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Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in Victoria – First Draft Report

The Energy Supply Association of Australia (esaa) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) draft report on the review of the effectiveness of competition in electricity and gas retail markets in Victoria, and we fully endorse the preliminary finding that competition in electricity and gas in Victoria is effective.

esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of more than 40 electricity and downstream natural gas businesses, including energy businesses in Western Australia. esaa member businesses own and operate some $110 billion in assets, employ over 40,000 people and contribute $14.5 billion dollars directly to the nation's Gross Domestic Product.

Victoria has long been considered to have one of the most dynamic and competitive energy retail markets in the world, an observation supported by the AEMC's finding that:

> *'The majority of energy customers are participating actively in the competitive market by exercising choice among available retailers as well as price and service offerings. There is strong rivalry between energy retailers, facilitated by the current market structures and entry conditions.'*

The esaa notes and agrees that all evidence in regard to the Victorian energy market suggests that each of the criteria developed by the Ministerial Council on Energy (MCE) to test the effectiveness of competition are met. Specifically:

- Independent rivalry is evident in both price and non-price competition;
- The energy market is highly contestable, new retailers have entered the market, and the barriers to entry are low;

- Customer choice and switching is evident with high and increasing rates of changing between retailers and to different products with the same retailer;

- Differentiated products and services are apparent in the range of contracts available with different pricing, duration and non price benefits such as 'greenpower';

- Analysis of price and profit margins indicates a highly competitive market, delivering real benefits for consumers;

- Customer switching rates are the highest of any retail market in the world, with about 60 per cent of all domestic and small business customers having switched to a competitive market contract.

In these circumstances of a contestable energy market characterised by a high degree of retail competition, retention of price regulation in any form would limit the realisation of fully efficient energy supply and use. In particular, retaining retail price regulation would:

- limit competition for lower priced and more innovative services by providing a target price for retailers which they need only marginally undercut to attract business;

- distort price signals for efficient investment in new energy supply and demand side management, by substituting a regulated determination of wholesale and retail energy costs as the basis for the benchmark retail price in place of comprehensive price discovery through effective competition;

- distort retailer behaviour by creating an unmanageable risk that energy costs may increase beyond those recoverable from the regulated price;

- impose unnecessary regulatory costs on the market and taxpayers.

A recent study undertaken for the esaa by CRA into the effect of retail price regulation found that price regulation in contestable retail energy markets is likely to confer little or no public benefit but impose considerable direct and indirect costs, thus reducing overall welfare.[1] As noted above, direct costs occur for government regulators and retailers during the price determination process, and indirect costs occur by dampening competition and reducing efficiency.

Price regulation is a poorly targeted and highly costly measure to deliver affordability for a relatively small number of less well-off consumers who may have difficulty accessing electricity and gas at current prices. More efficient measures for targeting assistance to the small number of potentially marginalised consumers are discussed below.

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[1] The effects of retail price regulation in Australian energy markets, January 2007, CRA International, page 5. (http://www.esaa.com.au/papers_submissions.html), posted 26 June 2007

Assistance measures

Given that energy is an essential service, it is important to ensure that a secure, competitively priced, supply of energy is available to all consumers. The evidence in the draft AEMC report strongly indicates that the competitive market is delivering to all consumers in Victoria.

The AEMC report notes however that there are two groups of consumers that may not be benefiting fully from effective retail competition:

- Consumers whose personal circumstances, such as financial hardship or personal disability, restrict their ability to access the benefits of the competitive market; and

- Consumers who may be less attractive to retailers due to factors such as location, credit history or low consumption volumes.

The Essential Services Commission has reported that disconnection rates have fallen to the lowest level in 20 years, indicating that retailers are effectively managing customers who may have restricted ability to pay,[2] and the AEMC found no evidence that retailers are discriminating against potential customers on the basis of location or low usage.

Consumers with personal circumstances restricting their ability to access the benefits of competitive markets

The esaa agrees there is a clear need to address the circumstances of customers in genuine hardship and those with disabilities. However, as the draft report highlights, addressing the root causes of issues such as hardship and the ability of people with disabilities to engage with the competitive market requires 'a complex mix of government policy and industry responses, and will rest upon effective collaboration from all sectors'. Capping retail prices is a blunt and ineffective method of addressing hardship issues.

The AEMC report highlights the recent initiative by the Victorian Government to assess appropriate support measures for customers suffering financial hardship. The Government has established arrangements that require all incumbent retailers to have comprehensive policies and procedures for identifying and dealing with hardship customers, and for those polices to be approved by the Essential Services Commission. The retailers must specify their processes for:

- identifying customers in financial hardship;

- providing and facilitating access to payment plans for those experiencing bill payment difficulties;

- managing customer disconnection and reconnection;

- streaming customers to other support mechanisms.

[2] Energy Retail Business Comparative Performance Report for the 2005-06 year, November 2006. Essential Services Commission.

In addition, the Government has established a substantial programme of concessions and grants to support those consumers in both financial hardship and with disabilities.

There may be scope for further optimising the arrangements and regulations with respect to people whose personal circumstances limits their ability to access or afford energy services, and the esaa supports the suggestion in the draft ruling that further work could be undertaken to examine the effectiveness, targeting and coordination of current policies.

This may help to ensure an appropriate balance between the role of government in addressing social policy matters and the role of retailers in identifying and assisting their hardship customers. However this is a separate issue from determining whether there is effective competition and the removal of retail price controls for all residential and small business consumers.

Consumers who may be less attractive due to location, load or credit history

The second group of consumers that the draft report identifies are those who may be less attractive to energy retailers for a range of reasons (eg, remotely located, relatively limited energy consumption, or poor credit history). It is suggested that retailers may be less inclined to make market offers to serve such consumers.

There is no evidence that this is occurring in Victoria's highly competitive market, and the esaa endorses the AEMC's finding that 'potentially less attractive customers are not being excluded or avoided by retailers who are predominantly utilising mass market approaches for customer marketing and acquisition'. In this regard, it is important to note that mass market energy retailing is evolving into a high volume, low margin business model where retention of the maximum number of customers possible is one of the most effective ways for a retailer to maximise its return. In addition, where customers have been purchased from asset sales, often at a cost of over $1,000.00 per customer, with those customers returning a net profit to the retailer of approximately $50.00 a year on the average $1000.00 annual domestic bill[3], customers need to be retained for over twenty years to earn the retailer a positive payback on the investment.

There is little incentive for retailers to limit market offers to customers characterised by some as relatively less attractive as long as the offers are reflective of the underlying costs to serve. As was noted by several of the submissions to the AEMC's draft statement of approach on the effectiveness of competition in electricity and gas retail markets, during the early years of full retail contestability, new entrant retailers did not make market offers available for standing off-peak tariffs because regulated retail prices were set below cost. A key conclusion from this example is that allowing the market to determine a cost reflective competitive price will ensure that market offers are provided to all consumers.

[3] See KPMG, *Benchmarking retail operating costs and margins*, September 2006, cited in *Cost Benefit Analysis of Smart Metering and Direct Load Control, Workstream 3: Retailer Impacts, Phase 1 Report for the MCE*, KPMG September 2007, pp. 15-17.

While it is likely that some direct marketing techniques, such as door knocking, may not be viable in all locations, this does not prevent any consumer contacting a retailer and obtaining a market offer.

In summary, the esaa supports the AEMC's first draft Report on the effectiveness of retail competition in Victoria's energy markets and fully supports the key recommendation that competition is effective.

esaa recommends that the AEMC adopt the draft report's findings in full and provide advice to the Ministerial Council on Energy as soon as practical recommending the efficient phasing out of retail price regulation, complemented by support for efficient measures to manage any social policy objectives for relatively disadvantaged customers.

Yours sincerely

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Chief Executive Officer