first time in the Victorian market in the past six to twelve months.

Accordingly, the market shares of the incumbents have declined, as customers have switched to other service providers.

There are also no significant barriers to exit for retailers. The primary barrier to *expansion* is price regulation, particularly in the current environment of increasing wholesale prices. The regulated prices are too inflexible to respond quickly to the changes in the wholesale price, thus severely squeezing retail margins. Moreover, while customers have a (almost) free option to revert to a regulated price at any time,[10] retailers face the risk of being stranded with high cost wholesale contracts, a risk which must in turn be priced into their market offers.

2.2 Independent rivalry and the behaviour of retailers

6. What does the level and extent of marketing indicate about the level of competition? 7. What do the types of marketing indicate about the level of competition?

Origin believes that the nature and types of marketing present in the retail energy market are more reflective of the type of product being sold than of competition per se. The

[9] According to the ESC's listing of active retailers of April 2007. See http://www.esc.vic.gov.au/NR/rdonlyres/EED3AD1E-1041-4A03-8A95-25ACB7311541/0/PBLListingofLicensedRetailersforDomesticandSmallBusinessApril07.pdf.
[10] An effect accentuated by the imposition of non-commercial limits on early termination fees which have in the past acted as a protection for the contracting retailer.

marketing of energy is typical of marketing for a commoditised, low involvement, 'hygiene' product, where high cost television advertising has limited benefit other than brand awareness. Thus the degree of competitive activity can not be readily observed or fully accounted for by simply reviewing general advertising such as on television and radio. Preferred channels used by all competitors appear to be door to door, telemarketing and internet. In this respect, there do not appear to be significant incumbency advantages.

Origin, for instance, has differentiated itself in the market by its early and very strong public commitment to green energy. Other retailers focus on more traditional areas such as discounts, vouchers, and sponsorships. Some competitors have emphasised their government owned status.

In brief, therefore, while there is only limited above the line advertising, there is a vigorous competitive market in direct communication and sales strategies. The key evidence for this is that of the 30% electricity and 22% gas market annual churn to date, around half of this has been to new entrants. Given that the vast majority of customer contract take up (including, but not limited to switching) is in response to retailer marketing rather than customer approaches to retailers, it can clearly be argued that marketing has been effective and has been key to the high level of customer participation to date.

Origin would welcome the opportunity to discuss this further with the Commission, and we are willing to provide a full package of our marketing material to the Commission on request (and subject to confidentiality).

8. Is there evidence of anti-competitive or misleading marketing activity?

There is no evidence of significant anti-competitive or misleading marketing activity that would reflect market failure or would warrant the retail energy market to not be found fully competitive.

Given the industry's necessary reliance on direct selling through door to door and telesales, it is possible that have been instances over the last few years of individual misrepresentations. However, the industry works hard to avoid this from occurring; Origin for example, has set up a strong internal process to manage our compliance with the regulatory framework.

Anti-competitive or material and systematic misleading activity is a matter for various regulators of market conduct to address, and specifically the ACCC, and we expect this behaviour to be prosecuted according to the law. If this is happening frequently (which we believe it is not) then the legal framework is in place to address this and we would strongly urge regulators to use their existing powers under the Marketing Code of Conduct and/or existing Fair Trading and competition law.

However, the existence or otherwise of such behaviour is not relevant to the question of the role of price regulation. It is more likely that it is a sign of a highly competitive market than a sign of market failure.

2.3 Customer choice and behaviour

We note the Commission's statement on page 19 of the Issues Paper that for customers to be able to effectively exercise choice in the market, they require:

- *An awareness of competition between retailers and the availability of customer choice of retailers;*
- *Easily obtainable and comparable information about retailers and their supply offers; and*
- *The ability to effectively exercise their choice.*

We would see the first two conditions relating to awareness and obtainable and comparable information as being key to customers effectively exercising choice. The third statement, that to be able to effectively exercise choice in the market customers require 'the ability to effectively exercise their choice', is self-referential and unclear.

Regarding awareness, the Commission also states on page 19 that 'In order for customers to participate in a market they must first be aware that they have a choice of retailer and be able to identify alternate suppliers'. While we do not disagree with the concept, it depends what part of this statement is emphasised. We agree that customers need to be *able* to identify alternate suppliers, however we suggest that it would be inefficient and unrealistic to expect them to be able to do so prior to any desire or need to choose a retailer. All consumers need to know is that they can change retailer if they want to, and how to access the range of providers when they want to do so.

To provide an example, most people probably cannot recall the names of the range of plumbing services available to them, but that does not mean that the market for plumbing needs regulation. It is commonly understood that if a person needs the service of a plumber they will know they have a choice and will access the range of options in the usual range of community and internet references.

We would also like to note that what is 'easily obtainable and comparable' will come down to customer perception, and that this is also likely to vary by customer, depending on their level of engagement with the market and level of sophistication. In Origin's view, the issue is more about the ease of obtaining the *necessary* information than it is in comparing information per se.[11] The key issue here is to determine (a) what information customers deem necessary to exercise choice in this market, and (b) if they can access this information.

9. What evidence is there of customers seeking or obtaining market offers?

We would see that there are two elements to this question:

(a) evidence of customers pro-actively seeking market offers; and
(b) evidence of customers obtaining market offers, regardless of whether they were solicited or not by the customer.

Regarding the first element, the majority of customer contracts are entered into as a result of retailer activity rather than the customer pro-actively seeking a market offer. We have found that perhaps up to a third of customers proactively seek out offers, which is reflective of energy as a relatively low engagement service.

However, there are points in the customer life cycle where energy moves from low to higher interest, such as where a customer moves house. We have found that customers are able to effectively seek market offer information if and when they need it.

Regarding obtaining market offers, regardless of whether the customer contacts the retailer or vice versa, the market contract take-up rates are evidence enough. We estimate that at least 60% of small customers in Victoria are on market contracts, whether with their incumbent or another retailer. Within that estimate customer churn is at 30% annually for electricity and 22% annually for gas. Given the trends to date, we expect the 60% estimate of market contract take-up to continue to grow.

For such a low engagement service as energy provision, the contract take-up rates are quite

[11] The ease of comparison is more a secondary characteristic, where it may be that the difficulty of comparison (if there is one) means that obtaining the necessary information to make a choice is not possible.

impressive. It would seem that retail energy competition is effective *despite* the lack of tangibility of energy (as compared to say, mobile phones or fashion), and despite it being low engagement. It is also cheap relative to overall household expenditure, and yet households are participating in the market.

Linking this matter of market contract take-up to the previous point that customers do not tend to seek out offers from retailers, in South Australian work carried out for ESCOSA by NERA,[12] NERA states:

> *Our assessment of market conduct suggests that most small customers are aware of their ability to choose their own retailer, although very few appear to be willing to contact retailers on their own accord or look for information regarding market offers that are available to them. While such apathy on the part of customers may in some circumstances suggest that competition may not be particularly effective, such behaviour must be always considered in light of actual switching data. Customer switching from standing to electricity market contracts has been relatively high over the last five years with around 60 per cent of residential and 35 per cent of all small business customers having switched to market contracts. Customer switching appears to have been led primarily through retailer marketing activity, with over half of all small customers having been contacted by an electricity retailer with a market offer since the implementation of FRC. (pages 86 - 87)*

Given that the Victorian market contract estimates are at least as high as those of South Australia, this argument would appear to hold for Victoria also. Competition is effective as long as customers *can* seek out offers, and as long as they are free to take them up *regardless* of how the customer became aware of the offer.

10. Are customers switching retailers to take advantage of competitive market offers?

We have found that in the main, the key driver of customer switching is to take advantage of competitive offers. Only the minority of those who switch retailer (around 1 in 10) do so because they are dissatisfied with their current retailer.

11. Is there sufficient awareness about the existence of competition and market offers?

Origin believes that there is sufficient awareness of the existence of competition and the presence of market offers.

Past Victorian ESC reviews of the effectiveness of competition have shown customer awareness to be high, at around 90%. We would expect awareness to continue to be high for 2007.

This is a trend that can be observed in other states. In NSW (a jurisdiction that is arguably less competitive than Victoria) a recent study by IPART[13] found that over 91% of respondents were aware that it was possible to choose their electricity supplier and 94% were aware they could choose their gas supplier.

While we disagree that customers needs to be able to identify a range of retailers for them to be aware that they can choose, and how to choose, Origin's own quantitative research conducted among Victorian consumers (both Origin customers and non-Origin customers) shows that over three quarters of Victorians are aware of the three incumbent retailers (Origin Energy, AGL and TRU Energy). Half of Victorians have heard of Red Energy, and one

[12] See NERA (2007) *Review of the Effectiveness of Energy Retail Market Competition in South Australia, Phase 2 Report for ESCOSA*, June.
[13] See IPART (2006), *Residential energy use in Sydney, the Blue Mountains and Illawarra Results from the 2006 household survey Electricity and Gas—Interim Report*, RP28, June.

in five has heard of Energy Australia and Country Energy. Thus, consumers are aware of the existence of many retailers. Half of Victorian households surveyed claimed to have already switched at least one fuel.

12. Are customers able to effectively evaluate and search for market offer information such that they can make an informed choice?

The rates of recall described above are particularly significant for a low involvement product. More generally, for a low involvement product, consumers find the names when they need the names rather than high 'top-of-mind' retention. With respect to finding the names, a simple search in Google along the lines of 'energy retailers/Australia' will lead directly to different retailers and to sites (such as the jurisdictional regulators) with lists of multiple retailers.

As noted above, the high market contract take-up rates are yet further evidence that customers are able to effectively evaluate and search for market offer information if and when they need it. The fact that they make the choices indicates that they believe their choices are informed, and the lack of systemic industry complaints about misinformation would also support this.

13. Are there differences in customer choice and participation across customer groups?

Origin believes that there are no significant differences in choice and participation across customer groups. The experiences of vulnerable and low-income consumers are addressed in our response to Question 30.

14. What motivates a customer to switch retailer?

This depends on where in the customer's decision-making we begin: there is the initial decision to investigate options, and there is the actual decision to switch retailer.

Regarding the initial stage, some customers might be unhappy with their existing supplier, thus prompting a decision to investigate their options. Others might have been encouraged by friends and family to look at their options, or may have been enticed by advertising. Moving house is also often a motivation to consider changing energy retailer. Origin's own consumer research has found that of those respondents who had switched energy provider, around 9 in 10 mentioned the offer as being a reason for switching. Less than 1 in 10 mentioned anything about the brand or company.

Once the customer has decided to engage with the market and consider their alternatives, it should be recognised that the motivations for actual switching will vary. While it might be expected that for most customers price will be the key criterion, this is not necessarily correct. Many products have non-price benefits such as magazine subscriptions or loyalty benefits. Further, many of our customers actually choose to pay more for their energy by choosing a premium green product. The motivation that makes the difference (in addition to the initial desire to investigate alternatives) might therefore be anything from a desire to minimise their carbon footprint, to saving money, to being a better football supporter, to being more informed about current affairs.

15. Does the option of receiving dual fuel supply from a retailer influence customer choice?

It is unclear to Origin how much customers value a dual fuel contract in their decision-making. Anecdotally, some consumers do appear to like to consolidate their energy supply with one retailer, but this is not essential. Offering a single fuel does not seem to be an impediment to a retailer in gaining market share.

16. Are there any barriers to a customer switching?

In our experience there are no significant barriers to a customer switching. The significant churn rates show this.

17. What impact do non-price offers have on customer behaviour?

Origin offers the market a number of non-price based offers. Examples of these include green energy at no extra cost, and free magazine subscription offers.

We have found that a significant sub-set of customers are attracted to non-price offers, an outcome consistent with the generally low percentage of household expenditure on energy. For a typical household, a 10% reduction is still only $100 per year, and at least some customers will find this less important than other features. This, in our view, is a sign that the competitive market is successful in responding to different customer needs in a way that regulated prices cannot do. Overall, the reality is that customers respond to products that appeal to them, whether this is price driven or not.

18. What is the relationship between customer switching and marketing activity?

As noted above, the majority of customer switching occurs because of marketing activity. Around 70% of those who switch retailer do so because an energy company approaches them with an offer (e.g. via door to door or telemarketing). This is reflective of a commodity, low involvement service or product.

2.4 Price and service quality outcomes for customers

19. What evidence is there of price competition, for example, are prices reflective of the efficient long run costs of supply?

Origin believes retail energy competition in Victoria is effective, and thus we believe that prices are reasonably efficient, albeit in the presence of regulated prices acting as a benchmark for market offers (because of the option of reversion), it is difficult to provide solid independent evidence that this is the case.

First, it is hard for any price to be truly reflective of the efficient long run costs of supply when retailers are not actually free to pass through these costs as they change over time. There are several factors involved, such as the absence of a 'causer pays' approach to cost allocation, retailer settlement in the wholesale market on profiles, and limits to rebalancing. Further, with the current price controls, a price that is efficient and profitable at one time may not be so at another time; as at mid-year 2007 for instance, retailer profits are increasingly being absorbed by increases in wholesale energy costs, yet regulated prices remain inflexible to this.

Second, the nature of what 'evidence' is required to support an argument for long run efficiency is not clear. As noted earlier, ascertaining these costs will be highly problematic, and deciding what is 'efficient' is beyond the capacity of most market observers.

Third, it needs to be recognised that a retailer's task is to manage risk and market products to end use customers. The efficient long run costs of supply only apply to the regulatory oversight and efficient investment decisions of network operators, and decisions made by generators. Retailers do not directly influence either of these cost components. Competition among retailers is a reflection of the efficiency of their risk management strategies and their ability to acquire customers based on these efficiencies. Therefore, the underlying structural features of the market make it difficult for retailers to assess long run costs of supply.

Origin energy

20. What types of competitive offerings are being made available to customers, and is there evidence of new types of offers being made to customers over a range of customer classes?

As noted above, there is a range of competitive offers being made available to customers, and Origin is happy to provide to the Commission hard copies of all our marketing material, on a confidential basis. Our green products have been particularly popular, with customer numbers doubling in the past year.

21. Do retailers clearly and accurately communicate information to customers about their market offers?

As noted above under Question 12, the high market contract take-up rates are evidence that customers are able to effectively evaluate market offer information. This would imply that the information has been clearly and accurately communicated. The fact that customers make the choices they do would indicate that they believe their choices are informed, and the lack of systemic industry complaints about misinformation would also support this.

Examples of how retailers have addressed the need to provide clear and accurate information to consumers includes prominent positioning of the price components of a market contract, the existence of exit fees or otherwise, and a summary of the key terms and conditions that the consumer should be aware of under the contract. In addition to this key information, full terms and conditions are provided (required by regulation).

Further to this, retailers are constantly seeking to improve our service to customers to meet their needs. We carry out research, including focus group testing, to inform how we present information to customers, and we seek to implement changes to our approach as they are required.

2.5 The role and impact of retail price regulation

22. Have the consumer safety net arrangements been effective in ensuring access to supply in Victoria?

Overall, and as stated in Section 1, Origin has some concern about the use of the term 'consumer safety net arrangements' as being interchangeable with retail price regulation. The combining of the terms has made this a more difficult issue to address, as the objectives of price regulation need to be separated from the objectives underpinning the rest of the safety net.

First, it should be understood that the objective of price regulation was not to ensure access; in fact, this was more the point of the obligation to make an offer, which is not explicitly part of the Commission's terms of reference. Origin believes that the non-price regulation aspects of the consumer safety net arrangements *have* been effective, and we even suggest a way to ensure greater access to supply and choice via an enhanced obligation to offer supply (see Section 1).

Second, the notion of price regulation ensuring access only makes sense if it is assumed that the point of price regulation was to keep prices so low that anyone could afford energy. However, this assumption is not supported by government statements at the time. As described by the Commission, the government's intent regarding price regulation was to provide a transitional safety net prior to retail energy competition being found to be fully effective. It was about avoiding price exploitation in the absence of a market, not about keeping prices artificially low to ensure affordability. Price regulation did not relate explicitly to access, and the two issues are not linked; in fact, general access to an effective market was a pre-requisite of price regulation being *removed*.

Even if the point of price regulation was to ensure access at affordable prices, it would be impossible to ensure this for all customers, or even for one customer. No form of price regulation can ensure this, as there will always be some people who do not have sufficient funds to support their consumption, whether this is a temporary or permanent situation. These people require assistance of a different sort, assistance already provided by government concessions and grants, consumer programmes and retailers' own support arrangements.

23. What are the benefits of the consumer safety net arrangements?

While the benefits of the consumer safety net arrangements are best described by consumer advocates, we would suggest they include certainty for consumers about minimum standards and access to supply. Origin would not argue for these benefits to be removed.

We are less sure of the benefits of price regulation to date, particularly beyond what should be a limited short term transition period. As noted above, we estimate that at least 60% of all small Victorian customers are on market contracts, where prices are not regulated, and which reflect mostly lower prices than the regulated price (with the exception of some green products). These customers benefit more, it would seem, from choosing an *alternative* to the regulated standing offer.

24. What are the detriments of the consumer safety net arrangements?

The detriments of the consumer safety net as a whole include sovereign risk issues to retailers, where several of the laws and regulations provisions have been onerous and unwarranted, and where further regulations continue to arise with little regard to public benefit or actual need. For example, the Wrongful Disconnection rules have created windfalls for some customers who were not affected, such as those with holiday homes. These rules have been costly to retailers, and we question the degree to which they truly meet customer needs.

Regarding price regulation, the major detriments relate to the use of political decision-making to short-circuit the price mechanism, which has a chilling effect on investment in the sector, including upstream activities such as generation. Inadequate generation obviously undermines security of supply and increases the risks of power outages.

We suggest that price regulation has also had the effect of penalising the many consumers whom the market could better benefit, in the purported interests of the few. We would also question how much price regulation truly benefits those whom it purports to protect, as the price governments set tends to then be the 'price to beat' for the market. As noted above, this means they set a ceiling rather than reflecting the cheapest price.

Origin has articulated these arguments in a number of submissions to policy-makers, and most recently to the Productivity Commission in its review of the Australian consumer policy framework.[14] Appendix B contains an extract from this submission that addresses some of the costs of intervention on the market.

25. Have the consumer safety net arrangements had unforeseen or unintended impacts on the development of competition?

Origin would argue that the effects of price regulation were quite able to be foreseen, and also had what we imagine was the intended impact, which was to limit government exposure to risk from potential consumer dissatisfaction from the threat, and reality, of price rises.

[14] See http://www.pc.gov.au/inquiry/consumer/subs/sub031.pdf for the full submission.

There are, however, risks that perhaps were not anticipated by government, such as the effects on investment through the value chain, as noted above. Further, it can be expected that the recent high degree of price squeeze on retailers as a result of the price ceiling set by governments and increasing underlying costs was not intended.[15]

26. Other than price, are there differences between the standing offers and the market offers that may impact on the effectiveness of competition?

This question is not clear, and Origin seeks guidance from the Commission as to its intent.

One difference to note is that the standing offers have provided a reversion right that is free to the customer, but not to the retailer, who must keep an open book position in order to meet an obligation to supply and/or cover a customer reverting to the standing offer.

2.6 Impact of competition on vulnerable customers

As noted in Section 1, we are concerned that a number of the questions asked within the Issues Paper about vulnerable customers cover issues that have recently been discussed at length in Victoria, specifically through the recent Victorian Committee of Inquiry into Financial Hardship of Energy Consumers.[16] The vulnerable customer questions also potentially take the review outside its terms of reference, as well as taking the review into an area of policy that remains ill-defined.

27. Which customers are likely to be considered vulnerable customers?
28. What factors contribute to customer vulnerability?

It is worth differentiating the customers referred to as 'hardship' customers from those considered 'vulnerable', and seeking to define which customers we are referring to. The term 'hardship customer' is used frequently by those in the energy industry to denote those who are already within retailers' financial hardship processes or schemes (such as those in receipt of a Victorian Utility Relief Grant), or those who are mistakenly disconnected for reasons of non-payment.

While the term 'vulnerable' customer has not been defined, it tends to refer to a broader group of customers, those who may not have been captured by retailers' hardship schemes or have been disconnected for non-payment, but still might require assistance. These people may be currently experiencing financial hardship but are not (yet) recognised by the retailer as requiring assistance or disconnection, or they may have managed the current level of payment but would not be able to afford any price increase.

While this provides a conceptual definition, defining this group in any *operational* sense is problematic. As we have discussed in detail in previous submissions to consultations on this issue,[17] there is no common definition on this customer population, and there are no specific proxies for financial pressure or hardship that retailers might use to better identify and target this customer group as a whole. The causes of hardship or vulnerability are many, and most do not relate specifically to energy consumption.

One of the tasks of the Victorian Committee of Inquiry into Financial Hardship of Energy

---

[15] See Murphy, M. (2007) "Retailer warns more may pull plug", *The Age*, Business Day, June 25, or http://www.theage.com.au/news/business/retailer-warns-more-may-pull-plug/2007/06/24/1182623742086.html.
[16] See http://www.dpi.vic.gov.au/dpi/dpinenergy.nsf/childdocs/-844e6406280eb3d5ca25729d00101732-1ac2510a81322843ca2572b10014f827?open for the papers released and government response.
[17] See the Origin (2005) submission to the Victorian Committee of Inquiry into Financial Hardship of Energy Consumers, and our more recent (2007) submission to the Productivity Commission.

Consumers was to address the causes of hardship. It found that the causes varied significantly, and were not linked specifically to energy consumption:

> *Both financial hardship in general, and difficulties with energy bills in particular, have many aspects and causes. While the two are related, they are by no means identical. Most difficulties in paying energy bills are due to temporary financial upsets, which customers, for the most part, are able to manage over time.*[18]

The eventual conclusion was:

> *Rather than spending effort on fine-tuning definitions for a situation that is known to be complex and fluid, the more effective use of effort is to develop systems that will respond effectively to people identifying themselves as being in hardship.*[19]

In line with this conclusion, Origin has found that the only reliable method of detecting and assisting customers who are having difficulty paying their energy bills is to provide the environment where customers feel confident and comfortable enough to *self-identify* through communicating their current inability to pay. Retailers can only identify customers in hardship by talking to these customers and understanding their individual circumstances - essentially to view those who identify themselves as unable to pay, or requiring more assistance, as requiring assistance. It is not particularly helpful to try to define hardship or vulnerability in the energy market beyond this, and trying to unpick the many causes of vulnerability does not tend to assist management of the issue.

29. Does the structure and operation of market contribute to customer vulnerability?

Origin does not believe that the structure and operation of the market has contributed to customer vulnerability. In fact, since the market opened our approach to providing support to those in need has far eclipsed what happened under the pre-competitive arrangements. Disconnection rates and assistance for customers in hardship have improved significantly since competitive reforms (and privatisation) were carried out in Victoria (see Essential Services Commission, *Energy Retail Businesses: Comparative Performance Report for the 2005-06 Financial Year*, November 2006).

It should be noted that hardship policies created by retailers have often preceded any regulatory requirement, and Origin's own *Power On* programme actually pre-dated the Victorian government's hardship policy by a couple of years.

Policy makers must separate the issue of the causes of financial hardship or vulnerability from the issue of retail competition. Retailers have always been faced with the problem of how to reveal the differences between customers who cannot pay and customers who will not pay, and how to deal appropriately with customers experiencing problems with affordability of energy use. This has nothing to do with competition.

There is no evidence to support an argument that any customer group will be left out of the market based on socio-economic characteristics. As found in the competition reviews carried out by ESC in Victoria and ESCOSA in South Australia, customers of all types are being offered and are taking up market contracts. There are also no apparent data to support the argument that customers are being disadvantaged through inappropriate contractual terms and conditions.

---

[18] See *Committee of Inquiry into the Financial Hardship of Energy Consumers*, Main Report, September 2005, page 11.
[19] Ibid., page 19.

30. How does a customer's vulnerability affect their participation in the market?

We might speculate that a customer experiencing serious financial hardship might not prioritise the energy market very highly. A customer struggling to manage significant life problems is less likely to place high value on choosing a different energy retailer than when their life is in relative calm.

However, this is separate from 'vulnerability', which, as noted above, is a broader group and includes customers who are not in direct hardship but who might have greater issues with bill payment than the customer mainstream.

Our own experience with customers who might be considered 'vulnerable' is that their vulnerability does not appear to affect their participation in the market. We market equally to all customer groups, and find that customer contract take-up does not vary significantly across customer classes.

It is worth noting the recent IPART report *Residential energy use in Sydney, the Blue Mountains and Illawarra, Results from the 2006 household survey* found that in NSW:

- the proportion of households that were aware they could choose their electricity and gas supplier did not vary significantly between low and high income respondents, or between low and high consumption respondents;
- the proportion of low and high income customers approached to change electricity or gas supplier was almost equal;
- the proportion of households approached to change electricity or gas supplier did not vary significantly between low and high income respondents or between low and high consumption respondents;
- of those approached, low income and low consumption electricity respondents were more likely to switch their supplier; and
- a higher proportion of lower income households switch once approached by an electricity supplier (39%) compared with high income households (33%).

31. How effectively do retailers identify vulnerable customers and assist them?

As noted above, Origin has moved away from the more historic approach of trying to determine if customers 'genuinely' have difficulty, and the usual debates which used to arise about differentiating those who *will not* pay from those who *cannot* pay. Engaging in these discussions only ever led to retailers setting themselves up to achieve the impossible; we have no way of knowing what customers' genuine circumstances are. We instead decided to take what our customers say on face value, and provide support from there. We have found this to be very effective from both a customer and business perspective.

In Origin's case, if a customer advises us that they are having difficulty, we then have set procedures to assist them, culminating in individual case management through our *Power On* programme, should that be required. We would be happy to discuss with the Commission how our *Power On* programme works if this is useful.

32. Do the existing regulatory policies facilitate participation in the market for vulnerable customers?

This question requires clarification, as it depends which regulatory policies are referred to, and what the purpose of these policies was to be. We would argue that none of the regulatory polices to date were *supposed* to specifically facilitate participation in the market for vulnerable customers, and even the hardship policies and legislation created to assist customers in hardship were not about FRC, or participation in the market per se.

In Origin's view, the best means of facilitating participation in the market for vulnerable customers would be to:

(a) Continue the obligation to offer a contract, and as outlined in Section 1, perhaps even enhance this approach to guarantee all customers a range of basic offers that adhere to basic contractual minimum standards.

(b) Enhance the transparency of offers, such as providing a website and other information through the community explaining options and providing assistance with comparing the range of basic offers referred to in (a).

(c) Encourage customer advocates and regulators to continue to work with retailers to provide an open and supportive environment for customers to feel comfortable engaging with retailers and the market as a whole. Overly negative press about the occasional retailer mistake or poor practice can overwhelm the positive stories and have the effect of creating a fearful or sceptical consumer community.

33. Are the existing government and retailer initiatives effective in managing vulnerable customers in a competitive market environment?

Once again, it depends which initiatives are referred to here, and what is the objective of 'managing' vulnerable customers in a competitive market environment.

It should be noted that this was another issue addressed by the Committee of Inquiry into the Financial Hardship of Energy Consumers, and specifically through its third Term of Reference, which was to 'Assess the impact on consumer hardship of the policies and practices of Victorian energy retailers, Government departments and agencies, and financial counsellors and welfare agencies'.

The Committee found that the system was functioning at an acceptable level, and stated that the current Victorian framework 'provides a firm base for dealing with energy hardship' (page 54). Some areas were considered worthy for potential extension or alterations, which the government then responded to with a package of revised funding arrangements and hardship legislation.

Origin believes that the existing government and retailer initiatives *are* effective, in that domestic customers:

- have a right to a basic offer;
- are provided a quote for a market contract from their retailer of choice if they request one;
- have their basic contractual rights and obligations, including payment terms, bill content, disconnection provisions and access to the Ombudsman, guaranteed through the Retail Code and associated guidelines;
- have access to payment plans if they require support paying a bill and advise us of the need for this support;
- have access to additional government support through the concessions and grants regime supported by DHS, and this has been improved since the Committee's recommendations were made; and
- have access to retailers' hardship programmes to assist with more serious hardship issues, including energy efficiency advice and appliance assistance, which is another improvement since the Committee's recommendations were made (although these were already elements of Origin's *Power On* programme).

This means that customers, whether vulnerable or not, have access to the market, and also have access to financial and other support services if they require them. The need for price regulation as a form of support for vulnerable customers has not been demonstrated.

Origin energy

Appendix A: Origin's preferred approach - extract from Origin's submission to AEMC *Draft Statement of Approach*

Overall, Origin suggests that the most meaningful indicators of competition are those related to market structure, particularly those that can inform a view about the degree of market power possessed by incumbents and specifically the degree to which this market power may be exercised in an ongoing way to charge monopoly rents or restrict entry.

This is not a unique view. Writing about conditions of entry, the observation of the Australian Trade Practices Tribunal (QCMA, 1976) was 'it is the threat of the entry of a new firm or a new plant into a market which operates as the ultimate regulator of competitive conduct'.

There are thus real precedents which can inform the AEMC's final approach.

Principles

Identifying the absence of market failure is easier than identifying success

The recent development of retail markets and corresponding regulation in energy has been the opposite of most other sectors, in that in each jurisdiction retail energy price regulation has been present from market start, with competition needing to be demonstrably 'effective' (that is, seen to be 'working') for regulation to then be reduced. Other industries usually need to have serious market failure *before* regulation is then imposed, with the onus on policymakers or regulators to prove this failure before intervening.[20]

We recognise the political and historical reasons why the approach to retail energy is different, but the fact is that the energy market's *presumption of failure*, with competition needing to be proved effective before governments can remove themselves from intervention in pricing, is not actually operationally meaningful or true to the premises of the market. 'Effective' market outcomes are impossible to define (and thus unambiguously observe) in practice, and even to define them in theory would presuppose that markets are static and predictable.

Rather than looking for positive evidence of the outcomes of competition, the primary aim should be to identify any significant impediments to competition, where these may be linked to misuse of market power to make monopoly profits in some way. Misuse of this type of market power is the market failure which should prompt regulatory intervention, and already has legal precedent through the *Trade Practices Act 1974* and legal interpretation of the Competition Principles.

It would then be logical to allow the market to work by removing the impediments to competition, rather than intervening in the market to impose prices.

Defining the objective

Leading from the previous point, the next issue is to define what we would see as an effective market. The AEMC has noted a range of definitions, including raising the concept of workable competition. While Origin agrees with the various means of understanding effective competition, we would suggest that this can be conceptually tightened a little. It is easier to define an effective market by what it is *not*. An effective market for the

[20] Indeed, the whole thrust of the general post-Hilmer reform process places the onus of proof on those who wish to regulate the market to clearly state the objective of the regulation, the 'harm' that is to be addressed, the overall costs and benefits and, more specifically, the impact the regulation will have on the development of a competitive market.

purposes of the AEMA requirements is one that does not exhibit characteristics of market failure, thus it does not require ongoing state price regulation.

The next issue is to define market failure. Market failure is where the market conditions allow for ongoing[21] anticompetitive behaviour arising from the misuse of market power, which would generally be behaviour in pursuit of monopoly profits. This is likely to be enabled through the creation of barriers to entry. Further, this behaviour is also likely to be best *observed* through the presence of barriers to entry. Given the problems with accessing reliable and objective 'outcome' based information (such as finding the 'efficient' price), structural conditions such as barriers to entry are the most practical means of observing misuse of market power.

Contestability, not observed competition

It should be noted that the structural issues relate more to *contestability* than observed competition in itself. Needing to demonstrate actual competition, even through structural indicators, ends up looking suspiciously like an outcome based analysis, and the issues raised above of what is 'enough' of any one factor to prove competition arises again. For example, how many are 'enough' retailers? What does 'effective' competition actually look like even from a structural perspective?

It should be recognised, as the Courts have done in multiple test cases, that an effective competitive market does not neccesarily require many sellers, merely the absence of demonstrable and ongoing market power. Highly concentrated markets can still be contestable if the structural features of the market, such as limited barriers to entry or exit, are in place. These limit the incumbent firm's ability to raise its price above competitive levels. The presence of potential competitors waiting to take advantage of any significant profits and unhappy customers is enough to keep incumbents attentive to pricing in a way that consumers find acceptable and mitigates misuse of market power.

As noted above, this view has been supported by the frequently quoted Australian Trade Practices Tribunal (QCMA, 1976) observation: 'it is the threat of the entry of a new firm or a new plant into the market which operates as the ultimate regulator of competitive conduct'. While retail energy markets are not perfectly contestable, as market entry and exit are not costless, there are still generally very few barriers to entry to a retail market with respect to traditional factors such as high upfront capital investment costs.

Understanding the effects of regulation on the market

A further problem with the presumption of failure approach is the inherent difficulty it presents with separating the effect of regulatory intervention from the effect of the market alone, and the circular effect this can have on market assessments.

State price controls, if prices are set too low, can reflect a barrier to market participation for retailers; it is logical that if there is no profit potential, retailers will not seek to participate in the market. This has been a common issue across Australian jurisdictions, where some regulated prices to certain customer segments still do not even allow for basic cost recovery. Even where low margins do not stifle innovation across the board, price controls and interventionist approaches from regulators and governments to date have had a dampening effect on competition.

This relative lack of retailer participation can in turn be perceived by a competition assessor as a symptom of inadequate competition arising from an undeveloped market, where the market is then seen to require ongoing state price controls until it improves. The problem here is there may well have been no problem with the market per se and the need for state price controls has been misunderstood.

[21] Market failure that warrants regulatory intervention is non-temporary by definition.

Fundamentally, a presumption of the need for state price regulation must be avoided, particularly where there is no evidence of this need. Making this presumption increases the risk of Type II regulatory errors (to regulate where state regulation is not warranted), and becomes a self-fulfilling prophecy where the resulting regulatory approach stifles competition. For example, if the AEMC or jurisdictional governments are waiting for competition in any one jurisdiction to significantly 'prove itself' through high churn rates before removing price controls, they may have created a vicious cycle (particularly if prices are set below cost of supply).

In summary, Origin proposes that there should be a clear theoretical framework that sets out concisely what the objective of a competition assessment is, in the sense of what can reasonably be expected to be observed by the AEMC and how it demonstrates the 'effectiveness' of competition.

We would suggest that the primary goal should be to evaluate whether there is market failure (caused by the market, not by existing regulation). The absence of market failure means that the market is effective enough to regulate price efficiently without state intervention in price setting.

The issue of any 'regulatory failure' arising from price controls and their negative effects on the market should be addressed separately, and clearly understood as not reflecting a failure of the market itself.

Origin believes the key matter is whether the market *structure* itself *provides for competition*, in particular the conditions for market entry. As noted, there is now a body of statutory law (e.g. s 46 of the TPA) and case law (e.g. Queensland Wire v BHP, Boral v ACCC) that define the requirements of a competitive market. These focus on market structure, and specifically, the presence or otherwise of barriers to entry.

Low retailer and customer participation do not demonstrate that market forces are not present, or are not sufficiently capable of regulating prices. They may only mean that prices are not yet at the levels that encourage active market involvement by either competing retailers or disgruntled/eager consumers. This may well be a result of effective market forces.[22]

Practical considerations

In addition to prioritising certain indicators, Origin strongly suggests that a core principle for any development of FRC effectiveness indicators should be to have some understanding about what the results of any particular query are likely to tell us about the state of the market. This in turn needs to sit within a theoretical framework that clearly sets out what might be seen as market failure and thus what is viewed as 'success' (that is, sufficient capacity for competition to negate the need for state price intervention). It will be a challenge to recognise an effective market if we have not established our expectations of what it may look like.

Thus answers to the following questions need to be understood:

1. What are the expected (observable) characteristics of an effective market?
2. How does the indicator in question demonstrate market effectiveness?
    a. What data would demonstrate adequate competition that would show state price regulation to be unnecessary?

[22] It may also be the result of unsustainably low regulatory price setting, but the point here is that market structure issues are more important to contextualise and render meaningful any competitive 'outcomes' such as churn and offers available.

b. What data would demonstrate market failure?
c. How practical is the collection of the data? Are the data truly objectively observable?

3. How does this indicator interact with other indicators?
4. Are there secondary characteristics of this indicator that might assist assessment of data arising?

Some of these may be a little hard to answer definitively, but if there is no succinct way of showing an indicator can add value through this process, we suggest it is deleted, or perhaps delegated to being a secondary characteristic of another indicator.

Further, there is a need when answering these questions to be clear about the various possible interpretations of data. As noted above, state price intervention itself can create perceived or real barriers to retailers, which can then look like market failure. However, this is not a failure of the market, but of the state's intervention. There is thus a requirement to assess the effects of state price controls, separate from issues of market failure.

We strongly suggest that a core principle for any development of FRC effectiveness indicators should be to have some understanding about what the results of any particular query are likely to tell us about the state of the market within the theoretical framework. There needs to be a way of differentiating 'nice to have' data that merely help contextualise the given situation, versus vital data that should demonstrate market failure (or the absence of market failure). The ease of accessing objective information also needs to be assessed.

Appendix B: The costs of intervention - extract from Origin's submission to the Productivity Commission's *Consumer Policy Framework* Issues Paper

What are the important costs of intervention?
How significant are the hidden costs of intervention?
How do these compare to the costs of not intervening?

As noted by the Commission on page 13 of the Issues Paper, intervention is not without costs. In fact, the costs of government intervention in energy markets can be extremely high.

In non-price terms, the costs can be high in regulatory compliance, in that retailers need to comply with a range of jurisdictional regimes, all with slight differences in many areas, such as what must be on a bill, and times for cooling off periods. There are additional costs related to auditing and reporting requirements.

However, while the costs of consumer protections in non-price areas can be onerous, the real problem for the retail energy industry in Australia comes from state price controls in contestable markets. While the theory would require governments to stay out of market outcomes, this is obviously not the reality, with state price controls of basic contractual offers still present in all Australian jurisdictions that have retail energy markets.

The problem with unwinding price controls seems to stem from governments being unwilling to lose control over price outcomes for which they are still seen as responsible. Governments are often politically vulnerable to consumer backlash over utility prices irrespective of the private sector ownership of the businesses or presence of a competitive market. The most significant problem occurs where prices to some consumers rise significantly in a brief period (sometimes known as 'price shock'),[23] which is often the result of unwinding embedded cross-subsidies in existing prices. Unwinding cross-subsidies to show who is receiving support and who is paying more than their share is also rarely popular.

The risks of market forces being seen to disadvantage some customers, and those customers (or their representatives) then damaging government's legitimacy to govern at the next election, is thus enough for governments to maintain reserve powers or direct control of prices for far longer than the initial industry reforms would have suggested.

Origin understands this political need to manage risk; however, we believe that governments and regulators need to also address the political risks of *state price regulation* rather than just seeing the benefits of protecting customers from this public perception of market forces. State price regulation leads to embedded cross subsidies that are invisible to consumers and distort consumption signals. This works against competitive outcomes and the economic growth associated with robust markets.

As discussed below:

- price shock is often the outcome of years of state regulation;

[23] The energy market is often marked by price shifts. These arise from such things as the prevalent weather patterns and their impact on supply and investment in generation and network capacity keeping up with the ever-increasing demand. Increases also occur from government policy, where the industry is expected to pass through government levies and the costs of environmental policy objectives around valuing carbon emissions. However, incremental increases are not the same as price shock. Price shock occurs when there is a large increase at one time that consumers find difficult to accept, and which make governments feel politically vulnerable.

- price regulation will stifle competition; and
- the costs of regulation can outweigh the benefits.

Most importantly, government intervention, and onerous or prescriptive regulatory programmes can discourage investment, as industry participants will view the sector as lacking opportunity, and possibly even presenting too much risk.

Price shock is often the outcome of years of state regulation

It should be recognised that any price shock felt by consumers in a competitive market (assuming the market is effective) is because market forces are providing for efficient outcomes, and there is a gap between what had been charged historically and what needed to be charged to recover costs. The reason for this gap is often actually the result of governments keeping prices to some consumers artificially low over many years (generally to obtain political goodwill from key constituencies) whether this is through depressing prices overall, or through maintaining cross-subsidies between consumers through the retail price. However, keeping retail prices low to some consumers by these artificial means provides only a short term fix, and only delays and exacerbates the effects of the inevitable price rise.

Where there are such price gaps, there are means of avoiding price shock in the transition to a truly competitive market (that is, with no state price regulation and competitive markets driving cost reflective pricing).

First, sometimes inventive approaches to price regulation can start to create a more level playing field rather than just reinforcing price inequities. For example, prior to full competition, developing a price path over a clear period of time can support the unwinding of cross-subsidies while also providing some certainty to customers and governments about the extent of any price increases. This provides a politically manageable compromise in the short term and at least establishes a more sustainable foundation for the longer term.

Second, if governments seek to protect some customers through ongoing subsidies they can still achieve this in a competitive market environment. However, subsidies must be provided transparently from Government, and thus be separate from the market itself. The community has a right to be informed about the cost of subsidies. While Origin recognises that transparent subsidies are also sometimes politically damaging, we believe this risk can be managed. There are always innovative means for governments to achieve their desired political outcomes and alleviate the risk of damage without resorting to heavy-handed or interventionist approaches.

There is also the possibility that the political cost of being seen to provide subsidies to some consumers is actually far less than the eventual political damage of undermining the market through price intervention. As discussed below, price regulation damages investor confidence, and, if unsustainable (as it frequently is), will eventually result in an energy sector that is unable to meet the expectations of the wider community.

Overall, any of the means available to governments to manage their risks should not be undertaken at the expense of the legitimate commercial interests of energy retailers. Any approach should be a cooperative programme funded by the state with the retailer assisting as appropriate in its implementation.[24]

[24] For example, the Victorian Network Tariff Rebate is an example of this cooperative approach which still protects the legitimate business interests of the retailer, while unwinding cross subsidies over an extended period.

Origin energy

Price regulation will stifle competition

It is important to point out that any consideration of price regulation should have some perspective about the way effective markets work.

To be effective, markets require price signals between demand and supply. The price is the ultimate means by which all the information across all market segments and players (necessarily limited for any one player) in the complex environment is condensed into a form all can access and understand. Market participants use this information to drive their own behaviour, and thus the market is a dynamic system which arrives at efficient outcomes through the constant interplay of buyers and sellers using prices as their currency of communication.

State price regulation generally dilutes price signals between the market and consumers. In fact, concealing the true costs to consumers is sometimes its primary purpose. This sends inaccurate and inappropriate messages to consumers about the costs of their consumption, and also reduces the power of any policy initiatives relating to demand side management or energy efficiency programmes.

Further, competition will be limited, or even non existent, where regulated price levels provide limited or non-existent margins. It is logical that if there is no profit potential, retailers will not seek to participate in the market. This has been a common issue across Australian jurisdictions, where some regulated prices to certain customer segments *still do not even allow for basic cost recovery*.

Even where low margins do not stifle innovation across the board, price controls and interventionist approaches from regulators and governments to date have had a dampening effect on the competitive mindset of the industry players.

Fundamentally, a presumption of the need for state price protection must be avoided, particularly where there is no evidence of this need. Making this presumption increases the risk of Type II regulatory errors (to regulate where state regulation is not warranted), and becomes a self-fulfilling prophecy where the resulting regulatory approach stifles competition. For example, if jurisdictional governments or regulators are waiting for competition in any one jurisdiction to significantly 'prove itself' through high churn rates before removing price controls, they may have created a vicious circle (particularly if prices are set below cost of supply).

Regulatory decision-making can be more costly than beneficial

In arriving at retail price decisions, jurisdictional regulators face a complex task of attempting to determine 'efficient' costs and resolve conflicting objectives, particularly given the dearth of relevant information to guide them. Regulators have, for instance, struggled to develop an appropriate methodology to assess the efficient cost of electricity, and are exposed to the very real threat of creating a California-type crisis situation in which large retailers are driven to bankruptcy, squeezed between wholesale prices and retail price controls.

The conflicting retail pricing objectives and approaches include:

- short term customer protection from price shock, versus economically sustainable pricing for retailers;
- encouraging competition by allowing an additional allowance in the retail prices, versus setting the lowest possible costs (sometimes, but inaccurately, claimed to be the efficient cost);
- explicit pass-through of regulated costs (such as network costs) with controls only on the retail component, versus controls on the bundled price; and

- providing broadly based price controls, versus detailed and specific prices for narrowly defined customer segments.

Jurisdictions have typically adopted different priorities, differences that in turn have been important factors in the very different competitive market outcomes. If any regulation of retail pricing is to continue, a national retail pricing framework is needed to refine these objectives.

In any event, we have real concerns about governments or regulators continuing to believe that they can somehow determine the 'right' or efficient price for a good or service in place of market forces. Given that market prices are the most efficient because *only the market can order all the necessary information*, any price setting by other means will naturally be inadequate. This is potentially dangerous to the industry if prices are low and not sustainable. This outcome ultimately does not benefit consumers.

Administration costs for regulation can also be high, including compliance costs for regulatees, enforcement costs for the regulator, and the costs of developing and managing regulatory arguments for both sides. Any form of price regulation chosen must be able to be matched by resources to collect and manage the required information, and to enforce regulation.

It is vital that there is a clear view of the materiality of the risks of exploitation of market power in the absence of regulation, compared with the costs of regulating away these risks.

<u>Price regulation will discourage needed investment</u>

Further, and most importantly, the cost of 'getting it wrong' with decisions related to price regulation can mean damage to the industry, and ultimately the economy.

The objective of the National Electricity Market, as stated in the National Electricity Law is:

> To promote efficient investment in, and efficient use of, electricity services for the long-term interests of consumers of electricity with respect to price, quality, reliability, and security of supply of electricity and the reliability, safety and security of the national electricity system.

Price regulation, and, in particular, getting price regulation 'wrong', will undermine each element of this objective.

First, it will have an negative effect on generation investment. There may be price signals in the wholesale market to build new plant (that is, wholesale prices are high), but these price signals are of no use if they cannot be profitably acted upon by either independent power producers or vertically integrated retail-generation entities.

To build new generation capacity, independent power producers need to be able to sell to retailers (or direct to large industrial consumers) and they will be less likely to do so if retailers do not want to purchase power from them because retail prices to end users do not allow for cost recovery for the energy bought (which includes the capital costs of building plant) and also provide a retail profit. As an alternative generation option, retailers can choose to build their own supply, and thus hedge their supply. However, once again, they also need to be able to pass through the costs of supply and remain commercially viable. If they cannot do so, they will not seek to build new plant.

What this means is that over time there will be insufficient generation to meet demand at peak times, and as consumption grows, wholesale prices will continue to rise. Thus the second negative effect on investment will be felt: investment in retail. In a retail price-regulated environment with little room to move, the pressure on retailers will increase as they incur greater costs from contracting with generators (or going through the Pool) yet are only able to retail to customers to a externally determined retail price ceiling.

Perhaps the view of policymakers is that if the pressure is great enough, retailers *will* build their own generation capacity, and this is the market 'working'. However, the effect of these higher costs for retailers may not be further investment, but exit from the market. This is because the longer term benefits to shareholders from further investment in the already risky environment will be less apparent than the immediate benefits of limiting further losses by simply ceasing retail activity. New investment will also be less likely.

One way of handling this situation from a policy perspective would be to further encourage demand side management, and thus reduce pressure on the generation sector at peak times. However, without a clear price signal to end users to reduce electrical load on the system at these times - a signal which retail price regulation will stifle - demand management initiatives will be limited in their effectiveness.

Inadequate generation obviously undermines security of supply and increases the risks of power outages, which is not a good political outcome and actively contradicts the NEM objective quoted above. Inadequate retailer investment means competition will be less effective, and the worst case scenario is that a viable retail sector is not possible. Where a retail market has already been established, this outcome is also likely to be unsatisfactory from a political perspective. Government might need to step in, which incurs significant financial costs and political damage.

These are the potential outcomes from intervening in the end price of a vertically integrated industry. Such intervention *short circuits the very mechanism that markets depend on to allocate investment and efficient use of resources*.